



REUTERS/HYUNGWON KANG

U.S. CAUGHT CHINA BUYING MORE TREASURIES THAN DISCLOSED

An obscure rule change in the auction system flushed out secret purchases that had masked the real level of China's Treasury holdings.

BY EMILY FLITTER
NEW YORK

THE RULES of U.S. Treasury auctions may not sound like the stuff of high-stakes diplomacy. But a little-noticed 2009 change in how Washington sells its debt sheds new light on America's delicate balancing act with its biggest creditor, China.

When the U.S. Treasury Department revamped its rules for participating in

government bond auctions two years ago, officials said they were simply modernizing outdated procedures.

The real reason for the change, a Reuters investigation has found, was more serious: The Treasury had concluded that China was buying much more in U.S. government debt than was being disclosed, potentially in violation of auction rules, and it wanted to bring those purchases into the open - all without ruffling feathers in Beijing.

Treasury officials then worked to keep

the reason for the auction-rule change quiet, with the acting assistant Treasury secretary for financial markets instructing subordinates to not mention any specific creditor's role in the matter, according to an email seen by Reuters. Inquiries made at the time by the main trade organization for Treasury dealers elicited the explanation that the change was a "technical modernization," according to a document seen by Reuters. There was no mention of China.



BLOG

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<http://link.reuters.com/heq72q>

The incident calls into question just how clear a handle the Treasury has had on who is buying U.S. debt. Chinese entities hold at least \$1.115 trillion in U.S. government debt, and are thought to account for roughly 26 percent of the paper issued by Washington, according to U.S. government data released on June 15.

China's vast Treasury holdings are both a lifeline and a vulnerability for Washington - if the Chinese sold their Treasuries all at once, it could undermine U.S. markets and the economy by driving interest rates higher very quickly. Scenarios of this sort have been discussed in Washington defense-policy circles for at least a year now. Not knowing the full extent of these holdings would make it even more difficult to assess China's political leverage over U.S. finances.

The Treasury has long said that it has a diversified base of investors and isn't overly reliant on any single buyer to digest new U.S. Treasury issuance. Evidence that China was actually buying more than disclosed would cast doubt on those assurances.

THE 'GUARANTEED' BID

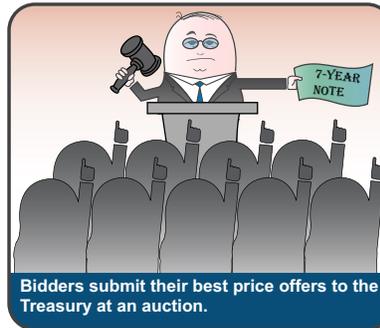
THE UNITED STATES sells its debt to investors through auctions that are held weekly -- sometimes four times per week -- by the Treasury's Bureau of the Public Debt, in batches ranging from \$13 billion to \$35 billion at a time. Investors can buy the bonds directly from the Treasury at auctions, or through any of the 20 elite "primary dealers," Wall Street firms authorized to bid on behalf of customers. The Treasury limits the amount any single bidder can purchase to 35 percent of a given auction. Anyone who bought more than 35 percent of a particular batch of Treasury securities at a single auction would have a controlling stake in that batch.

By the beginning of 2009, China, which uses multiple firms to buy U.S. Treasuries, was regularly doing deals that had the effect of hiding billions of dollars of purchases in each auction, according to interviews with traders at primary dealers and documents viewed by Reuters.

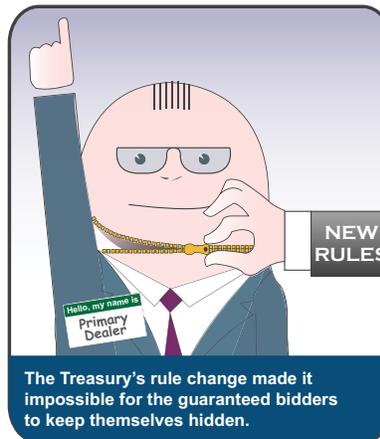
Using a method of purchases known as "guaranteed bidding," China was forging gentleman's agreements with primary

The Hidden Bidders

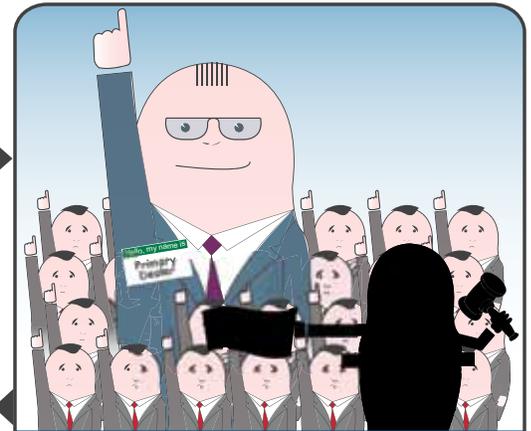
Guaranteed bidders hid their bids inside primary dealers' orders so the Treasury couldn't see them.



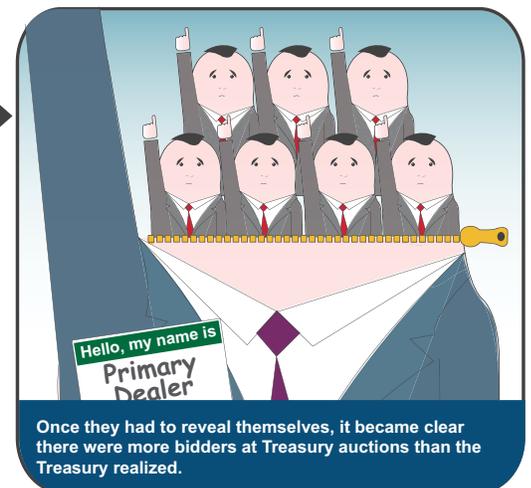
Bidders submit their best price offers to the Treasury at an auction.



The Treasury's rule change made it impossible for the guaranteed bidders to keep themselves hidden.



Before the hidden guaranteed bidders were revealed, primary dealers looked like enormous bidders, asking to buy many more Treasuries than they were actually planning to keep.



Once they had to reveal themselves, it became clear there were more bidders at Treasury auctions than the Treasury realized.

Source: Thomson Reuters

29/06/11

Reuters graphic/Stephen Culp

 **REUTERS**

dealers to purchase a certain amount of Treasury securities on offer at an auction without being reported as bidders in that auction, according to the people interviewed. After setting the amount of Treasuries the guaranteed bidder wanted to buy, the dealer would then buy that amount in the auction, technically on its own behalf.

To the government officials observing the auction, it would look like the dealer was buying the securities with the intent of adding them to its own balance sheet. This technicality does not preclude selling them later in the secondary market, but does influence the outcome of bidding in the auction, by obscuring the ultimate buyer. In fact, the dealer would simply pass the

bonds on immediately to the anonymous, guaranteed bidder at the auction price, as soon as they were issued, according to the people interviewed.

The practice kept the true size of China's holdings hidden from U.S. view, according to Treasury dealers interviewed, and may have allowed China at times to buy controlling stakes -- more than 35 percent -- in some of the securities the Treasury issued.

The Treasury department, too, came to believe that China was breaching the 35 percent limit, according to internal documents viewed by Reuters, though the documents do not indicate whether the Treasury was able to verify definitively that this occurred.

VIDEO

Eswar Prasad, Brookings Institution senior fellow, on China and Treasuries:

<http://link.reuters.com/vaq42s>

Guaranteed bidding wasn't illegal, but breaking the 35 percent limit would be. The Uniform Offering Circular - a document governing Treasury auctions - says anyone who wins more than 35 percent of a single auction will have his purchase reduced to the 35 percent limit. Those caught breaking auction rules can be barred from future auctions, and may be referred to the Securities and Exchange Commission or the Justice Department.

The Treasury Department generally does not comment on specific investors but a source in the department said China was not the only Treasury buyer striking guaranteed bidding deals.

People familiar with the matter named Russia as being among the guaranteed bidders. But Russia's total Treasury holdings, while significant, represent 2.8 percent of outstanding U.S. debt, versus one-fourth for China's.

CHANGING THE RULE

TRADERS AT PRIMARY dealers did not have the same diplomatic concerns about the level of Chinese buying. But they did have reasons to dislike guaranteed bidding, and they began clamoring for a change. One trader said in an interview he first brought the issue to the attention of Treasury officials in 2007.

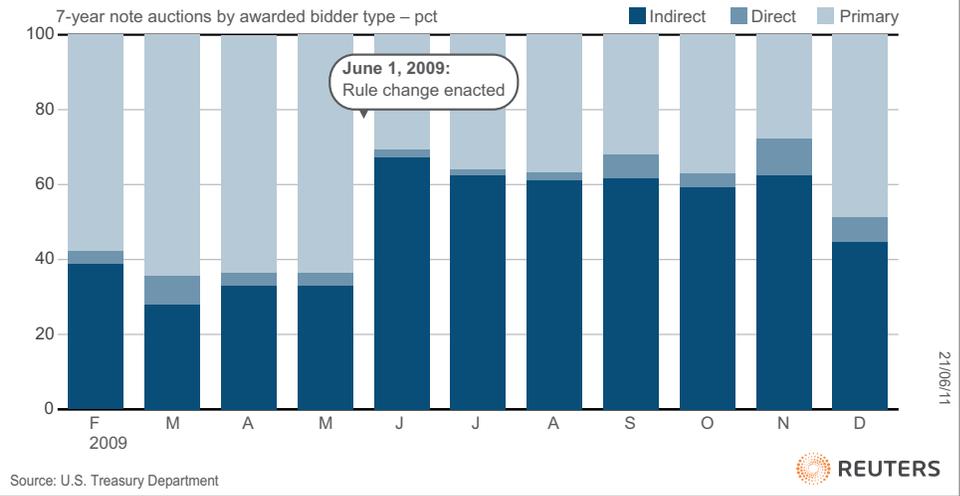
Some primary dealers began expressing concern that the deals were opaque in a way akin to the Salomon Brothers Treasury trading scandal in the early 1990s. In that case, traders from the securities firm submitted false bids under other bidders' names in Treasury auctions in order to more closely control the results, and their bids altered the auction prices. The idea that unseen bidders were again influencing auction prices raised similar concerns among traders.

There were also commercial concerns: Dealers say that knowing that the practice was going on at other firms made them less confident they could see and understand overall patterns of buying in the Treasury market. Such visibility can be one of the greatest benefits of being a primary dealer, since the service itself often doesn't pull in big profits directly.

Some traders at primary dealers say they

U.S. Treasury auctions and indirect bidders

The portion of each 7-year auction awarded to indirect bidders doubled after guaranteed bidding was outlawed.



simply refused to do the deals and ended up turning away customers, including China. That irked sales colleagues who were promising clients guaranteed bidding deals.

At the beginning of 2009, Treasury officials began discussing the issue of guaranteed bidders, with a focus on China's behavior, internal documents seen by Reuters show. The culmination of their efforts was a change to the Uniform Offering Circular published on June 1, 2009 that eliminated the provision allowing guaranteed bidding.

Treasury Secretary Timothy Geithner was in Beijing that day meeting with Chinese government officials on his first formal visit to China since taking up his cabinet post. There is no evidence he discussed the rule change with Chinese officials there.

A spokeswoman for the Treasury Department said: "We regularly review and update our auction rules to ensure the continued integrity of the auction process. The auction change made in June 2009 eliminated some ambiguity in auction rules and increased transparency, which ultimately benefits taxpayers and investors."

The rule change had an immediate impact.

In the first auctions conducted after guaranteed bidding was banned, a key metric rose sharply: the percentage of so-called indirect bidders, those who placed their auction bids through primary dealers. Indirect bidders are seen as a proxy measure for foreign central bank buying, because foreign central banks most often bid through primary dealers. With the elimination of the guaranteed bidder provision, far more buyers were put in this class in reports to the

Treasury Department.

The seven-year U.S. Treasury note, which was sold in sizes of between \$22 billion and \$28 billion once a month from February 2009 to September 2009, had an average indirect bid percentage of 33 percent from February through May. But from June to September the average indirect bid rose to 63 percent.

BIDDERS REACT

SHORTLY AFTER the Treasury revised the auction rules, U.S. officials learned from dealers that some bidders were seeking to continue using guaranteed bids. According to a Treasury document, a large client asked one primary dealer whether the Treasury might make an exception to the new rule for them. Neither the client nor the dealer were named.

Deutsche Bank, Goldman Sachs, JPMorgan, RBS Securities and UBS all received calls from clients asking for secret bid arrangements immediately after the rule change went into effect, according to the internal Treasury document, a summary of inquiries received seeking guidance from dealers after the rule change.

Deutsche Bank, according to the document, said their client canceled a bidding deal. Goldman told Treasury that a large client would be going to other dealers who in the past had done the deals after Goldman turned them away, the document said.

JPMorgan asked if there were any exceptions to the new prohibition on guaranteed bids. RBS said it actually struck a deal with a customer for a guaranteed bid after the rule change, but it used a different

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REUTERS

ONE GOVERNMENT OFFICIAL WARNED OTHERS IN A WRITTEN MESSAGE "NOT TO INCLUDE THE WORDS 'CHINA' OR 'SAFE' IN EMAIL SUBJECTS."

structure and wanted to know what was legal. UBS told the New York Fed that its former guaranteed-bidder client would now change its behavior and buy Treasuries in the secondary market directly after an auction, according to the document.

Spokespeople for Goldman Sachs and UBS declined to comment for this story. Deutsche Bank, RBS, and JPMorgan did not respond to requests for comment.

The change came at a delicate time in U.S.-Chinese financial relations. China, long a major buyer of American government securities, was at the time snapping up huge amounts of debt as Washington was suffering a sharp drop in tax revenue during a crushing recession.

Almost all of the business of buying Treasuries on behalf of the Chinese government is conducted by China's State Administration of Foreign Exchange (SAFE), an arm of the Chinese central bank which manages China's currency reserves, which

include large amounts of U.S. Treasury bonds.

SAFE, for its part, was facing heat in China over the extent of its U.S. holdings. SAFE was hit hard by the collapse of Lehman Brothers, the doomed investment bank that was SAFE's trading counterparty in the U.S. overnight-lending market. And the potential losses SAFE faced upon the collapse of the U.S.-backed mortgage titans Fannie Mae and Freddie Mac whipped up such a storm in China that Chinese officials publicly berated the Americans for lapses in financial stewardship. (For more, click on <http://link.reuters.com/qec28r>)

SAFE officials in Beijing did not respond to a request for comment.

After evidence mounted that China was disconcerted by the auction-rule change, U.S. officials moved to tweak the system, to offset some of the pinch of the stricter bidding rules. The move gave big buyers a way to maintain some anonymity, by increasing the

amount of securities it was possible to buy at a single auction without having to declare the purchase in a letter to the New York Fed.

The old requirement stipulated that any purchase of \$750 million in Treasury securities had to be declared by the buyer in a letter to the New York Fed. Officials increased the threshold to \$2 billion.

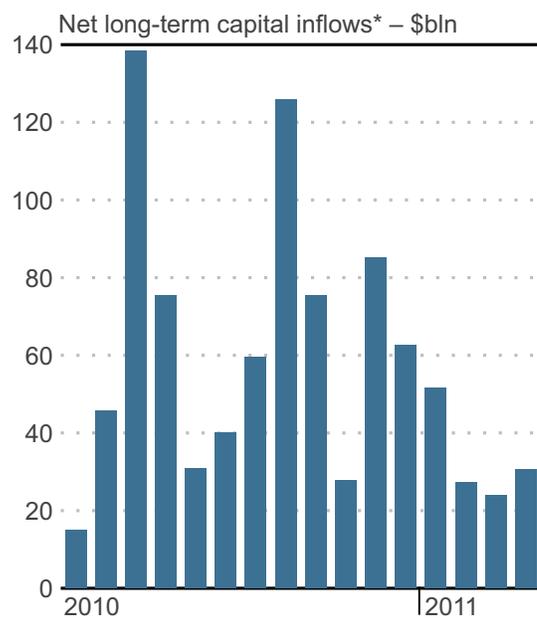
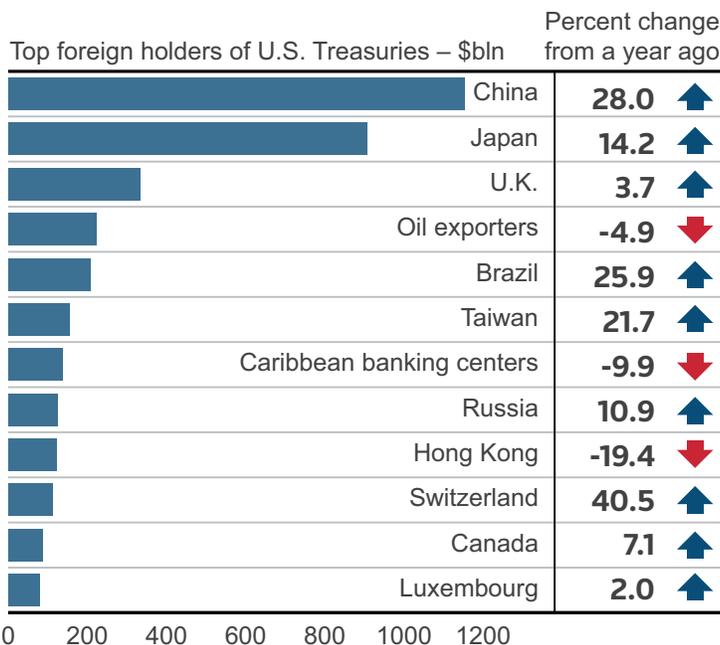
'TECHNICAL MODERNIZATION'

THE OFFICIAL EXPLANATION for eliminating guaranteed bidders did not mention foreign central banks at all. It focused instead on "technical modernization" of auction rules.

One government official warned others in a written message "not to include the words 'China' or 'SAFE' in email subjects." The Securities Industry and Financial Markets Association, the main trade organization for Treasury dealers, asked the Treasury in early June 2009 to explain the change. The Treasury's response: It had found that a detail in its auction rules no longer applied to

Foreign holders of U.S. Treasuries

In April, foreigners bought more long-term U.S. securities for the first time in five months as capital inflows rose to \$30.6 billion. China – the largest investor in U.S. Treasuries – increased its holdings from last month, up 28.0 percent from last year.



* Excluding swaps
Source: U.S. Treasury Department



the way auctions were conducted, and so the rule was changed, according to an internal Treasury memo.

Separately, the Treasury's acting assistant secretary for financial markets, Karthik Ramanathan, told subordinates in an email: "Please let's stick to the 'Modernization of Auction Rules' when outside requests come in on the (rule) change. Please DO NOT emphasize the guaranteed bid portion, or mention any specific investors."

Ramanathan, who left the Treasury in March of 2010 and is now senior vice president and director of bonds at Fidelity Investments in Merrimack, New Hampshire, declined to comment.

The Federal Reserve Bank of New York, which interacts directly with primary dealers on Treasury auctions, issued a strongly worded letter on June 23, 2009, dealers say, urging them to "comply with the spirit as well as the letter of this recent auction rule

clarification."

"That was how we knew they wanted us to tell them who was buying what," said a trader at one primary dealer.

(Additional reporting by Kristina Cooke and Benjamin Kang Lim; Editing by Michael Williams and Claudia Parsons)



ON THE TABLE: U.S. Treasury Secretary Timothy Geithner (R) speaks during a meeting with Chinese Vice Premier Wang Qishan at the Great Hall of the People in Beijing June 1, 2009. Geithner was visiting China on the same day the Treasury changed its auction rules to end guaranteed bidding. **REUTERS/ANDY WONG/POOL**

THE RULES OF THE GAME

FACTBOX

BY EMILY FLITTER
NEW YORK, JUNE 30

U.S. TREASURY AUCTIONS occupy a separate space from the trading of U.S. Treasuries in the secondary market, with different rules and reporting requirements. News that China was hiding some of its Treasury purchases at auctions draws attention to some important differences between auctions and Treasury trading elsewhere.

KEY PLAYERS IN TREASURY AUCTIONS

■ **Primary dealers** - The 20 securities firms authorized to deal directly with the Federal Reserve Bank of New York and the Treasury Department and place bids on behalf of customers at Treasury auctions.

■ **Direct bidders** - Individuals or firms with a direct connection to the Treasury through which they can place bids at auctions. These entities can't place bids on behalf of others.

■ **Indirect bidders** - Customers who submit bids at Treasury auctions via primary dealers.

AUCTION RULES

THE TREASURY MAINTAINS a set of rules in its Uniform Offering Circular laying out proper conduct at Treasury auctions. Rules for buying Treasuries in auctions differ from the rules for buying Treasuries in the secondary market in several ways.

For a start, auction bidders are subject to a limit on how much of a single auction they can buy. The limit is 35 percent, and the Treasury rules say anyone who bids for and wins more than 35 percent of a single auction will have his or her bid reduced to 35 percent.

"In Treasury auctions, it is acceptable to bid for more than 35 percent of the offering amount, but Treasury will not award more than 35 percent to a single bidder. There is no restriction on purchases in the secondary



TREASURY CHIEF: U.S. Treasury Secretary Tim Geithner is pictured during closing statements with China's Vice Premier Wang Qishan and China's State Councilor Dai Bingguo at the U.S.-China Strategic and Economic Dialogue at the Interior Department in Washington, May 10, 2011. **REUTERS/JASON REED**

market," said a spokeswoman for the Treasury.

Another key difference lies in reporting requirements. Primary dealers have to report their customer bids to the Treasury Department at an auction.

Afterward, the Treasury releases auction bidding statistics that separate the

customers -- indirect bidders -- from the primary dealers and the direct bidders. This helps market participants gauge demand for new Treasury issues. There are no such reporting requirements for purchases in the secondary market.

(Reporting by Emily Flitter)

COVER PHOTO: The People's Republic of China flag and the U.S. Stars and Stripes fly along Pennsylvania Avenue near the U.S. Capitol in Washington during Chinese President Hu Jintao's state visit, January 18, 2011. **REUTERS/HYUNGWON KANG**

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