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To the Addressee:

Enclosed is a copy of a statement issued on January 15, 1985 by the Treasury Department announcing a new program to facilitate Separate Trading of Registered Interest and Principal of Securities (STRIPS) and enclosing explanatory material.

Questions on the STRIPS program should be directed to H. John Costalos, Manager, Securities Transfer Department (Tel. No. 212-791-5986). Additional copies of the enclosure are available upon request directed to the Circulars Division.

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TREASURY NEWS

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Treasury Announces New STRIPS Program

Secretary of the Treasury Donald T. Regan announced today a new program to facilitate Separate Trading of Registered Interest and Principal of Securities (STRIPS). Treasury's plan to set up this facility was announced on August 16.

Secretary Regan stated that the STRIPS program exemplifies the basic public debt management and free market philosophy of this Administration. It reduces the cost to the government of financing the public debt by facilitating competitive private market initiatives with a minimum of direct government involvement.

The STRIPS Program. Under the new STRIPS program, selected Treasury securities may be maintained in the book-entry system operated by the Federal Reserve Banks in a manner that permits separate trading and ownership of the interest and principal payments. This will make it possible for the first time for the market to trade separate principal and interest components, or zero-coupon instruments, in book-entry form, as direct obligations of the U.S.

Currently, each Treasury marketable security has a unique CUSIP number that identifies the security for maintenance and transfer purposes. Under the STRIPS program, to facilitate identification of the component parts, each principal and interest component will be assigned a separate CUSIP number. For example, a Treasury 10-year note eligible in STRIPS form could be held either as the fully constituted note under its own CUSIP number or as 21 separate payments, with 21 separate CUSIP numbers identifying each of 20 semiannual interest components and the principal component.

Timing. The first securities to be made eligible for STRIPS will be the 10-year note and 30-year bond to be issued as part of the quarterly refunding on February 15. Details of these two securities will be announced on January 30. Shortly thereafter the Treasury plans to make STRIPS available for the 10- and 30-year securities issued November 15, 1984. The 20-year bond of November 15, 2004 will become eligible for STRIPS soon after the first interest payment date on May 15, 1985. As experience with the program develops and system enhancements are completed to accommodate a larger volume of requests, other long-term Treasury securities will be available for STRIPS.

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Call Feature. The 30-year bond to be issued in the February 1985 refunding will not have a call feature. Previous 30-year bond issues have been callable by the Treasury after 25 years; therefore, separat trading of the callable interest components has not been possible. The call feature is being eliminated to accommodate market demand for the separate trading of longer-term interest components.

Benefits of STRIPS Program. The STRIPS program will provide a more efficient instrument for the market that has developed since 1982 in zero-coupon obligations based on Treasury securities. Since mid-1982, approximately $45 billion of Treasury securities (principal value) have been "stripped" to create zero coupons, either by the issuance of separate instruments based on Treasuries or by the physical separation of coupons from bearer Treasuries.

Zero-coupon securities, because they provide for a single payment at a specific date in the future, have become very popular for those who wish to avoid reinvestment risk or seek greater certainty in matching the maturities of their assets and liabilities. They have been particularly attractive investments for Individual Retirement Accounts and pension funds.

The Treasury has realized significant savings in financing costs from the zero-coupon initiatives of the private market since 1982, which have broadened the market for Treasury securities. Secretary Regan stated that STRIPS will greatly reduce market transaction and financing costs, stimulate competition, and facilitate further expansion of the zero-coupon market. The savings made possible by STRIPS will be reflected in the competitive bidding for Treasury securities.

Issuance of Strippable Securities. Treasury will not itself be issuing zero-coupon securities under this new program. The Treasury will continue to auction its securities in the same manner; however, for selected issues, it will be possible for a depository financial institution that maintains a book-entry account at a Federal Reserve Bank to request that the securities be separated into their component parts (principal and interest). Each component will be tradable separately and thus may be separately owned.

Financial institutions will have the option to obtain the securities as STRIPS, either on the date of original issue or thereafter. However, all bids must be for the entire security, not separate components. Thus the market, not the Treasury, will decide how much of the securities will be held as STRIPS, based on market demand.

Minimum Amounts. In order for a book-entry security to be separated into its component parts, the par amount of the security must be an amount which, based on the stated interest rate of the security, will produce a semiannual interest payment of $1,000 or a multiple of $1,000.

Once a book-entry security has been separated, each interest and principal component may be maintained and transferred in multiples of $1,000, regardless of the par amount initially required for separation or the resulting amount of each interest payment.

Collateral. The Treasury also plans to make STRIPS eligible as collateral for Treasury Tax and Loan accounts and other public monies later in 1985, after the system becomes fully automated and the current valuation of STRIPS can be readily determined in a cost-effective manner.

Questions and Answers on STRIPS

Nature and Purpose of STRIPS

Q. What is the STRIPS program?

A. The STRIPS (Separate Trading of Registered Interest and Principal of Securities) program is a new facility that will enable depository financial institutions that maintain book-entry security accounts at the Federal Reserve Banks to request that eligible securities be separated into their component parts (principal and interest). When the components are held separately, each component will be identified by its own unique CUSIP number, different from the CUSIP number assigned to the fully constituted security. Each component will then be tradable separately under its own CUSIP number and marketable as a zero-coupon instrument in the secondary market. (In the case of a callable bond, one CUSIP number would be assigned to the components constituting the principal and all interest payments contingent on the bond not being called.)

Q. What does CUSIP mean?

A. A CUSIP number is a standard numbering method for identifying securities. It was developed by the American Bankers Association's Committee on Uniform Securities Identification Procedures (CUSIP). The assignment of CUSIP numbers is made by the CUSIP Service Bureau, operated by Standard and Poor's.

Q. Will there be different CUSIP numbers for components due on the same date but stripped from different security issues?

A. Yes.

Q. Why is the Treasury establishing this new program?

A. The popularity of stripped Treasury securities in recent years has been a major development in the government securities market. Since mid-1982, approximately $45 billion (principal value) of Treasury securities has been stripped either by the issuance of receipts based on them or by the physical separation of coupons from bearer securities. This creation of zero-coupon securities has benefitted the Treasury by broadening the appeal of Treasury securities. To further build on this progress Treasury decided to provide STRIPS as a more efficient method for trading for the zero-coupon market and thus lower the cost of financing the public debt.

Q. In the past, Treasury disapproved of stripping Treasury securities. Now it is offering the market an improved way to strip securities. Why the change?

A. Prior to June 1982, the Treasury Department disapproved of coupon stripping because taxpayers could maintain that various transactions involving stripped securities resulted in a lower tax liability. On June 9, 1982, the Treasury Department announced that it would seek to amend the Internal Revenue Code to deal with coupon stripping. These coupon stripping provisions were incorporated in the Tax Equity and Fiscal Responsibility Act of 1982. Treasury then withdrew its objection to coupon stripping and, in fact, viewed the creativity of the investment community in producing zero-coupon instruments based on Treasury securities as beneficial to Treasury debt management. As a natural further step to take advantage of the large new market for zero-coupon securities, the Treasury is now providing a more efficient mechanism for the secondary market to strip Treasury securities.

Q. What are the attractions of zero-coupon securities?

A. The absence of periodic cash payments on zero-coupon securities is an advantage to those who wish to avoid reinvestment risk and the necessity of finding an appropriate reinvestment vehicle for each interest payment. (This is, of course, a disadvantage to those needing cash flow in order to meet current expenses, including taxes on accrued interest.) Zeros are also much more price volatile than par value bonds of equal maturity, which appeals to speculators.

Because zeros are taxed currently and have a long duration, the main market for them domestically is composed of long-term investors with non-taxable or tax deferred accounts. Individuals have used low denomination zero coupons as investments for their Individual Retirement Accounts and Keogh Plans and as gifts to their children. Pension funds have used zero coupons as part of their immunization strategy with respect to their long-term liabilities. Zeros are also useful for corporate debt defeasance.

Individuals who have found the $10,000 minimum on Treasury's short-term bills too high will now be able to purchase through the secondary market interest components due in the near-term in $1,000 denominations.

Q. Why is the Treasury not selling zero-coupon securities directly?

A. The investment community will be better able to offer zero-coupon instruments that meet particular needs in a timely manner. The market for zero-coupon securities is a rapidly changing one. The demand varies substantially for particular maturities and with changes in interest rates and in the needs of various investor classes. There is not always a cost advantage to issuing zero coupons. This changing demand for zeros will be best accommodated by the STRIPS approach of making a broad range of maturities eligible for stripping but leaving it to the market to decide when and how much of an issue it will separate and market as zero-coupon instruments.

Eligible Institutions

Q. Who will be able to request the separation of a security into STRIPS form?

A. Depository institutions with book-entry securities accounts at Federal Reserve Banks will be able to request that their own securities and those of their customers that hold book-entry securities through these institutions be converted into STRIPS form.

Q. Will an individual be able to buy a single interest or principal component directly from the Treasury?

A. No. The STRIPS program is designed to facilitate the stripping of Treasury securities by private market participants. Individuals and other investors will be able to hold stripped interest or principal components through a private broker or financial institution that is directly or indirectly linked to the book-entry accounts maintained at Federal Reserve Banks.

Q. Will foreigners be allowed to hold STRIPS?

A. Yes. Foreigners, like U.S. investors, will be able to hold STRIPS through financial institutions. Foreign financial institutions will be able to hold STRIPS through a depository institution with a book-entry securities account at a Federal Reserve Bank.

Procedures

Q. What will be the procedures for a depository institution to obtain STRIPS?

A. Along with the auction results of a note or bond eligible for stripping, the Treasury will announce the minimum amount of the security required in order to hold the security in separate component parts. This amount is a function of the interest rate and is chosen so that payments can be further divided for trading purposes into even $1,000 (final payment value) amounts. (See attached table.) To obtain STRIPS, an institution must have the minimum amount specified for a particular issue, or an integral multiple of that amount.

The table shows that a security with a 12 percent interest rate requires a minimum amount (par value) of $50,000 in order to result in interest components in even $1,000 amounts. That is, a holder of $50,000 par amount of Treasury securities could convert them at a Federal Reserve Bank for STRIPS obtaining separate interest components of $3,000. The holder could then transfer to others on the book-entry system any of the separate $3,000 semiannual interest components, or he could transfer amounts as small as $1,000. As another example, an 11-7/8 percent interest rate requires a minimum exchange of $320,000, which would produce interest payments of $19,000. These could then be sold separately as a $19,000 interest component or as 19 separate

$1,000 interest components. The interest components could also be sold in integral multiples of $1000. The table shows that, for interest rates from 5 percent to 20 percent, the range of minimum exchange amounts runs from $10,000 to $1.6 million.

After the auction, financial institutions that have been awarded securities may request that, as of the issue date, some or all of their allotment be held as STRIPS (the amount must conform with the minimum and multiples that have been announced).

In addition, eligible financial institutions may convert their holdings of eligible Treasury securities to STRIPS subsequent to the issue date (again, in conformance with the required minimums).

The request for conversion must be made to the Federal Reserve Bank holding the securities to be converted into STRIPS and must be in the form specified by that Bank. Depository institutions should consult their Federal Reserve Bank for more specific information. The Federal Reserve Bank at which the request is made will inform the financial institution of the specific date on which the conversion will be accomplished, which will be no later than three business days after the request is received.

Q. Will STRIPS be available in all Federal Reserve Districts?

A. Yes.

Q. Will there be a fee charged for conversion of Treasury securities to STRIPS?

A. No. Treasury does not now charge a fee for conversion of securities, e.g., from definitive to book-entry form, and does not plan to charge a fee for the STRIPS conversion.

Q. Will there be a fee for each transfer of STRIPS through the Federal Reserve facilities?

A. Yes. Book entry transfer of interest or principal components will be subject to the same fee schedule applicable for the transfer of Treasury securities.

Q. Once a security is in STRIPS form, what is the minimum amount of principal or interest that can be transferred?

A. The minimum amount will be $1000 (final payment value). Larger amounts must be in integral multiples of $1000.

Q. Once a security is separated into its component parts, can it be reassembled and held under the CUSIP number for the fully constituted security?

A. Treasury plans to make such a facility available as the market and the STRIPS system develops.

Q. Will STRIPS be available in definitive form?

A. No. Only securities in book-entry form will be convertible into STRIPS form. No provision will be made for converting a STRIPS component once separated on the book-entry system to definitive form. An important purpose of STRIPS is to reduce the volume of definitive securities and the related paperwork costs.

Q. Will government securities dealers be able to finance a security for the time between a request for conversion into STRIPS and completion of the conversion by a Federal Reserve Bank with repurchase agreements?

A. A government securities dealer will be able to finance securities awaiting conversion with a repurchase agreement but must assure that the security is returned to the proper account at the Federal Reserve Bank on the day the conversion is to be done in order for that conversion to take place.

Eligible Securities

Q. For what Treasury securities will the STRIPS program be available?

A. In general, Treasury plans to make the STRIPS program available for new securities with 10 or more years of original maturity. Initially, it will be available for the 10-year and 30-year securities to be issued as part of the quarterly refunding on February 15, 1985. Then, Treasury plans to make STRIPS available for the 10-year note and 30-year bond issued on November 15, 1984. Also, the 20-year bond maturing November 15, 2004 will become eligible for STRIPS effective soon after the first interest payment on May 15, 1985. As experience develops, STRIPS may be made available for other securities that have already been issued.

Q. When will the CUSIP numbers for the February 15 issues be made available?

A. At the time of the announcement of these issues on January 30, 1985.

Q. Why is the STRIPS program not being made available for short-term securities?

A. There is little market interest at this time in stripping securities with maturities under 10 years.

Q. Will reopened securities be eligible for STRIPS?

A. Yes. However, we do not plan to reopen notes and bonds issued before July 1984, because of their different tax treatment due to the provisions in the Tax Reform Act of 1984 regarding market discount and the 30% foreign withholding tax.

Q. How will STRIPS be applied to the callable bond issued November 15, 1984?

A. The principal payment of the bond together with all interest payments due after the first call date will be treated as a single component and will be assigned one CUSIP number. Post-call date interest payments cannot be separated from the principal.

Reporting

Q. Will the amount of securities in STRIPS form be reported?

A. Yes. The Monthly Statement of the Public Debt will report the amount held in STRIPS form by security issue.

Q. Will the new STRIPS program affect the debt limit?

A. No. There will be no change in the amounts or timing of Treasury debt issues and thus no change in the accounting for debt limit purposes.

Q. Will daily yields on STRIPS be made available, as they are on Treasury notes and bonds?

A. The availability of quotes will depend on market activity. We expect that, once a liquid market for STRIPS develops, the Federal Reserve Bank of New York will collect from government security dealers price and yield information on the most active maturities.

Collateral

Q. Will the component parts of Treasury securities in the STRIPS program be eligible collateral for Treasury Tax and Loan accounts?

A. Initially, they will not be. Once a system is in place for the Treasury to value these component parts at their final payment value minus an appropriate discount depending on the length of time until payment is due, then they will become eligible collateral for TT&L accounts. This should be in place later in 1985.

Q. Will the component parts of Treasury securities in the STRIPS program be eligible collateral for advances from Federal Reserve Bank discount windows?

A. This determination will be made by the Federal Reserve.

Q. Will the Federal Reserve conduct open market operations with STRIPS?

A. Initially, they will not. When a liquid market develops for STRIPS, it will be up to the Federal Reserve to decide whether to buy and sell STRIPS as part of their conduct of monetary policy.

Q. Will STRIPS be used in repurchase agreements?

A. Market participants will determine this. The Treasury has no objection. However, it should be noted that zero-coupon securities are sold at substantial discounts and their prices are more volatile than other securities of equal maturity.

<u>Taxation</u>

Q. How are stripped interest and principal components to be taxed?

A. The stripped bond rules of the Internal Revenue Code will be applicable to STRIPS. In brief, a financial institution that has obtained all or a portion of its holdings of a Treasury security in strippable form will be considered to have stripped the amount of principal allocable to the STRIPS components sold at the time of disposition of one or more STRIPS components. For example, if a financial institution has obtained $1.6 million of a 10% Treasury security in strippable form and it sells a $1,000 interest payment, the financial institution would be considered to have stripped a $20,000 Treasury security. In order to compute gain or loss on the sale of a STRIPS component, the financial institution must allocate its basis immediately before the disposition among the components retained by the institution and the components disposed of on the basis of their respective fair market values. Thus, in the example the financial institution would recognize gain or loss on the $1,000 STRIPS component it has sold by allocating an appropriate portion of its basis in the $1.6 million of the Treasury security to the $1,000 interest payment sold. The STRIPS components retained (<u>e.g.</u>, the remaining components of the $20,000 Treasury security in the example above) by the institution with respect to the stripped security will be considered to be discount obligations; a portion of this discount, calculated according to a compound interest formula, must be taken into account each year by the holder. Similarly, a purchaser of a STRIPS component includes in taxable income each year a portion of the difference between his purchase price and the maturing value of the obligation. This portion is determined by a compound interest formula. Capital gains and losses recognized by holders upon a taxable disposition of STRIPS components are calculated with reference to the adjusted basis of the STRIPS components, which is equal to its acquisition price (or in the case of the person stripping the bond, the allocated portion of the basis in the bond) plus the portion of the discount that has been included in taxable income for the holding period. (The holding period for the financial institution stripping the bond begins when it acquires the bond, whether or not in STRIPS form.)

Q. Are short-term STRIPS components (due within one year) taxed for domestic purposes the same way as Treasury bills?

A. Yes.

Q. How are callable STRIPS to be taxed?

A. Tax regulations covering this subject will be issued in the near future. It is anticipated that, according to these regulations, a purchaser of a callable STRIPS will calculate, based on his acquisition price, both the yield to the first call date and the yield to final maturity. Whichever yield is less will be used to determine the portion of the difference between the principal value and the acquisition price that is to be included in taxable income each year. If all the discount has been included in taxable income by the first call date and the bond is not called, then subsequent interest payments are taxed in the year they are paid.

Q. How is interest to be reported on STRIPS to the IRS?

A. For purposes of complying with the broker reporting requirements, Publication 1212 currently supplies brokers and other middlemen with the amount of discount to be reported for particular original issue discount securities and for receipts such as CATS and TIGRs. With CATS and TIGRs discount is calculated for reporting purposes by referencing the original issue price. Since STRIPS can be created at any time, rather than issued all at once as are particular CATS and TIGR series, we plan to promulgate each year for reporting purposes prices and amount of discount to be reported for all possible maturity dates. We will initially do this by calculating prices for a particular date for zero-coupon obligations according to an established Treasury pricing methodology; once a liquid market develops for these instruments we may subsequently be able to use market prices as of a particular date. Under this arrangement, the amount of discount reported for STRIPS will be calculated based on a new computation of the price each year and without reference to the year an individual acquired the obligation. It should be emphasized that the amount of discount being discussed here is for reporting purposes only, and it will generally not be equal to the amount of discount includible in income for a particular taxpayer.

Q. Can STRIPS be held in Individual Retirement Accounts or Keogh Plans?

A. Yes, STRIPS are permissible investments for these tax deferred retirement plans.

Q. Will foreign holdings of STRIPS be eligible for the "portfolio interest" exemption from the 30 percent withholding tax on interest paid to foreign persons?

A. Discount income on STRIPS from bonds issued after July 18, 1984, is eligible for the portfolio interest exemption from the 30 percent tax on interest paid to foreign persons if the requirements for portfolio interest are satisfied with respect to STRIPS held by a foreign person. Thus, for example, the foreign beneficial owner must be identified by name. In addition, other applicable conditions for portfolio interest specified in regulations must be satisfied.

MINIMUM FACE AMOUNTS WHICH ARE MULTIPLES OF $1000 REQUIRED IN ORDER TO PRODUCE INTEREST PAYMENTS THAT ARE MULTIPLES OF $1000.

COUPON (%)	MINIMUM FACE ($)	INTEREST PAYMENT ($)	COUPON (%)	MINIMUM FACE ($)	INTEREST PAYMENT ($)	COUPON (%)	MINIMUM FACE ($)	INTEREST PAYMENT ($)
5.000	40000.00	1000.00	10.125	1600000.00	81000.00	15.250	800000.00	61000.00
5.125	1600000.00	41000.00	10.250	800000.00	41000.00	15.375	1600000.00	123000.00
5.250	800000.00	21000.00	10.375	1600000.00	83000.00	15.500	400000.00	31000.00
5.375	1600000.00	43000.00	10.500	400000.00	21000.00	15.625	64000.00	5000.00
5.500	400000.00	11000.00	10.625	320000.00	17000.00	15.750	800000.00	63000.00
5.625	320000.00	9000.00	10.750	800000.00	43000.00	15.875	1600000.00	127000.00
5.750	800000.00	23000.00	10.875	1600000.00	87000.00	16.000	25000.00	2000.00
5.875	1600000.00	47000.00	11.000	200000.00	11000.00	16.125	1600000.00	129000.00
6.000	100000.00	3000.00	11.125	1600000.00	89000.00	16.250	160000.00	13000.00
6.125	1600000.00	49000.00	11.250	160000.00	9000.00	16.375	1600000.00	131000.00
6.250	32000.00	1000.00	11.375	1600000.00	91000.00	16.500	400000.00	33000.00
6.375	1600000.00	51000.00	11.500	400000.00	23000.00	16.625	1600000.00	133000.00
6.500	400000.00	13000.00	11.625	1600000.00	93000.00	16.750	800000.00	67000.00
6.625	1600000.00	53000.00	11.750	800000.00	47000.00	16.875	320000.00	27000.00
6.750	800000.00	27000.00	11.875	320000.00	19000.00	17.000	200000.00	17000.00
6.875	320000.00	11000.00	12.000	50000.00	3000.00	17.125	1600000.00	137000.00
7.000	200000.00	7000.00	12.125	1600000.00	97000.00	17.250	800000.00	69000.00
7.125	1600000.00	57000.00	12.250	800000.00	49000.00	17.375	1600000.00	139000.00
7.250	800000.00	29000.00	12.375	1600000.00	99000.00	17.500	80000.00	7000.00
7.375	1600000.00	59000.00	12.500	16000.00	1000.00	17.625	1600000.00	141000.00
7.500	80000.00	3000.00	12.625	1600000.00	101000.00	17.750	800000.00	71000.00
7.625	1600000.00	61000.00	12.750	800000.00	51000.00	17.875	1600000.00	143000.00
7.750	800000.00	31000.00	12.875	1600000.00	103000.00	18.000	100000.00	9000.00
7.875	1600000.00	63000.00	13.000	200000.00	13000.00	18.125	320000.00	29000.00
8.000	25000.00	1000.00	13.125	320000.00	21000.00	18.250	800000.00	73000.00
8.125	320000.00	13000.00	13.250	800000.00	53000.00	18.375	1600000.00	147000.00
8.250	800000.00	33000.00	13.375	1600000.00	107000.00	18.500	400000.00	37000.00
8.375	1600000.00	67000.00	13.500	400000.00	27000.00	18.625	1600000.00	149000.00
8.500	400000.00	17000.00	13.625	1600000.00	109000.00	18.750	32000.00	3000.00
8.625	1600000.00	69000.00	13.750	160000.00	11000.00	18.875	1600000.00	151000.00
8.750	160000.00	7000.00	13.875	1600000.00	111000.00	19.000	200000.00	19000.00
8.875	1600000.00	71000.00	14.000	100000.00	7000.00	19.125	1600000.00	153000.00
9.000	200000.00	9000.00	14.125	1600000.00	113000.00	19.250	800000.00	77000.00
9.125	1600000.00	73000.00	14.250	800000.00	57000.00	19.375	320000.00	31000.00
9.250	800000.00	37000.00	14.375	320000.00	23000.00	19.500	400000.00	39000.00
9.375	64000.00	3000.00	14.500	400000.00	29000.00	19.625	1600000.00	157000.00
9.500	400000.00	19000.00	14.625	1600000.00	117000.00	19.750	800000.00	79000.00
9.625	1600000.00	77000.00	14.750	800000.00	59000.00	19.875	1600000.00	159000.00
9.750	800000.00	39000.00	14.875	1600000.00	119000.00	20.000	10000.00	1000.00
9.875	1600000.00	79000.00	15.000	40000.00	3000.00	20.125	1600000.00	161000.00
10.000	20000.00	1000.00	15.125	1600000.00	121000.00	20.250	800000.00	81000.00