DBRS Criteria: Canadian Government STRIP Bonds

DBRS assigns ratings to Canadian federal, provincial and municipal government Separate Trading of Registered Interest and Principal Securities (STRIPS) commensurate with the ratings on the underlying securities.

STRIPS are instruments created by the separation or “stripping” of a standard interest-bearing government bond into its individual coupon and principal components, so that they can be separately held or traded. The right to receive each payment of interest at separate future dates during the life of the bond and the right to receive the payment of the underlying principal at maturity of the bond can be bought and sold as separate financial instruments. In financial terms, the stripping process generates autonomous zero-coupon government bonds, which typically circulate only within a central depository system of government bonds.

The cash flows on the bundle of zero-coupon STRIPS are identical to the cash flows on the original unstripped bond. In a regulated STRIPS market for government securities, the stripped securities remain the direct obligations of the government and are registered in the books of the central depository system allocated for this purpose. Thus, the mechanism of stripping neither affects the amount of government debt outstanding or government borrowing costs nor changes the timing or size of the underlying cash flows. Stripping only facilitates transferring the right of ownership of individual cash flows.

STRIPS are zero-coupon bonds, bearing no intermediate cash flows. They simply repay the coupon or principal at maturity. This safeguards the securities from changes in interest rates, as there is no uncertainty related to the reinvestment rate for any coupons. The yield on a STRIP, held to maturity, is locked in at the purchase date. Bond stripping is attractive to government issuers, as it typically leads to a smoother yield curve for government securities, especially in its longer-end section.

DBRS’s mapping of underlying government bond ratings to related STRIPS is based on the following criteria:

1. The creation of Canadian government STRIPS is tightly controlled by CDS Clearing and Depository Services Inc. (CDS) and must meet strict eligibility requirements as defined in section 4.3.2 of the CDSX Procedures and User Guide. While the process of stripping individual interest and principal components is undertaken by entities other than the original issuer, CDS requirements prevent the incorporation of other risks into STRIP bonds. This ensures that the credit risk of the STRIPS remains the same as that of the original underlying bonds. As a result, the probability of default for the STRIP bonds is equal to that of the underlying government bonds.

2. CDS does not alter the allocation of cash flows and does not create or modify the priority of various cash flows from the issuer. Furthermore, legal documentation pertaining to the underlying securities does not establish any priority of principal repayment over interest payments (or vice versa). In the event of default, both STRIP bond holders and holders of the underlying bond rank equally in terms of priority of payment.

This methodology also applies to STRIPS derived from bonds issued by government-guaranteed entities and Crown agents, which are also covered by the CDS aspects referred to in point (1) above. Corporate STRIP bonds and STRIP bonds related to non-Canadian governments or those not administered by CDS are not covered by this methodology.