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# Coupon Stripping of Domestic Sovereign Bonds – Key Features in Select Markets

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## Coupon and Principal Stripping

Coupon and principal stripping is the process of converting periodic coupon payments and a final principal payment into tradeable zero coupon securities which will usually trade in the market at a discount and are redeemed at face value.

STRIPS (or, Separately Traded Interest and Principal of Securities) were innovated as a new instrument in the US in 1982 when Merrill Lynch issued Treasury Investment Growth Receipts (TIGRs), as zero coupon securities, to investors against treasury securities held in trust with a depository. Each TIGR was backed either by the principal or the coupon cashflow of the original Treasury bond.

Therefore, stripping a three-year semi-annual coupon paying bond would produce 6 coupon securities (representing the coupons), maturing on the respective coupon dates and one principal security representing the principal amount, maturing on the redemption date of the three-year security.

STRIPS have many advantages foremost of which is to facilitate the availability of zero coupon bonds (ZCBs) to the investors and traders. They provide the most basic cash flow structure thus offering the advantage of more accurate matching of liabilities without reinvestment risk and a precise management of cash flows. Thus to some investors who set the incoming inflows against an actuarial book (e.g. Insurance companies), STRIPS offer excellent investment choices.

Due to the divergent interests of different segments of investors in the market, demand for each component of the STRIPS could be great. Since they replicate the structure of a Treasury Bills, STRIPS can be a useful tool for short term liquidity management.

Additionally, an efficient and long-term debt management strategy need to ensure that the debt profile does not have an over-concentration at the short-end and would try to even out the redemption pattern, thereby minimizing the refinancing risk. Through the creation of securities of varied maturities from a single coupon bearing instrument offers investment opportunities for diverse investor groups having different investment horizons.

## Process of Stripping

India	UK	USA
<p>1. Stripping will be carried out at RBI (Reserve Bank of India) as an automated process within the Negotiated Dealing System (NDS).</p> <p>Requests for stripping will be generated and approved by market participants on the NDS and the same will, thereafter, flow to a Primary Dealer (PD) of their choice for authorization. After authorization by the PD, such requests would be</p>	<p>1. Only Gilt Edged Market Makers (GEMMs), Her Majesty's Treasury and the Bank of England may strip GILTS.</p> <p>The facility to strip GILTS will be available to the market through the GEMMs.</p> <p>Thus Non-GEMM participants who wish to acquire strips will be able to purchase them in the market or can strip GILT they</p>	<p>1. Under the STRIPS program, the holder of any eligible security can request the U.S. Treasury to create separate book-entry instruments for all of the principal and interest cash flows. The principal and interest portions of these instruments are assigned separate identification (CUSIP) numbers and may be owned and traded separately.</p> <p>2. When a Treasury fixed-</p>

<p>received and processed by the system (PDO-NDS) and necessary accounting entries posted in the accounts of the requesting participant for the STRIPS created.</p> <p>The NDS will do necessary validation check like eligibility of securities, balances available, etc., on the requests for stripping made by participants. However, participants are required to ensure that sufficient balances are available in their accounts before putting through requests for stripping.</p> <p>2. Individual STRIPS (Coupon as well as Principal) will have a face value of Rs.100.</p> <p>3. As STRIPS are created at the request of the participant, ISIN (International Securities Identification Number) as well as nomenclature for STRIPS are created automatically based on a predefined algorithm.</p>	<p>own via a GEMM.</p>	<p>principal note or bond is stripped through the commercial book-entry system each interest payment and the principal payment becomes a separate zero-coupon security. Each component has its own identifying number and can be held or traded separately.</p> <p>3. The Commercial Book-Entry System (CBES) is a multi-tiered automated system for purchasing, holding, and transferring marketable securities. CBES exists as a delivery versus payment system that provides for the simultaneous transfer of securities against the settlement of funds.</p>
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## Eligible Securities

<b>India</b>	<b>UK</b>	<b>USA</b>
Fixed rate bonds issued by the Government of India.	All strippable gilts are currently conventional fixed coupon instruments.	Any Treasury security with a maturity of 10 years or longer is eligible for the STRIPS process.

## Minimum Amount for Stripping

<b>India</b>	<b>UK</b>	<b>USA</b>
The minimum amount of securities that needs to be submitted for Stripping will be Rs. 10 million (face value) and multiples thereof.	Securities may only be stripped or reconstituted in a minimum amount of £10,000 nominal and in multiples of £10,000 nominal thereafter.	The minimum face amount needed to strip a fixed-principal note or bond is \$100 and any par amount to be stripped above \$100 must be in a multiple of \$100.

## SLR Status of STRIPS

India	UK	USA
STRIPS will be considered as eligible Government Securities for SLR purposes and retain all the characteristics of a Government Security. They will be considered an eligible security for REPO as well.	Gilt strips are eligible as collateral in the Bank of England's daily money market operations. In addition, the Bank of England accepts strips as eligible securities in intra-day repos for liquidity in the Real Time Gross Settlement (RTGS) programme.	STRIPS will be considered as eligible Government Securities for SLR purposes and retain all the characteristics of a Government Security.

## Trading in STRIPS

India	UK	USA
<p>1. STRIPS will be tradable only in the OTC market. Hence, trades in STRIPS will have to be undertaken in the OTC market and reported on NDS for clearing and settlement through CCIL (Clearing Corporation of India Limited).</p> <p>2. Participants shall not sell STRIPS upfront based on the requests placed by them for stripping. Accordingly, sale transaction in STRIPS shall be undertaken by participants only after the securities are stripped and the same is reflected in the SGL account of the participant.</p> <p>3. Short sale of STRIPS shall not be permitted.</p>	Tradeable on London Stock Exchange.	<p>STRIPS can only be bought and sold through a financial institution or brokerage firm, and held in the commercial book-entry system.</p> <p>All STRIPS are traded over the counter (OTC), with the primary government securities dealers being the largest and most important market participants.</p>

## Eligible Counterparties

India	UK	USA
1. Any entity, including individuals, holding balances of Government securities that are eligible for Stripping (as notified by RBI from time to time) can strip these securities.	Strips may be held only by a CREST (Central Securities Depository for Markets in the United Kingdom) Member, Her Majesty's Treasury and the Bank of England.	<p>Already explained under the following fields:</p> <ol style="list-style-type: none"> <li>1. Trading in SCRIPS</li> <li>2. Process of stripping</li> </ol>

<p>2. Stripping is permitted only in respect of securities held in electronic form, any participant desirous of stripping Government securities should have:</p> <p>a. A SGL Account (Subsidiary General Ledger Account) with the RBI or</p> <p>b. A Gilt Account (Opened and maintained for holding Government securities) with a custodian maintaining a CSGL Account (Constituent Subsidiary General Ledger Account) with the RBI.</p>	<p>Like any other government securities, strips may be held by one person on behalf of another. Any person may therefore own strips beneficially by making arrangements to hold them through a CREST member.</p>	
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## Valuation of STRIPS

<b>India</b>	<b>UK</b>	<b>USA</b>
<p>1. The discount rates used for valuation of STRIPS at inception should be market-based. However, in case traded zero-coupon rates are not available, the published zero coupon yields should be used instead.</p> <p>2. STRIPS, being zero coupon securities therefore they will have to be valued and accounted for as zero coupon bonds:</p> <p>Zero Coupon Bonds (ZCBs) should be shown in the books at carrying cost, i.e., acquisition cost plus discount accrued at the rate prevailing at the time of acquisition, which may be marked to market with reference to the market value.</p> <p>In the absence of market value, the ZCBs may be marked to market with reference to the present value of the ZCB.</p> <p>The present value of the ZCBs</p>	<p>The market will trade on a yield basis, i.e. strip prices will be quoted in yields rather than cash amounts. Yields will be quoted to three decimal places and will be calculated using an actual day count convention.</p>	<p>The prices of STRIPS are quoted on a discount basis, as a percentage of par. Eligible securities can be stripped at any time. Quotes for STRIPS are quoted in yields to maturity.</p>

may be calculated by discounting the face value using the 'Zero Coupon Yield Curve', with appropriate mark up as per the zero coupon spreads put out by FIMMDA periodically.		
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## Taxation

India	UK	USA
<p>If zero coupon bonds is held as capital asset, income from transfer thereof shall be taxed under the head 'income from capital gains' whereas if the same is held as stock-in-trade, income from transfer thereof shall be taxed under the head 'Profits and gains from business or profession'. Thus, no income from a zero coupon bonds shall be taxed on accrual basis during the period of its holding by a person unless there is a transfer of zero coupon bonds due to redemption, maturity or otherwise.</p> <p>Maturity, redemption or otherwise transfer of zero coupon bonds shall be treated as transfer in the hands of investor for the purpose of capital gains tax under Section 2(47) (iva). Income arising from zero coupon bonds as defined in Section (48) (2) shall be taxed only in the year in which same is transferred or redeemed or matured.</p> <p>Tax liability of investor on transfer of zero coupon bonds may be either short term or long depending upon the holding period, i.e. for note more than 12 months or otherwise.</p> <p>In such cases where the tax</p>	<p><b>Individual Investors:</b> All gains and losses on gilt strips held by individuals are taxed as income on an annual basis. At the end of the tax year, individuals are deemed for tax to have disposed of and reacquired their holdings of gilt strips at their then current value; any gain (or loss) arising during the year on the holding is taxed (or relieved) as income.</p> <p><b>Corporate Investors:</b> Under the loan relationship legislation, UK corporate investors are liable to tax at the corporation tax rate on the total return from their holdings of gilts and gilt strips according to the appropriate authorised accounting method. In most cases, taxable profits or losses will follow the credits or debits shown in the company's accounts. (There are special rules for companies carrying on a life assurance business).</p>	<p>Income earned on STRIPS must be reported in the year in which it is earned.</p> <p>Income must be reported even though it is not received until maturity or the STRIPS are sold.</p>

payable in respect of long-term capital gain arising from transfer of a zero coupon bonds exceeds ten per cent, of the amount of capital gains without indexing (i.e., before giving effect to the provisions of second proviso to section 48), then such excess shall be ignored.		
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## Fees and Charges

India	UK	USA
RBI will not charge any fees for stripping of Government Securities. PDs, who are the "authorized entities" for authorizing requests for stripping in the PDO-NDS may also not charge the participants for carrying out this activity.	No charges will be applied to applicants for the services of stripping the Gilts or reconstitution of the strips into Gilts.	

## References

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### **U.S:**

<https://www.treasurydirect.gov/instit/marketablestrips/strips.htm>

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### **UK:**

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Due care has been taken to refer to authentic documents available on official sources where possible. However, we still consider the conclusions drawn by our team members may subject to variance in interpretation and understanding. References to the source documents have been provided for reference where possible. Areas in particular including Tax may require professional consultants and subject to context and environment which was beyond the scope of our focus. The document has been prepared by our volunteers in their personal capacity, in good faith and spirit without any liability or assurance with regards to accuracy. CFA Society Pakistan has facilitated this research with the primary objective of contributing to market development.