DIPARTIMENTO DEL
TESORO

The new stripping model for Government bond

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MINISTERO DELL'ECONOMIA E DELLE FINANZE

The regulatory framework

- The activity of government bond *coupon stripping* has been so far regulated by the Decree of the Minister of Economy and Finance («DM») 28/12/2007, which provides the opportunity to separate the coupons from the principal for all bonds whether fixed rate nominal or inflation-linked.

- The issuance decrees authorize the stripping of all nominal BTPs with expiry date no less than 5 years and for all BTP€i

- Starting from the 17th of December 2012 this activity will be regulated by the new DM 07/12/2012 n° 96718, which introduces a substantial operative innovation: the *fungibility* between stripped coupon components originating from different bonds is extended to stripped principals coming from the same or other bonds, provided that they have the same maturity.

- The new decree doesn't change the *fungibility* characteristics of a strip originating from an inflation linked bond. For these strips the *fungibility* of the separate components from different bonds remain limited to the coupons.

- The new decree contains elements that aim to:
  - facilitate the application of tax treatment of strips components for investors under the withholding tax regime
  - redefine the minimum denomination of strips
  - clarify the consequences for the strip market arising from the introduction of CACS starting from 1/1/2013

The new fungibility between the coupon and the principal

- Following an approach already adopted by other countries in the Eurozone, that have a developed and liquid Government bond strip market, the principals and the last coupons of each nominal fixed rate bond will be merged in a new separate component **from December 17, 2012**. It will be fully fungible with separate coupons and similar components with the same maturity, originating from other fixed rate nominal bonds (article 4.3)

- This will significantly expand the possibility for intermediaries to separate and reconstitute bonds, with a sharp increase in trading opportunities and, by consequence, in the liquidity of each new separate component

- As these instruments will become more liquid, intermediaries will have higher incentives to undertake stripping activities responding to the demands of market participants, resulting in a larger offering of strips, that actually are zero coupon government bonds (confirmed in article 4.1).

- This process should therefore make the market of the underlying bonds more attractive, thereby supporting the demand for bonds with longer maturities

Clarifying the fiscal treatment of the strip (I)

- The new DM introduces provisions that make the fiscal treatment for income generated by the ownership and trading of stripped securities easier and more efficient (article 4, 1-3)

- Firstly, the new DM explains the nature of autonomous "zero coupon" government bonds for all strips, including those arising from the merge of last coupons with principals (article 4.1)

- When such securities are created by stripping, and subsequently negotiated, for tax treatment purposes the issue price is always equal to the purchase price sustained by the holder, and the issue date always coincides with the purchase date of the security. In addition, when purchases are made by the same person on the same security or securities with the same maturity, it is assumed that the purchase date is the weighted mean date of purchase, and that the price is the weighted average price of purchase (article 4.2)

- As a result, the fulfillment of provisions of Legislative Decree N. 239, 1996 and of those that regulate taxation of income coming from other sources (capital gains/losses) is homogeneously applied both for the tax regime on income gained by residents and for the tax regime existing for non-residents

Clarifying the fiscal treatment of the strip (II)

- The fact that these securities only circulate within the central depository system of government bonds, guarantees the correct fulfillment of Legislative Decree N. 239, 1996 and Legislative Decree N. 461, 1997 by intermediaries participating directly or indirectly to this system.

- More in particular, the tax (or any exemption) on interest, through special mechanisms provided by Legislative Decree N. 239, 1996, is applied by participating intermediaries to the interest income, which is calculated as the difference between the redemption price and the purchase price of each strip, using compound interest rule

- Since these securities are autonomous government bonds circulating within central depository system of government bonds, they are listed on regulated markets as the bonds from which they originate. So in case of formation of financial income coming from other sources they are excluded from taxation, if obtained by non-residents, pursuant to article 23.1f (n. 2) of the Tax Code for failure to comply with the territorial pre-requisite.

CACs and minimum denomination

- In July last year, when the Treaty which set out the European Stability Mechanism (ESM) came into force, the inclusion - starting from the 1st of January 2013 onward - of Collective Actions Clauses ("CACS") for all new bonds issued by Eurozone states with a maturity at issuance longer than a year was called for.

- The new DM disciplines this aspect of the strip market by clarifying that strips originating from bonds without such clauses cannot be fungible with those originating from bonds which do have these clauses. This discipline is clearly motivated by the impossibility for bonds with different contractual arrangements to be fungible (art. 4. 5).

- Given that the distinction between coupons and principal has been overcome if they share the same maturity date, the concept of differentiated minimum denominations for coupons and principals has been removed. The minimum denomination of all strips has been fixed at 1 euro cent, thanks to the new fungibility model (art. 4.7)

Technical Appendix

The new fungibility: technical operational aspects of the migration (I)

- From a technical point of view, the new fungibility is made possible by adjustments to systems specifically prepared by Monte Titoli SpA (the central securities depository system) who has collaborated with the MEF throughout all phases of design and execution of the initiative and has shared every functional and operational decision with the financial industry and the Bank of Italy

- From an operational point of view, the launch of the new system will happen through a migration procedure where a new ISIN code, which is admitted to the stripping process, is assigned to each fixed rate nominal government bond (principal + coupon). This ISIN code merges the last coupon with the principal (the result of which is technically defined by the settlment system as "hybrid coupon"), and becomes fungible with the coupons of other bonds with the same maturity (regardless of whether they are simple coupons or "hybrid" coupons)

- As part of the migration procedure, the two positions held by beneficiaries: one on the principal and the other on the last coupon, for each existing stripping case associated with each nominal fixed rate government bond, are unified into one position on this new separate component (the so-called "hybrid" coupon). This stage of the migration process takes place on 17 December 2012.

The new fungibility: technical operational aspects of the migration (II)

- HC will denote the new final coupon that has been merged with the principal (the 'hybrid' coupon)
- LC will denote the last coupon
- PR will denote the principal,

The table below lists the main steps for migration

Activity	Deadline
Census HC	before 03/12/12
Stripping plan for nominal fixed rate government bond / HC Inform the system	before 03/12/12
Close of market trading system Close of OTC trading Last settlement for LC and PR and open system for HC	11/12/2012 14/12/2012 14/12/2012
Empty the account on LC and PR	17/12/2012
Import account into HC	17/12/2012

Technical-operational aspects of the new implemented fungibility (I)

- The new model calls for:
  1. Removal of the principal
  2. Combined management in the 'hybrid' coupon of the principal (representative of capital) and of the last coupon

- The main consequence of adopting the new system is the different "accounting" behavior necessary for the processes of stripping and unstripping.

- In fact, while it should be noted that the activities of stripping and unstripping will be carried out according to normal operating procedures and techniques, new operational mechanisms of separation and reconstitution of the nominal fixed rate government bond will manage the final merged coupon ('hybrid' coupon, HC) in addition to the intermediate coupons.

- For each accounting day and for each ISIN covered by the stripping scheme, Monte Titoli will send the MSG 706 "extraction of daily operations."

Technical-operational aspects of the new implemented fungibility (II)

The STRIPPING

- As before, Monte Titoli will continue to require the stripping operation solely performed by authorized intermediaries via the appropriate electronic message (7A7) which will trigger:
  1. Charge of the nominal value of the fixed rate government bond
  2. Deposit of the nominal value of the intermediate coupons of the stripping plan
  3. Deposit of the nominal value of the 'hybrid' coupon which will also contain the principal value

- Following the MSG. 7A7, Monte Titoli will send to the intermediaries as many 71N messages as there are codes involved in the operation, in accordance with the stripping plan associated with the fixed rate government bond.

The UNSTRIPPING

- As before, Monte Titoli will continue to require the unstripping operation solely performed by authorized intermediaries via the appropriate electronic message (7A8) which will trigger:
  1. Charge of the nominal value of the fixed rate government bond
  2. Deposit of the nominal value of the intermediate coupons of the stripping plan
  3. Deposit of the nominal value of the 'hybrid' coupon which will also contain the principal value

- Following the MSG. 7A8, Monte Titoli will send to the intermediaries as many 71N messages as there are codes involved in the operation, in accordance with the stripping plan associated with the fixed rate government

Technical-operational aspects of the new implemented fungibility (III)

MODIFICATION TO THE PAYMENT ARRANGMENT

- Payment notification is carried out using the usual RNI 7B/2/3 messages (or the equivalent in SWIFT/ MT-X).

- Payment notifications are divided into the following categories:
  a) Provisional messages
  b) Definitive payment messages

  The interested parties of the notification are the beneficiaries (the payment recipients).

  Changes to the standard were made for users of the RNI 7B2 message (and the MT-X and RNI equivalents)

- The variation regarding the use of the IDC 71J –PROCEDURAL INFORMATION.

- A new information has been introduced, identifying the coupon as: “4 – ‘hybrid’ coupon” which distinguishes the monetary payment of the ‘hybrid’ code