Qoncept EXPLAINER

How Splitting Bonds can earn Extra Yield for Investors

Investment in Government bonds are considered as safe investment for investors combined with low risk for both retailers and institutions.

With recent changing environmental innovations occurring from time to time and new products have also evolved within fixed income space, one of such phenomena is G-Sec strip.

What is a strip?

STRIPS is the acronym for Separate Trading of Registered Interest and Principal Securities.

Introduction

STRIP was introduced by RBI as a pilot project in 1994 but the full-fledge STRIP mechanism where coupon and principal components of government securities can be stripped and reconstituted was operationalized in 2010. The reason for introduction of STRIP was to deepen the G-sec market and eliminate reinvestment risk with the view to attract long term investors like insurance, pension and provident fund with pure discount instruments and to increase secondary market liquidity.

Mechanism

Traditional plain vanilla bond consists of 2-part coupon payment and principal at the maturity; In Strip the bond coupon is separated into two parts interest paying coupon and zero-coupon bond. In Other words it is referred a separate trading of interest and principal securities.

Understand the concept with help of example:

Example:
When current benchmark 10-year G-sec consists of coupon 6.33 (paid semi-annually: Rs 3.165) Rs 100 maturing on 5th May 2035, which was issued on May 25th, 2025 is stripped, each coupon cash flow (Rs 3.165 each half year) will become a coupon STRIP. At the same time, the principal payment (of Rs 100 at maturity) will become the principal STRIP.

These cash flows are then traded separately as independent securities in the secondary market i.e. coupon can trade individually and so is principal.

It is vital to understand that the strips do not alter the cost of borrowing or the timing of the underlying cash flows. It only enables the transfer of the rights to ownership of individual cash flows.

How retail investors can invest in STRIPs

Being zero coupon bonds, STRIPS have zero reinvestment risk, and they are attractive to retail investors as well. Market participants with an Subsidiary General Ledger account with RBI can place requests directly in e-kuber for stripping of eligible securities, states the RBI portal.

Requests for striping by Gilt Account Holders (GAH) will then be placed with the respective custodians maintaining the Constituent Subsidiary General Ledger account, who in turn will place the requests on behalf of its constituents in e-kuber.

STRIPS can also be an alternative to the fixed deposits of banks to earn more when the coupon rate is higher than the fixed deposit rate. It helps to earn higher coupon rate and safer investment and can help to earn 100-150 basis points higher than traditional bank deposits.

What are the advantages?

Strips help to meet the requirements of the investor like pensions funds and insurance companies; STRIP provide the most basic cash flow structure thus offering the advantage of more accurate matching of liabilities without reinvestment risk and a precise management of cash flows.

Thus, to some investors who have set the incoming inflows against an actuarial book (eg. Insurance companies), STRIPS offer good investment choices.

Due to the divergent interests of different segments of investors in the market, demand for each component of the STRIPS could be so good that the sum of the values of the constituent parts exceeded the value of the whole bond, this adds apparel for the traders in strips market.

In the end it also helps to create zero yield curve for the sovereign bond market.

Conclusion:

STRIPS add an additional avenue to the investor profile with safety and low risk while for some investors like insurance and pension investment strategies would be guided by their primary objective of matching their assets to an actuarial book.

STRIPS will be traded in the same way as the coupon bearing bonds except for the fact that, being zero coupon securities, will normally be quoted on yield basis.