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Australian Asset-backed Securities: 101

INSIGHTS

The opportunity set in Australian ABS has been growing in size and appeal to investors over the years—but what are ABS, and how do they compare to RMBS?

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In recent years, asset-backed security (ABS) issuance has grown to become a key component of the Australian securitisation market. This is not just a function of the growth of the ABS market—but also of the increasing and potentially appealing investment opportunity set.

In this piece, we aim to improve the understanding of this asset class by answering some common questions:

- What are ABS?
- Are the risk-adjusted returns of ABS in Australia comparable to residential mortgage-backed securities (RMBS)?

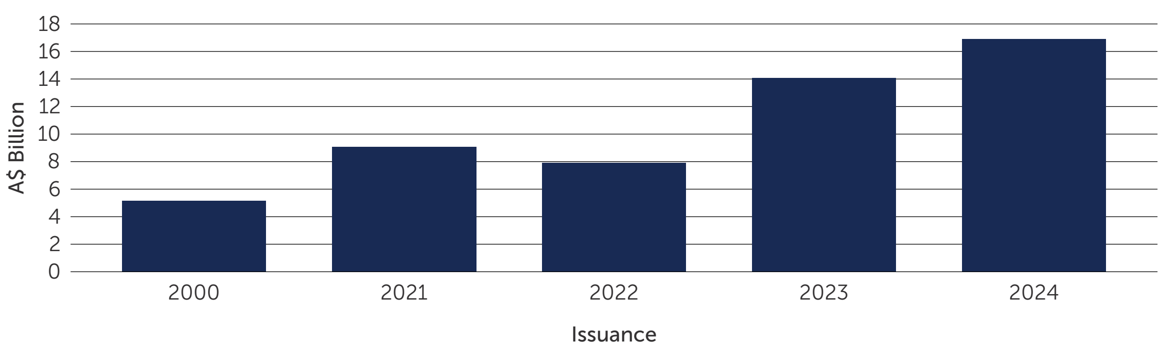
Background to the Australian ABS Market

Prior to 2021, the Australian securitisation market was dominated by RMBS, which represented approximately 82% of the average issuance between 2010 and 2020.[1] The remaining balance was represented by consumer ABS backed by cashflows from personal financial assets such as auto loans (auto ABS), credit cards and small-to-medium enterprise (SME) ABS backed by small ticket commercial and residential properties.

This contrasts with the U.S. market where ABS represented approximately 50% of public securitisation issuance and had evolved into a US$1.6 trillion market.[2] In the U.S., the asset classes being securitised are expanding rapidly beyond its origins in the mid-1980s of auto loans and credit card receivables, to now cover multiple asset classes including non-consumer assets such as corporate loans—which represent the largest ABS asset class (by volume) and are commonly used as an industry benchmark.

Unlike the U.S., Australian rated ABS have not ventured far from the original asset classes being securitised. However, since 2021, led by auto loans, ABS issuance has increased to approximately 24% of the total 2024 securitisation issuance.[3] This growth is a result of banks (including Westpac and Macquarie) divesting their more regulatory capital-intensive auto lending platforms in 2021 to non-banks, who now use securitisation (auto ABS) for the long-term funding of their auto loans.

Figure 1: ABS Issuance in Australia 2020–2024



Source: Gryphon and Bloomberg. As of December 2024.

1. Source: Bloomberg. Average issuance 2010–2020.
2. Source: SIFMA. As of December 2024.
3. Source: Bloomberg. As of December 2024.

The Securitisation Process: How do ABS and RMBS Work?

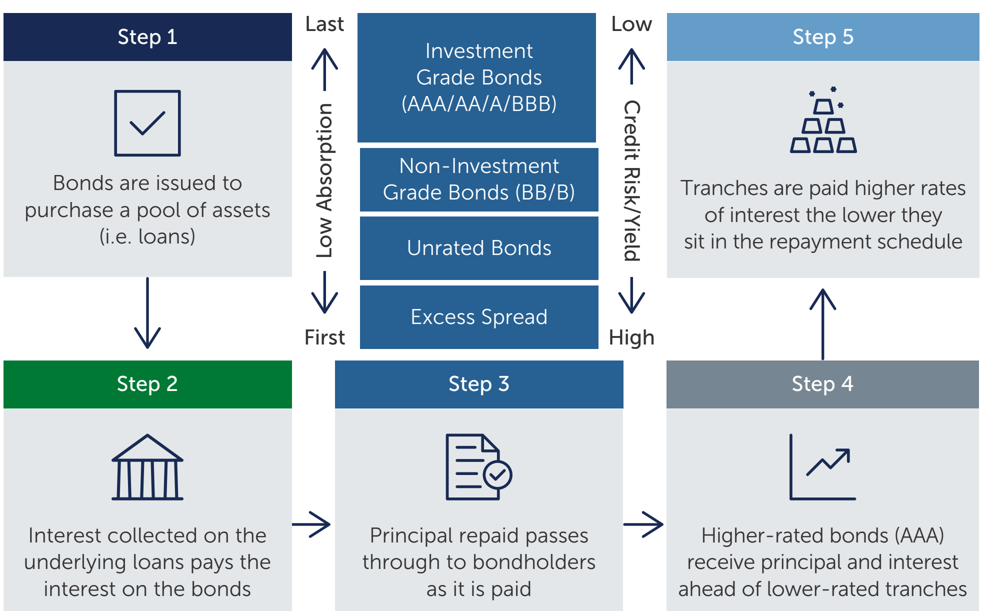
Irrespective of the underlying asset class, be it a highly diversified pool of residential mortgages (home loans) or a highly diversified pool of secured auto loans, securitising the underlying pool of assets to create an RMBS or an ABS follows a common path. To learn more about RMBS, see introduction to RMBS.

Some of the key outcomes and purpose of securitisation include:

1. **Funding of the asset pool:** For banks, this can also serve capital purposes.
2. **Issuance of rated bonds**: A securitisation vehicle is established and funds the acquisition of the asset pool (from the asset originator) by issuing "rated" bonds, which are tranched into different rating categories from AAA and investment grade to non-investment grade. These bonds are then offered to both domestic and international bond investors.
3. **Segregation of credit risk:** The credit risk of the rated bonds issued is segregated from the credit risk of the asset originator.
4. **Profit for the asset originator:** The profit for the asset originator is the difference between the interest earned on the asset pool, less the senior costs of the securitisation, the servicing costs of the assets and the bond interest expense. This is often referred to as "**excess spread**" and is equivalent to a bank's "net interest margin".

Excess Spread = Interest Earned on the Asset Pool - Senior Costs of the Securitisation - Servicing Costs of the Assets - Bond Interest Expense

Figure 2: The Securitisation Process



The process is simplified for illustrative purposes.

Gryphon Capital Investments

Gryphon Capital Investments is a specialist investor in public and private Australian RMBS and ABS, and has been investing in RMBS and ABS on behalf of clients since Gryphon's inception in 2014. Gryphon Capital Investments was acquired by Barings in 2023.

Bondholder Protections: ABS are Different but Comparable to RMBS

While the securitisation process is consistent, the underlying terms and conditions of the contract cashflows being securitised (for example, home loans versus auto loans) may be very different. These differences are taken into consideration in the rating process.

Figure 3: Collateral Comparison Between Australian RMBS and Auto ABS Transactions

	Prime RMBS[4]	Auto ABS[5]
Issue Size (Bonds Issued)	A$1.5 B	A$850 M
Total Value of Underlying Loan	A$1.5 B	A$850 M
Total Number of Underlying Loans	4,095	21,862
Weighted Average Interest Rate	6.52%	10.31%
Average Underlying Loan Size	A$362,698	A$38,880
Lender's Mortgage Insurance	Yes	No
Underlying Loan Maturity Range (Original Term)	30 Years	3–7 Years
Weighted Average Current Loan to Value Ratio	67%	95%

Source: Gryphon. As of December 2024. The samples are chosen as they were Gryphon's actual transactions issued in a similar period of time, they do not represent the overall market.

"While the securitisation process is consistent, the underlying terms and conditions of the contract cashflows being securitised may be very different."

4. Source: Gryphon and respective issuer's report. Prime RMBS example. Issued Q4 2024.
5. Source: Gryphon and respective issuer's report. Auto ABS example. Issued Q2 2024.

Bondholder Protections for Australian RMBS and Auto ABS

The different collateral terms for ABS mean that the building blocks of bondholder protections for an ABS are different to an RMBS *but* the robustness and risk of loss for a rated ABS is comparable to a similarly rated RMBS.

A key part of Gryphon's investment process is our stress testing of both RMBS and ABS transactions to ensure the resilience of bondholder protections are sufficient to protect investors during stressed environments. This includes testing for significant declines in house prices (for RMBS and SME ABS) and large increases in default and loss given default rates (for auto ABS).

Figure 4: Example of Bondholder Protections

	Prime RMBS[6]	Auto ABS[7]
Owner's Equity	Homeowner's Equity—Weighted Average Current LVR of 67%	Usually, the price of the car is being financed—Weighted Average Current LVR of 95%
Lender's Mortgage Insurance	Yes	Not Applicable
Excess Spread[8] (Originator's Profit/Net Interest Margin)	0.78% annually equivalent to A$35 million* over the life of the RMBS	4.82% annually equivalent to A$68 million* over the life of the ABS
Originator's First Loss	Yes	Yes
Hard Credit Enhancement—BBB Rating	1.00% or initial A$15 M	4.00% or initial A$34 M

Source: Gryphon. As of December 2024. The samples are chosen as they were Gryphon's actual transactions issued in a similar period of time, they do not represent the overall market. *At the discounted present value.

The key bondholder protections for RMBS transactions in Australia are the homeowner's equity and excess spread. For ABS, due to the higher interest rate charged to the borrower (the auto interest rate on the example in **Figure 3** was around 10.31% versus the prime home loan interest rate of 6.52%), excess spread is one of the more important bondholder protections.

In the example in **Figure 4**, at the BBB rating level, the auto ABS bondholder's protections of hard credit enhancement (4.00%) plus excess spread (4.82%)[8] totalled 8.82% annually, which is equivalent to a total of A$102 M (A$68 M[9] Excess Spread + A$34 M Hard Credit Enhancement) of protection over the life of the auto ABS. This is materially more than the RMBS equivalent of 1.78% (0.78% Excess Spread[8] +1.00% Hard Credit Enhancement) as the RMBS rating considers the bondholder protection of homeowner's equity. However, in aggregate, the level of bondholder protections for an auto ABS are comparable to a similarly rated RMBS.

6. Source: Gryphon and respective issuer's report. Prime RMBS example. Issued Q4 2024.
7. Source: Gryphon and respective issuer's report. Auto ABS example. Issued Q2 2024.
8. Underlying data sourced from issuers and model replicated by Gryphon. This is for illustrative purposes and no guarantee that the results will be achieved.
9. The discounted present value of excess spread over the life of the ABS.

If the RMBS and ABS pools are performing as expected, excess spread is paid each month (after all of the bondholder's interest is paid) to the originator. This makes sense as the excess spread is the originator's profit on the loans and, in Australia, is only paid running each month. However, in the event of deterioration in the quality and/or quantity of the underlying loan pool (i.e. higher arrears or losses), the excess spread will be diverted away from the originator and used to meet any losses or repay bondholder's principal. **In this context, excess spread is an important bondholder protection in all securitisations.**

ABS Investment Returns

Currently, rated securitised bonds including RMBS and ABS typically trade "over the counter", not on an exchange or electronic trading system. Securitised bonds including RMBS and ABS are tranched on seniority from AAA and investment grade (AA, A, BBB) through to non-investment grade (BB, B).[10] The different credit ratings together with the risk characteristics of the asset type, collateral and structure will shape bond investors' demand and ultimately determine the tranche's expected investment return potential (i.e. what the investors expect to be paid considering the perceived risk of each tranche). The highest rated AAA bonds are the lowest risk and not surprisingly have the lowest expected investment return potential.

Historically, in larger global securitised markets including the U.S. market, a comparably rated consumer ABS would trade at a lower investment return than a comparably rated RMBS. In Australia, as ABS was initially a relatively small market invested in by domestic investors, ABS would trade at a higher investment return than RMBS. Not anymore. The growth of the Australian ABS market in recent years has also caught the attention of international investors who price ABS relative to their home markets—sensibly, comparably rated consumer ABS are pricing (investment returns) consistent with RMBS.

Gryphon's Investment Process

Gryphon's detailed investment process is comparable for RMBS and ABS—from our loan level data requirements, to cash flow stress testing, to portfolio construction, and ultimately, the assessment of the RMBS/ABS aims to deliver capital preservation and predictable income. We don't just rely on the analysis of the rating agencies.

The foundation of Gryphon's investment process is a detailed due diligence on the loan originator and servicer. We examine management experience, issuer financial capacity, viability, and technological sophistication, amongst other factors. A focus on exceptions to underwriting standards, i.e. where the issuer consciously does not follow its own guidelines is an important factor. Data is also key—originator performance history, i.e. prepayments, delinquency rates, historical default, gross losses, and recovery rates can also influence the assessment.

Are the Risk-adjusted Returns of ABS Comparable to RMBS in Australia?

While the key building blocks of the bondholder protections for ABS are different to RMBS, the power of **excess spread** means in aggregate the bondholder protections for an ABS are equivalent to comparably rated RMBS.

Market pricing, rating agency stress testing and, importantly, Gryphon's detailed underwriting and stress testing, conclude that ABS is comparable from a risk perspective to RMBS, when investing in a rated investment universe.

Gryphon's increasing allocation to ABS is due to the growth of the ABS market and appealing investment opportunities, and not about taking more credit risk or stretching for additional yield potential. **In our view, ABS is a complementary asset class to an RMBS portfolio and, with diversification benefits, becomes a powerful and flexible portfolio construction tool.**

10. S&P rating scale.

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