Thirty-Second Meeting of the
IMF Committee on Balance of Payments Statistics

Thimphu, Bhutan
October 29–November 1, 2019

BOPCOM—19/16c
For discussion

Recording of Letters of Credit in External Sector Statistics

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In 2017, the Committee on Balance of Payments Statistics (Committee) asked for a clarification note on the recording of letters of credit in external sector statistics. In particular, the Committee considered that guidance was needed with respect to treatment after presentation and acceptance of the documents related to letters of credit as well as with regard to typical contractual designs. The following note provides the requested methodological elaborations. It also includes an appendix presenting the information on accounting options and statistical compilation practices in Germany. Regarding the methodology, the paper suggests that unconditional obligations from deferred letters of credit ought to be recorded as liabilities of the issuing bank. Off-balance sheet recording may sometimes occur in practice though: in instances where these instruments may have limited relevance, the potentially high implementation costs —due to the heterogeneity of accounting practices— may entail that consideration be given to cost-effectiveness. Such off-balance sheet recording (under some circumstances) would avoid the risk of double-counting of these liabilities in both the banking and the corporate sector, even if it might lead to a wrong sector allocation.

I. Introduction

1. At the 2017 Committee meeting, members agreed that the importance of letters of credit as an instrument to reduce risks in financing international trade does not coincide with the rather limited guidance on their recording provided in international statistical manuals. Current guidance for external sector statistics classifies letters of credit as contingent liabilities of issuing banks, and no financial asset is created until funds are actually advanced. This guidance does neither reflect on the different steps of the business process for a letter of credit nor does it differentiate for different contractual designs.

2. Members discussed a proposal of the Bank for International Settlements (BIS) and the State Administration of Foreign Exchange (SAFE) of China, namely to record an unconditional liability once the issuing bank has accepted the documents specified in the letter of credit.[1] It was further considered to expand guidance on the various types of letters of credit to better reflect the variety of documentary credits used in practice and possibly to achieve a more differentiated approach to their recording in external statistics. Therefore, the Committee assigned the task of preparing a clarification note for consideration of the Committee.[2]

[1] IMF BOPCOM 17/12, International Statistical Standards for Recording Letters of Credit.

[2] IMF BOPCOM 17/17, Summary of Discussions, §§ 22–24.

3. This clarification note is structured as follows: Section II gives a short definition of letters of credit. Section III cites the relevant paragraphs of the sixth edition of the *Balance of Payments and International Investment Position Manual (BPM6)* and indicates where provisions fall short of guidance for a consistent recording, across both institutional sectors and countries. Section IV clarifies how letters of credit are to be recorded when the conceptual principles of the *BPM6* are applied. It then introduces the different types of letters of credit and elaborates on differences in their recording in accounting and external sector statistics. The exposition thereby assumes that unconditional letter of credit liabilities are recorded on-balance in the accounts of the involved banks with a corresponding recording in the importer's and exporter's books. The suggested recording for macroeconomic statistics follows the (idealized) parties' bookkeeping. A final paragraph reflects upon the existence of alternative accounting practices and, as a corollary, the possible obstacles regarding actual data collection. In the conclusion we ask committee members to endorse the clarifications made in section IV, to agree on the possible need for country-specific simplifying assumptions in compilation practice and to publish a corresponding note on the IMF website.

II. Definition and Characteristics of Letters of Credit

4. Letters of credit are a widely used[3] and standardised[4] form of bank-intermediated trade finance. They reduce payment risk by providing a guarantee to the seller that the buyer's payment will be received on time and for the correct amount after the documents specified in the letter of credit have been presented and accepted. A letter of credit thus facilitates trade with countries and counterparts, for example, when the exporter's knowledge of legal and economic conditions of the jurisdiction where the buyer resides is limited.

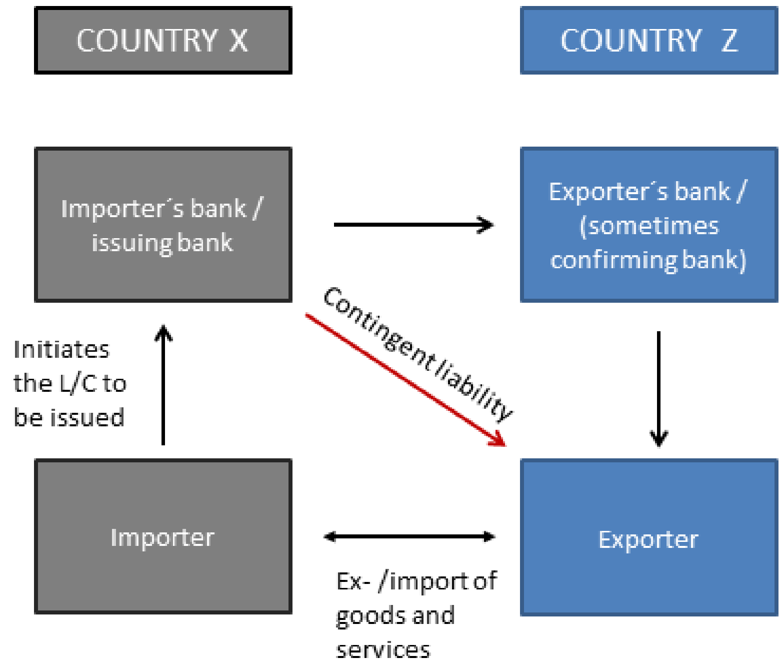
5. It should be noted explicitly that the issuing bank is only responsible for handling the documents specified in the letter of credit; it has no obligation regarding the goods or services to which the documents relate. Thus, the change of ownership concerning the goods exported or imported is not affected by choosing letters of credit as a means of payment.

6. Contractual variations and structuring may be used to adapt a standard letter of credit to the needs and preferences of both, buyer and seller. The different types of letters of credit commonly used and implications for their recording in external statistics are further explained in section IV.

[3] According to the International Chamber of Commerce (ICC) Germany, an estimated 10-15% of international trade is financed through letters of credit (see https://www.iccgermany.de/standards-regelwerke/handels-und-exportfinanzierung/richtlinien-fuer-dokumenten-akkreditive-era-600/).

[4] The International Chamber of Commerce (ICC) has published a set of international accepted rules governing letters of credit (UCP 600 – Uniform Customs and Practice for Documentary Credits). This official publication consists of a set of 39 articles on issuing and using letters of credit, and it applies to 175 countries around the world, constituting some US$ 1tn of trade per year.

Chart 1: Simplified Illustration of Contractual Relations for a Typical Letter of Credit



III. Provisions in *BPM6* Concerning the Recording of Letters of Credit and Gaps in Guidance

7. According to the *BPM6*, letters of credit do not give rise to financial assets (*BPM6*, § 5.9 (a)) until funds are advanced. They are defined as "promises to make payment only when certain documents specified by contract are presented" (BPM6, § 5.13). Consequently, as payment is dependent on the fulfilment of specific contractual conditions, they comprise contingent assets and liabilities and "are not recognized as financial assets or liabilities prior to the condition(s) being fulfilled" (*BPM6*, § 5.10).

8. Corresponding manuals also provide no further guidance. The *BPM6* Compilation Guide only mentions letters of credit in the context of trade credit and advances: "Note that letters of credit are not included in loans because they are contingent liabilities" (*BPM6 Compilation Guide*, § 10.86). Also, the *External Debt Statistics Guide for Compilers and Users (EDS)* does not go beyond this. It defines letters of credit as a contingent liability and gives advice on how to measure the value of contingent liabilities (*EDS*, § 9.12., § 9.34, and appendix 1, p. 198).

9. The treatment of letters of credit before documents are presented to and accepted by the issuing bank is undisputed – the issuing bank´s contingent liability is not to be recorded in external sector statistics. In the bank´s accounts, it is shown as an off-balance-sheet item. But the manuals do not give any guidance on recording letters of credit after the documents are presented and accepted or assume that no subsequent recording would be necessary. To eliminate this ambiguity, clarification seems warranted taking into account the terms and

conditions commonly used for different types of letters of credit. The agreed terms and conditions may have different implications for whether and how assets and liabilities are to be recorded in the external accounts.

IV. Clarification on the Recording of Different Types of Letters of Credit

10. The recording of letters of credit in external sector statistics depends on the instruments' life cycle. Prior to acceptance, a cross-border relationship exists only between the importer and the exporter. The bank´s contingent liability is not to be recorded – this applies to all types of letters of credit (see table 1, row B). Only after the documents have been accepted by the issuing bank does the contingent liability of the issuing bank turn into an unconditional liability which is recorded on the bank´s balance sheet[5] and might become relevant for external statistics.

11. The question of whether an entry becomes necessary and if so, how it is recorded, depends on the characteristics of the letter of credit. In practice, there are many different types, depending on what the counterparties need and agree upon. Some of the most common features are captured by terms like standard or stand-by, payment at sight or deferred payment, confirmed or unconfirmed letters of credit. If a letter of credit is subdivided into several tranches, the following clarifications apply accordingly for each single tranche.

12. The most common type is an <u>unconfirmed standard letter of credit with payment at sight</u>. In fact, in this basic case no further recording for the letters of credit becomes necessary: until the specified papers are presented and accepted the letters of credit remain a contingent liability. Once papers are presented and immediate payment is made, no cross-border liability arises for the issuing bank (table 1, row A1).

13. In terms of external sector statistical recording, there is no difference between standard and <u>stand-by letters of credit</u>. In the first case, the payment by the bank is the default option. In the latter case, the bank only steps in if the importer fails to pay (therefore table 1 summarizes standard and stand-by letters of credit in one line (row A1)).[6]

14. A different recording is required, however, for unconfirmed letters of credit with <u>deferred payment</u>. If the payment is deferred, the contingent liability turns into an unconditional liability after acceptance of the documents, and thus requires recording. A debt instrument (loan) has to be recorded as a liability by the issuing bank and as an asset by the exporting company, until payment is made (table 1, row A2). The importer accordingly cancels his trade credit vis-à-vis the exporter and records a (domestic) loan liability vis-à-vis the issuing bank.

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[5] See Annex 1, first bullet point.

[6] Non-payment by the importer does not affect recording in external sector statistics as it is assumed that both issuing bank and importer reside within one country (see Table 1, bottom line). Otherwise, the provisions for recording debt assumptions pursuant to *BPM6* § 8.42-8.45 will have to be followed.

Table 1: Recording of Different Types of Letters of Credit in External Sector Statistics[7]

	Types of Letters of Credit	External balance sheet of			Recording in the international investment position (IIP)*		
		Importer / exporter	Issuing bank	Confirming bank	Instrument(s)	Sector of importing country	Sector of exporting country
Before documents are presented and accepted							
B	All types	Trade credit payable / receivable	No position; contingent liability = item is off balance sheet	No position	Trade credit and advances	Non-financial corporations	Non-financial corporations
After the specified documents are presented and accepted*							
A1	Standard or standby, unconfirmed, payment at sight	No position / no position	No position; immediate payment = no liability	-	No position	No position	No position
A2	Standard, unconfirmed, deferred payment	No position / asset	Liability	-	Loans	Deposit-taking corporations	Non-financial corporations
A3	Standard or standby, confirmed, payment at sight	No position / no position	No position, immediate payment = no liability	No position, immediate payment = no liability	No position	No position	No position
A4	Standard or standby, confirmed, deferred payment	No position / no position	Liability	Asset	Deposit	Deposit-taking corporations	Deposit-taking corporations

Only positions between residents and non-residents are shown; it is assumed that the importer and its bank reside in one country, as do the exporter and its bank.
* Corresponding balance of payments flows – reconciling "before-" and "after-" positions -- to be recorded accordingly (not shown separately in order to keep the table concise).

[7] The table does not cover positions resulting from the settlement of letter of credit obligations (in particular assets / liabilities generated from the cross-border payment process).

15. In a <u>confirmed letter of credit</u>, the exporter´s bank additionally assumes a guarantee to pay the exporter once the specified documents are presented. Thus, the cross-border financial relationship shifts from the exporting company to the exporter´s bank. Accordingly, in the case of a confirmed letter of credit with deferred payment a debt instrument (interbank position / deposit)[8] has to be recorded by the issuing bank (as a liability) and by the exporter´s bank (as an asset), until payment is made (table 1, row A4). The importer and the exporter also cancel their cross-border liability or claim, respectively, arising from the trade credit. At the same time, corresponding (domestic) positions vis-à-vis the banks involved are to be recorded. In case payment at sight has been agreed upon (table 1, row A3), no entries are necessary as no asset / liability positions from the letters of credit agreement arise.

16. Though conceptually straightforward, national and/or international accounting practices of banks and nonfinancial corporations might not in all cases conform to the assumptions on which the above recording recommendations are based.[9] It may hence be difficult to ensure their proper implementation in practice as compilations systems often rely on reporting agents' bookkeeping for data generation. Experiences of BOPCOM members as well as accounting literature show that there is internationally no uniform standard if and if so, under which item banks acknowledge letters of credit as unconditional liability on their balance sheets. Likewise, importing and exporting companies may not necessarily adapt their recording (and reporting) of trade financing positions in accordance with the simplified assumptions made in table 1 above and continue recording a trade credit position vis-à-vis the other party.

V. Conclusions

17. Based on the *BPM6* provisions, this clarification note provides comprehensive conceptual guidance on the recording of letters of credit in external sector statistics by elaborating on the different stages of the letter of credit transaction process and the details of macro statistical recording once the documents are presented and accepted. For typical types of letters of credit, the conceptual recording is specified based on simplified assumptions regarding the accounting of the parties involved.

18. For unconfirmed and confirmed letters of credit with deferred payment, the contingent liability turns into an unconditional obligation once the documents are presented and accepted by the issuing (and the confirming) bank. In these two cases the off-balance entry is hence to be cancelled and a corresponding on-balance sheet liability to be recorded (see cases A2 and A4 in the table above).

19. However, off-balance sheet recording may occur in practice instead of the recommended recording in case of limited relevance of these instruments as well as the potentially high

[8] See *BPM6*, § 5.42 on the recording of interbank positions.

[9] See Annex 1, second bullet point.

implementation costs — due to the heterogeneity of accounting practices. Such off-balance sheet recording (under some circumstances) would avoid the risk of double-counting of these liabilities in the banking and the corporate sector, even if it might lead to a wrong sector allocation.

Questions for the Committee:

1. Does the Committee support the extended conceptual guidance provided by the clarification note as well as the recording recommendations made for the different types of letters of credit?

2. The liability of the issuing bank might also be recorded as "other accounts receivable/payable – other". Does the Committee consider this more suitable than the proposed recording as loans/deposits?

3. Does the Committee agree that diverging accounting practices of the parties involved may make it difficult to implement the recommended recording in practice and that hence the clarification note may need to recognize that off-balance sheet recording may in practice occur in cases of limited relevance of the phenomenon versus potentially high implementation costs due to the heterogeneity of accounting practices?

4. Does the Committee agree that the concluding step would be to publish a clarification note on the IMF's website?

Annex 1: Accounting Options for Recording Unconditional Liabilities from Deferred Letters of Credit Agreements and Application in Germany

- Option 1: On-balance sheet recording:
  According to the German general accounting rules for banks, contingent liabilities have to be recorded on-balance when a third party's claim enforcement is to be expected for certain and the claims are specified both in terms of amount and payment date. With regard to letters of credit with deferred payment, these conditions are fulfilled after presentation of the documents by the exporter and their acceptance by the (issuing or confirming) bank. From this moment on, hence, the off-balance entry is to be cancelled and an on-balance sheet entry to be recorded. In addition, to assure profit/loss-neutrality, a corresponding compensatory claim has to be recorded as an asset vis-à-vis the importer (unconfirmed letter of credit) or the issuing bank (confirmed letter of credit). The importer accordingly cancels his (rest of the world) trade credit liability vis-à-vis the exporter for a (domestic) liability vis-à-vis the issuing bank. The exporter in turn cancels his trade credit asset vis-à-vis the importer.

- Option 2: Off-balance sheet recording:
  In terms of economic substance, an actual asset claim arises only at the time of payment to the exporter (and not-yet payment by the importer / issuing bank). This is because importer and exporter explicitly agreed in the letter of credit that payment ought to take place only at the end of a specified period after presentation of the documents. A separate (letter of credit related) financing need of the importer, on part of the banking system, does hence not exist (in the time span between presentation and acceptance of the documents and payment). According to this view, the importer hence continues to recognize in his accounts a trade credit liability vis-à-vis the exporter (and vice versa). In other words, presentation and acceptance of the documents do not constitute a generic claim vis-à-vis either the issuing bank or the importer, thus justifying the continued recording as an off-balance sheet item in the involved banks' accounts.

- Application in Germany: Accounting practices seem to be different for bank and non-bank corporations and thus hint to possible hurdles of implementing the suggested recording in practice. For Germany's monthly banks' balance sheet statistics, domestic banks have to record unconditional letter of credit obligations on-balance as "other-other" liabilities without a counterparty breakdown in line with option 1 above. The allocation to the "other-other" liabilities item serves the purpose to exempt these obligations from European Monetary Union minimum reserve requirements.[10] A separate identification of letters of credit within the "other-other" liabilities item – for potential inclusion in the balance of payments/IIP – is not possible.
  Regarding German non-bank importers and exporters, however, a sample inquiry among major multinational enterprises showed that their accounting does not seem to be affected by the use of letters of credit as a means of payment. Hence, they continue to record (and report for balance of

[10] According to ECB-Regulation, minimum reserve requirements are applicable only to liabilities resulting from the intake of funds. Unconditional L/C obligations usually do not qualify for this. In other cases, for example when payment has already been received from the importer or the issuing bank, but not yet passed on to the beneficiary (exporter or confirming bank), L/C obligations have to be reported either as liabilities to banks or other liabilities to non-banks (depending on the creditor).

payments/IIP) a trade-credit liability (asset) vis-à-vis the exporter (importer), following the bookkeeping convention “option 2” above.