Letter from the Editors

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Between 1978 and 1983 there were no dollar denominated bonds with maturities of 100 years (century bonds) issued. Between 1983 and 1988 there were five issues of dollar denominated 100 year bonds and these were all floating rate and callable. Over the 1989 to 1994 period there was one such issue again floating and callable. From January 1st 1995 through November 3rd 1997 53 issues of dollar denominated century bonds for a principal amount of 12.5 billion dollars were issued, not counting the ten century bonds which were refinanced through trusts. Twenty six of the bonds were not callable and two of three of the issues gave investors the right to put the bonds back to the issuer. Ratings on the issues ranged from Baa to AAA and were concentrated at the lower end of Moody's investment grade spectrum.

Presumably this recent rush to tap the capital markets for 100 year debt was motivated by the desire and ability to secure long term funds at what were perceived to be relatively low rates. A factor which may have motivated private firms to issue century bonds sooner rather than later, even if they expected interest rates to fall further, was the Clinton administration's 1998 budget proposal to eliminate the corporate tax deduction for interest associated with debt having a weighted average maturity of longer than 40 years.

"Under the proposal, no deduction would be allowed for interest or OID on an instrument issued by a corporation (or issued by a partnership to the extent of its corporate partners) that (1) has a maximum weighted average maturity of more than 40 years" (Description and Analysis of Certain revenue-Raising Provisions Contained in the President's Fiscal year 1998 Budget Proposal, April 16th, 1997, 105th Congress, Fist Session, JCS-10-97). There was intense opposition from Bankers and Corporations regarding the proposal. The final budget did not change the definition of debt for tax purposes. In this case the new rules would not have been retroactive. A number of the century bonds give the issuer the right to reduce the maturity should the Code be altered in a way that disallows the deduction of interest on bonds with maturities less than that of the century bond.

Section 385 of the IRS Code gives the Treasury Department the right to issue regulations classifying financial instruments as debt or equity. In a letter to Dr. Lawrence Summers, Deputy Secretary of the Treasury, Professor Stewart C. Myers of the Massachusetts Institute of Technology writes, "Extending the maturity of a conventional debt instrument (even to infinity) does not give it any fundamental attribute of equity. The recent century bonds were issued by blue chips and had no special control rights. I see no economic or practical case for arbitrarily defining "debt" as "less than 40 year's duration" (Treasury Tax Correspondence, TNT 74-27, Release Date April 2nd, 1997).

The fact that foreign governments, foreign state owned businesses and tax exempt institutions namely, Boston University, Yale and MIT have tapped the century segment of the market indicates that the interest rate environment was a more important decision variable than the proposed changes in the tax code. New century bonds were also issued after Clinton dropped the proposal from his budget.

"With a view toward reducing our overall cost of capital, we took advantage of an opportunity to issue $300 million of 100-year debt and used a portion of the proceeds to buy back 8 million shares of company stock that we believed was under-valued" (Dresser Industries Inc., Annual report to Shareholders, October 31, 1996).

One hundred year bonds are at the extreme of the current fixed income maturity spectrum so they offer unique measures of duration and convexity that may not be available to portfolio managers at the same price in other segments of the derivatives and credit markets.

Insurance companies and pension funds are natural investors in century bonds, both have long term liabilities that can be immunized with the use of fixed income securities which have relatively long durations. Century bonds also offer interesting opportunities to high yield fund managers. Speculators can use century bonds as a vehicle for betting or covering bets on interest rates and

changes in a company's credit ratings.

Arbitrageurs look for unrealized value in securities and commodities. Value may be unrealized because it is embedded in the security and not apparent or temporarily locked in a local market in the case of a commodity, due to information asymmetries, transportation difficulties, a sudden and acute surplus, tax rules, or regulatory interference. Devising a way to finance the acquisition of the right to extract the pent up value at its pre-extraction price with a spot or forward sale at its post-extraction value is the job of arbitrageurs. In its purest sense arbitrage offers risk free profit with zero net investment and is the gravity of the financial markets, it is what bounds markets together and insures that prices align with value.

Financial engineers seek ways to defy gravity. Financial engineering is the process of constructing a more valuable security from one or more less valuable securities. The process is not with out its risks. Efficient hedging, judicious trading, good organization, and aggressive sales forces can control the risks of structuring and underwriting innovative securities.

Lehman Brothers ABS Corp., a wholly owned special purpose subsidiary of Lehman Brothers Commercial Paper Inc. which is itself a subsidiary of Lehman Brothers Inc., purchased, on the secondary market, $33,000,000 of 100 year noncallable debentures which U.S. West Capital Funding Inc. (USWCF) had issued as part of the record setting $4.1 billion bond issue in January of 1997. Of the USWCF debt issue $500,000,000 consisted of noncallable century bonds. Lehman Brothers ABS refinanced its purchase of the $33,000,000 7.95% by issuing two classes of trust certificates collateralized by the USWCF bonds. The series supplement for this transaction, Series 1997-USW-2 is dated September 10, 1997.

Lehman Brothers ABS Corp. as depositor purchases the underlying collateral and deposits the collateral into the trust and assigns to the trustee all rights and title to the assets. The transfer of the securities from the depositor to the trustee is structured as a true sale so that investors are insulated from all risks associated with Lehman Brothers ABS or its affiliates. In exchange for the securities the trustee on behalf of the trust delivers the trust certificates. The depositor sells the certificates to the underwriter who will offer the certificates in negotiated transactions.

The certificates are quoted under Lehman Brothers' RACERS program (Restructured Asset Certificates with Enhanced Returns). RACERS as stated by Lehman Brothers in their 1995 annual report is "A trust structure that purchases less liquid assets and provides institutional investors with a security that meets there investment and credit criteria". In this case the 100 year bonds were refinanced with 20 year amortizing certificate with a coupon of 7.8% (Certificate A-1) and zero coupon instruments (Certificate A-2). In return for buying this zero coupon bond the investor has a right to the trust's assets in the year 2017. Specifically the class A-2 certificate holder would receive an 80 year bond with a coupon of 7.95%, the unsecured senior bond issued by USWCF in January of 1997. A condition for the issuance of the trust certificates was that they would receive the same ratings as the underlying collateral, Baa1 (Moody's) and BBB+ (S&P).

Lehman Brothers identified a crease in the capital markets into which it could profitably sell the restructured century bonds originally issued by USWCF. It is worth noting that the credit risk of the underlying securities and the trust certificates are identical. There is no credit enhancement in this transaction. Lehman Brothers is adding value by creating securities with measures of duration and convexity which are scarce in the corporate bond market. The extreme duration/convexity of the class A-2 certificate offers portfolio managers a way of balancing a highly interest rate sensitive and convex liability structure or moderating the risk profile of a fund that has positions in CMO tranches which have high negative convexity such as principal only strips collateralized by pools of fixed rate mortgages.

Lehman ABS Corp. or an affiliate has the option to tender to the trust class A-2 and A-1 certificates in exchange for the underlying securities. If the Lehman Brothers Inc. wanted to exchange $X million of Class A-2 certificates representing 3% of the underlying collateral they would also have to tender an amount of Class A-1 certificates which represented 3% of the outstanding amount of class A-1 certificates. This restriction assures that the trust collateral is kept intact vis-a-vis its ability to service the outstanding class A-1 and class A-2 certificates. It protects Lehman Brothers from a significant depreciation of the certificates relative to the underlying collateral.

We obtained the data on the century bond market for this letter from Bloomberg L.P. via the search function, {SRCH} GO. Criteria for the search were currency, years to maturity, and maturity type.

We would like to thank the authors who invested so much of their valuable time to write the papers which compose this issue of ***The Financier***.

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