IC Brief

Refinancing Derivatives Transition – Operating Asset Debt

Scenario Type: Project Finance – Refinancing Phase
Asset Class: Transport / Utilities / Regulated Infrastructure
Situation Type: Operating assets refinancing long-dated debt with legacy interest-rate derivatives in place
Primary Issue: Embedded derivative value loss and execution risk during debt refinancing due to poor sequencing and derivative ownership misalignment

1. Decision Context

This scenario arises in mature operating assets where refinancing is economically attractive, and credit fundamentals are strong.

The asset is stable. Operating performance is in line with model. Covenants are comfortable. Market conditions support lower margins, longer tenors, and improved flexibility.

Interest rate risk was hedged years earlier using long-dated vanilla swaps executed at historically low fixed rates. On paper, refinancing improves equity value.

The IC decision is **not** whether the asset should refinance.
It is whether the **derivative book is being managed as a core value driver or treated as an afterthought**.

2. What Changed

At original financing:

- Long-dated floating debt swapped to fixed
- Conservative vanilla structures
- Clean ISDA documentation
- Hedging aligned with lender requirements

At refinancing:

- Debt margins compress
- New lenders enter with different preferences
- Legacy swaps remain with incumbent banks
- Termination or replacement becomes unavoidable if poorly sequenced

The refinancing changes the **ownership, leverage, and bargaining power** around the derivatives.

.3. How the Risk Actually Manifests

The risk does not appear as a market shock. It appears as execution drag.

As refinancing progresses:

- In-the-money swaps generate unexpected termination economics
- Funding and close-out adjustments erode apparent value
- Settlement timing creates liquidity gaps
- Bridge facilities creep in
- Embedded hedge value is surrendered to meet deal deadlines

Refinancing economics deteriorate **without any change in asset performance**.

4. What Surfaces on Review

When decomposed properly, consistent issues emerge:

- Legacy swaps often contain the most valuable financial optionality in the structure
- Documentation heavily favours bank close-out economics
- Relationship banks retain leverage through derivatives even after debt exits
- New lenders' preference for "clean structures" is economically motivated
- Time pressure collapses negotiating leverage and forces value leakage

This is not a pricing problem. It is not a hedge failure. It is a **sequencing and ownership problem**.

5. Structural Assessment

This is **not** a refinancing problem. It is **not** an execution problem.

It is a **structural coordination failure between debt refinancing and derivative ownership**.

Any solution must preserve:

1. Embedded hedge value
2. Liquidity stability through execution
3. Accounting and lender defensibility

Blunt termination strategies typically destroy all three.

6. Illustrative Structuring Logic

Effective responses typically focus on:

- Treating derivatives as a core refinancing workstream

- Mapping embedded value, termination triggers, and novation rights *before* lender selection
- Separating economic hedge value from counterparty relationships
- Using swap value as negotiating currency with new and old lenders
- Sequencing settlements, prepayments, and drawdowns deliberately
- Preserving hedge accounting continuity and audit defensibility

Objective: **controlled transition**, not cosmetic cleanliness.

7. Intended Outcomes

When addressed correctly:

- Refinancing economics land as modelled
- Embedded derivative value is preserved
- Termination costs are minimised or avoided
- Liquidity risk during execution is controlled
- Old lenders exit cleanly, new lenders align
- Accounting and IC optics remain stable

Not optimisation. **Control.**

8. IC Takeaway

This was not a market failure and not a derivative failure.

It was **value leakage created by treating derivatives as secondary to refinancing execution**.

Treating it as a debt problem destroys value. Treating it as a structural coordination problem restores control.

9. Applicability

Most relevant where:

- Assets are refinancing after long low-rate periods
- Swaps are materially in-the-money
- Multiple relationship banks are involved
- Refinancing timelines are tight

Less relevant where:

- Swaps are short-dated or near maturity
- Termination economics are immaterial
- Derivatives were never embedded meaningfully

10. Engagement Path

Primary Offer: Capital Drag Audit™– Refinancing-linked derivative transition, novation, and execution sequencing

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.