

All About ABF

The Benefits and Strategies of Asset-Backed Finance

FEBRUARY 2025

KEY TAKEAWAYS

- Asset-Backed Finance (ABF) is a fast-growing form of private credit, helping to power the real economy through secured lending against pools of cash flowing assets
- ABF investments are highly negotiated and structured transactions that afford lenders a significant margin of safety against impairment through structural credit enhancements and covenants
- With an estimated market size of \$20 trillion, ABF lending presents a compelling opportunity for investors by potentially providing excess risk-adjusted returns, lower volatility, and portfolio diversification

ABF helps power a broad swath of the real economy

What Is Asset-Backed Finance?

In its most distilled form, ABF is lending against assets that generate cash flows. These assets can be highly diverse in nature – ranging from credit-card receivables and mortgages to data centers and aircraft. With even more esoteric financial assets such as music royalties and insurance premium payments falling into scope, ABF lending helps power a broad swath of the real economy.

Corporate and financial borrowers use ABF to meet their bespoke financing needs on specific pools of assets via efficient capital solutions. In return for providing capital, ABF lenders receive attractive fixed income-like returns secured by diverse pools of predictably cash flowing assets.

A key feature of ABF investments is that repayment comes from the contractual cash flows and self-liquidation payments of the underlying assets themselves. This stands in contrast to corporate lending, where lender repayment often relies on a capital markets event (such as a debt refinancing or asset sale).

For investors willing to forgo trading liquidity (ABF investments are typically private and non-traded, albeit generally shorter duration and self-amortizing in nature), ABF investments may offer attractive excess risk-adjusted returns, meaningful downside protection, and portfolio diversification benefits.

The Everyday Loans of ABF



CONSUMER FINANCE

- Auto
- Credit Cards
- Home Improvement



REAL ESTATE

- Home Mortgages
- Commercial Mortgages
- Lease Finance



HARD ASSETS

- Aviation Finance
- Solar Panels
- Railcar Leases



OTHER ASSETS

- Royalties
- Patents
- Supply Chain Finance

Seize the ABF Opportunity

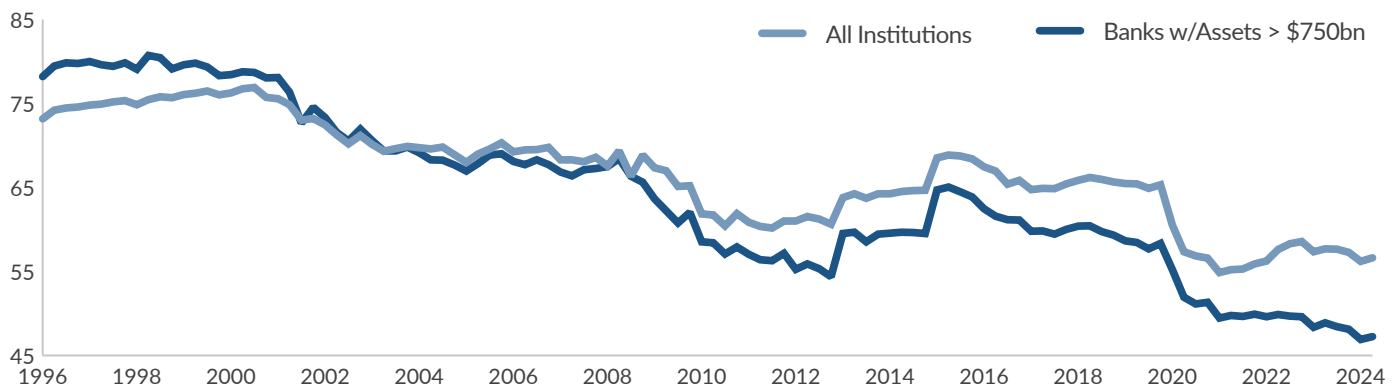
The environment today presents an attractive entry point into ABF. Not only is there an enormous opportunity set (we estimate the total addressable market to be roughly \$20 trillion), but traditional bank lenders in the space have been retreating. As a result, the competitive landscape today offers significant opportunities for non-bank lenders to source attractive deals. The availability of these opportunities, analyzed with significantly improved data access and analytical tools, offers investors the potential to participate in the asset class like never before.

The ABF market is estimated at roughly \$20 trillion

Bank lending as a share of total borrowing has been falling for decades, with the trend accelerating in the period following the Global Financial Crisis (GFC). New capital requirements and more stringent regulatory regimes drove a reduced risk appetite at banks, who were traditionally large ABF lenders. This ongoing period of retrenchment has seen banks largely shift their focus to core business lines (such as corporate relationship banking). The squeeze intensified even more in 2023 when the deposit funding of regional banks came under stress, highlighting an inherent asset-liability mismatch where banks borrow short (deposits) and lend long (most non-agency lending/financing), driving further pullback on lending. As a result, the traditional banking sector increasingly focuses on only the highest non-spread revenue and deposit customers, potentially leaving others in the lurch.

LARGE BANKING INSTITUTIONS SHEDDING RISKIER ASSETS

Risk Weighted Assets as % of Total Assets



Federal Reserve Bank of New York Research and Statistics Group – as of Q2 2024.

The caution that permeates bank balance sheets today has had the unintended consequence of shutting out a large segment of creditworthy borrowers from routine borrowing. In turn, these borrowers have turned to alternative sources of capital, such as ABF. This dynamic of decreasing supply and increasing demand has created significant white space for non-bank lenders to enter the market and extend credit at attractive risk-adjusted rates.

Access ABF Structures

ABF investments are highly structured, bespoke private transactions. This is done to solve pain points for both sides of the transaction – borrowers need customized lending tailored to their unique funding needs and asset characteristics, while ABF lenders need to generate attractive rates of return while minimizing the probability of impairment. As a result, ABF lending often looks quite different from corporate private credit.

THE CASE FOR ASSET-BACKED FINANCE

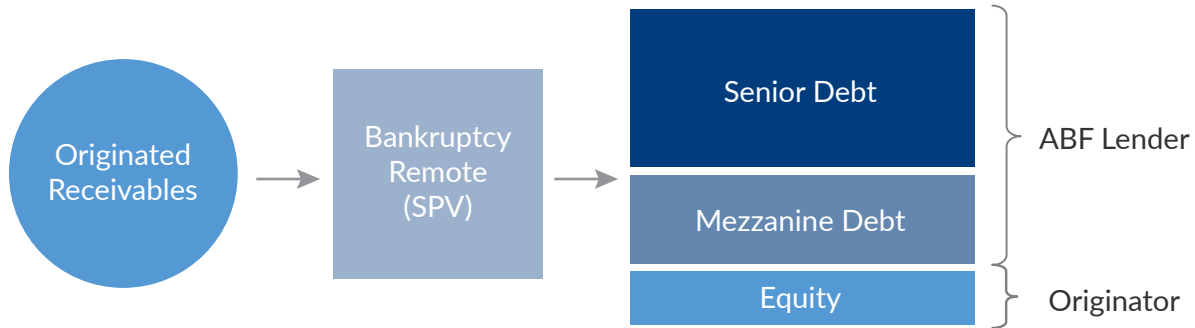
	Asset-Backed Lending	Corporate Direct Lending
Credit Risk	Granular array of non-corporate borrowers and pools of diversified collateral	Concentrated PE-backed middle market companies
Loss Given Default	Low (ring-fenced assets, low “walk away” incentive)	Moderate (creditor-on-creditor violence, asset-freezing)
Correlation to Equities, Bonds, and Loans	Low	Moderate to high
Underwriting Assumptions	Loss adjusted yield	Assume zero losses
Fixed vs. Floating	Mixed – floating and fixed	Floating
Inflation Mitigation	High (risk decreases as collateral value increases)	Mixed (expenses may inflate more than revenues)
Cash Flow Profile	Self-amortizing (de-risks over time)	Balloon payment at maturity (growing risk over time)

Source: TCW

In a typical ABF transaction, the assets used by a borrower to collateralize the loan are placed into a bankruptcy-remote special purpose vehicle (SPV). This entity sits outside of the borrower’s corporate estate, insulating the assets and associated cash flows from any potential bankruptcy of the sponsor. ABF lenders typically look to those cash flows generated by the assets placed into the SPV for repayment, rather than the originator itself. The opposite generally holds true for corporate lending, where lenders rely on the corporate borrower for repayment and are exposed to bankruptcy risk.

A bankruptcy-remote SPV is a key feature of ABF

THE TYPICAL ABF STRUCTURE



Source: TCW

ABF lenders will then lend capital against those assets placed into the SPV. This can be done via a single loan (“unitranche”) or sliced into various components (for example, a senior and a subordinated loan) to allow for more granular risk/return profiles. In most cases, the originator is required to keep some “skin in the game” and retain the first loss (aka equity) position in the capital structure.

ABF investments are generally structured to withstand meaningful increases in collateral losses (above baseline expectations) before they become impaired. This is achieved through a variety of credit enhancements (such as excess collateral) and covenants that act as early warning remedies and may trigger rapid deleveraging in the event of deteriorating collateral performance. ABF lenders will typically also require a variety of controls, ranging from bank account access and lockboxes to the ability to, under certain circumstances, replace the collateral servicer or even take direct control of the assets themselves.

Borrowers Need Capital

A key part of the growth of ABF is continued demand from borrowers. There are a number of different attributes to ABF lending that are attractive to borrowers. For some borrowers, ABF offers access to capital that might not be available on a corporate cash flow lending basis. For others, it offers flexible, scalable, and customized solutions designed to match a borrower’s funding needs. As a result, loan originators, financial sponsors, and corporate owners of assets or contractual cash flows have all become users of ABF. Many of these entities (both large and small) have unique financing needs, assets, and corporate situations that necessitate specialized solutions. We have observed that borrowers are increasingly turning to ABF as a source of differentiated capital to finance a wide variety of assets.

For smaller borrowers, in particular early-stage fintech lenders, private ABF loans or facilities are often their first and/or only form of debt financing. Customized ABF structures are particularly appealing to these borrowers as they are too small to have access to traditional corporate or securitization debt markets, offer improved speed and certainty to close, and allow them to only have to engage with one counterparty directly.

ABF demand is fueled by the borrower’s need for capital

For more established borrowers, ABF offers CFOs of wholesale funded financials or other capital-intensive businesses a way to borrow in an efficient and customized manner against their assets while simultaneously diversifying their sources of capital. In periods of capital markets dislocation (such as the GFC, COVID-19, and the period following the 2023 collapse of Silicon Valley Bank) public capital markets froze up – greatly hampering the ability of companies to borrow capital or finance their assets. As a result, we have observed an increased focus on the part of CFOs to diversify their funding sources away from just public markets. Indeed, ABF financing is increasingly being viewed by borrowers as a more flexible and stable source of capital, particularly in times of market stress.

Today, private financing tools such as ABF are being used by businesses to help generate growth, improve liquidity, and manage their own unique risks in a strategic way.

Investors Need To Diversify

Similarly, ABF investments offer a compelling opportunity for investors of all types. ABF opportunities can offer investors meaningful diversification away from corporate credit exposures, higher spreads relative to comparable public fixed income investments, lower volatility, and incremental margins of safety through bespoke structures and credit enhancements.

Today, many institutional investment portfolios have high levels of exposure to corporates – both via debt and equity investments. For example, a National Association of Insurance Commissioners (NAIC) report showed that across the U.S. insurance industry, more than half of their investment portfolios were corporate exposures. When looking at their bond portfolios, this number was even higher – roughly 75% of their non-muni/government guaranteed exposure was to corporates¹. Similarly, a study conducted by Willis Towers Watson (WTW) found that Fortune 1,000 pension plans were roughly 32% invested in corporate equities and 53% invested in fixed income at the end of 2022². While the data doesn't break down the components of the fixed income category, a substantial majority of the non-government guaranteed exposure is likely to be corporate credit.

ABF provides portfolio diversification

By rotating a portion of their investment exposure into ABF, allocators can achieve greater portfolio diversity away from corporate credit. As noted previously, ABF investments are backed by a broad and diverse set of physical and financial assets that tend to exhibit lower correlations to corporate credit.

ABF investments also offer attractive characteristics compared with other fixed income opportunities. Given the customized private, and bilaterally negotiated nature of ABF investments, investors can often generate excess returns per unit of risk when compared with public fixed income markets. While there is not an ABF-specific index,

we would point to the HFRI RV: Fixed Income - Asset-Backed Index that has generated north of 300 basis points (bps) of excess returns annually compared with the Bloomberg U.S. Aggregate Bond Index over the past 20 years.

Due to the contractual cash flow characteristics of their underlying assets, ABF investments tend to be shorter duration and offer more frequent opportunities for reinvestment via principal amortization than traditional fixed income investments. This, combined with the private nature of ABF investments, offers lower volatility of returns when compared with publicly traded fixed income. Taken together, the excess returns and dampened volatility of ABF investments has the potential to generate high Sharpe ratios and make a compelling case for investor allocation.

Finally, we believe that ABF investments offer attractive margins of safety for investor capital. The first layer of protection comes from diversity. ABF collateral pools are often backed by hundreds or thousands of underlying assets or obligations with predictable and analyzable contractual cash flows. This diversification helps protect against losses arising from idiosyncratic default risks associated with individual assets or obligors.

The next layer of protection comes from the legal structure of ABF investments. In periods of stress, ABF borrowers may, on occasion, enter bankruptcy. Because investments are structured using a bankruptcy-remote SPV, ABF investors have greater control of the underlying collateral via pre-determined cash flow waterfalls. This helps to mitigate disruptions associated with corporate bankruptcies, such as the suspension of payments to creditors and claims against the SPV assets stemming from obligations of the bankrupt debtor.

The final layer of protection comes from the bespoke credit agreements used for ABF investments. These credit agreements are tailored to both the borrower and the assets used as collateral. They are typically bilaterally negotiated and include a variety of covenants (or performance triggers), credit enhancements, and amortization schedules. The intent of these structural features is to provide a meaningful buffer against principal losses to ABF investors in the

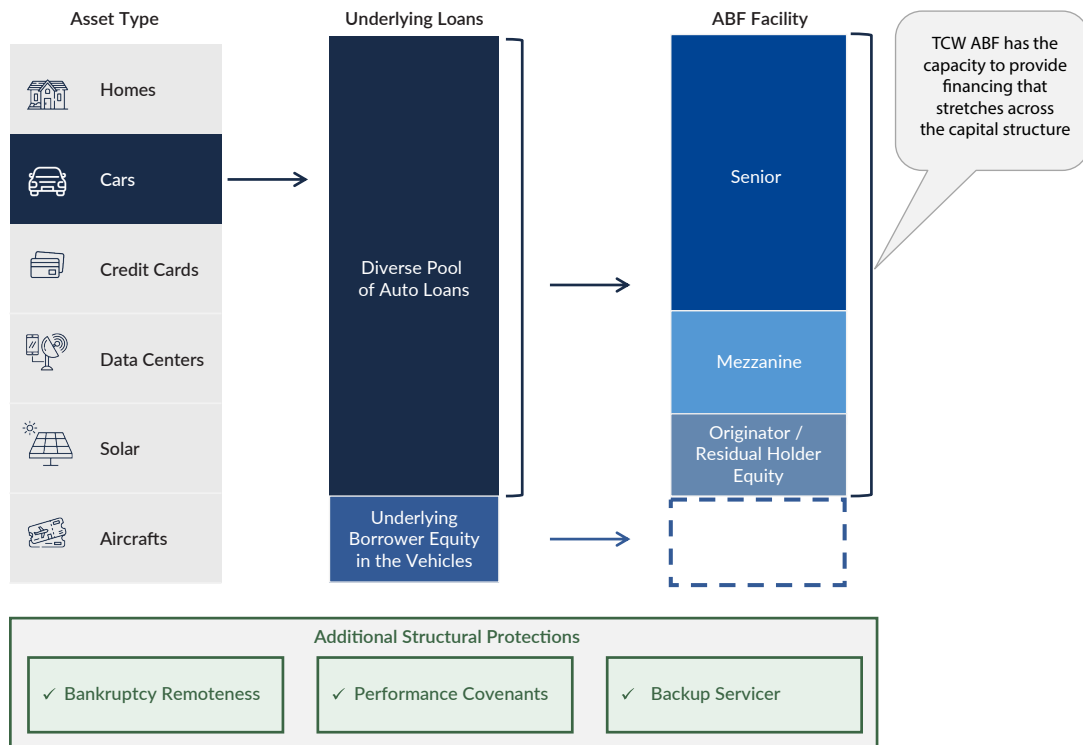
1 NAIC.org [Link](#)

2 wtwco.com [Link](#)

event of adverse events. Credit enhancements often take the form of subordinated borrower equity that absorbs collateral losses ahead of an ABF loan. Performance triggers are designed to add incremental protection and/or a greater level of control over the assets to ABF investors

in the event of deteriorating performance. They can range from a re-direction of cash flows in the structure’s waterfall to speed up the ABF investment’s amortization to the wholesale replacement of the asset servicer and/or forced liquidation of the collateral.

ABF STRUCTURES DESIGNED TO PROVIDE PROTECTION



Source: TCW

Conclusion

Asset-Backed Finance is a large and growing form of private credit. It is present across large parts of everyday life, helping power the real economy. Despite this, banks are retreating and creating significant white space for non-bank lenders. That said, ABF investments are complex, necessitating specialized and experienced managers to effectively navigate the opportunity.

From an investor perspective, there is little doubt that traditional asset allocation is evolving, with increasing focus on alternative assets such as private credit and ABF. The addition of ABF into an investor’s portfolio may improve risk-adjusted returns, diminish volatility, and contribute significant diversification benefits.

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