


LEGAL NATURE OF THE INTERNATIONAL DOCUMENTARY LETTER OF CREDIT

G. Amilakhvari, Doctoral Candidate, Assistant Professor
Georgian-American University,
Tbilisi Open Teaching University, Georgia

This author has analysed payments by the letter of credit widely used in international trade, when the buyer of goods (importer) writes an order to his bank to transfer funds to the seller (exporter) specified in the letter of credit and in compliance with the terms of the letter. The further development of international trade created a basis for the evolution of financial and trade letters of credit and shaped them into a secure financial tool of a documentary letter of credit. The term "documentary" has settled in practice as a part of the whole letter of credit process.

Keywords: financial intermediaries, letter of credit, financial guarantees, international trade and security backed guarantees.

Conference participant,
National championship in scientific analytics

 Digital Object Identification: <http://dx.doi.org/10.18007/gisap:ejm.v0i13.1627>

In modern times of globalization and the phase of the world integration, it is impossible for an economy to develop without highly rated financial system and in particular intermediaries. Experts kindly note that the productivity of financial intermediaries directly correlates with macro-economic indicators, as well as the social level and quality of life of the population. In this regard, it is important to mention that the commercial banks are regulated by domestic, as well as by bilateral and multilateral agreements.

One of the important agreements on banking regulation is set by the United Nations Commission on International Trade Law (UNCITRAL) and the International Chamber of Commerce (ICC), that is, convention on independent guarantees and standby letters of credit. There are recommendations for banking regulations as well, concerning activities such as bank transfers, international financial transactions, bank guarantees, documentary letter of credit, documentary list of rules, simplification of credit issuance to developing countries, electronic fund transfers, etc.

In international trade, parties, as a general rule, do not know each other and operate from different locations, increasing the credit default risk among various traders. In this regard, both profiles (those concentrated on imports and those on exports) may fail to deliver goods and services on time. They can also breach the promise and after receiving a certain amount of guarantee, avoid making a transaction at all and/or they can deliver low quality products without observing technical regulations introduced by internationally recognized standardization organizations.

Thus, it means that accrual basis, which is based on trust and ethics, may not work at all. In order to avoid disappointments, there are specific forms of payments such as international documentary letter of credit, which in its essence is a productive tool for the above-mentioned risk insurance. Precisely for this reason, International Documentary Letter of Credit is considered one of the safest forms of global payments.

For security reasons, International Chamber of Commerce (ICC) has adopted "Uniform Customs and Practice for Documentary Credits" in 2006, and common rules on banking guarantees have been established: "Uniform Rules for Demand Guarantees", "Uniform Rules for Collections". It is also important to mention the Geneva Convention on checks, transferable and ordinary bills concerning the legal assistance, which can be used for gaining banking information, as well as for checking the existence of financial sanctions on a bank account, etc. In the first article of the uniform rules, it is established that the terms fully determine the responsibilities of the parties and are used for any documentary credit settlements. These requirements are mandatory for all parties involved. Documentary Letter of Credit is an obligation of the provider bank, which is the one used by the seller of the goods, towards the buyer (payer) bank to carry out its responsibilities according to the waybill documents, and to provide payment of the value of the commodity according to the documentary letter of credit.

Since 1990s, the Georgian financial system, including financial intermediaries, has been stable and

developing gradually. It has been adapting legal norms with full compliance with the principles of international economic and trade law. The country adopted many normative regulations concerning not only usual banking activities, but also those related to commercial banks; these include: 3rd, 95th and 96th articles of the Georgia's main Constitution, defining the main aspects of the banking system in Georgia. Articles 859-890 of the Civil Code deal with the banking services, payments, bank loans, deposits, documentary (commodity) letter of credit, documentary collections, bank guarantees and other major issues. Apart from the international laws and domestic laws banking activities in Georgia are also regulated by many normative acts. Commercial banks are supervised by more than 270 normative acts, which include all appropriate changes and amendments.

At present, the current trend of intensification in foreign trade has laid the foundation for an international expansion of financial transactions, without which nowadays it would be impossible to establish any kind of foreign economic relations. It should be noted that international financial operations (unlike internal financial operations) assume conversion of domestic currency to international currencies and other complex processes. The form of International settlement transactions depends on such specific factors, as interdependence between the buyer and the seller, their international image and solvency, the value of the transaction for both parties (market situation, risk factors in countries of the parties), the product type (cigarettes, oil

products, food products, for example, flour, pasta, etc.), settlement, payments restrictions, customs tariffs and non-tariff restrictions and other factors. In order to reduce the risk of large-scale economic transactions the most commonly used tool is a documentary letter of credit, which is a solvent bank's commitment to adhere to the terms, stated in the contract between trading partners. It determines the terms of shipment of goods, payment and other important conditions.

The name "letter of credit" derives from the French word "accréditation" – a power to do something, which in turn derives from the Latin "accreditivus", meaning trust. Certain group of lawyers believe that international trade transactions in the form of a letter of credit payments were established a few hundred years ago. It is known that bank payments via the letter of credit were used in the Roman Empire, ancient Greece, the Philippines and ancient Egypt. G. Mansurov points out: "the letter of credit as a form of payment has been used for more than three thousand years, because it is the simplest, affordable and guaranteed method of bank payment".

Payment settlement in the form of the letter of credit has been used in the UK banking system since ancient times and has been part of the trade law since 1200, which since 1700 has been attributed to the common law of England. The letter of credit in the US also belongs to the common law since ancient times. United States Court of Appeals in one of its decisions indicated that the letter of credit is an ancient institutional function and despite its age it is still used today because of its reliability, availability and efficiency. It was especially prevalent in the US – in the form of a reserve letter of credit – in case of debtor's failure to meet his obligations. Today in the US domestic and international trade activities that take form of a letter of credit are regulated by the Unified Commercial Code. It is stated in the code that the provider of the letter of credit – eminent bank is obliged to fulfil the terms written in the letter and to settle payments with the seller of the goods in a timely manner.

Nowadays, payments by a letter of

credit are widely used in international trade, when the buyer of goods (importer) writes an order to his bank to transfer funds to the seller (exporter) specified by the letter of credit and in compliance with the terms of the letter. During the operation Commodity Credit Bank tasks its correspondent bank to pay the seller the amount specified by the agreement from the importer's (buyer's) account, after the seller has provided the shipping documents. The further development of international trade created a basis for the involvement of financial and trade letters of credit and shaped them into a secure financial tool of a documentary letter of credit. The term "documentary" has settled in practice as a part of the whole letter of credit process.

According to international legal norms and the national legislation, as well as the international trading practice rules and customs, there are the following types of documentary letters of credit:

Revocable – in practice revocable letters of credit are also known as withdrawal letters of credit, as such type of letter gives the seller permission to cancel and refund an order without informing the buyer, or to make changes to it after the goods have been dispatched to the buyer, which will most likely be unacceptable for the importer. Revocable letter of credit is beneficial to an importer in a situation when large quantities of goods were purchased (and they are a subject of letter of credit) and the goods are received in batches. In case the terms of the agreement have been violated the importer can cancel the letter of credit for further batches and hence such type of letter of credit is rarely used in practice;

Irrevocable (non withdrawable) Letter of Credit – this kind of letter of credit prohibits termination, initiated by a single party. In order to cancel the transaction both exporter's and importer's consent is required. At the same time it is necessary to specify in the letter of credit (in the agreement) that it is an irrevocable type of a letter and hence its termination is not permitted. There are two types of irrevocable letters of credit: a) unconfirmed by the exporter's bank and so, according to the rules set, it operates only on behalf of the

importer's servicing bank; b) confirmed by both exporter and importer and the other third-party bank. This kind of letter of credit set by the exporter and the importer ensures that both parties meet their obligations.

Covered and uncovered letters of credit. If a covered letter of credit is used then the issuing bank is required to transfer the entire amount of payment to the exporter's bank (to the buyer's account), or grant the relevant loan to guarantee that the recipient will be paid the full agreed cost of goods. If the uncovered letter of credit is used, the issuing bank does not transfer the amount of payment specified in the contract to the performer's bank, at the same time the performer's bank can withdraw the amount specified in the contract from the issuing bank's account within the agreed time limit. Hence there should be a corresponding relation between the issuing bank and the other party's bank. In international trading practice uncovered and revocable types of letters are used rarely. Hence covered and irrevocable types of letters are used most widely as they guarantee smooth and timely reception of the amount specified in the contract by the seller of goods;

Revolving Letter of Credit – this type of a letter of credit is often used in a situation when both parties have long term trade relations. Revolving letter of credit sets a specific limit that the bank has to pay to exporter party based on sent batches based on months, quartiles or other agreed periods. For this letter of credit, once money has been paid out for the sent goods, the payment is automatically made for the next shipment of goods, and so it continues until the fund limits are reached. One type of a revolving letter of credit is a cumulative letter of credit. It is used in a situation when the importer hasn't received a part of the goods and the payment is made when the delayed goods are finally received.

Divisible and indivisible letters of credit. In case of a divisible type of a letter of credit the payments to the seller are made separately – every time another shipment is received. In case of an indivisible type of a letter of credit the whole payment is made when all

the goods are received or when the last shipment is received.

Transferable letter of credit. This type of a letter of credit allows the exporter (beneficiary) to authorize other subcontractors to get the payment if they provide documents proving the production of the goods. For example in machine building industry the manufacturing process usually takes place in different locations and involves companies from several countries, so the seller-exporter uses transferable letter of credit so that other parties can easily get their share of payment;

Freely transferable letter of credit. In this case the importer is issuing a payment obligation, which in practice is called a commercial letter of credit. It is transferred to the exporter (beneficiary). This document is sent to the servicing bank of the importer, which is responsible for making the actual payments to the importer;

Reserve (Standby) Letter of Credit. This type of letter of credit is most widely used. In fact, it is used with all letters of credit. In such case, the importer's issuing bank is obliged to make a payment to the seller-exporter regardless of whether the importer has met the contract terms. Also the recipient-importer has to submit documents confirming that the exporter party hasn't met some of its obligations (usually consisting of a letter, confirming documents and etc.). In such situation the exporter is guaranteed to get the payment for the sold goods, regardless of whether the importer has paid for the goods or not.

Red clause letters. In trading relations the Red clause Letter (Red Amendment) is used when according to an agreement parties decide to make an advance payment. Hence this kind of tool is often called an advance letter of credit. The title red clause letter originates from the old times when in order to get an advance payment the letter had to be written with red ink. The seller can claim advanced credit specified in the agreement in order to purchase raw materials, to finance subcontractors or for other types of financial operations. The letter is issued with the written commitment that shipping documents will be submitted

at a specific date. The advance payment is made by the servicing bank to the importer from the issuing bank's account. In case the exporter has violated the terms of agreement after he had taken out advance payment (for example, the exporter failed to provide the shipping documents during the specified period), the servicing bank will receive the amount equal to the advance payment plus service fees from the importer's issuing bank. These funds are paid by the importer (beneficiary) to the issuing bank.

Financial securities. In global practice promissory notes and other financial securities are used for making payments by letters of credit. Using financial securities for letters of credit is also a subject of national laws and international legal norms. In 1930, the Geneva Convention was adopted which created the uniform rules for using the financial securities. Also on December 9, 1988 the General Assembly of the United Nations has approved the UNCITRAL convention which covered the issues of ordinary and transferable financial securities. Payments of documentary letter of credit using securities are governed by the laws of different countries. In the US such types of transactions have been regulated by the Uniform Commercial Code since 1962. In 1882 England adopted a law about payments through the transferable securities. In Georgia, on April 19, 1995 a law was adopted, according to which a promissory note is a security, and that the issuer of this security is obliged to pay the amount stated in that security (or obliges another person to make the payment).

In international trade when using such type of payments, securities are used instead of actual currency. By presenting this security in the servicing bank the seller gets the amount specified in the contract. Payment is carried out by the bank immediately after the document is examined. Either for international trade transactions or for one-off operations, the use of letters of credit is not regulated by legal norms, being widely dependent on the established practices. This is also defined in the Article 878 of the Civil Code of Georgia, according to which – unless stated

otherwise, party's rights and obligations are to be determined by the international practices of making payments using the letter of credit. The above mentioned creates a considerable "vacuum" in legal regulations since all related practices of the use of letters of credit do not constitute a legal basis, and are mere recommendations.

According to the Georgian Civil Code's article 876, payments by letters of credit are defined only as a general concept. Also, according to the decree of the National Bank president No. 220 approved on September 2, 1999, payments by the letter of credit are regulated by rules on cashless payments in Georgia. This decree was repealed by the National Bank decree No. 83/01 of June 2, 2010. Also another temporary regulations concerning open various types of banking accounts were abolished by the National Bank on March 17, 2004. Moreover, on July 16, 2008 according to the decree of the President of the National Bank No. 182, the process of using the letters of credit has been ratified in the Ministry of Finance, which is currently used to regulate documentary letters of credit procedures for international trade transactions, as well as for transactions within the country. Apart from the above mentioned types of documentary letters of credit, also other types of letters are used in international trade transactions, such as transport letter of credit, revolving letter of credit, deferred payment letter of credit, and sight letter of credit. However, they are rarely used in practice.

In international trade transactions, as well as in domestic purchase and sale transactions, payment by letter of credit is generally seen in positive light. Payment by letter of credit permits the bank to give out loans, which allows both the buyer and the seller to carry on their production and business activities. At the same time the seller of the goods is guaranteed to be fully paid for the goods at agreed time, irrespective of whether the buyer went bankrupt, encountered financial difficulties or became insolvent.

The use of the documentary letter of credit compared to other banking operations, has a number of advantages

listed above, and so it is widely used in practice globally. Many countries have specific laws according to which some specific purchase and sale transactions can be carried out only using the documentary letters of credit. Such special legal acts are adopted in the United States, France, Italy, Germany, Kyrgyzstan, Kazakhstan, Moldova, Belarus and other countries.

Currently, Georgia has not ratified any of the international agreements or conventions, which according to the Constitution would have legal power and would involve domestic law. So far, unlike other developed states, Georgia hasn't worked out the letter of credit-related regulations, which would be in compliance with international standards. The above mentioned problems create a legal "vacuum" in regulations of letters of credit, which has to be eliminated. The data clearly shows that in Georgian payments made by documentary letters of credit are mostly used for international trade transactions. Due to territorial constraints, as well as residential and industrial enterprises, on the wholesale markets located close to each other the use of letters of credit is less common. Despite these circumstances, it is recommended that letter of credit payments should be used in Georgia for internal trading as well, which will guarantee that both seller of the goods and the buyer will adhere to the terms of the agreement. Measures should be taken by both government institutions and private companies.


Legislative "vacuum" concerning the International Documentary letters of credit creates a lot of practical problems. First of all, it will be reflected in Georgian banking practices. In particular, we officially requested information from 3 major licensed commercial banks for the period of 2010-2014 about the use of letters of credit and obtained the following statistical records: according to the Bank Republic, in 2013-2014, they performed 68 letter of credit payment transactions amounting to 50 million (35% or 17 million and 500 thousand GEL were used for export operations). In 2010-2014 TBC Bank has performed 553 documentary letters of credit import transactions amounting to 1 billion GEL and 21 million.

During 4 years 96 documentary letters of credit were performed in exports with the corresponding payments of 86 million. In 2011-2014 and until May 1, 2015 the Procredit bank has issued and performed 17 documentary payments using the letter of credit amounting to 493 217 EUR and 2 079 087 USD.

In 2010-2014 Georgia's foreign trade turnover amounted approximately to 47.5 billion dollars. Despite the fact that statistical records obtained from banks do not represent all of the market transactions using the letters of credit (even though the information was gained from 3 major banks) and even multiplying the statistical volume of transactions by 3, we get that during the mentioned years the volume of this kind of transactions did not exceed 4 billion USD, which is approximately 10% of the total trade turnover. This clearly proves that the index of letter of credit tools used is catastrophically low. Despite the fact that such form of payment is generally favourable, due to the lack of legal regulations and practice companies prefer not to deal with letters of credit when trading internationally.

Based on the information obtained from the Tbilisi City Court (there are no statistical records of issues concerning letters of credit in the Georgian courts), one can conclude that there is nearly no cases or practice concerning the letters of credit. Hence, we are convinced that in order to increase the level of transaction via the letters of credit in Georgia, a legislative act should be developed and applied, as in other countries, which would cover all aspects of such transactions including the regulations and terms, mandatory obligations for export-import transactions, etc.

References:

1. Georgian constitution, TB, 2014.
2. Uniform rules on documentary acridities established by world trade organization, 2006., Access mode: <http://pravo.rse.ru./interi/doc/02.01>.
3. Convention on independent guarantees., Access mode: <http://pravo.rse.ru./interi/doc/02.01>.
4. Georgian Civil Law, TB, 2013. თბ. 2013წ.
5. Georgian Law on Central Bank and commercial banks.
6. US Trade law., Access mode: <http://pravo.rse.ru./interi/doc/02.01>.
7. Davis A. The law relating to commercial Letters of credit. – London, Pitman, 1939., pp. 1-9.
 <https://doi.org/10.1017/s0008197300013556>
8. Cook A. Financing export and import. 1923., p. 32.
9. Pelfreman D. Ford P. Elements of Banking. Pritman Publish – ung. – London., 1996.
10. Brigham E. Garenski L. Financial Management (Theory and practice). 7thed. – New York., The Dryden Press 1994.
11. Folsom, R Gor.on, M Sepanogle L, International business, Budapest, folpi 1996.
12. Perm G., Shea A., Arora A. The law and Practice of international banking. Bankinglaw. Vol. 2. – London, 1987., P. 296.

Information about author:

Giorgi Amilakhvari – Doctoral candidate, Assistant Professor, Georgian-American University, Tbilisi Open Teaching University; address: Georgia, Tbilisi city; e-mail: z.amilakhvari@openuni.edu.ge

