Guide to Public Asset Backed Securities investing

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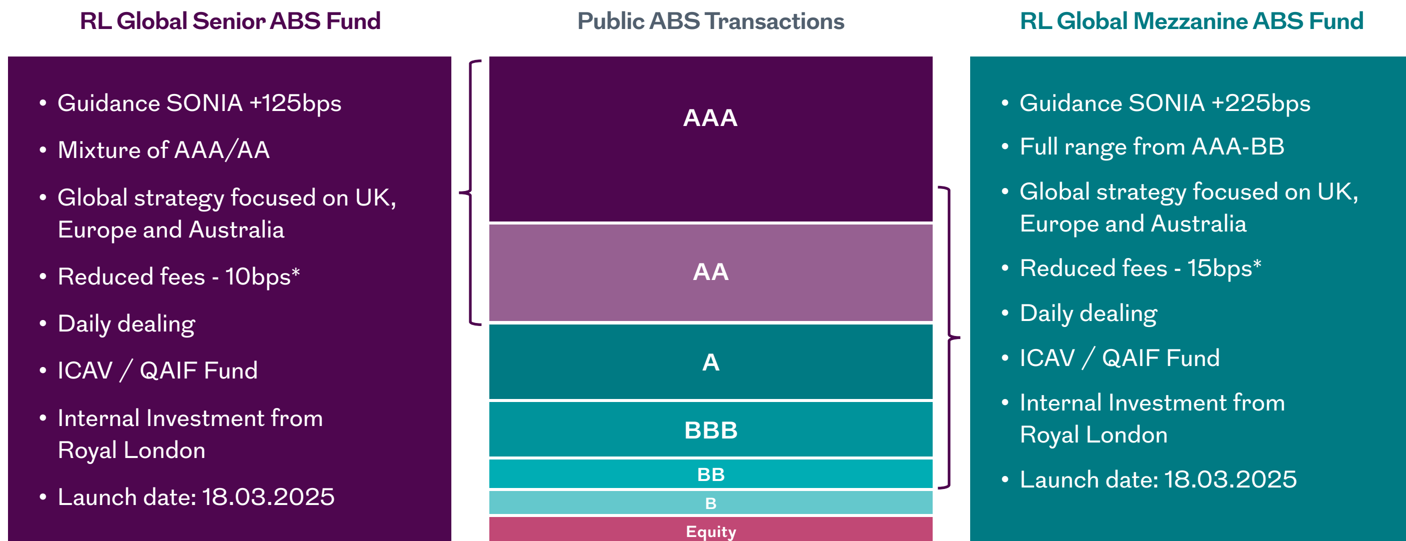
Royal London Asset Management is pleased to announce the launch of two new funds in its pooled fund range, specifically to invest in Asset Backed Securities.

Two new Public Asset Backed Securities (ABS) Strategies



Source: RLAM as at March 2025. *Plus expenses

Investors making a commitment to the RL Global Senior ABS Fund and the RL Global Mezzanine ABS Fund before 31 December 2025 will benefit from a reduced fee of 10bps and 15bps (both plus expenses), respectively. This fee rate will apply to that client's investments in the funds in perpetuity, as well as any subsequent top-ups. From 1 January 2026, for new investors these fees will revert to the standard rates of 20bps plus expenses for the RL Global Senior ABS Fund, and to 30bps plus expenses for the RL Global Mezzanine ABS Fund.

Why consider Asset Backed Securities?

Higher yield

Asset backed securities (ABS) offer a higher yield for the equivalent risk compared to corporate or government bonds (see figure 1) Investors can benefit from the 'complexity premium' that ABS offer, due to the specialisms required to understand both the underlying assets and how they operate within each securitisation.

Low default rates

Historically, ABS have had a very low default rate, through several economic cycles. (Source S&P, weighted average of European RMBS one-year default rates, 1988-2023, AAA – 0.06%, AA – 0.01%, A – 0.01%, BBB – 0.06%).

Interest rate protection

Almost all UK and European ABS are floating rate, which means they have near zero interest rate risk, thus making them less volatile in an uncertain interest rate environment than traditional fixed income.

Diversification

Investors would not normally be able to access exposure to the underlying consumer or private lending assets if they were not securitised as an ABS bond. Through ABS, investors can diversify their portfolios away from traditional corporate risk and benefit from enhanced risk-adjusted returns.

Flexibility

Due to the granularity of ABS and their capital structures, investors can choose an investment risk and return profile which suits their appetite. Assets range from AAA to B, and even unrated. Investors can also tailor which asset class they want, such as mortgages, auto loans and credit cards, and in which geographical jurisdiction they wish to invest.

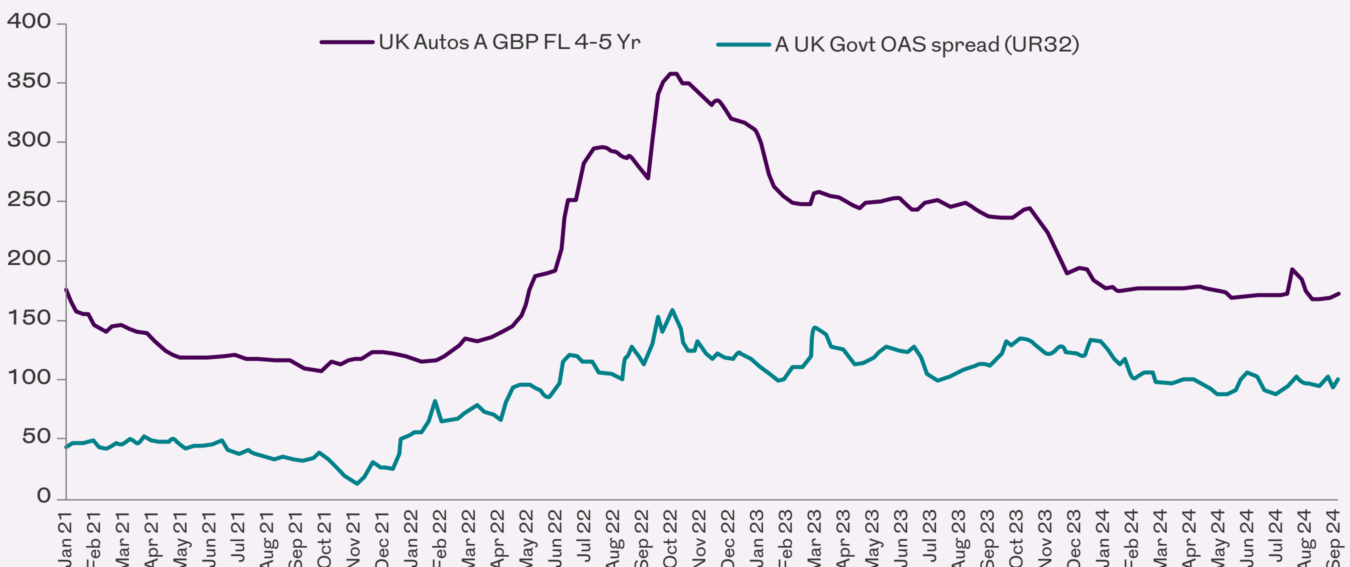
Investor protection

As the underlying assets of ABS transactions sit within a separate legal entity, they are protected from a lender's failure. Investors do not need to worry about the complexity of a bank's often opaque balance sheet, but can rather concentrate on understanding their lending criteria and underwriting process.

Transparency

Frequent reporting of the underlying assets is provided by the issuers, which allows for investors to view the performance of the collateral pool and manage their portfolios accordingly. Robust analysis of the underlying loans allows experienced and well-resourced investors to exit potentially deteriorating securities.

Figure 1. The appeal of ABS: Example showing securitised spreads versus corporate spreads



Source: RLAM, for illustrative purposes only.

Understanding Asset Backed Securities

Asset backed securities, or ABS, are a type of bond, typically issued by a bank or other lender. The difference between ABS and other conventional bonds are that ABS bonds are secured against an underlying pool of assets or cashflows.

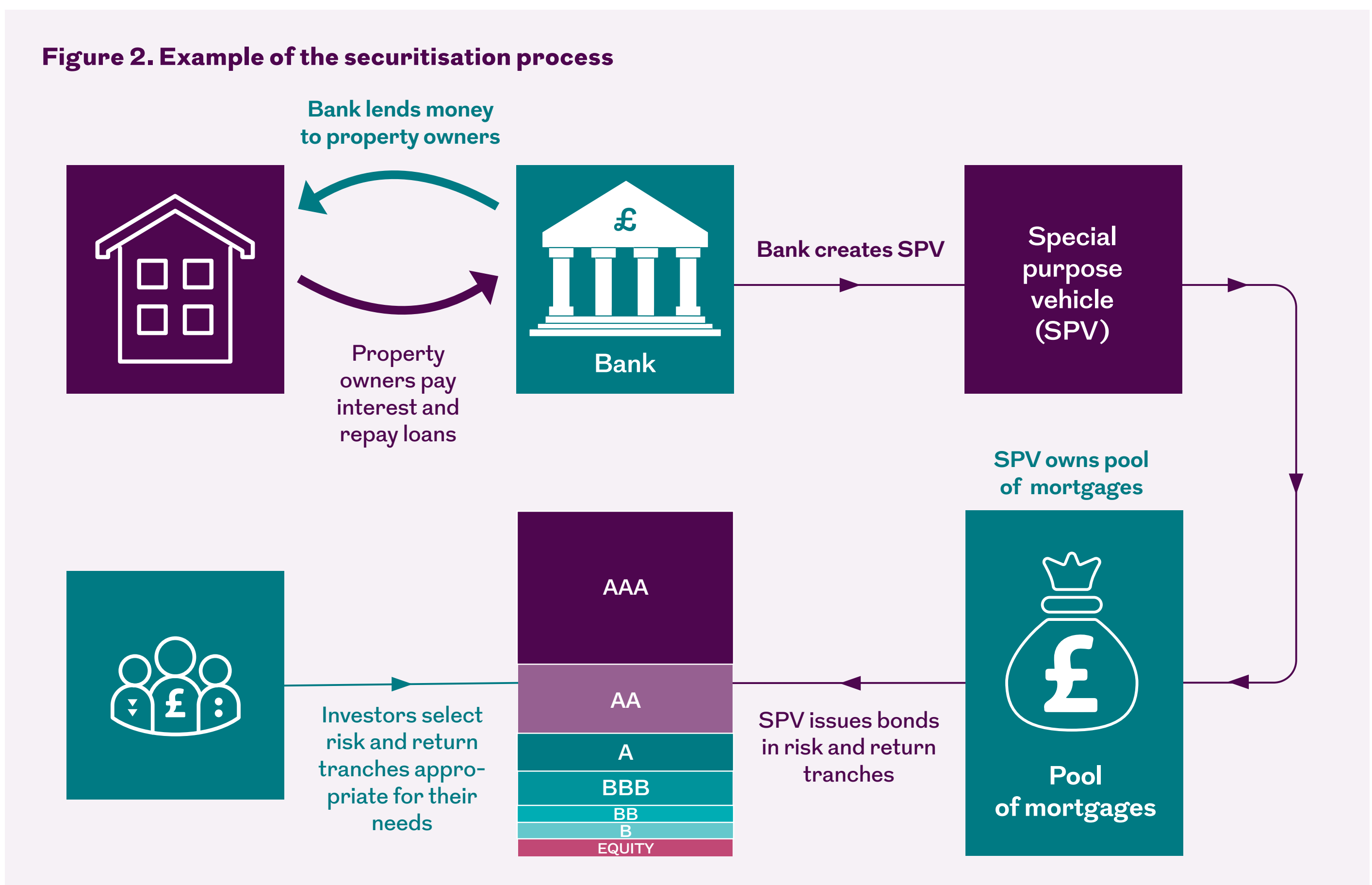
These assets are usually loans of a similar type such as mortgages, auto loans, student loans or credit card debt, which generate cashflows from their regular interest and principal repayments. In turn, this then pays investors coupons on their ABS bonds.

How are ABS bonds created?

ABS are created through a process called securitisation. The underlying assets, categorised according to sectors, are collectively pooled together and purchased by a bankruptcy remote special purpose vehicle (SPV). This separate legal entity is created by the issuing bank or lender to create new bonds which are secured against the collective asset pool and issues the bonds to investors.

The newly created bond is sold into the capital markets via ABS transactions. The bonds are structured into different layers of seniority or tranches, and each hold a certain risk and return dependent on where they sit in the transaction's capital structure. In the instance shown in figure 2, the AAA rated bonds are the highest ranked bonds, and thus lowest risk; they pay the lowest yield but are the first to receive interest and principal payments from the asset pool.

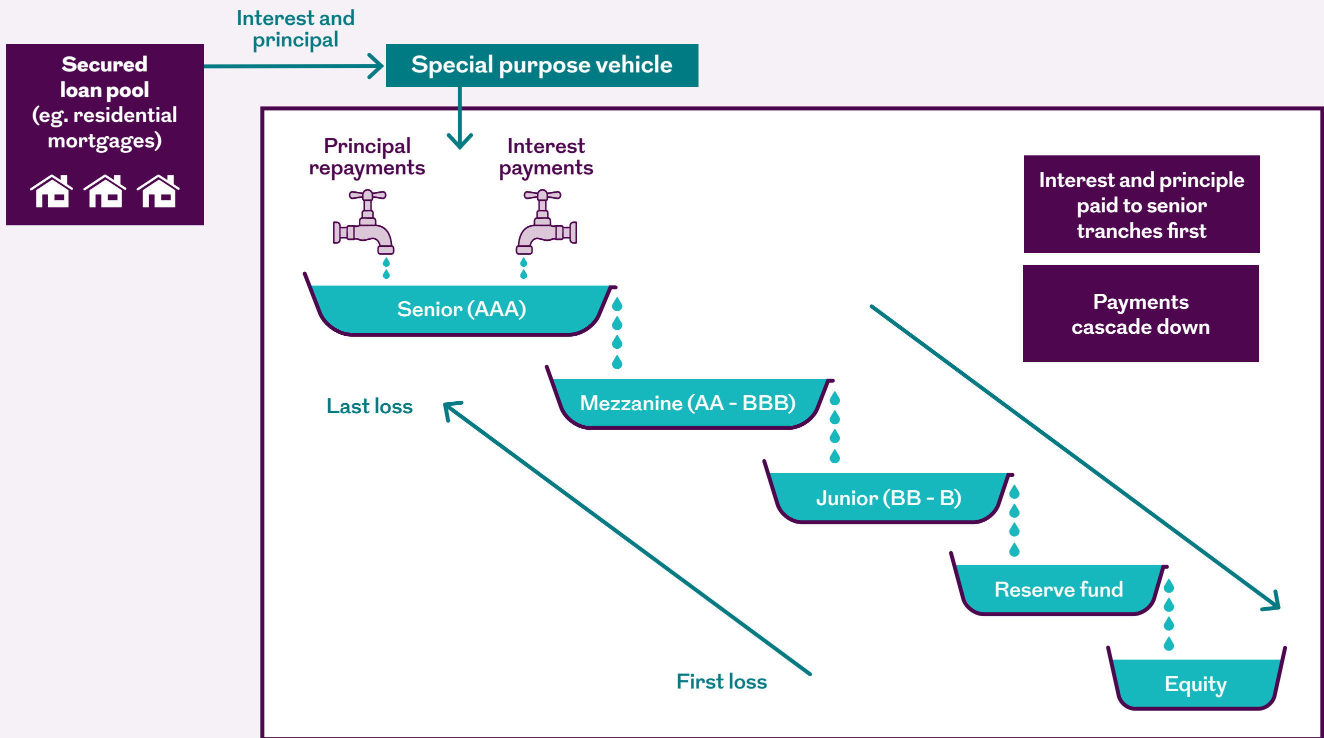
Figure 2. Example of the securitisation process



Source: RLAM, for illustrative purposes only.

After the needs of the AAA bonds are met, further payments cascade like a waterfall down the various tranches in order of seniority (see figure 3). Once the payments to senior bondholders are fulfilled, investors in the tranche below receive their payments, and so on. Meanwhile, losses flow upwards, meaning the most junior (eg equity) tranche absorbs losses first. Senior tranches only incur a loss once the tranche junior to it has suffered total loss. In the instance shown in figure 2, the equity, B, BB, BBB, A and AA tranches would all have to have suffered total loss of principal before the first penny is lost by the AAA tranche.

Figure 3. ABS waterfall payments

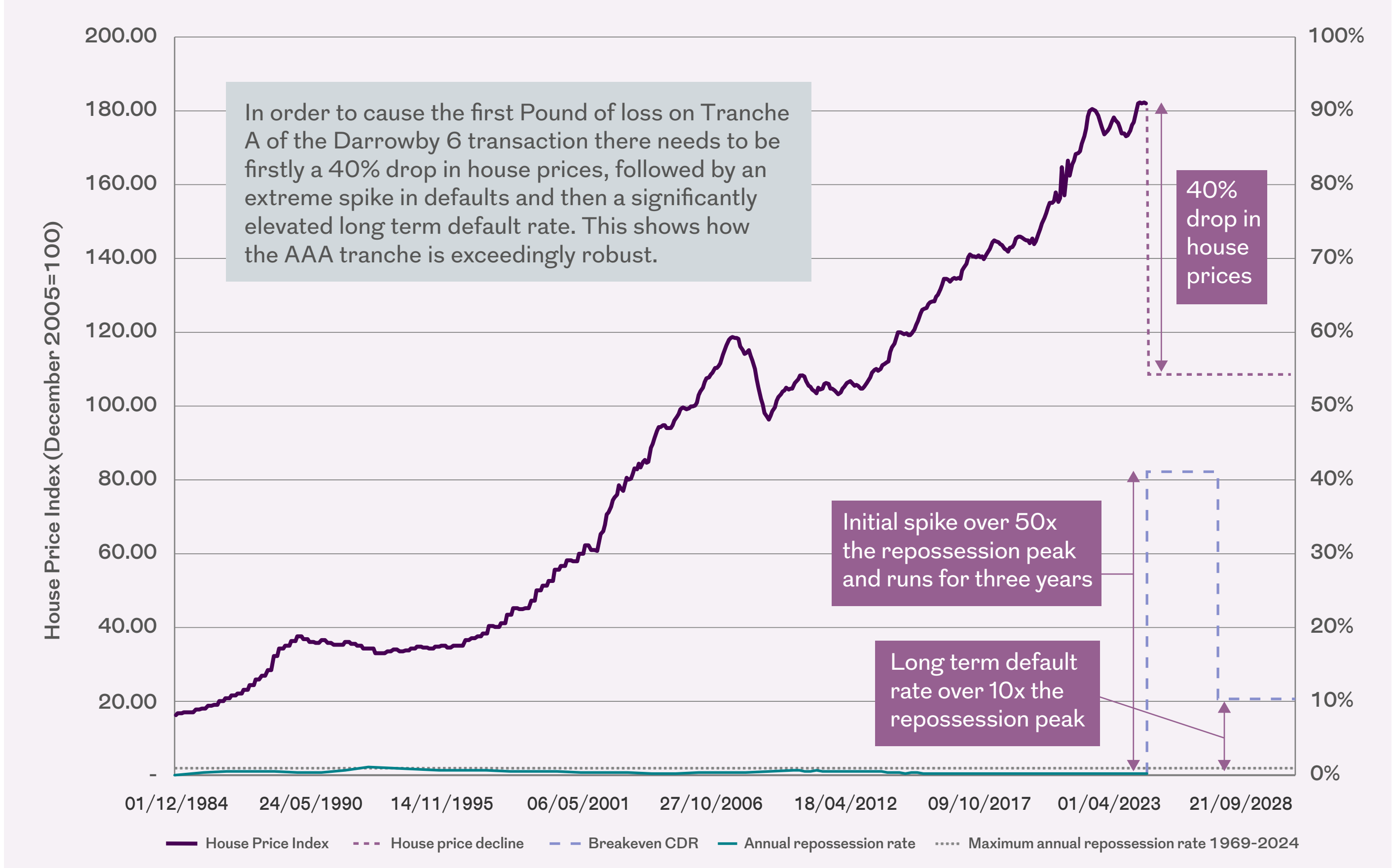


Source: RLAM, for illustrative purposes only.

For investors seeking to invest in the most senior tranches of the securitised market, the protections are significant. In figure 4 we examine the AAA tranche of a UK residential mortgage-backed security (RMBS). The chart shows that house prices could fall immediately by 40%, and never recover, at the same time as defaults going to many multiples of their worst ever experience before investors suffered the first penny of loss.

Figure 4. Strong investor protections

Example showing the robustness of AAA UK RMBS: Darrowby No 6 PLC Tranche A



Source: RLAM, Land Registry UK, UK Government and UK Finance. For illustrative purposes only. As at December 2024. Past performance is not a guide to future performance.

It should be noted that ABS deals are only impacted if a default results in an actual loss occurring. As these loans are secured by collateral, such as a residential home, car or recourse to the borrower's other assets, a default does not necessarily materialise in a loss for the lender. In fact, ABS transactions are robust in nature as they have a number of structural features that protect investors, such as credit enhancements and liquidity reserve funds. These reserve funds sit at the bottom of the capital structure and provide a cushion against losses, which makes it extremely rare, especially in European ABS.

Who issues ABS and why?

Financial institutions, notably banks, are the main issuers of ABS. They use securitisation as a funding and de-risking tool, like a government or company issuing a regular bond. As these institutions lend to individuals and businesses, they may involve large amounts of money and take varying amounts of time to be repaid. By pooling the assets and selling them to investors, the institutions receive new money to lend to borrowers.

Exploring some misconceptions of ABS

Were UK and European ABS to blame for the 2008 Global Financial Crisis (GFC)?

Mistakenly, some investors believe this to be the case. Essentially, the crisis began in the US due to weak lending standards, allowing poor quality loans to be underwritten which had a high chance of default. These loans were then packaged into US ABS bonds and purchased by many institutional investors, who increasingly bought yield over understanding the actual underlying risk of the transactions. Investors failed to complete necessary due diligence and increasingly just bought the rating – effectively outsourcing their analysis to the credit rating agencies. What they learnt was not all AAAs are of AAA quality, and you must understand the underlying assets and structures within ABS, not just the coupon.

As the initial low teaser rates on individual borrowers' mortgages and loans reset to market rates, borrowers were unable to make payments and began defaulting. The majority of US loans are 'non-recourse', meaning the lenders would not pursue individual borrowers for the money owed – a feature largely unique to the US. The underlying assets, the houses, were sold at increasingly depressed prices, thus creating a spiral of loss and compounding further defaults, eventually wiping out trillions of dollars of investments globally.

It was too much borrowing by the banks themselves, and their irresponsible lending practices that were the principal causes of the GFC. This was exacerbated by the increasing losses in the US mortgage market which exposed a range of flaws in the whole financial system, mostly unrelated to ABS, that turned a localised US housing market crisis into a global liquidity crisis and economic recession.

Differences between US and non-US ABS

There are a number of similarities between ABS markets in the US and elsewhere, for instance both being backed by an underlying pool of assets. However, there are fundamental differences between the two that enabled non-US ABS to perform incredibly well through the 2008 crisis.

According to Fitch, realised losses on the $5.2 trillion of US structured finance transactions issued between 2000 and 2008 and rated by Fitch were $195 billion, or 3.8%. Realised losses on the €2.18 trillion of European structured finance transactions issued in that period were just €8.2 billion, or 0.38%.

Losses in the US market were ten times those in Europe. In addition, every year since 2009 realised losses in Europe have been zero, and Fitch's expected lifetime loss rate for every European ABS issued since 2009 is also 0.0%.

European ABS: more investor friendly than US ABS?

Higher lending standards

The aggressive mortgage lending practices that occurred in the US sub-prime mortgage market simply aren't allowed to happen in the UK and Europe. Borrowers are required to hold significant equity in their property and demonstrate proof of income before loans are granted.

Alignment of interest

Following on from the GFC, all ABS issuers – typically the originator of the loans, the bank or financial institution – are required to hold the first loss (highest risk) piece. This creates 'skin in the game' and ensures the financial interests of the issuers are closely aligned to those of the investors; they will make sure the loans are of high quality and that the bond is structured well because they take the first loss if things go wrong.

Historically this was not the case in the US, where in the majority of deals, the risk of the entire asset pool was fully transferred from the issuer to the bondholders, meaning issuers had far less interest in the quality and performance of their ABS.

Borrower recourse

The US mortgage market is 'non-recourse', which means if borrowers can no longer afford their repayments, they can simply hand the keys to the property back to the bank with no threat of further action.

In non-US mortgage markets, the lender can continue to pursue borrowers for payments after default for a number of years (in some countries forever), typically leading to much lower default rates.

Investment risks

Past performance is not a guide to future performance. The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

The funds invest in Asset Backed Securities (ABS) which may be subject to greater credit, counterparty, liquidity, and interest rate risks compared to other investments such as government or corporate bonds. This may have a negative impact on the value of investment over the long and short-term.

Counterparty risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the fund to financial loss.

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Derivative risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both fund losses and gains. The impact to the fund can be greater where they are used in an extensive or complex manner, where the fund could lose significantly more than the amount invested in derivatives.

Exchange rate risk: Changes in currency exchange rates may affect the value of your investment.

Interest rate risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Contact us

For more information about our range of products and services, please contact us.

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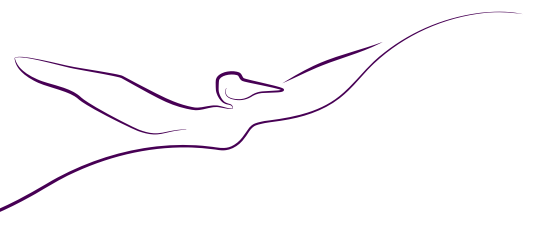

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