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International Statistical Standards for Recording Letters of Credit

Prepared by the State Administration of Foreign Exchange (China)
and the Bank for International Settlements

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International statistical standards for recording letters of credit

Paper prepared by Han Jian, SAFE, and Philip Wooldridge, BIS, for discussion at the 2017 meeting of the IMF Committee on Balance of Payments Statistics[1]

A letter of credit (L/C) offers the seller a conditional payment guarantee from the buyer's bank. They are used to finance a significant share of international trade. We propose that international statistical standards for recording them be expanded to clarify the conditions under which a L/C should be recorded on an accrual basis and recognised as a financial liability of the issuing bank.

Issue for discussion

The sixth edition of the IMF's *Balance of Payments and International Investment Position Manual* (BPM6) classifies L/C as contingent liabilities and suggests that they be recorded on a cash basis, when funds are disbursed:

> Lines of credit, letters of credit, and loan commitments assure that funds will be made available, but no financial asset (i.e., loan) is created until funds are actually advanced. Letters of credit are promises to make payment only when certain documents specified by contract are presented. (BPM6, paragraph 5.13)

The latest *External Debt Statistics: Guide for Compilers and Users* (EDS2013) provides similar guidance:

> Letters of credit provide a guarantee that funds will be made available only when certain documents specified by contract are presented, but no financial liability exists until funds are actually advanced. (EDS2013, Appendix 1, p 198)

The *BPM6 Compilation Guide* simply notes that "letters of credit are not included in loans because they are contingent liabilities" (paragraph 10.86) and does not provide any further guidance about how to record L/C.

Once the specified documents are presented and the issuing bank determines that the presented documents fulfil the conditions of the contract, a L/C is economically similar to a bankers' acceptance (BA) as a form of trade financing. BAs are drafts or bills of exchange – for example, drawn on an importer to pay an exporter – that have been endorsed ("accepted") by the importer's bank, whereby the bank makes an unconditional promise to pay a specific amount at a specified date. In

1 The views expressed in this paper are those of the authors and do not necessarily reflect those of the Bank for International Settlements (BIS) or the State Administration of Foreign Exchange (SAFE). The paper refers solely to the statistical treatment of letters of credit and has no bearing on the recognition of L/Cs within prudential or accounting frameworks. We are grateful to Yang Can and Siew Koon Goh for discussion and comments.

contrast to L/C, BAs are recorded on an accrual basis regardless of when the funds are disbursed:

> Bankers' acceptances are treated as financial assets from the time of acceptance, even though funds may not be exchanged until a later stage. (BPM6, paragraph 5.48)

Furthermore, market participants regard L/C as unconditional liabilities of the issuing bank once documents are presented that comply with the conditions of the contract. Under the latest rules agreed by the International Chamber of Commerce (ICC) governing the issuance and use of documentary credits, L/C are irrevocable. Once documents are presented and determined to constitute a complying presentation, the issuing bank's liability to pay is no longer contingent, even if the contract specifies a payment date in the future.

Proposal

1. We propose to modify BPM6 to clarify that a L/C, if irrevocable and once the issuing bank determines that the presented documents fulfil the conditions of the contract, be recorded like a BA, ie treated as an unconditional liability of the issuing bank from the time of acceptance.
2. There are many types of L/C, yet the *BPM6 Compilation Guide* does not provide any examples of how to record them. We propose that guidance relating to L/C be expanded to clarify how to record different types of documentary credits.

Background

A L/C refers to trade-related credit extended through banks. It is a separate transaction from the sale or other contract on which it is based. Whereas a bank guarantee is a commitment to pay if the terms of a contract between two parties are *not* fulfilled, a L/C is a commitment to pay if the terms of a contract are fulfilled. In other words, a guarantee insures against default, whereas a L/C eases payment. A L/C is considered one of the most secure payment instruments available for international transactions (see Figure 1).

Primary methods of payment for international transactions — Figure 1

Method of payment	Consignment	Open account	Documentary collection	Letter of credit	Cash in advance
Risk of non-payment	Highest risk (least secure)	→	→	→	Lowest risk (most secure)

Source: US Department of Commerce, "Trade Finance Guide: A Quick Reference for U.S. Exporters", April 2016, https://www.export.gov/article?id=Trade-Finance-Guide-Methods-of-Payment.

There are many types of L/C issued by banks. Below are some key differences:

- *Standard or standby*. Under a standard L/C, the issuing bank commits itself to paying the beneficiency when the conditions of the credit have been fulfilled. Under a standby L/C, the issuing bank pays only when the applicant fails to meet its obligations to the beneficiary.
- *Irrevocable or revocable*. A irrevocable L/C cannot be changed without the consent of all parties involved. A revocable L/C can be modified or cancelled by the issuing bank after its issuance without the beneficiary's consent.
- *Deferred payment or sight*. Under a deferred payment (or term) L/C, the issuing bank pays within an agreed period of time after the conditions of the credit have been fulfilled. Under a sight L/C, the issuing bank pays as soon as the specified documents are presented and determined to constitute a complying presentation.

A simplified overview of the business process for a L/C is illustrated in Annex A. The actual process is often more complicated. The most important steps are the following:

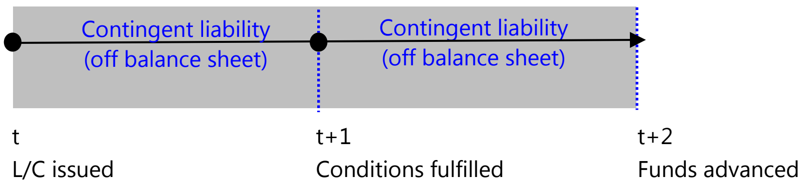
- *Issuance*. When an issuing bank agrees to an importer's request to finance its purchase of goods using a L/C, the issuing bank assumes a contingent liability to pay the exporter. The promise to pay is conditional and so recorded off the balance sheet of the issuing bank.
- *Presentation of documents*. Once the exporter has shipped the goods to the importer and presents the documents specified in the L/C, the exporter records a claim on the issuing bank (or the confirming bank, if other intermediaries are involved). If the L/C is not revocable and is not a standby credit, then the issuing bank's promise to pay is no longer conditional. The issuing bank now has an obligation to pay and, assuming that it follows trade date accounting, will recognise the L/C as a liability on its balance sheet (matched on the asset side by a loan to the importer).

- *Funds advanced*. When the issuing bank makes the payment to the exporter, it extinguishes the L/C from its balance sheet.

Under international statistical and accounting standards, contingent liabilities are not recognised on the balance sheet until certain conditions are fulfilled or events occur. In particular, contingent liabilities remain off balance sheet until the liability is both probable and the amount can be estimated. When issued in period *t*, L/C are contingent liabilities of the issuing bank. If the L/C are standby or revocable, then the liability is not necessarily probable. In such cases, the L/C might remain a contingent liability even after the conditions of the credit have been fulfilled, in period *t+1*, and the issuing bank might recognise a term L/C as a liability only when the payment is made, in *t+2* (see Figure 2).

Recording a standby or revocable letter of credit

Figure 2



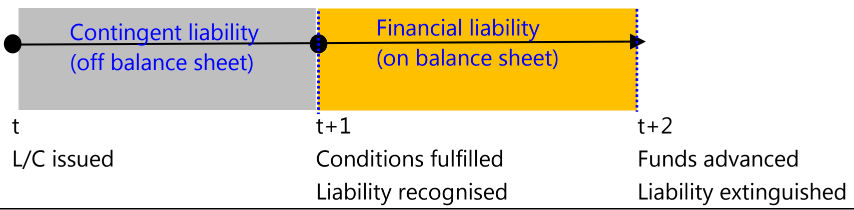
Today, L/C used in international trade are usually irrevocable. L/C are typically governed by the ICC's rules. The latest rules, which came into effect in 2007, state that L/C are irrevocable, in contrast to the ICC's earlier rules, which stated that they may be either revocable or irrevocable.[2] The European Central Bank also identifies irrevocability as a defining condition of a L/C:

> A L/C is "an irrevocable commitment by a bank (the issuing bank) or other issuer made at the request of a customer (the applicant third party) to pay a specified sum of money to a third party upon request, subject to terms and conditions drawn up in accordance with uniform customs and practices."[3]

If a L/C is standard and irrevocable, then there is a high probability that the bank will be required to fulfil its promise to pay. Therefore, once the conditions of the credit are fulfilled at *t+1*, the issuing bank should recognise the L/C as a liability. This liability remains on the balance sheet until payment is made in *t+2* (see Figure 3).

Recording an irrevocable letter of credit

Figure 3



[2] The latest version of the ICC's Uniform Customs and Practice for Documentary Credits, UCP600, came into effect on 1 July 2007. According to article 3 of UCP600, "A credit is irrevocable even if there is no indication to that effect." Article 7(b) states that "An issuing bank is irrevocably bound to honour as of the time it issues the credit."

[3] See ECB, "Glossary of terms related to payment, clearing and settlement systems", December 2009, www.ecb.europa.eu/pub/pdf/other/glossaryrelatedtopaymentclearingandsettlementsystemsen.pdf.

That said, irrevocability is not sufficient to eliminate uncertainty about payment. Another important source of uncertainty is whether the conditions of the credit have been fulfilled. Historically, issuing banks rejected as non-compliant many of the documents when first presented. One of the goals of the 2007 revision to the ICC's rules was to clarify what constitutes a complying presentation.

Decisions about whether a liability is probable require judgement, and this can result in inconsistent accounting practices among issuing banks, with some recording L/C as liabilities but others leaving them off balance sheet. Practices among beneficiaries are also likely to be inconsistent, with some recording claims against issuing banks and others against applicants.

Inconsistent practices for recording L/C create challenges for compilers of balance of payments (BOP) and international investment position (IIP) statistics. To ensure that L/C are recorded consistently in BOP and IIP statistics, China has adopted the practice of recognising all standard L/C as liabilities of the bank sector once documents specified in the contract are presented, regardless of whether issuing banks recognise them as liabilities in their own accounts. The treatment of L/C in China is discussed further in Annex B.

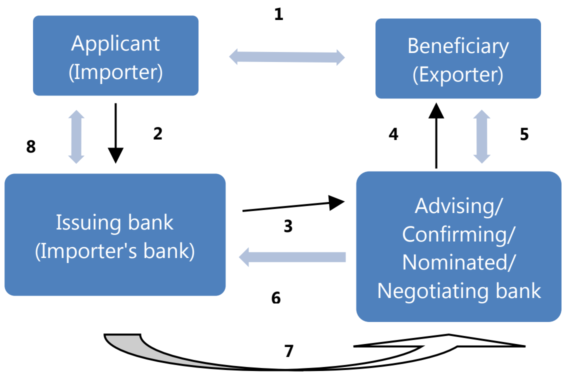
The recording of L/C is an especially important issue for BOP/IIP compilers in emerging market and developing economies because L/C finance a large share of these countries' trade. Most trade among advanced economies is financed through open accounts, where the exporter ships the goods and the importer pays after receiving them. Exporters are more likely to use L/C when trading with risky destinations where there is uncertainty about the rule of law.[4]

[4] See F Niepmann and T Schmidt-Eisenlohr, "Trade finance around the world", VOX, 11 June 2016, http://voxeu.org/article/trade-finance-around-world.

Annex A: Business process for a letter of credit

The business process for a typical L/C is illustrated below. First, the importer and exporter conclude a trade contract and agree to use a L/C as the method of payment. Second, the importer (applicant) requests its bank to issue a L/C. If the bank agrees, then it promises to pay the beneficiary if all the terms and conditions of the L/C are fulfilled. The issuing bank will also request the advising bank to notify the beneficiary that there is an L/C issued in his favour. Sometimes the beneficiary will ask another bank (normally also the advising bank) to "confirm" the L/C.[5]

Once the beneficiary presents the documents specified by the contract, the beneficiary receives payment, either immediately or within an agreed period. The payment may be channelled through the advising bank. When it makes the payment to the beneficiary, the issuing bank will also make arrangements with the applicant to repay the funds. Sometimes the issuing bank will require the applicant to deposit funds as collateral.



1. Trade contract
2. Apply for L/C
3. Inform L/C
4. Inform L/C
5. Payment to exporter
6. Claim of L/C
7. Payment to advising bank
8. Payment for redemption

[5] L/C confirmation is requested if the exporter is not comfortable with the creditworthiness of the issuing bank, or is concerned about the importer's country risk. However, to simplify illustration of the statistical recording at different stages of a L/C cycle, we focus on only issuing bank and do not include confirming banks in our discussion. Confirming banks are engaged in LC life cycle as if they issued the LC themselves.

Annex B: Recording of L/C in China's balance of payments

In China, L/C are used extensively to finance international trade. At end-March 2017, outstanding L/C issued by banks in mainland China totalled about $100 billion. Banks in China record L/C off balance sheet. Beneficiaries follow different practices when identifying the counterparty (issuing bank or importer).

To ensure that L/C are recorded consistently in China's BOP and IIP statistics, SAFE records L/C as liabilities of the bank sector once documents specified in the contract are presented. L/C with bankers' acceptance as one of the specified documents are recorded as debt securities when accepted by banks. L/C without bankers' acceptance are recorded as loans.

SAFE's practices for recording trade credits in BOP, IIP and external debt statistics are summarised below.

Recording of trade-related credits in China

Trade-related credit	Balance sheet of importer/ exporter	Balance sheet of issuing bank	Allocation in BOP and IIP		
			Instrument	Sector for importer's liability	Sector for exporter's asset
Trade credit and advances	Trade payable (importer)/ Trade receivable (exporter)	n/a	Trade credit and advances	Non-financial sector	Non-financial sector
Trade financing with L/C	Trade payable (importer)/ Trade receivable (exporter)	Contingent liability (off balance sheet)	Debt securities with bankers' acceptance	Bank sector	Non-financial sector
			Loans without bankers' acceptance	Bank sector	Non-financial sector
Forfaiting & buyout financing by a bank from exporters	Trade payable (importer)/ n/a (exporter)	Asset (on balance sheet)	Debt securities with bankers' acceptance	Bank sector	Bank sector
			Loans without bankers' acceptance	Non-financial sector	Bank sector