



PARA BELLUM ADVISORS

PRIVATE CREDIT · INFRASTRUCTURE DEBT

Covenant Breach from Hedge Ratio Drift

SCENARIO TYPE	Private Credit – Infrastructure Debt (Capital Drag & Covenant Failure)
ASSET CLASS	Private Credit – Infrastructure & Essential Assets (Operating Phase)
RISK FOCUS	Liquidity trapping, hedge ratio drift, covenant infeasibility, governance paralysis under rate volatility
PRIMARY OFFER	Capital Efficiency Rebuild™
RELEVANT SERVICES	Capital Efficiency Rebuild™ · Lender-side hedge redesign · Covenant re-engineering · Collateral optimisation · Refinancing feasibility support

THE SITUATION

A Melbourne-based infrastructure debt fund managing a multi-billion-dollar portfolio of senior secured project loans across Australia and New Zealand. The strategy focused on mid-market infrastructure assets – renewable generation, regulated utilities, transport, and social infrastructure – financed through long-tenor, amortising facilities.

Loans were conservatively structured. Cashflows were predictable, leverage was moderate, and covenant packages were robust by market standards. Interest rate risk was addressed through mandatory hedging provisions, typically requiring borrowers to maintain interest rate protection within a specified band relative to outstanding loan balance.

At origination, these structures appeared sound. The problem did not originate from credit deterioration or rate volatility. It emerged from how protection, covenants, and amortisation interacted over time.

HOW THE TRAP FORMS

As loans amortise, principal balances decline according to sculpted schedules designed to match project cashflows. The associated interest rate hedges, however, are executed once at financial close and left static. Over time, this creates a mechanical divergence between loan balance and hedge notional.

Once hedge ratios are embedded inside covenants with both minimum and maximum thresholds, that drift becomes legally and operationally meaningful. What begins as a spreadsheet artefact becomes a covenant compliance issue.

Critically, the cure paths almost always involve real cash, collateral, or consent. Partial swap terminations crystallise mark-to-market. Offsetting swaps require new CSA capacity. Amendments trigger counterparty negotiation, legal work, and sometimes syndicate approval. The drag is not just economic – it is organisational.

WHAT TYPICALLY BREAKS

The covenant embedded an unfulfillable assumption

Covenants required hedge ratios to remain within prescribed bands over the life of the loan, implicitly assuming dynamic adjustment. Documentation did not mandate it. Static hedges were permitted. Drift was therefore mathematically inevitable.

Cure paths destroyed optionality

Available cures were economically and operationally costly. None improved asset quality. They merely consumed liquidity and decision bandwidth – destroying value to resolve a problem created by documentation, not by credit stress.

Amortisation converted protection into compliance risk

As loan balances declined, static hedges became increasingly oversized relative to outstanding debt. What appeared conservative became legally problematic once ratio thresholds were crossed. The covenant had transformed time and amortisation into enforcement risk.

The risk was correlated across vintages

The same hedge–amortisation–covenant interaction appeared repeatedly across facilities originated under similar templates. This was a repeatable design failure at portfolio level, converting benign amortisation into correlated governance and liquidity risk.

THE STRUCTURAL INSIGHT

The starting point was not instrument selection, but decision sequencing. The question was not how should the hedge be fixed, but what degree of flexibility must be restored for the fund to manage capital rationally over the remaining life of the assets.

Remediation was sequenced deliberately. Consent–light facilities were addressed first to restore optionality quickly. Facilities approaching refinancing were addressed opportunistically – covenant clean–up embedded into refinancing discussions rather than as standalone remediation. Hard–consent facilities were addressed only after economic drag had been explicitly quantified.

Where remediation was required, blend–and–extend restructurings were used selectively to realign hedge notionals without crystallising mark–to–market losses. Covenant language was then standardised to remove ambiguity, with monitoring obligations embedded to ensure breaches could not accumulate unnoticed.

INTENDED OUTCOMES

- ▶ Avoidable covenant breaches eliminated – refinancing, asset sales, and restructurings evaluable on commercial terms rather than under pressure of imminent covenant cures.
- ▶ Trapped liquidity released – capital previously tied up in collateral or cure reserves made available for redeployment.
- ▶ Governance capacity restored – investment and risk committees no longer forced to allocate time to technical compliance issues with no bearing on underlying asset performance.
- ▶ Decision environment improved – the ability to evaluate refinancing, enforcement, or hold decisions without structural noise distorting judgement or forcing premature action.
- ▶ Portfolio standard established – covenant framework standardised so the same design failure cannot silently accumulate across future vintages.

WHERE THIS APPLIES

Most relevant where financial covenants reference hedge ratios or notional coverage; underlying debt amortises while associated hedges are permitted to remain static; and facilities carry multi-year amortisation profiles, delayed refinancings, or extension options that increase the likelihood of ratio drift over time.

Less relevant where covenants reference economic exposure rather than static hedge ratios; documentation explicitly requires dynamic hedge rebalancing; facilities are bullet structures with no interim ratio testing; or lenders actively manage hedge alignment as part of ongoing credit oversight.

TYPICAL ENGAGEMENT PATH

Capital Efficiency Rebuild™ – review of hedge, covenant, collateral, and liquidity interactions across the loan portfolio. Secondary: Hedge Rebuild™ for selected facilities, covenant standardisation, lender-side consent strategy, monitoring framework implementation.

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