

ASSET-BACKED SECURITIES: HOW STRUCTURAL MECHANISMS SHAPE INVESTOR OUTCOMES

Today's ABS structures provide better transparency & investor protections

Since the 2008 Global Financial Crisis (GFC), the asset-backed securities (ABS) market has undergone major reforms. These enhancements have significantly increased transparency, strengthened investor protections, and better aligned issuer incentives with investor interests. As a result, today's ABS structures are more resilient and better regulated than those of the past, potentially offering attractive risk-adjusted returns.

ABS have historically weathered crises with lower default rates and shallower drawdowns than corporate bonds, making them a potentially attractive relative value play. Such resilience is not accidental; it stems from a disciplined framework that evaluates collateral quality and embeds multiple layers of credit enhancement, which can vary depending on the underlying collateral.

In an ABS transaction, sponsors transfer the underlying loans or receivables to a special purpose vehicle (SPV) that passes along the cash flows generated by the collateral to investors. The legal structure prioritizes ABS investor claims over other creditors and is bankruptcy-remote from the sponsor.

While credit enhancements may serve as safeguards against potential losses, it's important to understand that issuers and rating agencies assess the credit risk of the underlying asset pool before an ABS transaction is even structured.

Assessing credit risk in ABS involves:

- Estimating probability of default (PD) for each loan or lease in the pool.
- Loss given default (LGD) and recovery rate assumptions.
- Stress testing under adverse scenarios to ensure structural resilience.

For example, subprime ABS stress scenarios may assume default rates that are well above historical norms to test structural resilience. In these scenarios, even BB rated bonds can suffer 20%-25% annual defaults (known as CDR, constant default rate) before beginning to impair principal, well above observed averages.



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Key takeaways

- Post-GFC reforms have made ABS structures significantly more resilient and transparent. These changes have contributed to zero investment-grade ABS defaults since 2010 and have created a more robust, standardized market framework.
- Multiple layers of credit enhancement work together to help protect investors – even in stressed environments. Key mechanisms absorb losses long before senior tranches are threatened, while deals naturally de-lever over time, increasing credit enhancement as principal amortizes.
- Recent rating agency actions highlight the effectiveness of these protections. In 2025, both Moody's and KBRA issued multiple ABS upgrades across auto loan transactions, citing increased credit enhancement. Even amid rising delinquencies in some sectors, structural protections proved sufficient to support stronger ratings and demonstrate the durability of modern ABS structures.

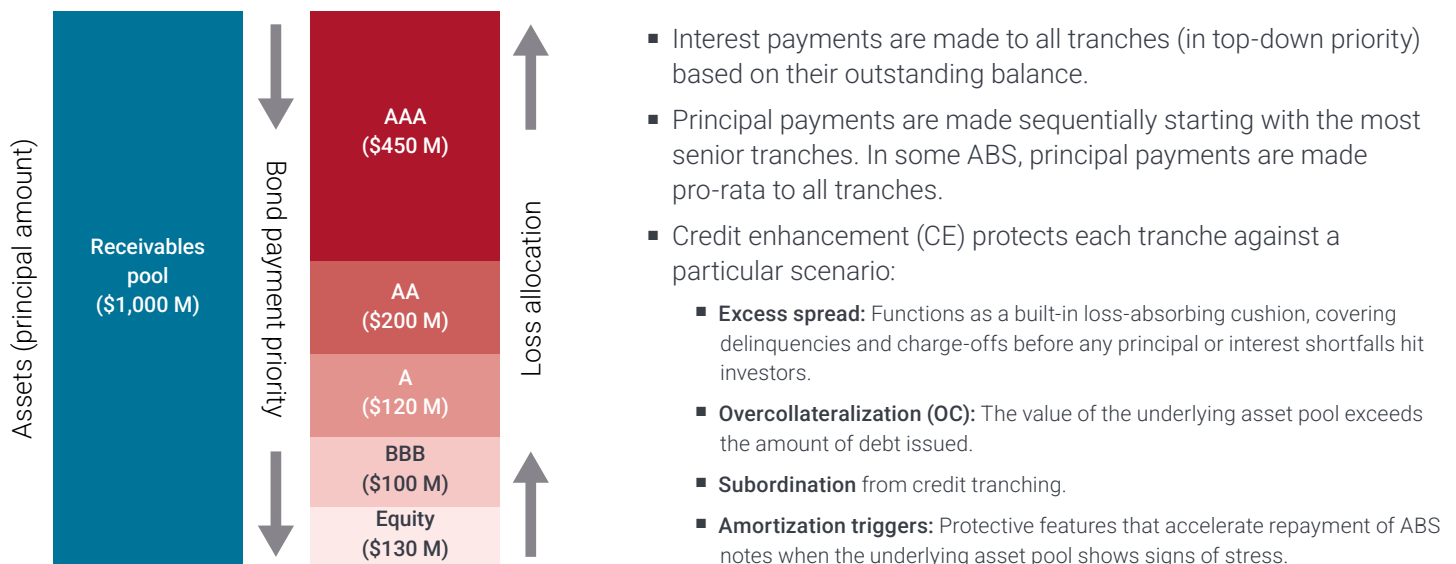
These default estimates drive:

- Credit enhancement levels (e.g., subordination, overcollateralization, reserve accounts).
- Tranche attachment points (how much collateral loss senior tranches can withstand).
- Expected vs. stressed cash flow models for ratings.

Additionally, most ABS structures amortize (receive principal payments every month from borrowers). These payments reduce the outstanding balance of the collateral pool and, in turn, reduce the amount of notes outstanding. This is what we mean when we say deleveraging.

As deals amortize, credit enhancement increases automatically because the same amount of subordination, overcollateralization, and excess spread now supports a smaller note balance. Imagine a bank originates a mortgage where the borrower provides 20% equity. If the home value stays constant and the borrower remains current on their mortgage, the equity will grow as principal and interest is paid. Even though nothing else changed, the bank's position as the lender is now safer given the increased equity. That's essentially what happens within ABS structures, potentially leading to rating upgrades and spread compression for lower-rated tranches over time.

ABS capital structure



Source: Janus Henderson Investors US LLC

Overview of credit enhancements in ABS

Credit enhancements are structural features designed to reduce the risk of loss for ABS investors. Post-GFC, these mechanisms have become more robust and standardized, offering stronger protection against collateral deterioration. As a result, there has not been a single default in investment grade ABS since 2010.

Excess spread

Excess spread can be described as the first line of defense in an ABS structure and is defined as the difference between the interest received on the underlying loans and the interest paid out to ABS noteholders. It functions as a built-in loss-absorbing cushion, covering delinquencies and charge-offs before any principal or interest shortfall hits investors.

How it works:

- Generated monthly as long as the loan pool yields more interest than the ABS tranches owe.
- If borrowers default, excess spread absorbs them before touching overcollateralization (OC) or subordinated tranches.
- Because of this, excess spread helps protect OC levels, delaying when structural protections must be used.

Post-GFC enhancements:

- Higher required credit enhancement levels overall, including stronger excess-spread buffers inside deals.
 - Lower trigger thresholds, making it easier to activate protections early.
 - Simpler, more transparent excess-spread mechanisms and clearer waterfalls.
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Cash trap mechanism

A cash trap is a structural trigger that redirects excess cash flows from equity holders to a reserve account when performance deteriorates.

How it works:

- Normally, excess spread (the difference between asset yield and ABS debt cost) flows to equity holders.
- If performance metrics (e.g., debt service coverage ratio, delinquency rate) fall below a threshold, the deal “traps” this cash.
- The trapped cash is held in a reserve account to cover future shortfalls or repay senior debt.

Post-GFC Enhancements:

- More frequent and granular performance tests (monthly or quarterly).
 - Lower trigger thresholds, making it easier to activate protections early.
 - Mandatory reserve buildup in certain structures, even before deterioration.
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Overcollateralization

Overcollateralization occurs when the value of the underlying asset pool exceeds the amount of debt issued. For example, if an ABS issues \$90 million in notes backed by \$100 million in loans, the \$10 million difference is the overcollateralization.

How it works:

- If any loans default, the excess collateral absorbs the loss before it affects noteholders.
- Enhances credit ratings: Rating agencies view overcollateralization as a key factor in determining tranche ratings.

Post-GFC enhancements:

- Higher overcollateralization levels are now standard, especially for senior tranches.
 - More conservative asset valuations are used to calculate overcollateralization, reducing reliance on inflated appraisals.
 - Dynamic overcollateralization tests are often embedded to adjust required levels based on pool performance.
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Rapid amortization triggers

Rapid amortization is a protective feature that accelerates repayment of ABS notes when the underlying asset pool shows signs of stress.

How it works:

- Triggered by events like rising delinquencies, declining asset balances, or breaches in coverage ratios.
- Once triggered, all available cash is used to pay down senior tranches, halting payments to junior tranches and equity holders.
- Helps reduce exposure to future losses by shortening the life of the deal.

Post-GFC enhancements:

- Expanded trigger definitions to include more performance metrics.
- Faster response times: Triggers activate more quickly to protect investors.
- Integration with other protections like cash traps and reserve accounts for layered defense.

Attachment points and subordination

An attachment point is the level in the capital structure where a tranche begins to absorb losses. However, the actual default rate required to impair a given tranche would likely be considerably higher after adjusting for recoveries. Subordination refers to the order in which tranches absorb losses.

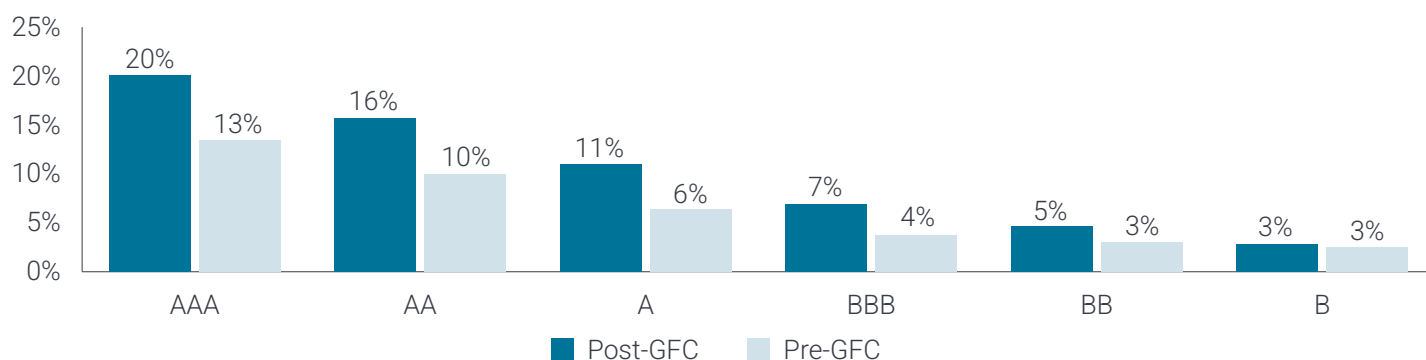
How it works:

- Attachment points can vary significantly across ABS structures/collateral types depending on the risk profile of the collateral itself (e.g. prime vs. sub-prime auto).
- Senior tranches have high attachment points and are protected by subordinate tranches.
- Junior tranches (e.g., mezzanine, equity) have lower attachment points and absorb losses first.

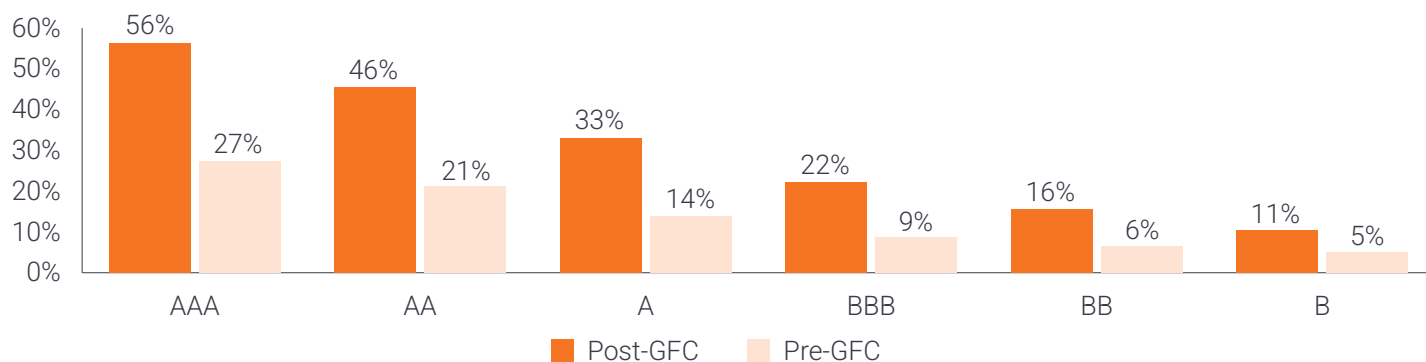
Post-GFC enhancements:

- Higher attachment points for senior tranches, meaning more subordination below them.
- Greater credit enhancement requirements from rating agencies.
- Standardized capital structures (e.g., AAA/AA/A/BBB/BB/Equity) with clearly defined loss absorption order.
- Reduced reliance on thin mezzanine (lower rated) tranches, which were vulnerable in the GFC.

Prime auto attachment points



Subprime auto attachment points



Source: Janus Henderson Investors US LLC, Goldman Sachs, September 30, 2025

Process in action

A common driver for ABS rating upgrades is the increase in credit enhancement (CE) relative to the remaining expected losses of the underlying loan pool, often due to a process called deleveraging.

On March 18, 2025, Moody's upgraded six tranches across three separate auto ABS transactions as performance weakened, due to built-in structural protections. Despite rising delinquencies and softening collateral performance, Moody's highlighted that structural credit enhancement from **overcollateralization**, **reserve accounts**, and **excess spread** justified higher ratings (*Moody's Investors Service, 2025*).

In August 2025, KBRA (a leading ABS credit rating agency) upgraded ratings on nine classes of notes across four different subprime auto ABS transactions (Kroll Bond Rating Agency, 2025). The primary drivers for the rating upgrades were a combination of structural mechanics of the deals and positive collateral performance:

- **Increased credit enhancement:** The primary reason cited was that the existing credit enhancement for the upgraded notes was sufficient to support the revised higher ratings. As auto ABS transactions season, the notes pay down, which effectively increases the proportion of credit enhancement (like overcollateralization, reserve accounts, and subordination) relative to the remaining loan balance.
- **Deleveraging:** The transactions experienced deleveraging, where the principal of the securities was paid down faster than the principal of the underlying auto loans (often due to strong prepayment rates and excess spread capture). This improved the risk profile of the notes by reducing the "dollars at risk" for investors.
- **Collateral performance within expectations:** The underlying loan collateral was performing within or better than KBRA's original expectations, demonstrating the sufficiency of available credit support to cover potential losses.
- **Sufficient loss coverage:** The increased credit enhancement levels were sufficient to withstand the higher stress scenarios commensurate with the new, higher rating levels.

Market outcomes

At Janus Henderson, we believe investors should truly understand what they own. Because securitized structures may be unfamiliar to some, navigating today's fixed income landscape requires using every tool available. Our world-class securitized team helps investors of all sizes identify opportunities within these markets and understand the protections embedded in the structures themselves. These enhancements have made ABS more resilient, aligning sponsor incentives with asset quality and strengthening investor protection. Notably, post-2010, ABS have experienced materially lower default rates than both pre-GFC ABS and similarly rated corporate bonds. With their potential diversification benefits, attractive yield potential, and lower duration risk, we believe ABS are a powerful component of a modern fixed income portfolio.

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Investing involves risk, including the possible loss of principal and fluctuation of value.

Actively managed portfolios may fail to produce the intended results. No investment strategy can ensure a profit or eliminate the risk of loss. Index performance does not reflect the expenses of managing a portfolio as an index is unmanaged and not available for direct investment.

Asset-backed securities (ABS) are financial investments backed by a pool of income-generating assets like loans, leases, or credit card balances.

The Bloomberg U.S. Aggregate Asset-Backed Securities (ABS) Index is a broad-based flagship benchmark that measures the investment grade, US dollar denominated, fixed-rate taxable bond market. The index only includes ABS securities.

A **credit spread** is the difference in yield between two debt securities with different credit quality but the same maturity.

Credit quality ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest). The S&P 500 Index or Standard & Poor's 500 Index is a market-capitalization weighted index of 500 leading publicly traded companies in the U.S.

Concentrated investments in a single sector, industry or region will be more susceptible to factors affecting that group and may be more volatile than less concentrated investments or the market as a whole.

Diversification is a common investment strategy that entails buying different types of investments to reduce the risk of market volatility.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Investment-grade securities: A security typically issued by governments or companies perceived to have a relatively low risk of defaulting on their payments. The higher quality of these bonds is reflected in their higher credit ratings when compared with bonds thought to have a higher risk of default, such as high-yield bonds.

Loss given default (LGD) is the amount of money that a bank or other financial institution is projected to lose when a borrower defaults on a loan.

Probability of default (PD) is the probability of a borrower or debtor defaulting on loan repayments. Within financial markets, an asset's probability of default is the probability that the asset yields no return to its holder over its lifetime and the asset price goes to zero. Investors use the probability of default to calculate the expected loss from an investment.

Securitized products such as mortgage- and asset-backed securities, are more sensitive to interest rate changes, have extension and prepayment risk, and are subject to more credit, valuation and liquidity risk than other fixed-income securities.

A **Special Purpose Vehicle (SPV)**, also known as a Special Purpose Entity (SPE), is a separate subsidiary formed by a parent company to isolate and manage financial risks. By operating independently, SPVs secure obligations even in the event of a parent company's bankruptcy.

Tranche: In securitized products, a tranche is one of a number of related securities offered as part of the same transaction, with each representing a different degree of risk and carrying a commensurate credit rating.

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