

# Understanding asset-backed securities (ABS)

ABS are financial instruments backed by a pool of assets, such as loans, leases, credit card debt or receivables. These assets generate cash flows, which are used to pay investors in the securities. ABS are created through a process called securitization, where the assets are pooled together and sold to a special purpose vehicle (SPV), which then issues the securities. These securities then trade in fixed-income markets.

## The value of ABS

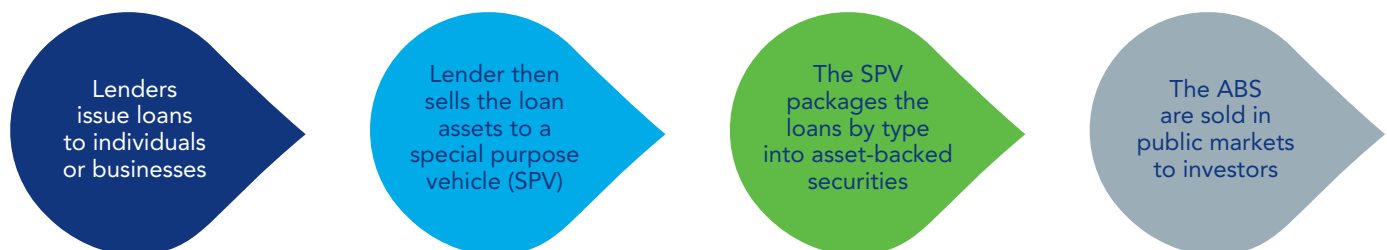
Asset-backed securities are an important part of the financial system, providing liquidity and funding for a range of consumer and commercial loans and leases. ABS offer a way for lenders to free up capital and for investors to gain exposure to different types of assets. They play a crucial role in the financial ecosystem by enhancing liquidity and providing investment opportunities.

## Types of ABS

The market includes a broad range of underlying assets that are efficiently securitized because they can generate regular cash flows which are then used to pay investors in the securities:

- **Autos:** car loans, leases and dealer floor plans
- **Credit card receivables:** outstanding balances on credit cards are pooled and securitized
- **Student loans:** includes private student loans and Federal Family Education Loan program
- **Equipment:** loans and leases for agriculture and construction equipment and computer hardware and software are the most common
- **Other:** a range of financing for items such as phones, furniture and other personal consumer loans can be securitized

## ABS creation process



## Potential general benefits of ABS

- **Diversification:** Exposure to a variety of asset classes, such as credit card receivables and auto loans can help diversify an investment portfolio.
- **Higher returns:** Compared to traditional government or corporate bonds, ABS can offer attractive income to investors in shorter maturity securities.
- **Risk mitigation:** ABS typically include credit enhancements like overcollateralization and excess spread, which may help mitigate the risk of default.
- **Liquidity:** By pooling illiquid assets and creating marketable securities, ABS can improve liquidity for the underlying assets.
- **Customizable risk and return:** The structure of ABS allows for customization to match specific risk and return potential objectives, making them flexible financial instruments.

## How are ABS rated?

In general, the ABS marketplace is very high quality and approximately 75% is AAA-rated.<sup>1</sup> Its default history is considerably lower than that of the corporate bond market. Even when comparing A-rated ABS with A-rated corporate bonds, the default frequency tends to be lower in the ABS market.

## Out-of-index diversification

ABS is significantly underrepresented or not represented at all in indexes relative to the overall size of the ABS market, and investors who tend to focus on tracking or benchmarking indexes may therefore have a lesser focus on ABS than on corporates. The ABS market doesn't lend itself to index investing, primarily due to the size of the tranches used to segment these securities. Most indexes impose a cutoff or minimum size of issue for inclusion. The size of ABS tranches is often below that cutoff amount.

## A brief history

The ABS market originated in the mid-1980s with the securitization of auto loans and credit card receivables. Throughout the 1990s and early 2000s, the ABS market expanded significantly to include a wide range of asset types such as student loans, equipment leases and even royalties from music and films. As of 2024, US consumer ABS had grown into a diversified \$300bn plus market in terms of annual issuance according to the Securities and Financial Markets Association (SIFMA).

While the 2008 Global Financial Crisis had a profound impact on retail mortgage-backed securities (MBS)<sup>2</sup>, the market saw a shift with increased scrutiny and regulation, but also innovations in financial technology that allowed non-bank entities to play a larger role in the non-mortgage ABS market. Better underwriting, higher levels of enhancement—such as smaller tranche sizes relative to a given collateral pool, more over-collateralization and better quality assets—have greatly enhanced the ability of ABS to withstand stress.

## What value can ABS bring to low duration portfolios?

- **Reduced principal risk:** ABS have strong structural features such as excess interest, overcollateralization, reserve accounts and subordination designed to protect bondholders from collateral losses.
- **Liquidity:** These securities are typically structured to provide regular cash flows, which can make them suitable for portfolios with liquidity objectives.
- **Competitive yields:** ABS can offer higher yields compared to other short-term fixed-income instruments, providing an attractive return for low duration portfolios.
- **Maturities:** The weighted average life (WAL) of ABS tends to be relatively short, usually 1-4 years. The combination of the short WAL and amortizing bonds that receive monthly payments can be an appropriate fit for short duration portfolios.



## The Federated Hermes asset backed securities investment process

Our Asset-Backed Sector Team conducts in-depth fundamental credit analyses of the universe of consumer and commercial ABS types using both quantitative and qualitative research. Bonds are reviewed and analyzed on a daily basis in both the new issue market as well as the secondary market.

Both credit and structural research is analyzed thoroughly. Key credit characteristics such as FICO scores, distribution tails, loan to value (LTV) ratios, debt to income (DTI) ratios, new/used, terms, etc. are all analyzed and compared to previous deals as well as other issuers. In addition, structural features such as credit enhancement, excess spread, overcollateralization, WAL and size are considered.

Additional qualitative analysis includes a review of sponsor senior management, strength of sponsor, servicer reviews, ratings considerations and funding capabilities of the sponsor. Face-to-face meetings with the senior management of issuers are done frequently on-site and at industry conferences.

Finally, a relative value analysis is done among other ABS issuers within the same industry as well as other sectors. Once a security has been included in the portfolio, the analysts review the holdings monthly using various surveillance systems.

## We have the experience to help you

Federated Hermes has been analyzing ABS credits for over 20 years. We have managed through many environments; including periods of extreme volatility such as the Global Financial Crisis in 2008 and as recently as the Covid 19 pandemic. If you have questions or are interested in learning more, please reach out to a Federated Hermes representative.

<sup>1</sup> The ratings referred to in the quality breakdown are provided by S&P Global Ratings, Moody's, and Fitch. The allocation of ratings presented aligns with the methodology of the Bloomberg index.

<sup>2</sup> Mortgage-backed securities (MBS) are a separate category and managed independently from ABS in Federated Hermes' portfolios.

Diversification does not assure a profit nor protect against loss.

The value of some asset-backed securities may be particularly sensitive to changes in prevailing interest rates, and although certain securities may be supported by some form of government or private guarantee and/or insurance, there is no assurance that private guarantors or insurers will meet their obligations.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

Bond credit ratings measure the risk that a security will default. Credit ratings of A or better are considered to be high credit quality; credit ratings of BBB are good credit quality and the lowest category of investment grade; credit ratings of BB and below are lower-rated securities; and credit ratings of CCC or below have high default risk.

## Definitions

**Duration** is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

**Weighted Average Life (WAL):** WAL, as it applies to fluctuating funds, is defined as the average time a dollar of principal is outstanding at an assumed prepayment rate.

**FICO** score is a credit score, a numerical representation of a person's creditworthiness, based on information from their credit report.

**Loan-to-value (LTV)** ratio is an assessment of lending risk that financial institutions and other lenders examine before approving a mortgage.

**Debt-to-Income (DTI)** ratio compares monthly debt payments to a borrower's gross monthly income, expressed as a percentage.

Under certain market conditions, liquidity risk may arise if there is difficulty in selling ABS positions quickly or at fair prices.

**Distribution tails** in ABS refers to the range of quality of collateral components (FICO scores, LTVs, DTIs) as opposed to the average of each in an SPV.

**The Federal Family Education Loan (FFEL)** was a program that worked with private lenders to provide education loans guaranteed by the US federal government.

**The value of investments and income from them may go down as well as up, and you may not get back the original amount invested.**

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