



Covenant Breach from Hedge Ratio Drift

Scenario Type: Private Credit – Distressed / Non-Performing Loans (Workout & Recovery Phase)

Asset Class: Cross-border NPLs, stressed bilateral loans, distressed portfolios

Risk Focus: FX exposure mutation, recovery leakage, governance blind spots, capital misallocation

Primary Offer: Capital Drag Audit™ (Workout & Recovery Lens)

1. Decision Context

This scenario addresses a recurring failure in distressed private credit portfolios where **FX risk is treated as static**, despite the underlying exposure changing materially through the NPL lifecycle.

The issue does not arise from poor FX execution. It arises because **the nature of FX exposure evolves faster than governance, documentation, and hedging frameworks**.

By the time recoveries are realised, capital outcomes are already impaired.

2. The Structural Problem

In cross-border NPL situations:

- Original loan exposure was often hedged (or implicitly assumed to be hedged)
- Enforcement, restructuring, or asset take-over changes the exposure profile
- Cashflows, recoveries, and exit proceeds shift currencies over time

FX risk quietly **migrates**:

- From borrower-side to lender-side
- From balance-sheet exposure to cashflow exposure
- From hedgeable risk to residual leakage

The structure assumes continuity. The reality is transformation.

3. Why This Matters at Portfolio Level

During workouts, IC focus is naturally on:

- Legal recovery
- Asset value
- Timing of exits

FX is often deprioritised as “secondary”.

That is precisely when it causes damage.

Unmanaged FX lifecycle risk:

- Erodes recovery value without triggering alarms
- Distorts IRR and DPI post-fact
- Forces reactive hedging decisions under time pressure
- Masks true performance attribution at portfolio level

Losses emerge quietly – after the hard work is done.

4. What Fails if Left Untreated

If FX exposure is not explicitly re-mapped as the NPL evolves:

- Recoveries are converted at unfavourable points
- Currency mismatches sit unhedged during extended workouts
- Hedging decisions become ad hoc and inconsistent
- Portfolio reporting misattributes FX leakage as asset underperformance

By the time this is visible, **the capital is already gone.**

5. Illustrative Structuring Response

The objective is not to “hedge FX”.

It is to **re-establish visibility and sequencing** across the NPL lifecycle.

This typically involves:

- Mapping FX exposure at each stage of the workout
- Distinguishing economic exposure from legacy documentation assumptions
- Aligning hedging decisions to recovery timing, not origination logic
- Preventing FX from silently re-entering the portfolio via exits and cash sweeps

Structure first. Instruments second.

6. Intended Outcome

- Clear FX exposure ownership through the workout cycle
- Reduced recovery leakage from unmanaged currency conversion
- Improved attribution between asset performance and FX impact
- Cleaner IC decision-making during restructurings and exits
- No increase in underlying credit or legal risk

This is a **recovery protection exercise**, not a trading strategy.

7. Applicability

Most relevant where:

- NPLs involve cross-border borrowers or offshore assets
- Recoveries occur in a different currency from fund base currency
- Enforcement or asset take-over changes cashflow denomination
- Workouts extend over multiple periods or exit windows

Less relevant where:

- All exposures, recoveries, and exits are single-currency
- FX is contractually passed through without lender exposure
- Recoveries are immediate and fixed in advance

8. IC Takeaway

FX risk in distressed credit does not disappear when loans fail.

It **moves**.

If not actively re-mapped, it quietly converts recovery effort into capital leakage.

9. Engagement Path

Primary: Capital Drag Audit™ Workout-focused review of FX, liquidity, and recovery mechanics across the NPL lifecycle

Secondary / Bespoke: Targeted FX lifecycle mapping, recovery-aligned hedging frameworks, and exit sequencing support

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.