SOVEREIGN CREDIT RATINGS

# China's pre-war bond default stirs US anger

By Gillian Tett in London, Richard Beales and Andrew Parker in New York and Andrew Yeh in Beijing

A group of US politicians has written to the Securities and Exchange Commission complaining about the way US credit rating agencies treat Chinese debt.

The politicians are angry that Beijing has allegedly failed to settle claims made by US citizens holding pre-war Chinese bonds, while acknowledging UK claims.

"The [rating agencies] should reclassify the sovereign credit ratings of the People's Republic of China [to reflect this]," argues Jim Saxton, chairman of the Senate Joint Economic Committee, in a letter to the SEC, which describes the allegations of China's default as "very serious".

Politicians will also file a resolution in the US Senate this week supporting these letters and calling for China to be excluded from US capital markets until the issue is resolved.

China has hitherto ignored demands for repayment, which have been bubbling in the US for several years, backed by a small group of senators and congressmen.

However, the latest move suggests these complaints are now being raised a notch – not least because of mounting irritation in Washington at China's economic activities, which could give the issue more political resonance than before.

Although the SEC has yet to issue a formal response to the letters, it is examining whether any Chinese government debt issues are registered with the regulator, which would give it jurisdiction.

The complaint about the Chinese bonds centres on a swathe of securities issued before 1949, when the Communist regime came to power. The most prominent was a £25m ($45m) sterling bond issued in 1913, indexed to the price of gold, which was due to mature in 1960 before China defaulted.

In 1987 Beijing settled outstanding claims with UK investors holding pre-war assets – including the 1913 bond – at a steep discount. The American Bondholder Foundation, which claims to represent 5,000 US investors holding these bonds, says it is entitled to a settlement as well. It claims the current value is about $120bn.

Officials with China's central bank and the China Banking Regulatory Commission last week denied knowledge of the issue. Most observers consider Beijing unlikely to act without external pressure.

People close to the SEC suggested the regulator had not yet reached any conclusions on the matter. However, the SEC is usually reluctant to become involved in the work of credit rating agencies. It does not have a legislative mandate to police the agencies, but does grant them a status, known as "nationally recognised statistical rating organisations", that has entrenched the dominance of the three main agencies: Fitch Ratings, Moody's Investors Service and Standard & Poor's.

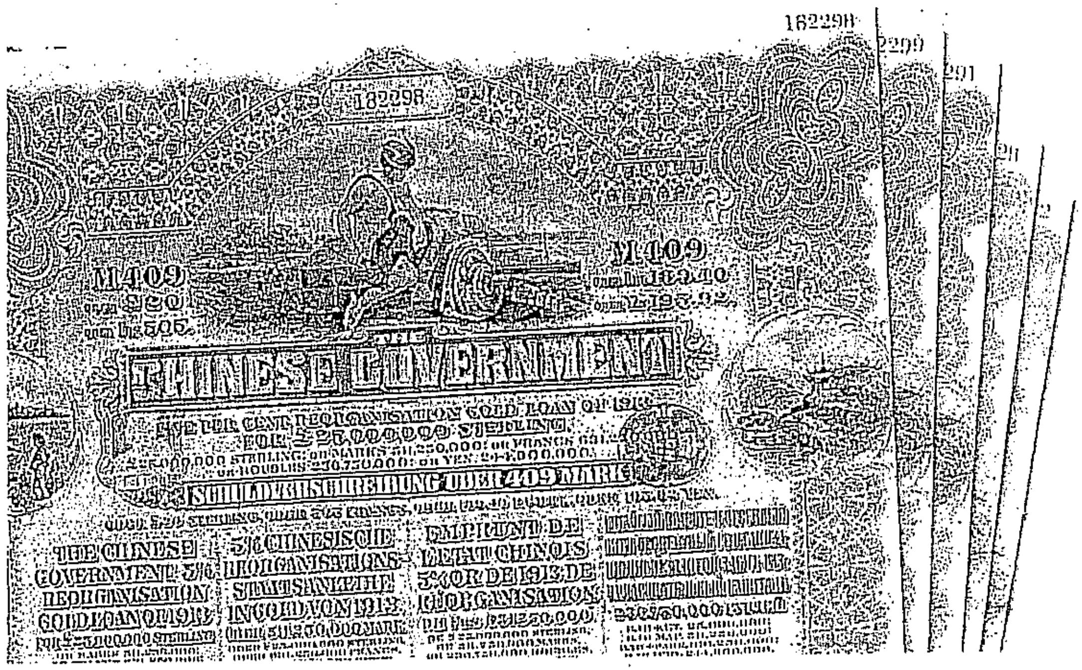
These three, which currently give China a mid-level investment grade rating, have not commented. However, Christopher Mahoney, executive vice-president of Moody's, said: "The fact a country has defaulted in the past is a credit negative, but does not preclude ... a high rating today."

Brian Coulton, senior director at Fitch, said: "[These complaints] are not something we take any account of in our rating of the PRC."

Some US politicians have suggested the bonds be sold at a discount to third countries, such as Iraq, to use to repay debts to China.

# People's Republic called to account

US groups want compensation for non-payment of bonds from the Qing Dynasty, write Gillian Tett, Richard Beales and Andrew Yeh




When the People's Republic of China decided 20 years ago to start issuing eurobonds, it ran into an embarrassing diplomatic hitch. Before the UK government would let Beijing sell debt in London, it insisted that China first settle its outstanding pre-war claims with British investors.

After protracted wrangling, China finally caved in: in 1987, it quietly paid a £20m ($36.4m) lump sum to compensate Britons who had lost their assets when China's Communists took power – ranging from defaulted sovereign bonds to debentures on the pre-war Shanghai cricket club.

Now, however, this odd episode of financial history is gaining a new geopolitical life.

In recent weeks a group of US senators and congressmen has written to the SEC, pointing out that China has failed to make any similar settlement with US investors. And in light of that alleged "default", these politicians want the SEC to take action against the US rating agencies, for their alleged failure to recognise the issue when they issue judgments on the creditworthiness of Chinese bonds.

Thus far, it is unclear how the SEC will respond. And legal experts in China argue that it is unlikely that Beijing will cave in again.

"In my opinion it is possible for China to reject the American bondholders under international rules," says an expert in International Law at Wuhan University in Central China.

But as the argument rumbles on, it could yet add more grist to the mill of Washington's current China-bashing – and highlight a long-running diplomatic headache for the rating agencies as well.

"It's a sensitive issue for agencies," says one international banker, who points out that the matter is doubly delicate because it is unclear whether responsibility for these bonds lies with China or Taiwan.

The issue revolves around a group of bonds that were mostly issued in the early 20th century by the late Qing Dynasty to foreign countries such as US and UK.

Back then, the government was hungry to fund projects such as the construction of railways. However, the practice created huge local resentment in China.

Consequently, when the Communists took power in 1949, these instruments went into default and in subsequent years, the bonds were largely deemed worthless, except to collectors.

But after the Chinese government settled with the UK in 1987, some US bondholders took note: five years ago they created an organisation, known as the American Bondholders Foundation, which started to press the Chinese for a settlement as well.

Some observers suspect the American pressure group stands less chance of success than the UK investors. One reason is that US domestic legal precedent on the issue is not entirely supportive.

Another problem is that the ABF is being very ambitious: whereas the UK bondholders settled their claims at a very steep discount, the ABF insists that China should pay the full, present-day value of the bonds, allegedly some $120bn.

However, a third factor is that the ABF has an unusual support base, at least by the standards of international finance. The main spokeswoman, Jonna Bianco, is a Tennessee cattle rancher, who claims to represent about 5,000 US bondholders.

Some of these apparently bought the bonds many decades ago; others may have acquired them more recently and opportunistically, hoping to cash in.

Either way, there is a strong Mid-West flavour to the group: in addition to winning the backing of Mid-Western politicians, the ABF's backers also include groups such as the Traditional Values Coalition, a Christian organisation.

Nevertheless, the letters to the SEC suggest that the group now enjoys a reasonable degree of political support in Washington – not least because the ABF is keen to capitalise on the current anti-China climate. And though there is no evidence that the Treasury is backing their efforts, the group is trying to exert more pressure on Beijing by using the controversial bonds in third-country so-called "offsets".

In particular, the group claims it is now negotiating with a group of Middle Eastern countries – including Iraq – to sell them the bonds at a discount. The idea is that these countries then use these instruments to repay their own debts to China. "We have both Republicans and Democrats backing us here – the issue [of Chinese bonds] now generates quite a bit of emotion," says Ms Bianco, who claims that the group will unveil some more news on these so-called offsets "in the next few weeks".