

The Official Gilt Strips Facility

A paper by the Bank of England



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The upgraded Central Gilts Office settlement service (CGO) will start on 10 November 1997 and it is planned that the official gilt strips facility which it incorporates will be available from 8 December 1997. This paper lists the decisions the authorities have made about the introduction of the strips market, following extensive consultation with gilt market participants and other parties.

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I Introduction

1 The official gilt strips facility will enable gilt holders to exchange a coupon-bearing gilt for a series of new zero coupon strips matching exactly the cash flows of the parent bond; or, conversely, to exchange an appropriate bundle of strips for a coupon-bearing gilt. Trading in gilt strips, for settlement on the first day of the facility, will be permitted from Monday 1 December.

2 The development of this facility has been part of the upgrade of the Central Gilts Office electronic book-entry settlement system.¹ The strips facility has been built following responses to the Bank of England's earlier consultations with the market; these consultations showed strong support for the proposed facility, as a further step in the continuing development of the gilt market.

3 Section II of this paper outlines what strips are and how they can be used by investors. Section III relates the authorities' decisions to date on the issuance and features of strippable gilts. Section IV details the mechanics of the strips facility. Section V describes some aspects of the trading and settlement of gilt strips. Section VI lists sources of information which will be available on, in particular, stripping activity and strip prices. Section VII sets out the legal and regulatory background; an appendix contains the Strips Memorandum which will govern the arrangements for stripping and reconstituting gilts through the strips facility. Section VIII summarises the tax treatment of strips. Section IX concludes, noting possible future developments.

¹ Information on the upgrade of the Central Gilts Office is contained in the Bank's Annual Review of the gilt market in 1996-97, available from the Bank (telephone 0171 601 3672).

II Strips and their uses

(a) What are strips?

4 Stripping is the process of separating a standard coupon-bearing bond into its constituent interest and principal payments, so that they can be separately held or traded as zero coupon instruments.² For example, a ten year bond could be separated into 21 zero coupon bonds, one from the principal repayment and twenty from the semi-annual coupons; coupon payments due, say, 6, 12, 18 months after issue would, if the underlying bond were stripped, become 6, 12, 18 etc month zero coupon bonds. The cash flows on the bundle of zero coupon strips would be identical to the cash flows on the original unstripped bond.

5 Gilt coupon and principal strips created through the official gilt strips facility will remain direct obligations of the UK Government, and will be registered securities on the gilt register kept by the Bank of England's Registrar's Department.³ Gilt strips will therefore be fully-fledged gilts, and so will have the same credit characteristics as standard coupon-bearing gilts. They will be zero coupon liabilities of HM Government.

(b) Who may hold strips?

6 HM Government, as issuer, permits any investor to hold strips. Trustees and others subject to restrictions on the type of investments they can hold will of course need to ensure that they have the appropriate authority to do so.

7 For reasons of operational efficiency, all strips will be held in the CGO book-entry settlement system, so paper certificates in respect of stripped gilts will not be available. Gilts held outside the CGO book-entry system will therefore need to be lodged with CGO before they can be stripped. Personal investors will be able to hold strips indirectly through, for example, the nominee services provided by custodians and other professional advisers. The introduction of the strips facility will not affect the ability of investors to hold coupon-bearing gilts, whether or not they are strippable, in paper form.⁴

8 The authorities do not plan to include gilt strips on the National Savings Stock Register (NSSR).⁵ This is because the secondary market price of a gilt strip will in principle be more volatile than that of a coupon gilt of the same maturity, on account of its greater duration.⁶ It would therefore be desirable for personal sector investors interested in strips to take professional advice, which is not available from the NSSR service, from their stockbrokers.

(c) What might strips be used for?

9 The official gilt strips facility will make available to investors and traders the most basic cash flow structure, namely zero coupon paper. Through investing in a portfolio of strips, an investor could thus in principle more easily achieve a desired pattern of cash flows.

2 Originally "stripping" referred to the practice of stripping coupons from a bearer bond certificate. As the US market developed, the term "STRIPS" was employed to stand for Separate Trading of Registered Interest and Principal of Securities.

3 For example, for the strips derived from the existing strippable issues with 7 June and 7 December coupon dates, there would be a register for a 7 June zero coupon gilt issue and for a 7 December zero coupon gilt issue for each year up to and including 7 June 2021, which is the redemption date of the longest maturity gilt so far declared strippable (8% Treasury Stock 2021). Two strips will mature on, for example, 7 June 2021, one representing the final coupon of 8% 2021 and one representing the redemption of the bond; there will be separate registers for the coupon and principal strips.

4 Over 95% of gilts by nominal value are held in the CGO system.

5 The NSSR is a separate gilt register for small investors. Orders to buy or sell gilts are made on forms from the Post Office. Investment advice is not available.

6 The duration of a bond is a measure of the timing of its cash flows. It is calculated as the weighted average of the times to each of its cash flows, where the weights are the present value of each of the payments as a proportion of the total present value of all cash flows. Modified duration is an adaptation of this to give the sensitivity of the price of a bond to changes in its yield. At current yields, the more than 23 years' duration of the principal strip of the longest maturity bond so far declared strippable (8% Treasury Stock 2021) would be more than twice the duration of the coupon bond itself.

10 Market consultation has indicated that this possibility is attractive to a wide range of investors. Domestic long-term savings institutions are interested in the higher duration assets which stripping will make available, and more generally in the enhanced ability to match liabilities without reinvestment risk. Retail investors, and their advisers, are attracted by a product which could permit them to have investments with cash flows of their choice. Domestic and international traders concentrate on the duration and convexity⁷ properties of strips. Strips also allow traders to take a view on forward rates in different countries.⁸

11 Market interest appears greatest at long maturities, but there have been clear signs of potential demand in other maturity areas. For example, it has been suggested that short strips might be used to back retail products offering a guaranteed minimum return or, at the very short end, as a money market instrument.

12 The fact that a gilt has been declared strippable does not affect in any way the payments made to holders of the gilt in unstripped form; and if some holdings of an issue are stripped, the rest of that issue will continue to trade unstripped. Arranging for a gilt to be stripped is at the option of the holder, and no one is obliged to use the gilt strips facility. Similarly, no one is obliged to purchase a gilt strip. As with any investment decision, appropriate advice should be taken if in doubt.

7 Convexity is, broadly, the rate at which the price sensitivity of a bond with respect to yield changes with yield; it tends to increase with the square of a bond's modified duration.

8 A trader can purchase one strip and sell another strip maturing, say, six months earlier, thereby locking into a forward rate; a similar process can then be carried out in reverse for strips of another country, thereby trading one forward rate against the other.

III Issuance and features of strippable gilts

(a) **Strippable gilt issues**

13 The then Chancellor of the Exchequer announced on 10 July 1995 that an official gilt strips facility would be developed. Since then seven gilts have been declared strippable from the start of the facility; these are listed at Appendix 1. The total nominal amount of strippable stock outstanding at 1 October was £78.2 bn. Appendix 2 sets out the nominal value of the individual coupon and principal strips which it will be possible to create from this amount of the currently strippable issues.

14 It is the authorities' intention that future gilt issuance should continue to build up the pool of strippable gilts; HM Treasury's current Remit to the Bank of England for the 1997-98 Financing Requirement states that all new issues of conventional benchmark gilts will be strippable from the start of the market.⁹ In addition, there may from time to time be offers for the conversion of unstrippable gilts into strippable ones of similar maturity; any conversion programme is unlikely to be extensive.

15 Whether a gilt is to be strippable will usually be stated in the prospectus under which it is issued. On occasion, a gilt which was initially not issued on terms that it was strippable could subsequently be declared strippable; any such cases would be announced.

(b) **Aligned coupon dates and fungibility of coupon strips**

16 Taken on its own, a single gilt issue would not generate a significant volume of coupon strips; for example, a £5 bn (nominal) issue of a stock with an 8% coupon would produce (semi-annual) coupon strips of only £200 mn (nominal) each, with a cash market price (given the period over which the payment would be discounted) which could be lower, substantially so for longer maturities. To promote the liquidity of strips, the authorities have therefore decided to align the coupon dates of strippable gilt issues and to make all coupon strips maturing on the same date fungible; that is coupons payable on the same date stripped from

different underlying gilts will be completely interchangeable. All the stocks so far announced as strippable have 7 June and 7 December dividend dates. This means that an investor in strips will have a choice of two dates each year for receipt of the cash flows.

17 The Bank has consulted on whether there should be a second pair of coupon dates in addition to the 7 June/7 December pairing. This would increase investor choice over the in-year timing of cash flows, but would reduce the outstanding amount of each coupon strip for any given quantity of strippable stock, and so might reduce liquidity. Most market participants have stressed the importance of liquidity at the start of the market. Those who favoured the eventual introduction of a second pair of coupon dates generally accepted that the initial priority should be liquidity. At least initially, therefore, there will only be one pair of coupon dates.

18 The authorities will consider whether to introduce a second pair of coupon dates, either just at the short end or across all maturities, at a later date once demand and liquidity can be better assessed.

(c) **Fungibility of principal strips**

19 There are varied views on whether coupon strips should be made fungible with principal strips maturing on the same day. On the one hand, fungibility could increase liquidity. On the other hand, it is not a feature of other government bond strips markets. It would also mean that the market could create more of a coupon-bearing gilt, via the reconstitution facility, than had originally been issued. This might be detrimental to holders of the stock, as the size of an issue would be uncertain.

20 It has been decided that coupon and principal strips will not be fungible when the market is introduced, but this issue will be reviewed as experience with gilt strips is established. To that end, the legislation governing strips, the tax regime and the upgraded CGO system have been designed so that there is no obstacle to coupon/principal strip fungibility if it is desired in the future.

⁹ A new short conventional stock in the range 2003-2004 is to be auctioned on 26 November; the date of this auction will be reviewed in the light of the timing of the Green Budget.

21 For the same reasons, principal and principal strips will not generally be fungible, at least initially, even if the redemption payments of two strippable stocks fall on the same day. This situation could arise if two different stocks matured on the same day, for example the principal strip of a five year stock issued five years after the issue of a ten year stock.

22 It is intended that there will be one circumstance where principal and principal strips will be fungible. This will be where an “A tranche”¹⁰ of an existing strippable stock is issued. During the period of non-fungibility of the unstripped gilt, all the strips (including the principal strip) of the A tranche will be fungible with the strips of the existing stock. Any reconstitution of stock during this period would be into the existing stock, not the A tranche.¹¹ For technical reasons, however, the upgraded CGO will not be able to strip A tranches initially; it will be announced when this becomes possible, which may not be in the short term.

(d) No limits on strippability

23 There will be no limit on the amount or proportion of any strippable gilt issue that can be stripped. While a limit might in principle help to avoid an underlying coupon-bearing gilt being in short supply in the secondary market, the reconstitution facility should ensure that that is achieved through market mechanisms. (There will, though, need to be a minimum strippable amount for each stock - see Section IV.)

24 Similarly, the only limit on the maximum use made of the reconstitution facility will be the amount of the underlying coupon gilt in issue¹²; this

follows from the non-fungibility, at least initially, of coupon and principal strips (and generally of principal/principal strips). If in the future coupon and principal strips were made fungible, an important question would be whether there should be a limit on the amount of a coupon gilt which could be created via reconstitution, so as to prevent the amount of a coupon-bearing gilt in market hands being larger than the size of the issue created by the authorities. (Again, there will need to be a minimum reconstitutable amount for each stock.)

(e) Strips of non-standard conventional gilts

25 Market consultation has indicated that there would not be material interest in strips of non-standard conventional stocks such as, for example, callable gilt issues.¹³ Stripping of these bonds is not therefore planned. However, the strips enabling legislation does not prevent stripping of such issues, in case demand should emerge in the future.

(f) Index-linked strips

26 By contrast, potential market interest in index-linked (IG) strips is apparent, as these would provide guaranteed real returns on desired cash flows. However, there has also been market concern that the small size of IG stocks, and therefore the associated coupons, would entail a relatively small pool of strips, and more generally that the index-linked market may not yet be sufficiently liquid for an efficient IG strips market to develop. The case for IG strips will be reviewed once experience has been gained with conventional gilt stripping. In the meantime, the authorities would welcome further views on the details of introducing IG strips in due course. The strips enabling legislation permits IG stripping.

10 An A tranche is identical to its parent stock in all respects except that it is issued without accrued interest. A tranches are issued, for example, where the parent stock is close to its ex-dividend date and so carrying a large amount of accrued interest, which can be unattractive to some investors; an A tranche becomes fungible with the existing stock on the next dividend date thereafter.

11 Stripping the A tranche would usually produce a lesser quantity of the first coupon strip than would stripping the existing stock, and thus reconstitution into the same nominal amount of unstripped stock would first require the holder having more of the first coupon strip.

12 Including, in due course, any A tranche of that gilt.

13 There are two types of callable gilts. Double-dated gilts have a final maturity date and in addition an earlier maturity date, with HM Treasury having the right to redeem the gilt on any day between these two dates, provided that the relevant notice is given (usually 3 months). Undated gilts have a date after which they can be redeemed (for example, 3 1/2% War Loan is dated ‘1952 or after’).

(g) Other types of gilt issuance

27 Investors will be able to use strips to synthesize deferred payment gilts or annuities¹⁴ by acquiring strips providing the cash flows specifically desired or, alternatively, stripping a coupon bond and selling the strips that are not desired.

28 The Bank has considered whether direct issuance of zero coupon gilts would be attractive alongside the gilt strips facility. There is uncertainty both as to the scale and pattern of demand for zero coupon bonds. The gilt strips facility will enable such demand to be satisfied without the authorities having to identify it exactly. The possibility of direct issuance of zero coupon gilts will, however, be reviewed in due course in the light of experience gained with strips.

¹⁴ A deferred payment gilt would not pay any coupon income for a set period. An annuity would pay a stream of coupon income but there would not be a principal repayment at maturity.

IV Stripping and reconstitution procedures

(a) Availability of the functionality¹⁵

29 Any one who holds gilts in the CGO, whether directly or through a nominee, will also be able to hold strips in the CGO. The facility to strip and reconstitute gilts will be available to the market through the gilt-edged market makers (GEMMs). Thus a non-GEMM participant which wants to acquire strips will be able to purchase them in the market, or can strip a gilt it owns via a GEMM. If a non-GEMM wants to convert a holding of a strippable gilt into all or some of its constituent strips it could achieve this by one of two routes:

- Selling the strippable gilt to a GEMM and then buying back some or all of the strips derived from it (not necessarily from the same GEMM); or
- Arranging for a GEMM to strip the coupon-bearing gilt on its behalf, by means of a delivery free of payment to a GEMM's account, and taking receipt of the resulting strips by free delivery. It could then sell any strips which it did not want.

30 Similarly a non-GEMM wishing to reconstitute stock could either sell the constituent strips of a strippable stock to a GEMM and buy back the strippable stock, or, alternatively, it could arrange for a GEMM to reconstitute the stock on its behalf by delivering appropriate coupon and principal strips free of payment to the GEMM and receiving the coupon-bearing gilt in exchange.

31 Stripping and reconstitution will be available while the normal settlement processing is available - ie until the commencement of DBV¹⁶ processing (on the current planned timetable, 08.30 to 14.45).

32 Once the strips facility is available, it will thereafter be possible to input strip or reconstitution requests up to one month ahead of the intended settlement date. This period could be extended if experience shows, in due course, that there is demand for a longer period, and that the benefits of

extending the period would not be outweighed by any disadvantages.

(b) Stripping by GEMMs

33 The information needed in a stripping request, whether for a GEMM's own account or intended for the account of a client, will include:

- a unique transaction reference;
- the intended settlement date (to allow for forward requests);
- the identifier of the relevant CGO member account;
- the nominal amount of the coupon-bearing gilt to be stripped; and
- the ISIN¹⁷ of the stock to be stripped (there will be no need for either the ISINs or the nominal amounts of the resulting strips to be provided).

34 The request may optionally include:

- the priority assigned to the stripping request, which will determine the order of processing if there is more than one item in the participant's stock queue; and
- a client identification number.

35 A strip request will be validated to ensure, for example, that:

- the participant is eligible to strip stock;
- the stock is strippable; and
- the quantity is in units accepted by the system (see below).

36 After successful validation, the stock accounts of the GEMM will be updated, subject to:

- there being a sufficient amount of the stock to be stripped on the member's account;
- the transaction reaching the top of the stock queue; and

15 Further details of this and other aspects of the strips facility functionality are provided in the Reference Manual for the upgraded CGO, available from the Central Gilts and Moneymarkets Office of the Bank or by telephone (0171 601 3984).

16 A delivery-by-value (DBV) transaction in the CGO allows stocks to a given aggregate value (rather than specific stocks) to be delivered to another CGO member overnight, with the transaction being reversed the next day.

17 The ISIN (International Security Identification Number) is the 12 digit internationally recognised securities identifier. It incorporates the 7 digit SEDOL (the Stock Exchange Daily Official List) number for UK securities, including gilts.

- the intended settlement date being reached.

37 The process will take a short time to complete and participants will be able to monitor their stock postings - either interactively or by file transfer¹⁸ - to confirm that the necessary movements have taken place across their stock accounts. It will be possible to withdraw a stripping request at any time prior to it being processed by the system.

38 Unsuccessful validation will cause the system to generate an error message.

39 Where insufficient stock is available to satisfy a strip request, the request will be rolled forward unless and until it is deleted by the participant.

40 There will be no partial fulfilment of requests which failed because of insufficient stock being available for the full amount of the requested transaction.

(c) **Reconstitution by GEMMs**

41 The system will deliver a coupon-bearing gilt on request in exchange for the relevant principal strip together with appropriate amounts of all the unmatured coupon strips representing the bond's cash flows. The information needed in a request to reconstitute an amount of a strippable stock will be broadly similar to that needed in a stripping request. It will only need to include the ISIN of the stock to be reconstituted, rather than the ISINs of the component strips. The checks performed by the CGO system will also be similar.

42 The system will automatically search the relevant member account for the requisite strips, which will need to be held on a single CGO member account. Unless all of the constituent strips are held in sufficient quantity to reconstitute the amount of the coupon-bearing gilt, fulfilment of the request will not occur. Instead the request will be queued, as for an unsuccessful stripping request.

(d) **Minimum units for stripping and reconstitution**

43 For each strippable stock there will be a minimum amount below which the system will not accept a strip request. The need for this arises because nominal holdings of a gilt, whether of an unstripped bond or a strip, must be in multiples of

one penny. This implies that, for example, at least £4 of a bond would need to be stripped if the annual interest payable was, say, 7 1/2%, because each six-month coupon would be denominated in 1/4 percentage points (in this case a coupon of 3 3/4%). In the same way, the minimum strippable amount of a 7 1/4% stock would need to be £8, and of a 7 1/8% stock £16.

44 The system also needs minimum units for the strippability of stock in amounts above the minimum and for a minimum reconstitutable amount. For example, for a 7 1/4% gilt it will not be possible to reconstitute to, say, an amount of £500, as the necessary coupon strips would be £18.125p and thus not in whole pence.

45 The method of stripping and reconstitution which has been adopted is simple to use and understand, which is particularly important in the early days of the market; but the minimum units are also small enough to provide flexibility. Unless otherwise stated at the time of issue, the minimum strippable amount for a gilt will be £10,000 nominal, which will be increased in multiples of £10,000 (ie gilts will be strippable in amounts of £10,000, £20,000, £30,000 etc). Similarly, the minimum reconstitutable amount of a strippable gilt will be £10,000 of the gilt being reconstituted, again unless otherwise stated at the time of issue.

46 The minimum strippable unit of £10,000 will apply also to issues of a new strippable stock which have a long or short first coupon, or where a re-opening of an existing issue is not immediately fungible with the parent because it carries a different amount of accrued interest; non-standard first coupons or amount of accrued interest are generally calculated to four decimal places. Were a future non-standard first coupon or amount of accrued interest to be calculated to, say, five decimal places, this would suggest that a minimum amount for stripping or reconstitution of £100,000 would be needed to ensure that fractions were avoided; in such a case the minimum amount would be specified at the point at which the new issue was announced.

47 Transfers of strips in the secondary market can be made in units of one penny of nominal value, as for unstripped gilts.

18 The file transfer facility allows members to retrieve data from the CGO system (and to input delivery information to it) direct from their back office systems.

(e) Stripping or reconstituting stocks which are ex-dividend or close to redemption

48 If a gilt is stripped after it has gone ex-dividend,¹⁹ a strip will not be issued in respect of the dividend in question, which will be paid in the usual way. After its shutting date,²⁰ a coupon strip will not be included in a bundle of strips submitted for reconstitution into a coupon-bearing gilt.

49 A coupon-bearing gilt will not be eligible for stripping after its shutting date, nor can the final coupon strip and principal strip then be reconstituted.

(f) CGO tariff

50 The CGO will recoup the cost of providing a stripping service by charging for each act of stripping or reconstitution. The initial tariff will be 60p per stripping or reconstitution request.

19 Transfers of gilts are made without the right to the succeeding dividend from 7 working days before the payment of the dividend (10 working days for 3 1/2% War Loan). In February 1997 the Bank consulted market participants about the possibility of abolishing the ex-dividend period for gilts held in the CGO; no decision has yet been made on this.

20 Transfers of a right to the proceeds of a maturing gilt are not accepted after 7 working days before redemption; this is known as the shutting date. Abolition of the shutting date for gilts held in the CGO is also under consideration.

V Trading and settlement of strips

(a) Trading in strips

51 Coupon and principal strips will be freely tradeable (under Stock Exchange rules), for settlement on a next day basis except when otherwise agreed by the counterparties (ie the same as for coupon-bearing gilts). GEMMs will make a market in strips as part of their general market-making obligations, though it is recognised that the quality of service provided in strips could be affected by the size of the individual stock issues.

52 It will also be possible to lend and/or repo - and thus go short and borrow/reverse repo - coupon and principal strips in the stock lending and repo market, just like any coupon-bearing gilt. Repoing or lending strips would need careful monitoring and there may be specific margining requirements, in order to take into account that the prices of strips will in principle be more volatile than those of coupon-bearing bonds of the same maturity.

53 The service provided by the gilt Inter-Dealer Brokers, acting as matched principals between GEMMs, will be extended to strips. The minimum displayed bid or offer amount on an IDB screen will be £1 mn nominal.

(b) Strip prices

54 The market will trade on a yield basis, ie strip prices will be quoted in yields rather than cash amounts. Yields will be quoted to three decimal places²¹ and will be calculated using an actual/actual daycount convention.²²

55 For settlement purposes, yields will need to be converted to cash prices. The formula for this will be:

$$P = \frac{100}{\left(1 + \frac{y}{2}\right)^{\frac{r}{365} + n}}$$

where: P = Price per £100 nominal of the strip

y = Gross redemption yield (decimal), ie if the yield is 8% then y = 0.08

r = Exact number of days from the settlement/issue date to the next quasi-coupon date

s = Exact number of days in the quasi-coupon period in which the settlement date falls

n = Number of remaining quasi-coupon periods after the current period

NB: r and s are not adjusted for non-working days.

56 Quasi-coupon dates occur on the semi-annual cycle defined by the maturity date. For example, a strip maturing on 7 December 2000 would have quasi-coupon dates of 7 June and 7 December each year until then. A quasi-coupon period is defined to be the period between consecutive quasi-coupon dates. Quasi-coupon periods are always six calendar months, regardless of the nature of the first coupon (long, short or conventional). For example, a gilt settling on its issue date (assuming this is not also a quasi-coupon date) will have a quasi-coupon period which starts on the quasi-coupon date prior to the issue date and ends on the first quasi-coupon date following the issue date.

57 Cash prices will be calculated up to six decimal places.²³

21 The rounding convention is to round the third decimal place up by one if the fourth decimal place is 5 or above, and then to truncate at the third decimal place.

22 For strips (and unstripped gilts), the daycount convention is used to discount cashflows. (For unstripped gilts, the daycount convention is also part of the formula used to calculate the accrued interest payable to the seller by the buyer when gilts are traded between dividend payments.) The current convention is actual/365, under which accrued interest is half of the annual coupon multiplied by the number of days between the start of the dividend period and the settlement date, divided by 182.5. Following market consultation, this convention will be changed to actual/actual in 1998, but not before July.

23 The rounding convention uses the same methodology as for yields; see footnote 21.

(c) Futures market issues

58 Strippable gilts will continue (where otherwise eligible) to be included in the deliverable basket for London International Financial Futures and Options Exchange contracts.

59 Individual strips will not be deliverable into LIFFE contracts, nor will a set of coupon and principal strips corresponding to the whole of a deliverable gilt; it will be necessary to deliver the underlying gilt.

60 There could in principle be trading in negotiated options or warrants in strips, which might be on or off the Stock Exchange.

(d) When-issued trading

61 When-issued (WI) trading²⁴ for gilts being issued at auction is generally permitted from the time of the confirmation of the specific stock to be auctioned until close of business on the auction day itself, ie currently for a period of seven to nine days for each auction. WI trading will also be permitted during such periods in any strip derivable from the stock being auctioned. As with WI deals in the auction stock, WI transactions in strips will generally settle on the business day following the auction.

62 The reports made by GEMMs in the run-up to gilt auctions and on auction day itself will be extended to positions in WI principal strips (and any of the principal strip already in issue). Reports may from time to time also be requested on positions in relevant coupon strips.

63 The period from 1 December 1997 will be a special WI period in advance of the strips market. During this period transactions in strips for settlement on 8 December may be entered into; they would be conditional on the strips facility being available on 8 December.

(e) Settlement norms

64 The authorities will keep under review, in the light of experience, whether there is a need for specific market norms on the settlement of strips.

After consultation with the market, no such norms have yet been identified as being desirable.

(f) Strips and the CGO

65 As noted above, strips will be transferable in the CGO in multiples of one penny nominal value, as for unstripped gilts.

66 Strips will be eligible as collateral under the CGO's DBV functionality.²⁵ Reflecting in part the fact that strips would potentially be more volatile in price than a coupon-bearing gilt of the same maturity, the DBV functionality allows the giver and taker of collateral to specify amongst different classes of security for inclusion within a DBV. For the DBV to settle, both parties must of course specify the same class.

67 The DBV options will be:

- all classes of security held in the CGO, ie including strips and "bulldogs" (securities other than British Government Stock)
- coupon-bearing gilts and "bulldogs"
- coupon-bearing gilts and strips
- only coupon-bearing gilts.

68 If no option is specified by the parties to a DBV transaction it defaults to the first option, namely all classes of security held in the CGO system.

69 Strips will also be eligible to support the collateralised debit caps of the participants in the CGO system.²⁶ Settlement banks will be able to set a margin against the four categories of stock which can support these caps.

70 Reflecting strips' potentially greater volatility in price, these categories are:

- short-dated non-stripped gilts
- medium-dated non-stripped gilts and short-dated strips
- long-dated and undated non-stripped gilts and medium-dated strips
- long-dated strips and bulldogs.

24 Transactions in stock which has not yet been issued may be made on a when-issued basis under Stock Exchange rules if it has been announced by the Bank that this will be permitted; such deals are conditional on the stock being issued as announced.

25 See footnote 16.

26 The upgraded CGO system includes an important amendment to the Assured Payment System; the settlement bank acting for a CGO member will be able to set a cap representing the maximum net debit available to a member at any point during the day.

71 For these purposes “short” means 0-7 years, “medium” means over 7 and up to 15 years and “long” over 15 years.

(g) Strips and the Bank’s operations in the money market

72 In principle the Bank intends in due course that gilt strips be eligible as collateral in its daily money market operations. The Bank will consider after the start of the market what the appropriate margin arrangements should be in the light of trading experience.

(h) Strips and Real Time Gross Settlement

73 Similarly, the Bank intends in due course that gilt strips be eligible securities for the purposes of the Real Time Gross Settlement facilities provided by the Bank for settlement members of the CHAPS Clearing Company Limited.²⁷ The margin arrangements will be considered after the start of the market.

(i) Operations in strips by the authorities

74 In the interests of facilitating market liquidity and efficiency, the authorities reserve the right to re-open strippable issues with a view to increasing the size of the strips market, or via a tap for market management reasons if, for example, a strip was being squeezed. The authorities also reserve the right to lend or repo strips if market conditions were to make this appropriate.

²⁷ The purpose of the RTGS programme is to eliminate receiver risk from the same-day value payments process. This is achieved by the settlement of individual CHAPS payments continuously throughout the day. To facilitate the flow of payments, the Bank provides a facility whereby CHAPS members may sell certain high quality assets (eligible securities) to the Bank under a Master Repurchase Agreement in exchange for intra-day funds.

VI Market information on strips

(a) Information on stripping and reconstitution activity

75 At the start of the market, the Bank will publish information on stripping activity on a weekly basis covering:

- the nominal amounts of each strippable stock in issue;
- the nominal amounts of each strippable issue held in stripped and unstripped form; and
- the nominal amounts that have been stripped and reconstituted, and the net amount stripped (or reconstituted), over the previous week.

76 This information will be made available each Monday morning (or the first working day of each week), showing the stripping and reconstitution activity in the previous week.

77 The information will be made available on the Bank's wire services pages and in the markets section of the Bank's Internet site (<http://www.bankofengland.co.uk>); a paper version will be available from the Bank's front desk. The information will remain available until it is updated so that it is a constant source of reference. The format for this information is given at Appendix 3.

78 It will also be possible, at least initially, for CGO participants to enquire how much of a strippable stock is currently in stripped form.

79 The weekly information on stripping and reconstitution activity will be published as a series in the Bank's monthly Monetary and Financial Statistics release.

80 The authorities will keep under review the amount and availability of information on stripping and reconstitution activity.

(b) Information available from the CGO system

81 In addition to the information referred to above, CGO participants will be able to interrogate the system to find out information such as:

- which stocks are strippable;
- which coupon and principal strips result from stripping a particular stock, or are necessary to reconstitute a particular coupon-bearing gilt; and
- the enquiring member's holdings of each of the stripped components of a strippable stock and the amounts that it would need in order to reconstitute a given amount of a coupon-bearing gilt.

(c) GEMMA reference prices

82 The Gilt-Edged Market Makers Association currently arranges for end of day prices for each conventional gilt to be provided by GEMMs to the Bank; these are averaged²⁸ and published on the Bank's wire services pages each evening.²⁹ These GEMMA reference prices will include prices for strips, both on a yield basis and in cash terms.

83 The GEMMA reference prices for strips for the end of the tax year will be available from the Bank and published on the Bank's Internet site.³⁰ These may be of use to private investors who hold strips when completing their tax returns - see Section VIII.

28 Excluding outliers, defined as prices more than a certain number of ticks from the median price.

29 These prices will also be available on the CGO reference prices screens. CGO will use the prices for various purposes, for example in calculating the value of stocks to be included in a DBV. Only cash prices are shown on the CGO screens.

30 <http://www.bankofengland.co.uk>

(d) ISINs and SEDOL numbers

84 A unique ISIN and SEDOL number³¹ has been allocated to all potential coupon strips maturing on the same day and to each potential principal strip. These numbers will also be used for WI trading in these strips in advance of the strips facility. Different ISINs and SEDOL numbers will also be allocated to each of these strips when any future WI trading is permitted in them. These will be used both during that WI period, when it is necessary to be able to distinguish WI deals from (forward) deals in the existing strips and thereafter for all future WI periods for those strips (except in dual auctions - see below). Similarly, for subsequent new potential strips, the ISINs and SEDOL numbers allocated in WI form will also apply to the strips once they have been issued and they will then each be allocated another ISIN and SEDOL number for all subsequent WI periods except in dual auctions. Each strip will thus (except in the case of dual auctions) have two ISINs and SEDOL numbers; one for its first WI period and for trading in the strip once-issued, and one for all subsequent WI periods.

85 During dual auctions, there could be WI trading for strips which will be available as the result of both auctions, for example where both auctions are for strippable stock of the 7 June/7 December series. Although WI deals for strips in each leg of a dual auction could be distinguished by their different intended settlement date, it should minimise the risk of confusion for there to be different ISINs and SEDOL numbers for WI deals in the second leg of dual auctions; a third set of ISINs and SEDOL numbers will thus be used in such circumstances.

86 The Bank's wire services pages will specify the relevant ISINs and SEDOL numbers for strips of auction stocks on each occasion that auction details are issued.

(e) Statistical information on holdings of strips

87 Banks' holdings of strips will be reported to the Bank each quarter, distinguishing conventional strips and, when relevant, index-linked strips. Information on this will be available in the Bank's monthly Monetary and Financial Statistics release. It is envisaged that in due course building societies

will also report strips holdings and it is possible that in the future other investors will report strips holdings to the Office of National Statistics.

31 See footnote 17.

VII The legal and regulatory background

(a) Enabling legislation

88 Legislation to facilitate the introduction of the strips market was contained in the Finance Act 1996. Its provisions relate to the definition of strips and their transfer and registration. The Act introduced powers to amend other legislation as necessary, consequent on the existence of strips as new legally defined objects. The aim has been to ensure a statutory framework which will enable the authorities to have flexibility in developing the strips market.

89 Two pieces of secondary legislation have to date been introduced. These are: amendments to the Government Stock Regulations 1965, relating to the registration and transfer of strips³²; and amendments to the Stock Transfer (Gilt-Edged Securities) (CGO Service) Regulations 1985, enabling the Bank to effect a transfer of strips through the CGO, notwithstanding that the registered holder's membership of the service has been terminated or suspended.³³ Further secondary legislation is expected to be laid shortly, providing that legislation affecting the interests of government departments etc are interpreted to include strips, except where contrary provision is made for specific cases.

90 It should be noted that, as registered securities, coupon strips held to maturity will be repaid under the procedures for redemption rather than those for dividend payments; under current arrangements, repayment of coupon strips will therefore be made directly to a CGO member's settlement bank account rather than according to mandated dividend instructions.

(b) The Strips Memorandum

91 The Strips Memorandum is at Appendix 4. This sets out information about the terms of issue of strips and the arrangements governing the stripping and reconstitution of unstripped stock.³⁴ The Strips Memorandum is the prospectus under which strips are issued and reconstitutions made. **The Strips**

Memorandum is an important document and should be read carefully, if appropriate with the benefit of legal advice.

(c) Stock Exchange rules

92 The rules of the Stock Exchange are being amended to recognise strips as gilt-edged securities and to specify that, unless otherwise agreed by a member firm and its counterparty, the yield formula used to price a gilt strip shall be that notified by the Exchange from time to time (Section V sets out the agreed formula). The rule changes will also reflect the decisions on the service to be provided in strips by the gilt Inter-Dealer Brokers (see Section V).

(d) Supervision

93 The regulators of firms dealing in strips need to ensure that their capital adequacy requirements capture the risk of holding and trading zero coupon securities and that firms have in place the necessary systems and controls.

94 For UK and other European banks and investment firms, including GEMMs, the EU Capital Adequacy Directive has introduced minimum capital requirements to cover the market risk and counterparty credit risks arising on strips business. Firms regulated under these requirements are able to choose whether to apply capital requirements based on the duration³⁵ of their positions, including strips, or to use a maturity ladder approach under which strips are treated in the same way as other low coupon securities. Any questions regarding the detailed prudential treatment of strips should be directed to the appropriate supervisory or regulatory body.

95 Gilt strips will, like other gilts, qualify for inclusion in the sterling liquidity stock requirements applied to some banks by the Bank's Supervision Department. This will be subject to review in the light of the development of the strips market.

32 Statutory Instrument 1997 No 1709.

33 Statutory Instrument 1997 No 1329.

34 Other information and terms relating to issues of British Government Stock is contained in an Information Memorandum which is available from the Bank (0171 601 3672) and is in the markets section of the Bank's Internet site (<http://www.bankofengland.co.uk>).

35 See footnote 6.

VIII The taxation of strips

(a) Gross payment of dividends on strippable stocks

96 All strippable gilts pay interest gross to all holders, ie there is no withholding tax; a net payment option is available by request to the Bank's Registrar's Department. There is no withholding tax on gilt strips.

97 In addition, dividends and manufactured dividends on strippable stock are not subject to the quarterly accounting arrangements for gilt interest applying to some market participants.³⁶ If a gilt is issued on the basis that it will only become strippable from a future date, the exemption from quarterly accounting arrangements may take effect only from that future date; any such provision would be stated in the issue's prospectus.

98 Under current legislation, tax on strippable gilts and strips will thus be accounted for on an annual basis for all those subject to UK tax.

99 All currently strippable gilts and all gilt strips are FOTRA ("Free of Tax to Residents Abroad"). This means that, except in certain circumstances (as set out in the Strips Memorandum), they are exempt from all United Kingdom taxation, present or future, so long as it is shown that the Stock is in the beneficial ownership of persons who are neither domiciled nor ordinarily resident in the United Kingdom.

(b) Taxation implications of the act of stripping

100 Under the "total return" tax regime for bonds introduced in the Finance Act 1996, companies determine their liability for tax by valuing their gilt positions either by marking-to-market or on an accruals basis.

101 For companies using a mark-to-market basis, the act of stripping (or reconstitution) counts as a disposal (purchase) of the unstripped gilt and as the

purchase (disposal) of the corresponding series of strips.

102 Companies using an accruals basis are treated as disposing of the gilt being stripped at market value and acquiring the strips at an aggregate value equal to that of the coupon gilt. This value is allocated among the strips in proportion to the market value of the individual strips at the point of stripping. Reconstitution is dealt with in the same way.

103 Non-corporates, including individuals and trusts, are not within the "total return" regime. The Accrued Income Scheme therefore continues to apply to individuals.³⁷ A gilt held by a non-corporate which is stripped is treated as being transferred with accrued interest; and a gilt being reconstituted is treated as having been acquired with accrued interest. This should ensure that the act of stripping or reconstituting a gilt does not produce anomalous results under the Accrued Income Scheme.

(c) Taxation treatment of the return on gilt strips

104 The return on gilt strips held by companies is treated in the same way as returns from unstripped bonds, namely the total return is taxed as income in a company's annual tax assessment. In the case of index-linked gilt strips held for non-trading purposes, the taxable return is adjusted by an amount reflecting the movement in the retail price index for the year (just as for unstripped index-linked gilts); as noted above, it has been concluded that experience should be gained with conventional strips before IG stripping is planned.

105 Gilt strips held by non-corporates are "relevant discounted securities",³⁸ with the difference between the purchase and sale prices being taxable each year; there is a deemed disposal

36 Holders of gilts subject to UK corporation tax are required to account for tax on a quarterly basis on gross gilt interest received, normally using the quarterly periods employed by companies for other purposes. Quarterly accounting does not apply to overseas holders of gilts (except to the extent that non-FOTRA gilts are held by a branch or agency trading in the UK) or to UK exempt bodies, such as pension funds.

37 The Accrued Income Scheme brings into taxation accrued interest on gilts transferred from one person to another in certain circumstances. The Inland Revenue produce a leaflet on the AIS (IR68), which is available from the Tax Enquiry Centres in most Tax Offices; their addresses are in local telephone books under 'Inland Revenue'.

38 A set of rules introduced in the Finance Act 1996 to replace previous provisions dealing with deep discount, deep gain and qualifying indexed securities.

and acquisition at the end of each tax year.³⁹ Profits made by individuals are assessable each year as income, with no charge to capital gains tax; any loss is relievable against income in the year concerned. This treatment minimises the differences between the tax treatment of strips held by non-corporates and that of unstripped gilts, and thus minimises the risk of tax-induced distortions arising in the pricing of a bundle of strips compared with the price of the strippable bond from which they were derived.

106 The legislation provides that special rules could, if necessary, be made to cover non-corporate holdings of particular kinds of strips, such as for example index-linked gilt strips.

³⁹ As noted in Section VI, the GEMMA reference prices for strips relating to the end of the tax year will be published in the markets section of the Bank's Internet site (<http://www.bankofengland.co.uk>). The prices will also be available from Tax Enquiry Centres.

IX Future developments

107 The authorities wish to do whatever they sensibly can to facilitate market liquidity and efficiency. They will therefore keep under review the development of the strips market. In the light of experience, there may be modifications in the operation of the official gilt strips facility or in other aspects of the legal and regulatory framework for strips. Stripping may also be extended to other types of gilt, in particular index-linked gilts.

108 As outlined in HM Treasury's consultative document of 29 July 1997,⁴⁰ it is envisaged that the Bank's role as HM Government's agent for debt management, the sale of gilts and oversight of the gilt market will be transferred to HM Treasury from April 1998. The Bank will continue to operate the Central Gilts Office and the official gilt registration system through the Registrar's Department in Gloucester. HM Treasury has been fully consulted on the proposed workings of the gilt strips facility outlined in this paper.

109 The authorities welcome comments on the operation in practice of the official gilt strips facility and of the strips market more generally. Comments should be sent to:

The Head of Gilt-Edged and
Money Markets Division
Bank of England
Threadneedle Street
London
EC2R 8AH

110 Further copies of this paper are available from the same address or by telephone (0171 601 3672). General enquiries may be made by telephone (0171 601 4540).

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40 "The Future of UK Government Debt and Cash Management", available from the Bank (0171 601 3604).

Appendix 1: Strippable stocks

At 1 October, strippable stocks outstanding were:

<u>Redemption date</u>	<u>Stock title</u>	<u>Nominal amount in issue (£ mns)</u>
7 June 2000	8% Treasury Stock 2000	9,800
7 June 2002	7% Treasury Stock 2002	9,000
7 December 2005	8 1/2% Treasury Stock 2005	10,373
7 December 2006	7 1/2% Treasury Stock 2006	11,700
7 December 2007	7 1/4% Treasury Stock 2007	7,000 ⁴¹
7 December 2015	8% Treasury Stock 2015	13,787
7 June 2021	8% Treasury Stock 2021	16,500
TOTAL		78,160

A new conventional stock in the range 2003-2004 is to be auctioned on 26 November 1997; the date of this auction will be reviewed in the light of the timing of the Green Budget.

41 A further amount of this stock is to be auctioned on 29 October 1997.

Appendix 2: Potential strips outstanding

The table below shows the cash flows on the seven gilt-edged stocks so far declared strippable (as at 1 October 1997 but excluding the 7 December dividends, which will be payable before the start of the strips facility). In each case, the final payment is the cash flow representing the redemption of the principal and the final dividend.

£ mn								TOTAL CASH FLOWS	
	8%2000	7%2002	8.5%2005	7.5%2006	7.25%2007	8%2015	8%2021	coupon only	coupon and principal
07-Jun-98	392.00	315.00	440.85	438.75	253.75	551.48	660.00	3051.83	3051.83
07-Dec-98	392.00	315.00	440.85	438.75	253.75	551.48	660.00	3051.83	3051.83
07-Jun-99	392.00	315.00	440.85	438.75	253.75	551.48	660.00	3051.83	3051.83
07-Dec-99	392.00	315.00	440.85	438.75	253.75	551.48	660.00	3051.83	3051.83
07-Jun-00	392.00	315.00	440.85	438.75	253.75	551.48	660.00	3051.83	3051.83
07-Dec-00	10192.00	315.00	440.85	438.75	253.75	551.48	660.00	3051.83	12851.83
07-Jun-01		315.00	440.85	438.75	253.75	551.48	660.00	2659.83	2659.83
07-Dec-01		315.00	440.85	438.75	253.75	551.48	660.00	2659.83	2659.83
07-Jun-02		9315.00	440.85	438.75	253.75	551.48	660.00	2659.83	11659.83
07-Dec-02			440.85	438.75	253.75	551.48	660.00	2344.83	2344.83
07-Jun-03			440.85	438.75	253.75	551.48	660.00	2344.83	2344.83
07-Dec-03			440.85	438.75	253.75	551.48	660.00	2344.83	2344.83
07-Jun-04			440.85	438.75	253.75	551.48	660.00	2344.83	2344.83
07-Dec-04			440.85	438.75	253.75	551.48	660.00	2344.83	2344.83
07-Jun-05			440.85	438.75	253.75	551.48	660.00	2344.83	2344.83
07-Dec-05			10813.85	438.75	253.75	551.48	660.00	2344.83	12717.83
07-Jun-06				438.75	253.75	551.48	660.00	1903.98	1903.98
07-Dec-06				12138.75	253.75	551.48	660.00	1903.98	13603.98
07-Jun-07					253.75	551.48	660.00	1465.23	1465.23
07-Dec-07					7253.75	551.48	660.00	1465.23	8465.23
07-Jun-08						551.48	660.00	1211.48	1211.48
07-Dec-08						551.48	660.00	1211.48	1211.48
07-Jun-09						551.48	660.00	1211.48	1211.48
07-Dec-09						551.48	660.00	1211.48	1211.48
07-Jun-10						551.48	660.00	1211.48	1211.48
07-Dec-10						551.48	660.00	1211.48	1211.48
07-Jun-11						551.48	660.00	1211.48	1211.48
07-Dec-11						551.48	660.00	1211.48	1211.48
07-Jun-12						551.48	660.00	1211.48	1211.48
07-Dec-12						551.48	660.00	1211.48	1211.48
07-Jun-13						551.48	660.00	1211.48	1211.48
07-Dec-13						551.48	660.00	1211.48	1211.48
07-Jun-14						551.48	660.00	1211.48	1211.48
07-Dec-14						551.48	660.00	1211.48	1211.48
07-Jun-15						551.48	660.00	1211.48	1211.48
07-Dec-15						14338.48	660.00	1211.48	14998.48
07-Jun-16							660.00	660.00	660.00
07-Dec-16							660.00	660.00	660.00
07-Jun-17							660.00	660.00	660.00
07-Dec-17							660.00	660.00	660.00
07-Jun-18							660.00	660.00	660.00
07-Dec-18							660.00	660.00	660.00
07-Jun-19							660.00	660.00	660.00
07-Dec-19							660.00	660.00	660.00
07-Jun-20							660.00	660.00	660.00
07-Dec-20							660.00	660.00	660.00
07-Jun-21							17160.00	660.00	17160.00
Total Cash Flows (£mns)	12152.00	11835.00	17426.64	19597.50	12075.00	33640.28	47520.00	76086.42	154246.42

Appendix 3: Format of weekly strips announcement

[date] (£mns)	[STOCK]	[STOCK]	[STOCK]
Nominal in issue	123	123	123
Nominal held in stripped form	123	123	123
Nominal held in unstripped form	123	123	123
Activity in week beginning [date]:			
-Nominal stripped	123	123	123
-Nominal reconstituted	123	123	123
-Net stripped (reconstituted) in week	123	123	123

Amounts will be quoted to the nearest million.

The text on the left hand side will appear on every page used.

Appendix 4: The Strips Memorandum

Memorandum relating to arrangements for the stripping and reconstitution of United Kingdom government stock

1. Introduction

- 1.1 This memorandum sets out -
- (a) the arrangements under which United Kingdom government stock may be stripped and strips may be reconstituted into holdings of stock; and
 - (b) the terms on which strips and stock will be issued and exchanged under those arrangements.

2. Stock which may be stripped and reconstituted

2.1 Subject to paragraph 2.3 below, the stocks which may be stripped under the arrangements described in this memorandum are -

- (a) any stocks issued on terms that they may be stripped, and that holdings of them may be reconstituted; and
- (b) any other stocks specified as stocks which may be stripped, and of which holdings may be reconstituted, in notices issued by, or on behalf of, HM Treasury or the Bank of England, whether before or after the date of this memorandum.

2.2 The stocks which at the date of the issue of this memorandum may be stripped are:

8% Treasury Stock 2000

7% Treasury Stock 2002

8¹/₂% Treasury Stock 2005

7¹/₂% Treasury Stock 2006

7¹/₄% Treasury Stock 2007

8% Treasury Stock 2015

8% Treasury Stock 2021

2.3 Stock which is held on the Belfast or Dublin registers or on the National Savings Stock Register may not be stripped. Accordingly the expression "**eligible stock**" is used in this memorandum to

refer to stock falling within paragraph 2.1 above which is held on the register maintained by the Bank of England under regulation 1 of the Government Stock Regulations 1965.

3. Who may hold strips; who may strip and reconstitute stock

3.1 Strips may be held only by a member of the Central Gilts Office ("**CGO**") Service (subject to the rules of that Service), HM Treasury or by the Bank of England. 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 member of the CGO Service.

3.2 Only a gilt-edged market maker, HM Treasury or the Bank of England may strip and reconstitute stock.

4. Stripping of stock

4.1 Subject to the terms of this memorandum, an amount of eligible stock of any description may be exchanged for -

- (a) an individual security or individual securities consisting of one such security for each outstanding interest payment⁴² in respect of that amount of stock, each such security conferring the right to receive on the due date of the relevant interest payment a sum equal to that of the relevant interest payment; and
- (b) a security conferring the right to receive, on the due date for the repayment of that stock, a sum equal to the sum payable in respect of principal on the repayment of that amount of stock.

4.2 In this memorandum -

- (a) the process of exchange described in paragraph 4.1 above is referred to as the "**stripping**" of the relevant amount of stock;
- (b) securities of the kinds described in paragraph 4.1(a) and (b) above are referred to as "**strips**";
- (c) a security of the kind described in paragraph

⁴² For this purpose an 'outstanding' interest payment means an interest payment for which the record date (that is, the date on which a balance is struck for payment of that interest payment under section 2 of the National Debt (Stockholders Relief) Act 1892) has not passed at the time the right to strip is exercised.

4.1(a) above is referred to as a "**coupon strip**"; and

(d) a security of the kind described in paragraph 4.1(b) above is referred to as a "**principal strip**".

Any reference in this memorandum (in whatever terms) to strips of any description held by a person is a reference to the balance of such strips held by that person at the relevant time, taking account of all exchanges made under this paragraph or paragraph 6 below and all transfers made under paragraph 5.3 below.

4.3 The procedure for stripping is set out in the rules of the CGO Service, as amended from time to time.

4.4 Upon the issue of the appropriate strips in exchange for stock stripped in accordance with this paragraph, the stock stripped will be cancelled and the register will be amended accordingly.

4.5 Where eligible stock is stripped during the period between the record date for an interest payment and the date of payment, the holder will not be entitled to receive a strip in respect of that interest payment, which will be paid to the person registered as the holder of the stock on the record date.

4.6 Eligible stock may not be stripped after the shutting date. For the purposes of this memorandum the "**shutting date**" of stock of any description means the last day on which transfers of the stock may be submitted for registration before the redemption date of the stock.

5. Strips

5.1 Strips will be securities issued by HM Treasury under the National Loans Act 1968 and will be subject to regulations made from time to time under section 47 of the Finance Act 1942. Sums payable in respect of strips will be a charge on the National Loans Fund, with recourse to the Consolidated Fund of the United Kingdom.

5.2 Each strip will confer on the holder the right to payment, on the due date for payment of the strip, of a sum equal to the nominal amount of the strip.

The due date for payment of a strip will be specified in the title of the strip designated on the register.

5.3 Strips will be registered and will be transferable in multiples of one penny. The current regulations⁴³ provide that strips may be transferred only through the CGO Service. The regulations provide for the arrangements for registration to reflect the terms relating to fungibility referred to in paragraphs 5.4 and 5.5 below.

5.4 Subject to paragraph 5.5 below, strips will be issued on the following terms relating to fungibility

-
- (a) coupon strips payable on the same day will not be distinguished one from another by reference to the stock from which they are derived or in any other manner⁴⁴;
- (b) principal strips will be distinguished from coupon strips;
- (c) principal strips derived from stock of a particular description will not be distinguished one from another but will be distinguished from principal strips derived from stock of any other description, even where the other principal strips are payable on the same date.⁴⁵

5.5 Strips of any description may be issued on terms that, in respects or in circumstances or to an extent different from those provided by paragraph 5.4(b) and (c) above, they will be distinguished from, and will accordingly not be fungible with, other strips or other strips of a particular description or descriptions. Such terms may also preclude or restrict the use of the strips in question for the reconstitution of stock in accordance with paragraph 6 below. Any such terms will be set out in a notice given in accordance with paragraph 8 below at or before the time of issue of the relevant strips.

6. Reconstitution of stock from strips

6.1 Subject to the provisions of this memorandum, strips such as are specified in paragraph 6.2 below may be exchanged for an amount of eligible stock of any specified description the shutting date of which has not then

43 The Government Stock Regulations 1965 (S.I. 1965 No. 1420, as amended).

44 This includes coupon strips derived from an "A" tranche of stock, which will not be distinguished from coupon strips of the parent stock even during the period when the "A" stock continues to be distinguished from the parent stock. "A" tranches will not, however, be strippable at the commencement of the strips market.

45 For the purposes of stripping an "A" stock will be treated as stock of the same description as the parent stock. Principal strips of the "A" stock will not therefore be distinguished from principal strips of the parent stock, even during the period when the "A" stock is distinguished from the parent stock. As noted above, "A" tranches will not be strippable at the commencement of the strips market.

passed. Such an exchange is in this memorandum referred to as the "**reconstitution**" of such stock.

6.2 The strips referred to in paragraph 6.1 above are -

- (a) principal strips derived from eligible stock of the description in question conferring the right to receive a sum equal to the principal sum payable on the repayment of the amount of stock to be reconstituted; and
- (b) in respect of each interest payment date in respect of such stock for which the record date has not then passed, coupon strips conferring the right to payment on that date of a sum equal to the interest payable on that date on the amount of stock to be reconstituted;

other than any strips which may not be used for the proposed reconstitution because of a restriction of the kind described in paragraph 5.5 above.

6.3 Stock may be reconstituted regardless of whether any or all the coupon strips for which it is exchanged are derived from stock of the relevant description and regardless of whether the stock from which those coupon strips are derived can be identified.

6.4 The procedure for reconstitution of stock is set out in the rules of the CGO Service, as amended from time to time.

6.5 Reconstituted stock will carry the same rights as, and will not be distinguished from, the existing stock of the relevant description.⁴⁶ Stock issued on reconstitution will be amalgamated on the register with any other stock of the relevant description then held by the person to whom it is issued.

6.6 Principal and coupon strips exchanged under this paragraph for reconstituted stock will be cancelled upon the issue of the reconstituted stock.

6.7 Where eligible stock is reconstituted during the period between the record date for an interest payment and the date of payment, the stock will be reconstituted on an ex-dividend basis and accordingly the strips exchanged for the reconstituted stock will not include strips corresponding to that interest payment.

6.8 Stock may not be reconstituted after its shutting date.

7. Taxation

Exemptions from taxation for foreign residents

7.1 Strips will be exempt from all United Kingdom taxation, present or future, so long as it is shown that they are in the beneficial ownership of persons who are not ordinarily resident in the United Kingdom. For the purposes of this paragraph persons are not ordinarily resident in the United Kingdom if they are regarded as not ordinarily resident for the purposes of United Kingdom income tax.

7.2 The exemption set out in paragraph 7.1 is subject to the following:

- (a) The exemption will not apply so as to exclude strips or amounts payable in respect of strips from any computation for taxation purposes of any income, profits or gains derived from any trade or business carried on in the United Kingdom.
- (b) The exemption is subject to the provisions of any law, present or future, of the United Kingdom directed to preventing the avoidance of taxation by persons resident or ordinarily resident in the United Kingdom. In particular, no amount in respect of a strip will be exempt from income tax where, under any such provision, it falls to be treated for the purpose of the Income Tax Acts as income of any person resident or ordinarily resident in the United Kingdom.
- (c) The exemption will not entitle a person to claim any repayment of tax unless the claim is made within the time limit provided for under applicable legislation. In general, such a claim will be made within the time limit if it is made within five years from the 31 January following the year of assessment to which it relates.

⁴⁶ It will not be possible to reconstitute into an "A" tranche, even though it will, in due course, be possible to strip an "A" tranche.

7.3 Attention is drawn to the fact that eligible stocks issued before 29 April 1996 and further amounts of stocks originally issued before that date confer the right to exemptions which are not in all respects identical to those set out in paragraphs 7.1 and 7.2 above. The terms of the exemptions applicable to these stocks are set out in the Information Memorandum for Issues of British Government Stock.⁴⁷ Any holder who is in any doubt as to his tax position is recommended to seek professional advice.

General

7.4 The general taxation position for strips, under current legislation, is broadly as follows:

- (a) Any strip of a stock which is itself specified as a gilt-edged security for the purposes of Schedule 9 to the Taxation of Chargeable Gains Act 1992 will also be a gilt-edged security for those purposes. Accordingly, a disposal of such a strip will not give rise to a chargeable gain or allowable loss for the purposes of capital gains tax.
 - (b) Strips are "relevant discounted securities" for income tax purposes. Thus any profit realised on the transfer or redemption of a strip (including any profit deemed to be realised where the strip is held at the end of 5 April in any year of assessment) will be chargeable to income tax in accordance with the provisions of Schedule 13 to the Finance Act 1996.
 - (c) For a holder within the charge to corporation tax, a holding of a strip will be a "loan relationship" to which the provisions of Chapter II of Part IV of the Finance Act 1996 will apply.
 - (d) Transfers are free of stamp duty.
- (b) extend, limit or redefine who may hold strips and who may strip and reconstitute stock, either generally or in relation to particular cases or categories;
 - (c) modify the terms relating to fungibility in paragraphs 5.4 and 5.5 (including a modification to provide that strips of specified descriptions will no longer be distinguished one from another);
 - (d) modify the arrangements for reconstitution in paragraph 6.

8.3 Any notice given under this paragraph will be published by HM Treasury in such manner as HM Treasury considers appropriate.

8. Amendments to this memorandum

8.1 The right is reserved to amend or supplement this memorandum by further notices given from time to time.

8.2 Any such amendments or supplements may affect stock and strips already in issue and may in particular -

- (a) extend the scope of the securities which may be stripped and reconstituted;

⁴⁷ See footnote 34.