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The Sep Gilt Auction Announcement

- **At 15:30 on Tuesday 19th September the BoE will announce the exact maturity date of the 2005 – 2007 stock to be auctioned on 27th September.**
- **If the BoE issues a new 07Dec or 07Jun stock, the market will assume that it is these stocks that will be made STRIPpable.**
- **If the BoE issues a new stock with a non-07Dec/Jun maturity, then the market will assume that the new issue will be made STRIPpable (as will subsequent issues with the same coupon date).**
- **If the BoE issues a tranche of an existing stock ($8\frac{1}{2}$%05 or $7\frac{3}{4}$%06) then the choice of STRIPpable date will still be unclear: we must await subsequent developments.**
- **The commencement of the STRIP market might be delayed until the planned new settlement software is in place: a likely start date is therefore January 1997.**

At 15:30 on 19th September the Bank of England will announce the exact maturity of the gilt to be auctioned 8 days later. The BoE announced on 30 Jun that this auction "will be of a stock in the maturity range 2005 to 2007 inclusive".

Naturally the BoE will wish to set about building liquidity in the STRIP market, and will not wish to create new issues that are not STRIPpable. However, the decision as to whether or not to give the 07Dec stocks the tax privileges associated with STRIPpability (see box overleaf) will have to be taken before liquidity can be built. This decision is of material consequence to the Treasury:

- If a decision has been taken, such that STRIPping of the 07Dec (and future 07Jun) stocks will be permitted, then the Bank is free to create a new $7\frac{1}{2}$% or $8\frac{1}{4}$% 07Dec2006. In this case it is quite likely that the bank would also explicitly announce the pro-07Dec decision, in addition to signalling it by the creation of the 07Dec2006 issue.

- If a decision has been taken, and the 07Dec/Jun stocks are not to be made STRIPpable, then we are confident that no existing stocks will be made STRIPpable. (See *One Series of Gilt STRIPS; Not $7\frac{3}{4}$% '06,* dated 18 August.) In this case the new stock auctioned in September will be made STRIPpable: an 11Dec maturity is possible and fits conveniently with the weekday cycle.

  The likelihood of a new series of STRIPpable stocks has been increased by the Bank's publication of *A Proposal To Upgrade The Central Gilts Office Gilts Settlement System.* This suggests "if upgrading of CGO software is deferred, [to await the new version] it might be necessary to delay the start of a gilt STRIPS facility until the upgrade is in place". The BoE has already announced that STRIPping will not commence before Q3 '96 at the earliest, and that a possible upgrade timetable has the new CGO software running from Q4 '96. If STRIPS are to await the new settlement software then a likely start date is Jan '97. **If STRIPS are so delayed, then the BoE will have more time to build liquidity in the STRIPpable stocks, and so will be less dependent on using existing stocks. This increases the chance that the BoE will opt for a new series of STRIPpable paper.**

  Assuming that a decision had been taken to make only new stocks STRIPpable, the Bank would wish to maximise its price at auction. This would be best achieved by simultaneously announcing the new stock's future STRIPpability at the same time as the auction is announced.

- If no decision has been taken, the BoE will not wish to create a new stock that might not subsequently become STRIPpable. Hence the BoE's logical choice would be to reopen an existing stock.

  If the Bank reopens an existing stock, which would this be? The $8\frac{1}{2}$% 07Dec2005 will still have $10\frac{1}{4}$ years to maturity, is the cheapest to deliver into the Sep95 and Dec95 futures contracts, and is the 10-year benchmark. In our opinion this would be the natural choice of existing stock. (Note that stock bought at auction on the 27th is delivered into CGO accounts on the 28th, and can then be delivered into the futures contract on 29th Sept.)

  However, there is "talk" in the market that the BoE will instead reopen the $7\frac{3}{4}$% 08Sep2006. We believe this very unlikely: to do so might signal that this currently illiquid paper is to become STRIPpable, an outcome we believe to be highly improbable. (Again see *One Series of Gilt STRIPS; Not $7\frac{3}{4}$% '06.*)

It should be noted that when the BoE announced "2005 to 2007" no decision had then been taken. We know this because the Bank was still consulting the market about the form the STRIP market would take.

The disadvantage of allowing STRIPping of the 07Dec stocks (or any other existing paper).

There are three obvious stocks to make STRIPpable: those maturing on 07 Dec. These are the 8% 07Dec2000, 8½% 07Dec2005 & 8% 07Dec2015, which have issue sizes of £4·8bn, £8·9bn & £6·5bn. Choosing these would mean that there is already £20·2bn of STRIPpable paper. Not making these STRPpable would either delay the start of the STRIP 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 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.

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

So what is the market impact of these possibilities?

- An 07Dec06 stock (especially if accompanied by official conformation of the STRIPpability of the 07Dec stocks) would be supportive of all the 07Dec stocks: 8%00, 8½%05, 8%15 and the WI.
- A new issue not maturing on 07Dec or 07Jun (especially if accompanied by an announcement of its STRIPpability and the non-STRIPpability of the 07Dec's) would trade dear. The non-STRIPpability of the 07Dec's would cause these to soften significantly.
- A new tranche of the 8½%05 would be broadly neutral for the market, although the additional supply might temporarily weigh down on the 8½%05.
- A new tranche of the 7¾%06 (albeit unlikely) might come with an announcement of which stocks were to become STRIPpable. This announcement would be self explanatory. A new tranche of the 7¾%06 without such an announcement would confuse the market: it would not be clear whether or not this was "stopgap" issuance, not to be repeated after a decision has been taken.
- In theory the BoE could produce a new tranche of the 8½%Jul07, or even of the 9½%Apr05. However, this is only in theory: the 8½%07 has almost 12 years to maturity, and it would seem unlikely that the BoE would issue the non-deliverable 9½%05.