

Letter Of Credit as a Payment Instrument of the Export-Import Deal

Nadezhda A. Butakova

Russian Academy of National Economy and Public Administration under the President of the Russian Federation, North-West Institute of Management, PhD in Juridical sciences, Associate Professor of the Department of Civil and Labor Law, Russian Federation, St. Petersburg nadbutakova@gmail.com

ABSTRACT

Letter of credit — a financial term, one of the types of payment instruments between the participants of export-import contract. Today the letter of credit is recognized by financiers in all over the world as the most universal way of payment in foreign economic activity. The letter of credit allows the businessmen to solve several problems at once. The letter of credit guarantees: minimization of possible legal risks; additional insurance against unfair contractors in a foreign trade. Russian companies that have experience of working with international partners on the basis of long-term cooperation are able to reach an agreement on payment for products upon delivery. However, start-up companies have no chance to find a foreign company that would be willing to work on such conditions. In addition, payment in advance is unprofitable and not safe for the start-up traders, making the first steps in foreign markets. In this situation the letter of credit is an universal instrument of international payments.

Keywords: letter of credit, confirming Bank, advising Bank, issuing Bank, covered and uncovered letter of credit, revocable and irrevocable letter of credit.

Introduction

In accordance with the current legislation, all enterprises, institutions and organizations, regardless of the legal form, must settle accounts among themselves in a non-cash form. The bank makes settlements on customer accounts in accordance with payment documents provided for by law.

The legal regime for making settlements is determined by Chapter 46 of the Civil Code of the Russian Federation and the "Regulations on the Rules for the Transfer of Funds" (approved by the Bank of Russia on June 19, 2012, No. 383-P; as amended on October 11, 2018; Registered with the Ministry of Justice of Russia on June 22, 2012, No. 24667; as amended, into force since January 6, 2019).

According to article 847 of the Civil Code of the Russian Federation "the rights of the persons who implement the instructions of the client on the transfer and payment of cash from the account shall be certified by the client by means of presenting to the bank of statutory documents in conformity with the bank rules established by the law and the bank account agreement".

In accordance with clause 1 of article 862 and clause 1.1 of the "Regulations on the Rules for the Transfer of Funds", the following forms of cashless payments are established:

- payment orders;
- under a letter of credit;
- by check;
- by collection of payments;
- in other forms provided for by law, banking rules or customary practices used in banking.

Letter of credit payment method

A letter of credit is one of the most effective means of settlement when implementing trading transactions, mainly export-import ones. Such a document performs the function of enforcing a trade agreement and a credit function at the same time. "Thus, a letter of credit in the payment system is a powerful tool in trading operations that allows a skillful trading agent to refute the inevitability of loans in transactions and gain hope for success using situational information and a variety of letters of credit technologies".¹

When entering into an export-import transaction, the parties often use various types of letters of credit as a payment instrument to make settlements between/among themselves. Such crediting was developed through commercial practice. The parties may choose one or another type of a letter of credit at their own discretion. However, indeed, the choice of a letter of credit depends largely on finan-

¹ Semikova P. V. Letters of credit as payment instruments [Akkreditivy kak instrumenty platezha] // Finance and credit [Finansy i kredit]. 2 (116), 2003. P. 11. (In rus)

cial reasons or on whether the buyer's country is subject to strict currency regulation. The degree of mutual trust of commercial partners can also be the reason for choosing a particular type of letter of credit. The use of various types of letter of credit is a common practice in the commercial world when entering into export-import transactions.

According to article 867 of the Civil Code of the Russian Federation "in payments by a letter of credit the issuing bank acting on behalf of the payer shall undertake to make payments to the recipient of cash or to accept or discount a bill of exchange issued by the funds recipient or to perform other actions required to honor the letter of credit upon the recipient's submission of the documents provided for by the letter of credit and under the terms of the letter of credit".

Settlements under a letter of credit, with the exception of the letter of credit honoring through payment, acceptance or discounting of bill of exchange, in accordance with clause 6.1 of section 6 of the "Regulations on the Rules for the Transfer of Funds" (approved by the Bank of Russia on June 19, 2012, No. 383-P; as amended on October 11, 2018; Registered with the Ministry of Justice of Russia on June 22, 2012, No. 24667; as amended, into force since January 6, 2019), are carried out by the bank acting by order of the payer on opening a letter of credit and in compliance with his instructions (hereinafter referred to as the issuing bank), which undertakes to transfer the funds to the recipient subject to the submission of documents stipulated by the letter of credit and confirming fulfillment of its conditions (hereinafter — payment under the letter of credit) or to empower another bank (hereinafter — the paying bank) to pay under the letter of credit.

Currently, the letter of credit, like other forms of settlement, has gained the next round of development, i. e. blockchain.

According to the draft "Regulations on the Rules for the Transfer of Funds" published by the Bank of Russia, the procedure for crediting funds to the recipient's bank account, as well as the features of the information exchange and the submission of electronic documents on a letter of credit using information systems, including distributed information systems (blockchain), have been determined.

A letter of credit is the bank's obligation to make a payment out of the client's funds within the specified amount and subject to the conditions specified in the payment order.

Settlement participants should provide the banks with links to information systems created on the basis of the blockchain, which contain documents on a letter of credit.

The Regulations provide for a number of conditions, under which the document will be deemed to be submitted. The bank that received it should be able to open it, read it and check for compliance with the terms of the letter of credit. The information system it was sent with should be identifiable and accessible during the period of its verification. Access to such a system may be restricted, including paid, if it is stipulated by the terms of the letter of credit, otherwise the document placed therein will not be considered submitted.

Recipients of funds under the letter of credit will be able to notify the paying banks of the completion of the submission of e-documents (including using the blockchain system) or hardcopies thereof.

Documents on letters of credit can also be stored on the basis of the blockchain created on the Central Bank's Masterchain platform. Masterchain is a platform for interaction between financial market participants. It allows you to quickly confirm the relevance of customer or transaction data, as well as quickly create various financial services enabling financial market participants to provide customers with fundamentally new services and products.

In addition to the Central Bank, the largest financial organizations participated in the Masterchain creation, including Sberbank PJSC, VTB PJSC, Alfa-Bank JSC, Gazprombank JSC, Otkritie FC PJSC Bank, QIWI Bank JSC, and NSPK JSC.

Types of letters of credit

The following types of letters of credit can be distinguished:

- a) revocable or irrevocable
- b) standby;
- c) deferred;
- d) transferable;
- e) back-to-back;
- f) red clause;
- g) revolving; and
- h) transit.

Revocable or irrevocable letter of credit

The very name “revocable” implies that such a letter of credit can be canceled by the buyer at any time before payment, which may cause great inconveniences for the seller. The overwhelming majority of export-import trade is based on an irrevocable and confirmed letter of credit due to the inherent advantages of such a letter of credit, namely, guaranteed payment by the buyer, after which the seller can complete in advance preparatory steps, often necessary for the manufacture or purchase of goods to be delivered. However, it should be emphasized that a letter of credit can be canceled, especially in cases where the importer (buyer) is not too sure of the seller’s reliability as a trading partner, although his business reputation was checked in the usual manner. Therefore, entrepreneurs, of course, strive to conduct business on the basis of an irrevocable letter of credit. The letter of credit should clearly indicate whether it is revocable or irrevocable. In the absence of such an indication, the letter of credit will be deemed irrevocable (article 6 of the Uniform Customs and Practice for Documentary Credits; publication of the International Chamber of Commerce No. 600; rev. 1993, enforced on January 1, 1994; hereinafter referred to as ICC 600).²

In case of change or cancellation of a revocable letter of credit, the issuing bank must refund the bank, authorized by it to make a payment upon presentation, acceptance or negotiation under a revocable letter of credit, for any payment, acceptance or negotiation made by this bank upon receipt of a notice of change or cancellation, against the documents that, by their appearance, comply with the terms of the letter of credit (article 8 i of ICC 600). If prior to notification of revocation or change of the letter of credit, such a bank has accepted or agreed upon the documents that by appearance comply with the terms of the letter of credit, the issuing bank must provide a refund to the bank authorized by it to make payments by installments under the revocable letter of credit (article 8 ii of ICC 600). These provisions are designed to protect the second (other) bank.

An irrevocable letter of credit, on the other hand, represents a specific obligation of the issuing bank to make a payment, provided that the relevant documents are submitted either to the issuing bank or to confirming bank, if any, or to any paying bank. If the letter of credit provides for payment upon presentation, it must be paid upon presentation; if it provides for deferred payment, it must be paid after the expiration of the period specified in the relevant letter of credit.

The availability of a documentary letter of credit does not always mean that the beneficiary (exporter) can receive the payment immediately upon the presentation of the prescribed documents. Documents are considered by a confirming or advising bank. Despite the fact that the issuing bank undertakes to make a payment, the confirming bank will not make settlements with the exporter until it receives its refund (article 18 of ICC 600). If there is no confirming bank for this purpose, the exporter can submit documents to his service bank.

It should be noted that an irrevocable letter of credit may be confirmed or unconfirmed.³ In order to confirm an irrevocable letter of credit, the issuing bank authorizes the confirming bank to provide its own confirmation, which constitutes a firm obligation of such a bank (confirming bank) in addition to the obligation already provided by the issuing bank. An unconfirmed irrevocable letter of credit will be based only on the issuing bank’s obligation. In the case of such letters of credit, the advising bank merely advises the beneficiary (clause B of article 19 of ICC 600).

ICC 600 does not provide for “revocable” and “unconfirmed” letters of credit, apparently because the drafters believed that import-export trade was mainly based on confirmed irrevocable letters of credit. However, there are entrepreneurs who still enter into export-import transactions based on ICC 500 or ICC 400. ICC 500 provides for a “revocable” letter of credit, while ICC 400 provides for a “revocable” and “unconfirmed” letter of credit.

Standby letter of credit

Standby letters of credit (SBLC) are letters of credit that serve as a guarantee. Such letters of credit are often used when there is no full certainty that the importer will fulfill his contractual obligations. The issuing bank becomes obligated to pay under the letter of credit in case of the importer’s violation of contractual obligations. The standby letter of credit difference from the guarantee is that the

² Uniform Customs and Practice for Documentary Credits (publication of the International Chamber of Commerce No. 600) [Unifitsirovannyye pravila i obychai dlya dokumentarnykh akkreditivov (publikatsiya Mezhdunarodnoi torgovoi palaty № 600)] rev. 2007 // SPS Consultant Plus (accessed 12.12.2018).

³ See: Alibuttaeva D. M. Types of letters of credit in the international practice. [Vidy akkreditivov v mezhdunarodnoi praktike]// Banking Law [Bankovskoe pravo]. 2004. No. 2. Available at: <https://www.lawmix.ru/bux/113431> (accessed 12.12.2018)

standby letter of credit can be subject to the ICC 600 unified rules, which provide for certain standards for verifying the documents, which does not apply to the guarantee. Moreover, the submission of standby letters of credit to the ICC 600 unified rules eliminates the problems associated with the fact that guarantees are usually subject to the legislation of the country of the guarantor bank.

In order to use a standby letter of credit, the beneficiary (exporter) must submit to the bank a commercial invoice issued to the importer. Standby letters of credit are generally irrevocable, which is explained by the fact that the exporter expects to receive payment due to him for the delivered goods in any case. The importer, in turn, will strive to prevent such a letter of credit from being activated, because if to activate it, the obligating bank must pay against it, which in fact jeopardizes the business relationship between the importer and the bank. Such letters of credit are activated only in exceptional and unforeseen circumstances.

The usual practice, customs and application of standby letters of credit are shown in the International Standby Practices (ISP98). They establish separate rules for standby letters of credit. The practice of standby letters of credit is quite extensive, which indicates the seriousness and importance of this financial instrument.

ISP98 suggests a standard procedure for submitting electronic documents. The condition on the submission of e-documents must be indicated in the standby letter of credit itself. ISP98 applies if the parties have indicated this in the document itself. Therefore, some varieties of standby letter of credit may be subject to ISP98 and some — to ICC 600. To subordinate a standby letter of credit to ISP rules, it is necessary to include therein the phrase that this obligation is made in accordance with the 1998 International Standby Practices. Deferred letter of credit

As the name implies, a deferred letter of credit means that the payment thereunder is deferred for a specified period agreed between the beneficiary / supplier and the importer / buyer. One of the reasons for doing business based on deferred letters of credit is that it can help avoiding stamp duty on a bill of exchange, which can be very high in some countries. A deferred letter of credit differs from a “deferred payment”. Under the deferred letter of credit agreement, the exporter / seller is obliged to submit all the necessary documents to the advising / confirming bank; and payment will be made within the time limit agreed by the interested parties. The legal question whether the importer / buyer possessing a bill of lading can resell goods that are on their way by transferring the bill of lading to another buyer before payment of the transaction remains in abeyance. The problem is that before the funds arrive at the seller’s account, the initial sale and purchase transaction is considered incomplete.

Transferable letter of credit

According to article 48 of the ICC 600, “A transferable letter of credit is a letter of credit whereby the beneficiary (primary beneficiary) is entitled to authorize the bank making the payment or installment payment, acceptance or negotiation, or any bank authorized to negotiate the transferring bank, so that one or several other parties (second beneficiaries) could use the letter of credit in whole or in part”.

In order for a letter of credit to become transferable, the issuing bank must nominate it as such. In accordance with clause B of article 48 of ICC 600 “such terms as “divisible”, “fractional”, “assignable” and “negotiable” does not make the letter of credit transferable. If such terms are used, they should not be taken into account”. At or prior to the request for the transfer of the letter of credit, the first beneficiary should give irrevocable instructions to the transferring bank about whether he wants to retain the right to refuse the latter to advise the amendment for the second beneficiary (beneficiaries). If the transferring bank agrees to transfer the letter of credit under such conditions, it must inform the second beneficiary (beneficiaries) during the transfer of the first beneficiary’s instructions regarding the amendments. Unless otherwise specified in the letter of credit, a transferable letter of credit may be transferred only once. Thus, a letter of credit may be transferred only to the second beneficiary. However, it can be returned to the first beneficiary, while the reverse transfer to the first beneficiary does not contradict the conditions of transferability.

Such letters of credit are usually used in cases where the seller and the buyer enter into a commercial transaction through an intermediary. The intermediary is likely to prefer a transferable letter of credit, since this allows him to avoid investing his own funds in the purchase of goods. Having found the buyer and seller, the intermediary can set a condition of payments using a transferable letter of credit. The method of using transferable letters of credit can be explained as follows: the buyer opens a letter of credit in favour of the intermediary, the advising bank notifies the intermediary of the opening of the letter of credit in his favour. Further, the intermediary instructs to transfer the letter of credit in favour of the seller / goods supplier for an amount less than the amount of the letter of credit opened by the buyer. The supplier / goods seller, who becomes the second beneficiary, purchases or manufactures the goods and ships them either to the ultimate buyer or to an intermediary, to an agent or to a third party.

The second beneficiary submits transport documents and commercial invoices, which are the basis for the transfer of the letter of credit, to the bank. The intermediary also issues its invoices to receive remuneration, which is calculated as the difference in the amount of purchase and sale of goods. The advising bank, which receives the documents required by the applicant for the letter of credit, sends them to the issuing bank. If the first beneficiary fails to submit its commercial invoices, the relevant bank may send the documents it has to the issuing bank, including commercial invoices received from the second beneficiary.

Back-to-back letter of credit

A back-to-back letter of credit means that there are two letters of credit, the first and the second ones, which manage the compensatory system of the letter of credit. Based on this system, the second letter of credit is opened in favour of the second beneficiary / supplier, and the first letter of credit is opened in favour of the first beneficiary / intermediary. The reason for opening a back-to-back letter of credit arises in specific situations, which can be explained by an example.

A stockbroker in London (Party 1) received an order for the supply of a particular product to a company in Africa (Party 2). The payment should be made on the basis of an irrevocable letter of credit. The London-based stockbroker finds a supplier in a third foreign country (Party 3) who also wishes to deal with an irrevocable letter of credit.

The first letter of credit is opened by an African company (Party 2) in favour of the intermediary (Party 1). Party 1 opens a letter of credit in favour of the supplier (Party 3). Party 3 provides the specified documents to the bank; if the documents are accepted, the bank makes payment. Party 3 sends goods to Party 2.

The remuneration of the intermediary is the difference in the amount between the first invoice (invoice to the African company) and the supplier's invoice (this last invoice shows the amount less than that in the African company's invoice).

Features of back-to-back letters of credit:

- both letters of credit are independent of each other, since there are different beneficiaries;
- the second letter of credit is opened on the basis of the first, and the issuing bank takes into account the requirements of the first letter of credit;
- the second letter of credit is opened by the bank that advised the first letter of credit;
- the first letter of credit must be irrevocable and confirmed;
- goods are delivered directly from the second beneficiary to the applicant of the first letter of credit.

Having paid under the letter of credit to the supplier, the confirming bank submits the documents received from the supplier to the bank that issued the second letter of credit (intermediary bank). The bank that issued the second letter of credit is at the same time a confirming and advising bank for the first letter of credit. It replaces the supplier's invoices with the intermediary's invoices and sends the entire package of documents to the bank that issued the first letter of credit. The issuing bank of the first letter of credit deducts the entire amount payable under the trading contract from the buyer's account. Upon receipt of the amount of the letter of credit from the issuing bank, the confirming intermediary's bank closes the intermediary's loan account, and the amount exceeding the payment amount on the supplier's accounts becomes the intermediary's profit.

However, according to the compensatory method of payment under the letter of credit, the intermediary bank is responsible for paying under the second letter of credit, regardless of whether the payment under the first letter of credit has been received; this is due to the fact that these two letters of credit are completely separate instruments. The second letter of credit dates back earlier than the first one.

The two most important differences between a transferable letter of credit and a compensatory one are as follows:

- in the case of a transferable letter of credit, the buyer knows that he is dealing with an intermediary, while in the case of a compensatory credit, the buyer does not know about the intermediary;
- the intermediary and his bank are not liable for the transferable letter of credit, but in the case of a compensatory letter of credit, both parties remain responsible for paying under the second letter of credit.

Red clause letter of credit

According to the red clause letter of credit, a beneficiary (seller) is allowed to receive an advance payment (a certain percentage of the amount of the letter of credit) before the shipment of the goods and the submission of documents provided for by the letter of credit. This clause used to be high-

lighted in red, so this letter of credit is called a "red clause" letter of credit. Obviously, this financial privilege allows the seller to purchase materials for the production of goods intended for delivery, without the need to spend his own funds or to lend from other sources. However, following shipment, the seller submits documents to the bank in the usual way, in order to receive the final payment. The funds transferred as an advance are deducted from the last payment.⁴ Advances under the "red clause" of a letter of credit can be secured or unsecured.

Secured Advances

In the case of secured advances, they are permitted only against certain documents confirming the availability of goods, namely, warehouse receipts and the obligation to provide bills of lading.

Unsecured Advances

When advance payment is provided against the beneficiary's application, advance is required to pay for pre-shipment of goods.

If no payment is received from the buyer, the paying bank that has paid the letter of credit is entitled to apply to the issuing bank for compensation. Consequently, an advance payment of any nature should be made against the appropriate bank guarantees of the seller's / supplier's bank.

Revolving letter of credit

A revolving letter of credit is used in cases where trade relations are of long-term nature and deliveries are made regularly. Therefore such a letter of credit is automatically renewed after each delivery within the stipulated period. For example, a revolving letter of credit in the amount of € 50,000 for 6 months has been issued. When documents evidencing the shipment of goods are submitted to the bank, the letter of credit is renewed automatically. The number of write-offs for amounts within the indicated € 50,000 can be almost unlimited.

Transit letter of credit

A transit letter of credit is opened if the issuing bank contacts the intermediary bank in one country to confirm or advise the letter of credit in favour of the beneficiary resident of another country. The advising bank may send the letter of credit directly to the exporter or advise it through a selected agent in the exporter country. As a rule, a bank acts through an agent when it has no agency agreement with the seller's bank or the seller's bank is unknown to it.

Conclusion

Thus, the presented types of letters of credit and their functionality characterize the variety of their scope of application. The author believes, that a documentary letter of credit should be chosen in order to meet the specific needs of the parties.

All types of letters of credit described herein are well known in commercial practice. They appeared as payment instruments necessary in international trade. Therefore, we believe that in the foreseeable future these tools are unlikely to undergo significant changes in terms of economic content, except for the technical improvement of the document flow.

References

1. Alibuttaeva D. M. Types of letters of credit in the international practice. [Vidy akkreditivov v mezhdunarodnoi praktike] // Banking Law [Bankovskoe pravo]. 2004. No. 2. Available at: <https://www.lawmix.ru/bux/113431> (accessed 12.12.2018)
2. Semenikhin V. V. Foreign economic activity [Vneshneekonomicheskaya deyatel'nost']. Available at: <http://bzbook.ru/Vneshne-ekonomicheskaya-deyatelnostj.135.html> (accessed 12.12.2018).
3. Semikova P. V. Letters of credit as payment instruments [Akkreditivy kak instrumenty platezha] // Finance and credit [Finansy i kredit]. 2 (116), 2003. PP. 10–14. (In rus)

⁴ See: Uniform Customs and Practice for Documentary Credits (publication of the International Chamber of Commerce No. 600) [Unifitsirovannye pravila i obychai dlya dokumentarnykh akkreditivov (publikatsiya Mezhdunarodnoi torgovoi palaty № 600)] rev. 2007 // SPS Consultant Plus (accessed 12.12.2018).