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One Series of Gilt STRIPS; Not 7¾% ’06

- **There is an argument circulating in the gilt market that, at the start of the STRIP market, the Bank will introduce two STRIPpable series, and that the 7¾% 08Sep2006 will be included in one of these series.**

  Such a decision by the Bank and the Treasury would be perverse. It would not serve the interest of the market nor the taxpayer.

  Hence, at the outset of the market, expect one (and no more than one) STRIPpable series of gilts. This will consist either of the 07Dec stocks, or of newly issued paper. Further, it is highly unlikely that the relatively illiquid 7¾% 08Sep2006 will become STRIPpable.

On 23 May The Bank of England published a consultative document on the possibility of starting a STRIP market in the UK, seeking comment on some aspects of how this could best be done. On 10 July the Chancellor of the Exchequer announced that the required tax changes would proceed, and that there would be a STRIP market.

No announcement was made about which gilts would be STRPpable, but the Bank did explicitly acknowledge that liquidity would best be served by aligning the coupon dates of issues. (BoE’s consultative document, ¶17 page 5.)

> The Bank would want to consider what steps could usefully be taken to promote the liquidity of STRIPS given that, taken on its own, a single gilt issue would not generate a significant volume of coupon STRIPS; for example, a £5bn (nominal) issue of a stock with an 8% coupon would produce (semi-annual) coupon STRIPS of only £200mn (nominal) each, with a cash market price (given the zero coupon) which was substantially lower. Most obviously, all coupon STRIPS maturing on the same date would need to be fungible — that is coupons payable on the same date STRIPped from different underlying gilts would be completely interchangeable; **and the coupon dates of STRIPpable gilt issues could be aligned in order to build up scope for reasonably liquid coupon STRIPS.**
> (Our bolding.)

In a semi-annual market the coupon STRIPS are only half the size of the coupon STRIPS in an annual market, so liquidity in the individual coupons is much harder to achieve. Of course, the UST market is semi-annual, but the sheer number and size of its issues allow this problem to be overcome, and for there to be two STRIPpable series. Even so, beyond ≈12 years the smaller “issue size” and hence reduced liquidity of coupon STRIPS means that UST principal STRIPS typically trade richer (lower yield) than coupon STRIPS.

It would not be possible for the fraction of the (much smaller) gilt market that was initially STRIPpable to sustain two STRIPpable semi-annual series. Even if almost all the gilt market were STRIPpable (which probably won’t be true for at least ten and maybe twenty years), a second series of STRIPpable semi-annual gilts would substantially undermine liquidity (unless the government’s debt had greatly increased). Note that although the OAT market has two series (Apr & Oct), these each pay annually, so for these purposes the OAT market could be said to have one semi-annual series (paying in Apr & Oct).

For this reason J.P.Morgan’s reply to the Bank’s request for comments advised that:

> The overriding consideration should be that of promoting liquidity. Hence the Bank should pick on one set of coupon dates, create a number of conventional issues with those coupon dates and make those issues STRIPpable. In a semi-annual market liquidity in the coupons will be hard enough to achieve; liquidity should not be spread over two or more sets of coupon dates.

So having argued that there should only be one series of STRIPpable issues, what should this series be?

There is an obvious candidate: the three stocks maturing on 07 Dec. These are the 8% 07Dec2000, 8½% 07Dec2005 & 8% 07Dec2015, which have issue sizes of £4·8bn, £8·9bn & £6·5bn. To issue another £20·2bn of new matching-date paper would take the Bank about a year, and would hence either delay the start of the market by a year or reduce its liquidity at inception. (Or would require the Bank to enact a substantial programme of stock conversions.)

Unfortunately, there is a disadvantage to the taxpayer in allowing existing paper to be STRIPped. For domestic investors† gilt coupons are taxed quarterly, but capital gains taxed annually. If existing paper were STRIPpable then

† Non-UK investors are reminded that, from 02 Jan 96, all coupons are paid gross and hence that non-UK investors need not have any concerns about British taxation.

domestic investors would hold this paper in STRIPped form, and would sell each coupon a few weeks before it matured. This would generate a capital gain, to be taxed annually. The upshot of all this is that the payment of taxation would have been delayed by an average of ≈13 months‡.

What is this worth? 13 months cost of carry on the domestic tax liability over the life of the gilt. Let's say that the average effective tax rate is 10%. Each year we have coupons totalling (say) £8, with a tax bill of £8 × 10%. We will assume that the average money-market rate over the life of the gilt is its GRY, and that this is 8%. Then 13 months cost of carry on the tax over the gilt's life is £8 × 10% × 8% × 13/12 ≈ 6·9bps/year.

Rather than have all the domestic investors delaying their tax in this manner the Inland Revenue has decided that it would be administratively simpler if the relevant issues were given a tax privilege: **coupons from STRIPpable gilts will be taxed annually rather than quarterly**. The Inland Revenue's press notice of 10 July confirmed this (¶31):

> The Bank of England have proposed the introduction of an official STRIPS market in gilts. The consultative document raised the question of whether gilts STRIPpable through any such market should be exempt from withholding tax and the quarterly accounting arrangements being introduced in connection with gilt repos. Responses have suggested that such an exemption would be appropriate. The Government will introduce legislation to achieve this.

Hence the authorities' difficulty:

- If the Treasury decides to "give" this tax privilege to **any** outstanding issues, then this will cost the Treasury ≈6·9bps over the life of these issues.

- If the Treasury decides not to "give" this tax privilege to any outstanding issues, but instead to create new stocks with this privilege, then the cost will be recouped through a higher issue price of the new paper. But the start of the STRIP market will have been delayed.

That the authorities have this dilemma is not new. But the "talk" in the gilt market is suggesting that they will make the 7¾% 08Sep2006 STRIPpable. This suggestion has the distinction of achieving the worst of both worlds.

- By making this tax privilege applicable to an outstanding issue, the Treasury would still have voluntarily agreed to delay receipt of revenues;
- Yet the only STRIPpable stock would be the 7¾% 08Sep2006, which is one of the least liquid conventional stocks between longer than 5-years.

If this rumour were correct then the Treasury would be planning to delay revenue for no gain in liquidity. Such a decision would be perverse, and is therefore highly improbable.

At the outset of the market, expect exactly one STRIPpable series of gilts. This will consist either of the 07Dec stocks, or of newly issued paper. Further, it is highly unlikely that the relatively illiquid 7¾% 08Sep2006 will become STRIPpable.

An alternative argument that could be used in favour of some random existing stock being made STRIPpable is that "the Bank has to choose some date". Yet, as the lists below show, there are plenty of free coupon dates for the BoE to choose. If a new date were required then (for example) the "vacant" 11 Jun & Dec could be used, and would still "leave room for expansion", allowing a second series to pay on the also vacant 11 Mar & Sep.

Coupon dates already "used" by conventionals and callables:
Jan & Jul: 12, 14, 15, 16, 19, 22, 25, 26, 28;
Feb & Aug: 06, 10, 21, 25, 26, 27;
Mar & Sep: 01, 03, 08, 10, 15, 19, 20, 25, 26, 27, 30;
Apr & Oct: 05, 11, 13, 18, 25, 27;
May & Nov: 01, 03, 06, 07, 15, 18, 19, 20, 21, 22, 25, 26;
Jun & Dec: 07, 10, 12, 14;

"Vacant" coupon dates:
Jan & Jul: 01…11, 13, 17, 18, 20, 21, 23, 24, 27, 29…31;
Feb & Aug: 01…05, 07…09, 11…20, 22…24, 28;
Mar & Sep: 02, 04…07, 09, 11…14, 16…18, 21…24, 28, 29;
Apr & Oct: 01…04, 06…10, 12, 14…17, 19…24, 26, 28…30;
May & Nov: 02, 04, 05, 08…14, 16, 17, 23, 24, 27…30;
Jun & Dec: 01…06, 08, 09, 11, 13, 15…30;

‡ Tax on gilt coupons is paid two weeks after the end of the quarter. Assuming that an average coupon is paid in the middle of the quarter, this is 2 months after receipt. Annual taxation is paid 9 months after the end of the tax year, and the average coupon is paid 6 months before the end of the year, so this is 15 months after receipt. The difference averages at about ≈13 months.