

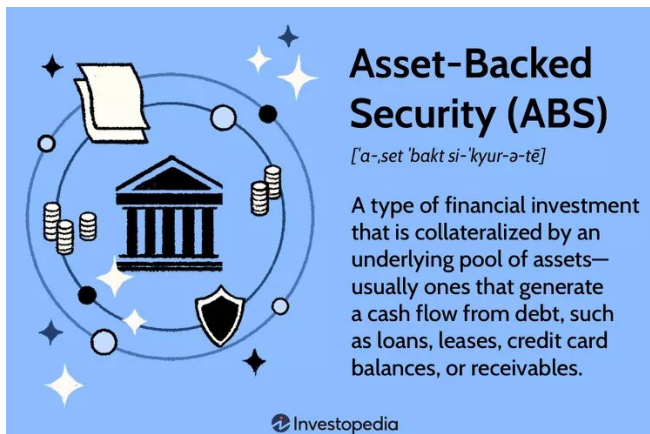


Asset-Backed Security (ABS): What It Is, How Different Types Work

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What Is an Asset-Backed Security (ABS)?

An asset-backed security (ABS) is a type of financial investment that is collateralized by an underlying pool of [assets](#)—usually ones that generate a cash flow from [debt](#), such as

Securitization: Definition, Pros & Cons, Example

Securitization pools assets and repackages them into interest-bearing securities. [more](#)

Collateralized Debt Obligation (CDOs): What It Is, How It Works

A collateralized debt obligation (CDO) is a complex financial product backed by a pool of loans and other assets and sold to institutional investors. [more](#)

Conditional Prepayment Rate (CPR): Definition and Calculation

A conditional prepayment rate is an estimate of the percentage of a loan pool's principal that is likely to be paid off prematurely. [more](#)

Residential Mortgage-Backed Security: Definition, Pros, and Cons

Residential mortgage-backed securities are created from residential debt such as mortgages, home-equity loans & subprime mortgages. [more](#)

loans, leases, credit card balances, or [receivables](#). It takes the form of a bond or note, paying [income](#) at a fixed rate for a set amount of time, until maturity.

For income-oriented [investors](#), asset-backed securities can be an alternative to other debt instruments, like corporate bonds or bond funds.

KEY TAKEAWAYS

- Asset-backed securities (ABSs) are financial securities backed by income-generating assets such as credit card receivables, home equity loans, student loans, and auto loans.
- ABSs are created when a company sells its loans or other debts to an issuer, a financial institution that then packages them into a portfolio to sell to investors.
- Pooling assets into an ABS is a process called securitization.
- ABSs appeal to income-oriented investors, as they pay a steady stream of interest, like bonds.

Over-Collateralization (OC): Definition, Benefits, and Examples

Over-collateralization is the provision of more collateral than is needed to reduce risk to a lender or an investor in a debt security. Learn how it works. [more](#)

Collateralized Loan Obligation (CLO) Structure, Benefits, and Risks

Collateralized loan obligations (CLO) are securities backed by a pool of debt, usually loans to corporations with low credit ratings or private equity firms. [more](#)

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- Mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs) can be considered types of ABS.

Understanding Asset-Backed Securities (ABSs)

Asset-backed securities allow their [issuers](#) to raise cash, which can be used for lending or other investment purposes. The underlying assets of an ABS are often [illiquid](#) and can't be sold on their own. So, pooling assets together and creating a financial instrument out of them—a process called [securitization](#)—allows the issuer to make illiquid assets marketable to investors. It also allows them to get shakier assets off their books, thus alleviating their [credit risk](#).

The underlying assets of these pools may be home equity loans, automobile loans, credit card receivables, student loans, or other expected [cash flows](#). ABS issuers can be as creative as they desire. For example, asset-backed securities have been built based on cash flows from movie revenues, royalty payments, aircraft landing slots, toll roads, and solar photovoltaics. Just about any cash-producing vehicle or situation can be securitized into an ABS.

For investors, buying an ABS affords the opportunity of a revenue stream. The ABS allows them to participate in a wide variety of income-generating assets, sometimes (as noted above) exotic ones that aren't available in any other investment.

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Asset-Backed Security (ABS)

How an Asset-Backed Security Works

Assume that Company X is in the business of making automobile loans. If a person wants to borrow money to buy a car, Company X gives that person the cash, and the person is obligated to repay the loan with a certain amount of [interest](#). Perhaps Company X makes so many loans that it starts to run out of cash. Company X can then package its current loans and sell them to Investment Firm X, thus receiving the cash, which it can then use to make more loans.

Investment Firm X will then sort the purchased loans into different groups called [tranches](#). These tranches contain loans with similar characteristics, such as [maturity](#), [interest rate](#), and expected [delinquency rate](#). Next, Investment Firm X will issue securities based on each tranche it creates. Similar to bonds, each ABS has a rating indicating its degree of riskiness—that is, the likelihood that the underlying loans will go into [default](#).

Individual investors then purchase these securities and receive the cash flows from the underlying pool of auto loans, minus an

[Bond Market](#)

[Corporate Bankers in a Meeting](#)

administrative fee that Investment Firm X keeps for itself.

Special Considerations

An ABS will usually have three tranche classes: A, B, and C. The senior tranche, A, is almost always the largest tranche and is structured to have an investment-grade rating to make it attractive to investors.

The B tranche has lower [credit quality](#) and thus has a higher yield than the senior tranche. The C tranche has a lower credit rating than the B tranche and might have such poor credit quality that it can't be sold to investors. In this case, the issuer would keep the C tranche and absorb the losses.

Types of Asset-Backed Securities

Theoretically, an asset-based security can be created out of almost anything that generates an income stream, from mobile home loans to utility bills. But certain types are more common. Among the most typical ABS types are:

Collateralized Debt Obligation (CDO)

A CDO is an ABS issued by a [special purpose vehicle \(SPV\)](#). The SPV is a business entity or trust formed specifically to issue that ABS. There are a variety of subsets of CDOs, including:

- Collateralized loan obligations (CLOs) are CDOs made up of bank loans.
- Collateralized bond obligations (CBOs) are composed of bonds or other CDOs.
- Structured finance-backed CDOs have

underlying assets of ABS, residential or commercial mortgages, or real estate investment trust (REIT) debt.

- Cash CDOs are backed by cash-market debt instruments, while other credit derivatives support synthetic CDOs.
- [Collateralized mortgage obligations \(CMOs\)](#) are composed of mortgages—or, more precisely, mortgage-backed securities (MBSs), which hold portfolios of mortgages (see below).

Though a CDO is essentially structured the same as an ABS, some consider it a separate type of investment vehicle. In general, CDOs own a wider and more diverse range of assets—including other asset-based securities or CDOs.

Home Equity ABS

[Home equity loans](#) are one of the largest ABS categories. Though similar to mortgages, home equity loans are often taken out by borrowers who have less-than-stellar credit scores or few assets—the reason why they didn't qualify for a mortgage. These are amortizing loans—that is, payment goes toward satisfying a specific sum and consists of three categories: interest, principal, and prepayments.

FAST FACT

A [mortgage-backed security \(MBS\)](#) is sometimes considered a type of ABS but is more often classified as a separate variety of investment, especially in the United States. Both operate in essentially the same way;

the difference lies in the underlying assets in the [portfolio](#).

Mortgage-backed securities are formed by pooling together mortgages exclusively, while asset-backed securities consist of any other type of loan or debt instrument (including, rather confusingly, home equity loans). MBSs actually predate ABSs.

Auto Loan ABS

Car financing is another large category of ABS. The cash flows of an auto loan ABS include monthly interest payments, principal payments, and prepayments (though the last is rarer, for an auto loan ABS is much lower than a home equity loan ABS). This is another amortizing loan.

Credit Card Receivables ABS

Credit card receivables—the amount due on [credit card](#) balances—are a type of non-amortizing ABS: They go to a revolving line of credit, rather than toward the same set sum. Thus, they don't have fixed payment amounts, while new loans and changes can be added to the composition of the pool. The cash flows of credit card receivables include interest, principal payments, and annual fees.

There is usually a [lockup period](#) for credit card receivables where no principal will be paid. If the [principal](#) is paid within the lockup period, then new loans will be added to the

ABS with the principal payment that makes the pool of credit card receivables staying unchanged. After the lockup period, the principal payment is passed on to ABS investors.

Student Loan ABS

ABSs can be collateralized by either government student loans, guaranteed by the U.S. Department of Education, or private student loans. The former have had a better repayment record and a lower risk of default.

What is an example of an asset-backed security (ABS)?

A [collateralized debt obligation \(CDO\)](#) is an example of an asset-based security (ABS). It is like a loan or bond, one backed by a portfolio of debt instruments—bank loans, mortgages, credit card receivables, aircraft leases, smaller bonds, and sometimes even other ABSs or CDOs. This portfolio acts as [collateral](#) for the interest generated by the CDO, which is reaped by the institutional investors who purchase it.

What is asset backing?

Asset backing refers to the total value of a company's shares in relation to its assets. Specifically, it refers to the total value of all the assets that a company has, divided by the number of outstanding shares that the company has issued.

In terms of investments, asset backing refers to a security with value deriving from a single asset or a pool of assets; these holdings act as collateral for the security—"backing" it, in

effect.

What does ABS stand for in accounting?

In the business world, ABS stands for accounting and billing system.

What is the difference between MBS and ABS?

An asset-based security (ABS) is similar to a mortgage-backed security (MBS). Both are securities that, like bonds, pay a fixed rate of interest derived from an underlying pool of income-generating assets—usually debts or loans. The main difference is that an MBS, as its name implies, consists of a package of mortgages (real estate loans). In contrast, an ABS is usually backed by other sorts of financing—student loans, auto loans, or credit card debt.

Some financial sources use ABS as a generic term, encompassing any sort of securitized investment based on underlying asset pools—in which case, an MBS is a kind of ABS. Others consider ABSs and MBSs to be separate investment vehicles.

How does asset securitization work?

Asset securitization begins when a lender (or any company with loans) or a firm with income-producing assets earmarks a bunch of these assets, then arranges to sell the lot to an investment bank or other financial institution. This institution often pools these assets with comparable ones from other sellers, then establishes a special purpose vehicle (SPV)—an entity set up specifically to

acquire the assets, package them, and issue them as a single security.

The issuer then sells these securities to investors, usually institutional investors (hedge funds, mutual funds, pension plans, etc.). The investors receive fixed- or floating-rate payments from a trustee account funded by the cash flows generated by the portfolio of assets.

Sometimes the issuer divides the original asset portfolio into slices, called tranches. Each tranche is sold separately and bears a different degree of risk, indicated by a different [credit rating](#).

The Bottom Line

Asset-backed securities (ABSs) are pools of loans that are packaged together into an investable security, which can in turn be bought by investors—predominantly large institutions like hedge funds, insurance companies, and pension funds. ABSs provide a method of [diversification](#) from typical bond mutual funds or individual bonds themselves. Most importantly, they are income-generating assets, typically with a higher return than a normal corporate bond, all depending on the credit rating assigned to the ABS.

The underlying assets of an ABS could consist of auto loans, credit card receivables, and even more exotic investments, such as utility bills and toll roads. Such categories of ABS are referred to by different names such as collateralized debt obligations (CDOs), which are broken down into further subcategories,

such as collateralized loan obligations (CLOs). However, by far, the most popular and therefore [liquid](#) ABS are mortgage-backed securities (MBSs), which provide an income stream from mortgage payments.

For the investor, ABSs provide an income stream in line with the credit rating of the security, and they offer an alternative to standard bond mutual funds.

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