

STRIPPABLE stocks allows domestic[†] investors to pay the tax on the coupons an average of 13 months[‡] later. Assuming a marginal tax rate of $\approx 10\%$, this is worth about 5 to 6 bps. To see this, let us assume an 8% coupon, and a yield of 8%. The annual tax bill is $\text{£}8 \times 10\%$, and so 13 months cost of carry is $\text{£}8 \times 10\% \times 8\% \times 13/12 \approx 7$ pence per annum ≈ 7 bps of yield. However, assuming that the STRIP market starts after the 07Dec96 coupon is paid, but before the 07Jun97 coupon, the next three coupons will not have this advantage: reducing the value by $\approx (1+0.96+0.92) \times (\text{£}8 \div 2) \times 10\% \times 8\% \times 13/12 \approx 3/32$ nds. Thus, assuming a 10% marginal tax rate, the 8¹/₂%05 and the 7¹/₂%06 ≈ 5 ¹/₂bps, and the 8%15 ≈ 6 bps.

In order that the Treasury can capture the full benefit of the tax privilege in reduced financing cost, the BoE will only

want to make new issues STRIPPABLE (rather than give the benefit *gratis* to existing holders). This is why this information came with the announcement of the auction of the 7¹/₂%06. Thus, contrary to recent rumour, the 10% Sep 03 and 7³/₄% Sep 06 will not be made STRIPPABLE. Indeed, if the Bank were subsequently to desire a Mar/Sep STRIPPABLE series in addition to the current Jun/Dec series, then we expect that the BoE would create new 07Mar or 07Sep stocks, rather than permitting STRIPPING of the relatively illiquid 7³/₄% 08Sep06. However, in France there are two STRIPPABLE annual coupons (for these purposes equivalent to one semi-annual series), with a total issue size of $\approx \text{£}102$ bn. It will take the BoE a number of years to increase the issue size of the Jun/Dec series to this level — if there is to be a second STRIP series then this will probably not happen this century, and may not happen at all.

[†] Non-UK investors are reminded that, from 02 Jan 96, all coupons are paid gross and hence non-UK investors will not be subject to UK taxation.

[‡] For domestic institutional investors, 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.

Conclusion. The 7³/₄%06 has been trading expensive on the assumption of its STRIPPABILITY; this assumption being disappointed it has started and will continue to underperform. Switch holdings of this into the 8¹/₂%05 and 7¹/₂%06, and switch 8³/₄% Aug 2017 into the 8% Dec 2015.

Related J.P.Morgan research:

<i>One Series of Gilt STRIPS; Not 7³/₄% '06</i>	18 Aug 95
<i>The September Auction Announcement</i>	31 Aug 95

European Fixed Income Research: Sterling

New 7¹/₂% '06; 07Dec's to be STRIPPABLE

- **The BoE has announced that the 07Dec stocks (8%2000, 8¹/₂%2005, 8%2015 and the new 7¹/₂%2006) will become eligible for STRIPPING.**
- **“If other stocks are to be eligible for STRIPPING, this will be announced in due course” — BoE. In practice this will be announced only for new stocks: hence, contrary to recent rumour, the 7³/₄% Sep 06 will not be made STRIPPABLE.**
- **The tax privilege associated with STRIPPABILITY is worth about ≈5 bps — expect the 07Dec stocks to trade at least this expensive to the curve.**
- **The tax privilege and the STRIPPABILITY will cause the 7³/₄% Sep 06 and 8¹/₂% Jul 07 to cheapen relative to the 8¹/₂% Dec 05 and new 7¹/₂% Dec 06 — expect a change in the Sep and Dec cheapest-to-deliver.**

The Bank of England has announced which stocks will be made STRIPPABLE when the STRIP market commences: these are the 8% 07 Dec2000, 8¹/₂% 07Dec2005, the £3bn September auction stock 7¹/₂% 07Dec2006, and the 8% 07Dec2015. This announcement resolves the last major market-sensitive uncertainty concerning the gilt STRIP market.

The announcement of STRIPPABILITY has several implications:

- Domestic holdings of the 07Dec stocks will be taxed annually rather than quarterly; this alone should cause the the 07 Dec paper to trade about ≈6bps expensive (assuming a marginal rate of tax of 10%).
- The market was expecting the 7³/₄% Sep 06 to become STRIPPABLE, and we believe that a number of speculative positions to this effect were established. As these are unwound the 7³/₄%06 will underperform and the 8¹/₂%05 will outperform neighbouring stocks. Thus the Sep95 CTD could be the 7³/₄%06, or possibly the 8¹/₂% Jul 07.
- Future auctions will also be of 07Dec stocks. In particular, the 7% Nov 01 will **not** become next year's 5-year benchmark, instead we expect a new 07 Jun or Dec 2001, probably with a coupon of either 7¹/₄% or 7¹/₂%. Expect relative underperformance of the 7% Nov 01.

The Bank of England's announcement:

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1430          GILT-EDGED MARKET          GEDR
              OFFICIAL BANK OF ENGLAND INPUT
ISSUE FOR BID PRICE AUCTION 27 SEPTEMBER OF STG 3000 MN OF
7 1/2% TREASURY STOCK 2006. FULLY PAID.
7 1/2% TREASURY 2006 WILL, TOGETHER WITH 8% TREASURY 2000,
8 1/2% TREASURY 2005, AND 8% TREASURY 2015, BE
ELIGIBLE FOR STRIPPING WHEN THE GILT STRIPS FACILITY
IS INTRODUCED. IF OTHER STOCKS ARE TO BE ELIGIBLE FOR
STRIPPING, THIS WILL BE ANNOUNCED IN DUE COURSE. THE
INTRODUCTION OF STRIPS WILL FOLLOW THE START OF THE GILT
REPO MARKET IN JANUARY 1996 AND WILL NOT BE BEFORE THE SECOND
HALF OF 1996. AFTER THE START OF THE STRIPS MARKET,

1431          GILT-EDGED MARKET          GEDS
              OFFICIAL BANK OF ENGLAND INPUT
DIVIDENDS ON STRIPPABLE STOCKS WILL BE PAID GROSS TO ALL
HOLDERS, AND BOTH DIVIDENDS AND MANUFACTURED DIVIDENDS
WILL NOT BE SUBJECT TO THE QUARTERLY ACCOUNTING ARRANGEMENTS
TO BE INTRODUCED IN CONNECTION WITH GILT REPO. UK RESIDENTS
WHO ARE NOT EXEMPT FROM TAX WILL REMAIN LIABLE TO INCOME
TAX ON DIVIDENDS.
DIVIDEND DATES 7 JUNE AND 7 DECEMBER. FIRST DIVIDEND STG 1.4384
PER CENT ON 7 DECEMBER 1995. MATURES 7 DECEMBER 2006.
PROVISION FOR COMPETITIVE AND NON-COMPETITIVE APPLICATIONS.
PROVISION FOR NON RESIDENT TAX EXEMPTION.

1431          GILT-EDGED MARKET          GEDT
              OFFICIAL BANK OF ENGLAND INPUT
WHEN ISSUED DEALINGS MAY BEGIN FROM NOW. SEDOL CODE 0-999-830.
EPIC CODE AUC SHOULD BE USED FOR TRADE REPORTING PURPOSES.
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- In the future, the BoE is likely to start a programme of conversions, exchanging old non-STRIPPABLE stock for new 07Dec STRIPPABLE paper. It is not clear by what mechanism this will be done, but we do not expect any realistic candidate for CTD status to be converted. In practice, this means that the 7³/₄%06 will not be converted until Q4 96 at the earliest (when it drops out of the futures basket).
- Liquidity will concentrate to a very great extent on the STRIPPABLE stocks. This process will not be instantaneous, and will occur primarily after STRIPPING becomes possible. This concentration of liquidity will exacerbate the STRIPPABLES' premium to the curve.
- Much further in the future, if the conversion programme is sufficiently extensive and the concentration of liquidity as extreme as we believe likely, then it is not impossible that the specification of the futures contract will be changed so that only STRIPPABLE paper is deliverable.

How does one assess the worth of annual rather than quarterly accounting? The tax privilege associated with