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Frequently Asked Questions

about Loan Loss Reserves and Private Debt Funds

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Loan loss reserves (LLRs) may seem like an obscure topic for investors to worry about, but for investors in private debt funds, LLRs can affect distributions and the consistency of returns. This FAQ is designed to answer investor questions about LLRs. More generally, it also serves as a supplemental resource to Arixa Capital's white paper about private debt funds, "Alternative Income for a Low Interest Rate World: Understanding Private Debt Funds".

Frequently Asked Questions:

What are loan loss reserves (LLRs) in the context of a private debt fund?

Private debt funds are like banks but with a few key differences. They take in capital from investors and place that capital into loans. The interest income from these loans is passed on to investors, typically as monthly or quarterly distributions. There are two types of LLRs: (a) those that can be specifically attributed to a specific loan, and (b) a general loan loss reserve that is not specific to an individual loan, but a reserve for future unforeseen losses inherent in the portfolio as of today. As a LLR balance is increased in the fund, the net effect of LLRs is to reduce current distributions to investors.

If a fund increases LLRs, does that mean the fund is performing poorly and/or expecting losses on specific loans in the near term?

Not necessarily. Some funds add general LLRs regularly as part of its normal business practices, like how a bank operates, because it anticipates some loans will incur losses over time. In the case of LLRs becoming too large (in the judgment of the fund managers), then LLRs can be released to investors, which will increase distributions in the period when LLRs are released, relative to what they would have been otherwise. There is a wide range of practices relating to LLRs which is one of the reasons that the authors have created this FAQ.

Should LPs (investors) prefer LLRs to be higher, lower or zero? And why?

The authors believe that multiple approaches to LLRs may be legitimate, depending on the circumstances. One key factor is the makeup of the loan portfolio. Loan maturities, collateral type, loan to value, security position and the expected volatility of the underlying real estate assets all weigh heavily on what level of LLR may be appropriate. The goal of the LLR, beyond a specific reserve for a known loss, is to create equitability amongst the LPs such that the net result to all investors is fair.

How does volatility of the underlying property value relate to LLRs?

Suppose a given fund makes senior loans that are sized to 75% of the value of a property. In this case, an investor who purchases a property for $1 million could borrow $750,000. One of the most important factors in determining whether any LLRs may be required for this loan is the expected volatility of the underlying property. During the Great Financial Crisis, homes in the Inland Empire located east of Los Angeles fell more than 50% in value. Meanwhile, homes in Santa Monica fell about 25%, and in some cases, apartment building values fell even lower. During COVID-19, many hotel values fell dramatically, while some property types experienced only a mild correction in value. The greater the expected volatility of the value of the collateral for the loan, the more likely that some loss might eventually occur, all other things being equal. And the greater the chance of losses on individual loans, the argument for having sizable LLRs becomes more compelling.

How does loan maturity relate to the appropriate amount of LLRs?

Longer maturities may dictate a larger loan loss reserve. Consider “Note A” (which is a 12-month note) versus “Note B” (which has a 60-month maturity). If the market begins to turn negative at month 10, Note A only has 2 months left before the fund can step in and take corrective action. On the other hand, Note B has a longer maturity, and if the market continues to degrade but the borrower continues to perform, the fund manager will be left with no options but to wait. The collateral property could lose so much value by the time the fund can take corrective action that the loan might be larger than the property value. For this reason, longer maturities dictate a larger LLR, all other factors remaining the same.

Should LLRs be sized based on a fund’s investor capital (unlevered AUM) or levered AUM? And why?

LLRs are a component of the loan portfolio in total. So no matter how the capital stack is created, investor capital or investor capital plus debt, it will be focused solely on the size of the loan portfolio only.

What is the main reason that some debt funds use LLRs?

An established general LLR in the fund hedges against unforeseen losses, which when realized could cause a significant impact to the distributions paid. Some investors rely on the steady income from their private debt fund investments to pay for monthly or quarterly expenses. If distributions were to go down dramatically, or go to zero, during one month every year or two, some investors may find this to be a hardship. Furthermore, financial advisers may be more comfortable investing in a private fund that is likely to have steadier returns.

What is the difference between LLRs in open-ended vs closed-end funds?

LLRs play a significant role in open-ended funds, whereas its role in a closed-end fund is less impactful. This is due to investors' ability to come and go in an open structure. Consider two investors, Investor X and Investor Y. Investor X contributed capital on Day 1 of the fund, and for 365 days, the fund performed without any loss, paying Investor X his or her pro-rata share of the earnings. On Day 366 Investor X redeems and Investor Y contributes capital, essentially trading places. On Day 367 the Fund finds that one of the loans in the portfolio is not performing, and the fund is not going to collect the full amount due. If there was no LLR balance available, Investor X would have collected all the earnings from that loan, while Investor Y missed those earnings and would be allocated its share of the loss. Some might argue that this situation is not equitable to the investors and therefore a LLR should have been built up to keep the results of the fund fair to all investors no matter when they invest.

In a closed-end fund, a LLR does not have as much impact, because the investors will not come and go. All investors are expected to stay for the duration of the fund, so there is less of a need for a LLR to make the allocation of income and any capital losses equitable. In a closed-end fund, the LLR is for specifically identified losses in the portfolio, in other words, known losses that have not yet been realized.

What is the top concern that some investors have about the use of LLRs?

LLRs can create concerns and there are limits to how it can be used under accounting rules (see below for US GAAP-related issues). Reducing distributions to fund LLRs may be objectionable to some investors who would rather receive the maximum distribution possible every month or quarter. Consider an open-ended fund where investors can redeem their investment with a few weeks' or months' notice. One can imagine that if a fund has no losses or expected losses on any investments, an investor who is going to request a redemption would prefer to have no additions to LLRs, because he or she isn't going to get the benefit of those LLRs in the future. That investor would rather receive every dollar of possible distributions today, prior to his or her redemption. However, for the benefit of the investors who choose to stay in or new investors coming into the fund, the LLR provides a margin of safety to ensure that the value of their investment remains stable through any market-driven volatility.

In determining the fair value of a loan portfolio, do loan values need to be adjusted when interest rates change? And if so, how would rate changes affect loan values? Are there any arguments to disregard this effect in fair value accounting?

This depends on the maturity of the loan: the greater the maturity of the loan, the greater the impact of changes in interest rates on the value of loans. Changes in the risk-free interest rate impact the value of the cash flows from the loan, and therefore the value of the loan itself. However, most debt funds that make short-term (1 to 3 year) loans do not typically adjust fair values as rates move, since the change in the risk-free rate does not materially impact the discounted cash flow value of the loan. For longer maturity loans, changes in the risk-free rate can have a material impact on the fair value of private real estate debt.

How do banks compare to debt funds when it comes to LLRs?

Banks routinely build up LLRs and are required to do so by its regulators. Differences between banks and debt funds may include (a) differing amounts of equity cushion, and (b) different maturities. In banks, the underwriting of a loan depends heavily on the borrower's credit. The property value used as collateral is factored in, but sometimes to a lesser extent than in loans from debt funds. Some debt funds on the other hand are collateral-based lenders, focused first and foremost on the property and its value. Other debt funds take a hybrid approach. Typical LTVs for debt funds might be 65%, so that the 35% cushion serves as protection for the fund and limits the potential for losses. Also, bank loans tend to be longer term financing versus debt funds which are typically short-term bridge loans.

How do redemptions interplay with LLRs?

LLRs are not designated or tied to any specific investor account but instead tied to a general pool of reserves for the entire investment vehicle. Therefore, if an investor were to redeem prior to the winddown of the fund operations, he or she would forgo the reserves built up and find no benefit upon redemption. Those investors that remain invested to the end could potentially gain the benefit of the LLRs being released back to the investors, but only if the fund was expected to collect on all the outstanding assets in full or at amount greater than the net value (when factoring in the LLR impact to the AUM). The key benefit is that LLRs protect investors who choose to stay in, or are coming into the fund, because it provides a protective cushion from losses on loans where the redeeming investor took all the benefit from.

How does the accounting profession view LLRs?

There are two possible ways to classify private debt funds - either as a lending company or as an investment company.

As a lending company, LLRs are currently acceptable under US GAAP to the extent the LLRs are consistent with the company's loss experience. The current accounting rules for LLRs takes a historic view with regards to a company's ability to aggregate reserves. Under likely changes to accounting rules that have not yet been implemented, LLRs will need to factor in expected future losses for the company and industry as a whole, which the authors view as a potential step forward.

As an investment company, each real estate secured loan must be held at "fair value". For most loans, fair value approximates par value, which is the total loan amount outstanding, unless there is reason to believe that one or more loans are impaired. Under fair value accounting, if there is an expectation that loans are impaired, those loans would be re-marked to the new estimated fair value. As a result, fair value funds are generally not permitted to adopt a general LLR. Currently there is a divergence in practice in the industry, whereby some advisors allow and advocate for the establishment of general LLRs for the private debt funds, provided that such LLRs fall within range of the materiality threshold. Others may take a more hardline point of view, which the authors believe is counter to the best interest of investors and the progress of the industry as whole.

What does it mean for LLRs to be "material" and why does it matter?

Materiality is an accounting concept defined as an amount by which the financial statement (if not corrected or changed) would be misstated, and reasonably be expected to influence the economic decision making of an investor or other recipient of those financial statements.

What is the standard for determining the materiality threshold for LLRs in a private debt fund?

Methodologies vary in the industry. A common definition of materiality on a private debt fund is approximately 1% of net assets. The established general loan loss reserve balance should be in range of this threshold for the financial statements to be considered materially accurate.

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