IC Brief

Covenant Breach from Hedge Ratio Drift

Scenario Type: Private Credit – Infrastructure Debt (Operating Phase)
Asset Class: Senior secured, amortising project-style loans
Risk Focus: Structural capital drag, covenant infeasibility, trapped liquidity, governance paralysis
Primary Offer: Capital Efficiency Rebuild™ (Lender-Side Structural Review)

1. Decision Context

This scenario addresses a recurring issue in private credit portfolios where assets perform as expected, yet technical covenant breaches arise due to the interaction between **amortising debt**, **static interest rate hedges**, and **hedge ratio-based covenants**.

The risk is not credit deterioration or market stress.
It is a **structural misalignment** embedded at origination that becomes legally binding over time.

2. The Structural Problem

- Loans amortise predictably over time
- Interest rate hedges are executed once and remain static
- Covenants reference hedge ratios or notional coverage bands

As amortisation progresses, hedge notionals become oversized relative to outstanding debt.

What initially appears conservative becomes **mathematically incompatible with covenant design**.

This converts time and amortisation into a source of technical default risk.

3. Why This Matters at Portfolio Level

Once a hedge ratio breach exists:

- Cure paths consume **real liquidity** (cash, collateral, margin)
- Amendments require **consent, legal work, and governance bandwidth**
- Optionality collapses – commercial decisions become compliance exercises

Importantly:

Enforcing the covenant often **does not improve credit quality** but still destroys capital efficiency.

This is how benign structures quietly create correlated capital drag across a portfolio.

4. What Fails if Left Untreated

If unaddressed, ICs typically face forced choices between:

- Crystallising mark-to-market losses via hedge termination
- Posting additional collateral to maintain compliance
- Entering consent-heavy amendment processes
- Accepting persistent technical breach risk

None of these outcomes improve asset performance.
They simply consume liquidity and decision bandwidth.

5. Illustrative Structuring Response

The objective is **not** to "fix the hedge".

It is to restore **decision space** before consuming capital.

This typically involves:

- Identifying where covenant assumptions are structurally infeasible
- Quantifying capital drag created by forced cures and collateral usage
- Re-sequencing remediation to restore optionality first
- Redesigning hedge–covenant interaction so amortisation no longer manufactures default risk

Instrument selection follows structure – not the other way around.

6. Intended Outcome

- Elimination of avoidable technical covenant breaches
- Release of trapped liquidity and collateral buffers
- Restoration of portfolio-level optionality
- Cleaner IC decision-making without structural noise
- No material increase in underlying credit risk

This is a capital efficiency intervention, not a risk-taking exercise.

7. Applicability

Most relevant where:

- Covenants reference hedge ratios or notional coverage
- Debt amortises while hedges remain static
- Documentation allows mechanical breach without economic stress
- Facilities share common structural templates across vintages

Less relevant where:

- Hedge notionals dynamically adjust by design

- Covenants reference economic exposure rather than ratios
- Bullet structures dominate
- Hedging is discretionary or short-dated

8. IC Takeaway

This is not a hedging problem. It is not a credit problem.

It is a **structure design problem**.

Left unaddressed, it converts time into default risk and drains capital without improving downside protection.

9. Engagement Path

Primary: Capital Efficiency Rebuild™
Lender-side review of hedge, covenant, collateral, and liquidity interactions

Secondary / Bespoke:
Targeted hedge realignment, covenant standardisation, consent strategy, and monitoring frameworks

A full structural narrative is available for readers who wish to review the underlying mechanics, trade-offs, and remediation sequencing in greater detail.

Disclaimer

Illustrative scenario for discussion purposes only.
Not a transaction summary or client-specific case study.