

Activating Letter of credits under the Swift system in Iraq

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Abstract:

Documentary credits are considered successful means to reduce imports, especially unnecessary imports that lead to the outflow of foreign currency from the country. However, due to the backwardness of the banking methods, the reintroduction of documentary credits after 2003 did not effectively contribute to reducing import rates. This has had a negative impact on the Iraqi economy and made it vulnerable to external markets. Documentary credits are also considered the best way to ensure payment in international trade, providing independent credit support and sufficient security for exporters and importers against commercial risks. Documentary credits are used to finance foreign trade. The importance of researching the activation of documentary credits and their role as an effective tool to reduce imports of unnecessary goods in the SWIFT system arises. The Iraqi economy faces several challenges, including structural imbalances in various economic sectors (industrial, agricultural, and service sectors) and the inability to meet local demand, leading to increased imports of unnecessary goods and leakage of foreign currency abroad. The research hypothesis suggests that documentary credits have an impact in reducing the leakage of foreign currencies and as a tool for controlling foreign trade under the SWIFT system. The aim of the research is to shed light on the reality of documentary credits in Iraq in light of the development of banking methods and the role of documentary credits in reducing the outflow of foreign currency and unnecessary imports. The role of the SWIFT system in Iraq in curbing the smuggling of foreign currency is also examined. The research reached several conclusions, including the significant importance of documentary credits and the SWIFT system in regulating foreign trade and reducing the outflow of foreign currency abroad. There is also substantial international support from financial institutions for the SWIFT system in financing foreign trade. The key recommendations include directing operating banks to work with the system of documentary credits to cover imports and not relying on the external currency exchange window.

Keywords : documentary credits, SWIFT system, currency exchange window

Introduction:

Documentary credits serve as a reliable method to ensure secure payment in international trade, providing exporters and importers with independent credit support and protection against commercial risks. They are widely used to finance foreign trade and offer a trusted framework accepted by international traders. Document collection, a payment mechanism where the bank collects payments on behalf of the exporter by delivering documents to the importer, is employed when there is mutual understanding and a certain level of trust between the parties involved. The SWIFT system, which stands for "Society for Worldwide Interbank Financial Telecommunication," is a global financial system established in 1973. It facilitates convenient and swift funds transfer across borders, connecting thousands of banks and institutions in numerous countries. The system enables instant correspondence between exporters and importers, providing information on payment timing. With over 50 million messages sent daily, the SWIFT system facilitates the exchange of trillions of dollars between companies and governments worldwide. While documentary credits are considered effective in reducing imports, particularly unnecessary ones that deplete foreign currency reserves, their reintroduction after 2003 did not significantly contribute to lowering import rates in Iraq due to limitations in existing banking methods. This has negatively affected the Iraqi economy and made it susceptible to external market influences.

First: Importance of the research

The importance of the research lies in exploring the Activating¹ of documentary credits and their role as an effective tool to reduce imports of non-essential goods under the SWIFT system.

Second : Research problem

The Iraqi economy faces several challenges, including structural imbalances in various economic sectors (industrial, agricultural, and service sectors) and the inability to meet local demand. This has led to an increase in imports of non-essential goods and the outflow of foreign currency.

Third : Research hypothesis

The research hypothesis assumes that documentary credits have an impact in reducing the outflow of foreign currencies and serve as a tool to regulate foreign trade under the SWIFT system.

Fourth : Research objectives

The research aims to shed light on :

1. The current status of documentary credits in Iraq in light of the development of banking services.
2. The role of documentary credits in reducing the outflow of foreign currency and non-essential imports.
3. The role of the SWIFT system in Iraq to combat the smuggling of foreign currency.

Fifth : Research Structure

The research is divided into three sections. The first section discusses the conceptual framework of documentary credits, their types, procedures for opening documentary credits. The second section covers the conceptual framework of the SWIFT system and its implementation in Iraq. As for the

¹) Activation is intended to enhance the role of documentary credits as they are activated in government banks and are effective in reducing imports of unnecessary goods under the Swift system.

third section, it analyzes the relationship between documentary credits, foreign trade, and the SWIFT system in Iraq. The research concludes with conclusions and recommendations.

Topic One: Conceptual Framework of Documentary Credits and Their Types

1-The concept of documentary credits and their parties

Documentary credits serve as a financing tool for international trade transactions and are typically facilitated by banks. They offer a sense of assurance and stability to both importers and exporters, as they rely on the trustworthiness of banks to execute these credits. When the conditions outlined in the documentary credit are met, the exporter receives payment for the goods they have exported. Importers understand that the issuing bank will only release payment once they have verified that the conditions stipulated in the documentary credit have been fulfilled. A documentary credit is a commitment issued by the opening bank, upon the request of an importer, wherein the bank agrees to pay a specified amount or authorize another bank to make the payment on behalf of the exporter. This payment is contingent upon the presentation of documents that comply with the agreed-upon conditions detailed in the documentary credit (Faour, 2006: 23).

When initiating a documentary credit, there are several essential documents that must be provided. One such document is the commercial invoice, which is issued by the exporter and contains details regarding the value, quantity, and specifications of the goods being shipped. Additionally, a certificate of origin, obtained from the Chamber of Commerce in the exporting country, is necessary to determine the place of production for the imported goods. This certificate must undergo the same authentication process as the commercial invoice. The shipping bill is a mandatory requirement for all documentary credits. Air shipments necessitate an airway bill, while sea shipments require a bill of lading, and land shipments call for a bill of land border ports. These documents serve as evidence of receipt, transportation contracts, and proof of ownership. The bill of lading, provided by the shipping company upon receiving the goods, ensures the safe handling of the shipment and includes information such as the shipping port, destination, shipping fee, and payment method. The issuing bank of the documentary credit often requests the bill of lading to be issued in their favor, as it is a document held by the carrier's agent and is used to deliver the goods to the individual presenting the original bill of lading. As the goods serve as collateral for the payment of the documents, the issuing bank retains control over the goods and only releases the bill of lading to the customer once the credit value has been paid. The weight certificate is typically required when the weight of the goods is a relevant factor, and the weight stated in the certificate should correspond to that indicated in the bill of lading issued by the shipping company. A specifications statement is often included among the documents to provide details about the dimensions and measurements of the goods, including length, width, and height. An inspection certificate, issued by specialized inspection companies, may also be required. These companies examine and inspect the goods prior to shipment, usually by selecting a random sample, and provide a certificate indicating the condition and specifications of the inspected goods. Furthermore, a health certificate may be necessary for documentary credits involving the importation of food or meat, ensuring that it is suitable for human or animal consumption. This certificate is typically issued by the Ministry of Health in the exporting country. The parties involved in documentary credits include importers, who enter into a contractual agreement with the issuing bank. The bank

responsible for opening the documentary credit evaluates the request, reviews the credit conditions, and sends it to the beneficiary and the exporters to fulfill the specified conditions within the credit's validity period. The correspondent bank, on the other hand, informs the beneficiary about the content of the credit letter received from the issuing bank. Importers can identify exporters through various means, such as international trade exhibitions, commercial directories, or by directly visiting importers and exporters in both countries to gather information about the commodity and its source (Bassioni, 2014: 67).

2- Types of Documentary Credits

There are several types of documentary credits, including : (Bassioni, , 2014: 77)

2-1. Revocable and Irrevocable Credits: Revocable credits can be modified or canceled by the issuing bank at any time without prior notice to the beneficiary. However, this type of credit is rarely used as it has not found practical acceptance by exporters due to the risks and damages it may cause them. On the other hand, irrevocable credits cannot be canceled or modified unless all relevant parties, especially the beneficiary, agree and consent to such changes. In this case, the issuing bank remains obligated to fulfill the conditions stipulated in the letter of credit. Irrevocable credits are the most commonly used type of documentary credits.

2-2. Confirmed and Unconfirmed Credits: In an unconfirmed credit, the payment obligation lies with the issuing bank, and the confirming bank acts as an intermediary in executing the credit against a commission fee. The confirming bank is not obligated if either party fails to meet the conditions stated in the credit. In contrast, in a confirmed credit, the correspondent bank in the beneficiary's country adds its commitment to the issuing bank's commitment. The issuing bank only requests confirmation from the correspondent bank when it is a requirement imposed by the exporter on the importer.

2-3. Sight, Acceptance, and Deferred Credits: In a sight credit, the issuing bank immediately pays the full value of the presented documents upon examining them and verifying their compliance with the credit. In an acceptance credit, payment is made through drafts drawn by the beneficiary and presented as part of the shipping documents. As for deferred credits, they are definite credits that allow the beneficiary to withdraw specified amounts in advance upon notification of the credit, before submitting the documents. The issuing bank is obligated to compensate the correspondent bank upon its first request. If the credit is not honored, and the beneficiary fails to refund the advanced payment, the applicant is responsible for compensating the issuing bank.

2-4. Fully Covered, Partially Covered, and Uncovered Credits: A fully covered credit is one in which the applicant covers the full amount of the credit with the bank. The bank then pays the price of the goods to the seller upon receipt of the shipping documents. In this case, the bank bears no financial burden. On the other hand, a partially covered credit is one in which the customer opens the credit by paying a portion of the goods' price from their own funds, and the bank shares the risk of financing the remaining portion of the credit amount. Traditional banks calculate interest on the uncovered parts, while Islamic banks use the concept of participation credit. An uncovered credit is when the bank provides full financing to the customer within the limits of the credit amount. The

bank disburses the amount to the beneficiary upon document submission. Islamic banks differ in how they provide financing in this type of credit, often using the concept of Murabaha.

2-5. Transferable, Revolving, and Back-to-Back Credits: A transferable credit is a non-revocable credit that grants the beneficiary the right to request the authorized paying bank to transfer the credit, either wholly or partially, to another beneficiary. A revolving credit is one that is opened for a specific amount and period but automatically renews upon being utilized or exhausted. The beneficiary can present documents for a new transaction within the limits of the credit. As for a back-to-back credit, it is used when the beneficiary of the original credit acts as an intermediary rather than the actual supplier of the goods. In this case, the beneficiary opens a new credit in favor of the actual supplier, with the original credit serving as collateral.

2-6. Export and Import Credits: Export credits refer to the credits opened by foreign buyers in favor of domestic exporters to purchase local goods. Import credits, on the other hand, are credits opened by importers in favor of foreign exporters to purchase foreign goods.

3- Documentary Credits Opening and Amendment Mechanism

When initiating a documentary credit, the importer and exporter engage in negotiations to reach an initial agreement that aligns with international norms and rules for such credits. This agreement includes details about the goods, prices, method and date of shipment, ensuring compliance with documentary credit standards. The credit amount, required documents, shipment date, and credit expiration date are determined, and the bank is authorized to record expenses and payments related to the account of the importer, adhering to international regulations and norms for documentary credits. Subsequently, the bank enters the credit opening request information into an approved documentary letter of credit, signed by bank representatives, and sends it to the correspondent bank in the source country. Prior to this, the bank ensures that there is sufficient balance to cover the cash, commission bonds, and postal expenses associated with the credit, deducting them from the importing customer's account. The details of the documentary credit, including the credit number, local and foreign currency amounts, the name of the customer opening the credit, beneficiary name, and credit opening date, are recorded in a specialized register called the Documentary Credits Register. This ensures compliance with the agreed-upon conditions with the importer and facilitates the preparation of the required documents. Subsequently, the exporter prepares the goods and obtains the necessary documents specified in the credit, delivering them to the correspondent bank, which then sends them to the bank that opened the credit. Upon receiving the documentary credit, the bank compares it with the documents to ensure there are no discrepancies in terms of description, quantities, and shipment date. The bank's decision to pay the value of the documents or withhold payment holds significant importance for both the bank, the exporter, and the importer. Paying the value of the documents without conformity with the credit conditions poses a risk for the bank, as the importer may refuse to pay the credit value if the documents do not comply with the previously agreed-upon credit terms (Faour, 2006: 23).

Modifications to documentary credits are possible upon the importer's request. When the importer seeks to amend the credit, they submit a request to the bank that issued the credit. The issuing bank then informs the correspondent bank about the amendment, which subsequently notifies the

exporter of the modification. These changes may involve adjusting the credit value, extending its validity, or making other necessary modifications.

Regarding the methods of shipping goods in documentary credits, the responsibility for the costs, insurance, and shipping expenses depends on the agreed-upon terms. F.O.B (Free On Board) indicates that the importer assumes responsibility for the goods once they are ready for delivery at the exporter's shipping dock. The importer then arranges for insurance and covers the shipping costs until the goods reach the importer's port, assuming the associated risks. On the other hand, C & F (Cost - Freight) means that the exporter bears the costs of the goods and shipping expenses, while the importer covers the insurance costs. C & I (Cost - Insurance) implies that the exporter bears the costs of the goods and their insurance, while the importer is responsible for the shipping costs from the source port to the importer's port. Typically, importers prefer the C.I.F method, while exporters prefer the F.O.B method.

It is important to note that there are various types of documentary credits. The most common type is the documentary credit at sight, where the beneficiary receives payment immediately after presenting the agreed-upon documents. Deferred payment documentary credits involve payment to the seller at a later date after submitting the specified documents. There is also the option of an Advance Payment Documentary Credit, where the seller can obtain an advance payment to finance the manufacturing or purchase of the goods to be shipped. Revolving documentary credits allow the seller to receive payment in fixed installments for goods shipped over specified periods. Lastly, standby credits serve a similar purpose to a letter of guarantee, where the beneficiary receives payment upon submitting a simple request (Maher, 2004: 87).

second topic:Theoretical framework

1- The Concept Of The Swift System

SWIFT, short for The Society for Worldwide Interbank Financial Telecommunications, is a non-profit cooperative organization that offers a highly efficient and cost-effective messaging service for financial payments. Its establishment in 1973 was driven by the need for a global system to facilitate monetary transactions and international trade. Headquartered in Belgium, SWIFT commenced its operational activities in 1977. The system functions as an international banking transactions network, connecting banks worldwide. Its primary objective is to provide advanced and secure means of linking and exchanging messages and information among international financial markets through participating banks in different countries. By utilizing SWIFT, subscribers can effectively meet the requirements of both foreign and domestic customers. The system enables various banking operations, such as matching customer orders, settling transactions, and approving trading operations between relevant parties. SWIFT serves as an advanced platform encompassing all correspondence related to financial and banking transactions between banks and financial institutions. It ensures the secure and swift delivery of these transactions to the relevant authorities. Banks rely on the SWIFT system to send standardized messages concerning interbank transfers, customer transactions, and orders to buy or sell assets. As of the first quarter of 2020, the number of financial institutions and banks participating in SWIFT exceeded 11,507 subscribers across more than 200 countries worldwide. Over the past decade, the organization has reduced the prices of

exchanged messages by over 70%. During the same period, the number of messages exchanged through the SWIFT network exceeded 2.4 billion, with a growth rate of 16.6% compared to the previous year. The peak of message exchange in a single day reached over 43 million messages on February 28, 2020. Russia ranks as the second-largest user of the SWIFT system after the United States, with approximately 300 Russian financial institutions being members. However, Russia has developed its own local financial infrastructure, including the SPFS system for bank transfers. While Western countries threatened to exclude Russia from the SWIFT system in 2014 following the annexation of Crimea, this action was not implemented. Experts believe that the exclusion of a significant country like Russia, which is a major global supplier of oil and gas, could prompt Moscow to accelerate the development of alternative financial networks, potentially in collaboration with China, countries in the Shanghai Cooperation Organization, or the BRICS Organization. The SWIFT system network is jointly owned by over 2,000 banks and financial institutions and is supervised by the National Bank of Belgium in partnership with major central banks worldwide, including the US Federal Reserve and the Bank of England (Noman, 2013: 43).

2- The operation of the SWIFT system in Iraq

The operation of the SWIFT system in Iraq has caused a depreciation of the Iraqi dinar against the US dollar and has posed significant challenges for large segments of Iraqi society, given the extremely difficult living conditions resulting from the high prices of goods and services. When this system is imposed, the process of smuggling dollars out of the Iraqi market will be halted, which is beneficial to the Iraqi economy. However, its effects in the short term have a major impact on the living conditions of the majority of the population.

Therefore, the government needs to find immediate solutions to mitigate the effects of the SWIFT system. Maintaining the current situation will affect most social classes, including the poor and middle class, leading to higher prices of essential goods, including food and construction materials. There are several reasons behind the US sanctions, according to their claims. One reason is the alleged economic sanctions evasion by affiliated banks with Iran and the smuggling of hard currency to support its economy due to its continued development of its nuclear program.

The creation of the SWIFT system was driven by the desire of American and European banks to prevent the concentration of financial power in a single institution and the establishment of monopolies. Exclusion from the SWIFT system can have severe financial repercussions for a country. In 2012, Iran experienced this firsthand when it was banned from using SWIFT as part of the sanctions imposed on its nuclear program. As a result, Iran suffered significant losses, including a nearly 50% decline in oil export revenues and a 30% decrease in global trade. Similarly, Russia faced substantial economic impacts when access to the system was suspended due to international sanctions related to the conflict with Ukraine, resulting in losses estimated in the billions of dollars.

Third Topic:

practical framework

International trade is considered the main driver of development and economic growth due to its connection with various economic sectors. Trade exchange between countries is like the main artery that links different nations, allowing them to gain trade benefits, ensure the stability of foreign

currency, and prevent its outflow. Documentary credits, being the tool that connects the local economy with the global economy, play a crucial role in achieving these objectives. Furthermore, documentary credits contribute to stimulating the national economy through the banking sector. They enhance the liquidity of banks by facilitating the acquisition of foreign currencies from abroad. Additionally, documentary credits serve to protect domestic industrial and agricultural products from foreign competition through the privileges and regulations embedded in the opening of these credit.

It is necessary to regulate customs procedures, which is why documentary credits are considered a tool for organizing imports and limiting the flow of substandard goods, which have a negative impact on the local economy. They also help in preserving the country's wealth by preventing the smuggling of foreign currencies. The Central Bank of Iraq can direct the financing of imports through documentary credits instead of relying on external bank transfers. The latter refers to the financial transfer window for funding imports through companies, offices, and banking intermediaries, which is the most common method of organizing international trade. This approach ensures the rights of foreign trade operators before the activation of the SWIFT system in 2023 to regulate external transfers and the supervision of the Central Bank of Iraq and the Federal Reserve Bank.

The directives and decisions issued by the government and the Central Bank of Iraq came to work with the SWIFT system, activate documentary credits, and leave the remittance system in order to preserve foreign currency and limit its exit abroad.

In order to achieve the objective of these directives, banks and commercial institutions must take several measures, including :

- 1- Regulating the import structure that takes into account the real domestic demand and limiting unnecessary and inferior goods.
- 2- Developing appropriate customs procedures that are commensurate with the volume of foreign trade. Which requires examining and reviewing exported goods, whether from border crossings, airports or seaports.
- 3- Activate the standardization and quality control system in order to focus on good imported goods that deserve foreign currency exchange.
- 4- Contracting with qualified international companies to examine imported goods as well as examine exported goods before shipping them to importing countries.
- 5- The central bank should harmonize the opening of documentary credits with the legislation in force.

There are several challenges facing banks in making documentary credits:

- 1- The complex legal procedures that take a long period of time to obtain documentary credits overburden the opening of documentary credits.
- 2- Recent technological developments are still below the level required to start opening letters of credit and applying the Swift system.
- 3- The lack of modern experience, skill and specialization in the field of banking work and interaction with the SWIFT system.

4- The large guarantees imposed on opening bank credits and the high percentage of commissions generated from opening credits.

5- The backwardness of banking services through messages and the procedures followed by banks, especially documentary credits, and the reliance on primitive methods to carry out banking business.

Conclusions

1- The role of documentary credits and the Swift system is of great importance for regulating foreign trade and limiting the diversion of foreign currency abroad.

2- There is great international support by international financial institutions for the SWIFT system for financing foreign trade.

3- Documentary credits and the Swift system work to develop the financial and banking sector, especially banks, as a result of their dealings with other banks in developed countries.

4- The foreign trade transactions show that the importer prefers to follow the C.I.F method, while the exporter prefers to follow the F.O.B method.

5- The failure to activate the documentary credits system and the Swift system to regulate imports and foreign transfers and finance them by the banking system makes banking companies and offices carry out commercial operations, which leads to an increase in the smuggling of foreign currency abroad.

6- The feature of limiting unnecessary imports, which works to increase currency leakage and imbalance in the country's trade balance, has not been invested.

7- Working with the Swift system has caused a decrease in the exchange rate of the dinar against the dollar and the confrontation of large classes of Iraqi society with very difficult living conditions as a result of the high prices of goods and services in the short term.

8- Banks operating according to the "Swift" system contribute to sending unified messages about transfers of funds between them, transfers of funds to customers, and purchase and sale orders for their financial assets.

Recommendations

1- Finding immediate solutions by the government for the effects of working with the Swift system, since the situation remaining as it is will affect most of the classes, including the poor and middle in society.

2- Directing operating banks to work with the bank credits system for the purpose of covering imports and not working with the foreign exchange window.

3- The central bank motivates banks operating under the documentary credits system by granting them cash incentives such as reducing the legal reserve ratios or granting them soft loans.

4- Government institutions developing and qualifying their cadres working in the banking sector or contracting, such as documentary credits and the Swift system.

5- Banks working on developing and innovating banking methods and introducing their cadres to advanced training courses.

6- Obliging companies and government institutions when conducting contracts for the purpose of meeting their needs to make documentary credits.

7- Drawing up a clear trade policy by the government that is consistent with foreign trade plans with regard to customs duties and the quota system.

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