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LEGAL RELATIONS BETWEEN LEGAL ENTITIES IN REGARD TO THE LETTER OF CREDIT WITH A REFERENCE TO THE ROLE AND SIGNIFICANCE OF BANKS IN THE STRUCTURE OF THE FINANCIAL SECTOR IN SERBIA

ABSTRACT: Banks are the most visible financial intermediaries in the field of economy. Their importance derives from the place and role in both economic and financial systems of each national economy. In the financial sector of Serbia, banks are the most important financial institutions, accounting for about 90% of total financial sector assets. The topic of the research refers to the letter of credit as a service banking business and it is extremely current topic, scientifically and socially justified, being important for domestic and foreign trade payments. The letter of credit is a complex banking business. Its complexity is reflected, among other things, in the number and types of legal relationships formed between the participants. Having in mind all previously mentioned facts, the paper analyzes the issues of the concept and classification of banking business as well as the legal aspect and legal relations formed

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in the letter of credit. The research part of the paper deals with the role and importance of banks in the financial sector of Serbia.

Keywords: *the letter of credit, legal relations in the letter of credit, banking, financial sector, Republic of Serbia*

1. Introduction

The impact of economic policy, flows and market mechanisms at the global and regional level is primary of interest for national economies and economic flows. On the other hand, it is also important for individual businesses, whose interests are basically the fulfillment of obligations undertaken on the basis of contracts in the businesses with in which they operate.

This is a very important issue, so due to its importance in recent decades, there has been an inevitable and much-needed improvement in ensuring the fulfillment of obligations undertaken on the basis of concluded contracts, as well as mediation in the implementation of specific business activities (values, doing business abroad, complexity in the realization of a specific job, as well as other jobs that carry with them certain risky or complicated constitutive elements or parameters), exceed the standards in business that are part of the daily activities of business entities.

According to Milosavljević (2017), “in the business of economic entities, the tendencies of modernization and harmonization of rules on international business are increasingly pronounced” (p. 50).

Letter of credit is very important in business law. In the theory and practice of banking, it is emphasized that a documentary letter of credit is practically an irreplaceable service banking business, especially in international payment operations. According to its principle classification, it belongs to the group of neutral banking operations, precisely because of the specific status of the bank during the opening and realization of letters of credit. Namely, in the business of letters of credit, the bank does not have the status of a debtor or a creditor, but performs certain actions on behalf of its client.

The letter of credit is regulated in both domestic and international law. In domestic law, the letter of credit is regulated by the provisions of the Law on Obligations (1978) and the provisions of the General Customs of Trade (1954). In international law, the letter of credit is governed by the Uniform Rules and Customs for Documentary Letters of Credit – UCP 600 (1933) of the International Chamber of Commerce based in Paris, the latest version of which was adopted in 2007 by the Commission on Banking Technology and Practice.

Having in mind the topic of the paper, in the following text we will talk more about the conceptual definition and classification of banking operations, the concept and characteristics of the legal transaction in regard of letters of credit, and legal relations in that are indicated in this business. The empiric research part of the paper will deal with the role and importance of banks in the structure of the financial sector in Serbia

2. The concept and classifications of banking transactions

According to Carić (2007), banking transactions are “legal transactions concluded between banking organizations in connection with the legal circulation of money and the provision of economic services with money” (p. 15). According to Mastilović (2019), “all banking operations have certain specifics, and that is that they are composed according to pre-prepared and compiled standard, and standard contracts or according to the general rules of business of the banking organization, which means concluding transactions by adhesion. One of the contracting parties is always a banking organization and contracts are valid only if they are drawn up in writing” (p. 773).

In legal theory, there are several ways of dividing the banking operations. In principle, any of the divisions has its advantages and disadvantages, and to some extent one is more or less acceptable, or not acceptable. Over time, starting from the objections that have imposed themselves in theory and practice as decisive in the classification of banking operations, the classification that is currently most widely accepted, and which includes the tripartite division of banking operations, has been determined. According to this classification, banking activities can be divided into three basic groups: “active banking operations (banking operations in which a banking organization appears in the role of a creditor); passive banking operations (banking operations in which the bank appears in the role of a debtor); neutral banking operations (banking operations in which certain specialized banking services are regulated, in such a way that the bank in these operations is neither in the role of creditor, nor in the role of debtor in relation to monetary claims)” (Carić, 2007, p. 18).

According to the given classification, a letter of credit belongs to a neutral banking business, which means that “a bank is only an intermediary in performing business between its clients in order to facilitate it, and it has the right to commission for performing its work” (Mastilović, 2019, p. 774). Although its “gaining increasing importance in domestic payments” (Mastilović, 2019a, p. 99), the letter of credit is an important instrument of international payments, where the role of international banking in international

payments is unavoidable because all transactions take place through authorized banks and/or their foreign correspondent banks with which banks have opened accounts" (Milenković, 2010, p. 15).

3. The legal concept and characteristics of a letter of credit as business activities

According to Vukadinović (2012), "the term letter of credit derives from the Latin word *accreditivum* and in the legal sense means the power of attorney of one person to make a payment to another authorized person" (p. 791). Vojnić Hajduk (2019) notes that "a letter of credit is a legal transaction that arises from the conclusion of a contract in regard to the opening of a letter of credit, on the basis of which a statement on the opening of a letter of credit is given" (p. 284). In legal theory, a letter of credit is in principle defined as "a set of legal relations in which the bank, on the order of its client and in accordance with his instructions, makes payments to the user, without any conditions or if the user meets certain conditions" (Mastilović, 2019, p. 775).

In the context of the above, it is worth mentioning the review made by Ćirić (2018), which under international letter of credit means "neutral banking business when the letter of credit bank, at the request of its client (principal) makes available, or issues an order to its bank correspondent, to the third party (user, remitter), to make available the amount of money indicated by the letter of credit at a certain time, provided that the user presents and submits to the bank proper "goods" documents provided as a condition for payment of the letter of credit" (p. 473).

Emphasizing the importance of letters of credit as a complex business, Milenković Kerković and Spirović Jovanović (2013) state that "the essence of a complex letter of credit transaction lies in the fact that goods are symbolically represented by "goods documents", and that the role of documents is representative goods is three ways: the goods have been shipped, the goods is comply with the provisions of the contract, and that after payment by the bank, and therefor by taking over the documents, the buyer acquires ownership of the goods, without its physical presence" (p. 363).

"From the point of view as a banking business," a letter of credit is a rather complex banking service business. It is a transaction in which one legal person, a letter of credit bank, undertakes by order of another person, a client (debtor of a financial obligation in the main transaction), to personally or through another bank (associate bank) pay a certain amount of money to a

third party, if he request it within the seted deadline" (Jovanović et al., 2020, pp. 524–525). By its legal nature, "a letter of credit is a type of instruction (assignment) of the obligation law, where the subject of it is the payment of money" (Jovanović et al., 2020, p. 525).

Therefore, the essence of the letter of credit is to, regardless of the spatial distance between the seller and the buyer, ensure that the buyer receives the goods he ordered (both qualitatively and quantitatively), and that the seller has certain guarantees that the buyer will pay for the goods he received. A letter of credit therefore protects both parties – the buyer and the seller, and the bank certainly appears as a third party.

Continuing in the context of the above, Leon points out that the most important characteristic of a letter of credit is actually its reliability, ie security of payment. Therefore, parties who would otherwise be reluctant to enter into a transaction are encouraged to participate because they can rely on a secure source of credit and thus more accurately assess possible business risks (Leon, 1986, p. 432).

4. Legal relations in the letter of credit

At least three entities appear in the letter of credit. This means that three entities will certainly appear in each letter of credit transaction, but it is not excluded that a fourth entity will be involved in this transaction, if there is a need for that in a specific transaction. Entities in the letter of credit that certainly appear are:

- Client of the bank who gives the order for opening a letter of credit (debtor from the main business) – the ordering party;
- The person in whose favor the letter of credit was opened (creditor from the main business) – the user of the letter of credit;
- Bank to which the order for opening a letter of credit was sent – letter of credit bank.

These are subjects "between which legal relations are established and therefor have their own independent legal nature and which is established mutually separated, independent and autonomous, but aslo still mutually conditioned, so that together they form a legal unity" (Babović, 2021, p. 452).

With the help of a letter of credit, "the ordering party fulfills some of its financial obligations from a certain economic contract (payment of the purchase price, payment of the construction price, etc.), regardless of is it clearly seen from the letter of credit itself. To this end, this subject gives an

order to “his” bank to open a certain type of letter of credit with his or another bank (depending on the basic agreement between the principal and the user of the letter of credit)” (Antonijević et al., 1982, p. 273).

The user of the letter of credit is the person in whose favor the letter of credit was opened, which means the person “who should be paid the amount specified in the letter of credit, after fulfilling the conditions (usually a seller of goods or a service provider – eg contractor, etc.)” (Antonijević et al., 1982, p. 273).

A letter of credit bank is considered to be a banking organization that accepts the order for opening a letter of credit, which is usually the bank of the ordering party, and thus takes over the service of this neutral banking business, exactly according to the instructions given in the order.

The fourth entity that may appear in the business of letters of credit is the bank that fulfills the order of the letter of credit bank regarding the letter of credit that is open – named, ie intermediary bank.

The appointed bank is “any other bank that, under the authorization of the letter of credit bank, assumes certain obligations towards the user of the letter of credit. Most often it is a bank from the country of the beneficiary of the letter of credit. Designated bank is any bank, except the letter of credit bank, which received an order from the letter of credit bank to perform some action related to the letter of credit. The appointed bank can also be a confirming bank” (Gregurek & Vidaković, 2011, p. 83).

In addition, the issue of the legal nature of the letter of credit is specific and very important. Dealing with the legal nature of letter of credit, especially documentary letter of credit as a very common type of letter of credit, Milenković points out that “documentary letter of credit is a banking business that received a legal basis from a sales contract or investment contract concluded between a bank client and his foreign partner.” The conclusion of this contract specifies the letter of credit clause which obliges the debtor – buyer or client to open a documentary letter of credit with his bank in favor of creditors (sellers or contractors) (Milenković, 2010, p. 22).

In modern legal theory and practice, over time, an approach has emerged according to which letters of credit are actually classified as banking service. The essence is that the bank, based on the power of attorney given to it by the client, can perform legal and all other actions agreed upon, and already during the preliminary analysis it can be concluded that “elements of the power of attorney agreement are clearly expressed in the letter of credit” (Antonijević et al., 1982, p. 272). In addition, “given the obligations that the bank assumes

towards its client, but also the powers that the client gives to the bank, it is undoubtedly an order agreement" (Antonijević et al., 1982, p. 272).

Having in mind the nature of the business and the essence of the letter of credit, according to Jovanović and associates, "by its legal nature, a letter of credit is a type of instruction (assignment) of the obligations law, in which is payment of money is the subject of contract" (Jovanović et al., 2020, p. 525).

As it has already been said in this paper, letter of credit as a business is a rather complex banking activities, and the complexity of which is reflected, among other things, is in the number and type of legal relations that are formed between the participants. Legal relations are established between the participants in this banking business are mutually separate and independent, but in their essence still conditioned with each other, so that in the cohesion of their relations, in the general sense of letters of credit, they form a legal unity.

The following will analyze several legal relations between entities in the letter of credit, namely: the legal relationship between the principal and the letter of credit bank, the legal relationship between the principal and the beneficiary, the legal relationship between the letter of credit and the beneficiary, the legal relationship between banks participating in the letter of credit business, and the legal relationship between the correspondent bank and the beneficiary of the letter of credit.

The legal relationship between the ordering party (principal) and the letter of credit bank is created by concluding an agreement on opening a letter of credit. The letter of credit bank assumes the obligation to pay the letter of credit in its own name, for the account of the principal, and in favor of the letter of credit user. The agreement authorizes the bank to issue announcements and pay the letter of credit at the same time. Based on the contract, the principal has the right to require the bank to fulfill the obligation to announce all subject and the obligation to pay the letter of credit. If the user refuses to pay the letter of credit, it belongs to the principal. The same applies in case of revocation of the letter of credit or if the user does not meet the letter of credit conditions. This is because the coverage of the letter of credit is provided by the principal. A letter of credit bank is entitled to a letter of credit commission from the principal even when it has not been agreed. In that case, the client owes compensation in the usual amount, and if there is no custom determined, then a fair compensation" (Vojnić Hajduk, 2019, p. 289).

In this context, it is important to point out that it is quite logical and in practice automatically expected that the ordering party issues an order to open a letter of credit to a bank with which it has regular business interactive relations, and in which it has coverage (eg account).

The legal relationship between the principal and the user of the letter of credit, according to Vojnić Hajduk (2019), is “the relationship from the previous business (eg sales contract) on what basis the letter of credit is created. By its nature, it is a *sui generis* relationship” (p. 290). The legal relationship between the principal and the user of the letter of credit practically indicates that there are debt-creditor relations between the principal and the user of the letter of credit (whereby the obligations of the parties are reciprocal). The basic contract is valid for these relations. In the relations between the principal and the user of the letter of credit, the letter of credit itself is only an instrument (means) for fulfilling the debtor's financial obligation (and partly the natural obligations of the other contracting party) from the basic contract. If for some reason the principal (through the bank) does not fulfill this obligation, the user of the letter of credit will not be able to point out the requirements based on the documentary letter of credit, but only the requirements based on the basic, previous business” (Antonijević et al., 1982, p. 287).

The legal relationship between the letter of credit bank and the user of the letter of credit “produces its legal effect from the day when the user was notified of the opening of the letter of credit. The user of the letter of credit has his own and direct right directed to the bank to pay the letter of credit. Also, the bank has an independent and direct obligation to the user. The obligation to pay the bank to the user is not an independent obligation. Namely, although there are two basic legal relations within letters of credit, there are no two substantively different payment obligations in them, but there is only one and the same obligation. The conditions of this obligation are determined by the ordering party, and not by the bank in a statement by which the user is only informed about them” (Vojnić Hajduk, 2019, p. 290). As the theory also points out, in the relationship between the letter of credit and the user of the letter of credit “the user does not pay or make any promise to the letter of credit or correspondent bank in exchange for its (their) payment promises” (Kozolchyk, 1979, p. 277). By fulfilling the obligation to pay, “the bank fulfills its obligation both to the ordering party and to the user of the letter of credit” (Vojnić Hajduk, 2019, p. 290).

Legal relations between banks participating in letter of credit operations are legal relations that belong to the category of relations established by involving other banks in letters of credit, and which in theory and practice can be threefold as: legal relationship between letter of credit bank and correspondent bank, legal relationship between correspondent bank and the user of the letter of credit and the legal relationship between the correspondent bank and the issuer of the letter of credit.

The legal relationship between a correspondent bank and a letter of credit user is also a legal relationship that falls into the category of relationships that are established by involving other banks in the letter of credit business. Specifically, the legal relationship between the correspondent bank and the beneficiary of the letter of credit can be “direct or indirect, depending on whether it is an advising or confirming bank” (Antonijević et al., 1982, p. 289), and in accordance with the above may differ two situations:

- 1) “The advising bank is not in any direct legal relationship with the user of the letter of credit. It can be said that her role in the business with documentary credit is very limited. Its primary task is to “convey” to the user the notice of the letter of credit bank that a letter of credit has been opened in his favor and to inform him about the terms of the letter of credit. It is not in a direct relationship with the user even if it has the role of a paying bank. In both of these cases, the advising bank acts in relation to the user in the name and on behalf of the letter of credit bank.”
- 2) “The legal position of the confirming bank is significantly different from the position of the advising bank. In relation to a letter of credit bank, it is basically a commission agent who acts according to the user of the letter of credit in his own name, and on behalf of the letter of credit bank. In that case, the certifying bank assumes an independent and immediate obligation to pay the letter of credit. This means that the user can apply for payment to either a letter of credit or a confirming bank.”

5. The role and importance of banks in the structure of the financial sector in Serbia

Before presenting the structure of the financial sector in Serbia, it is necessary to say that “every bank, as well as other economic entities, performs a certain activity for profit” (Milosavljević Nikov, 2020, p. 228).

According to the Law on Banks (2005), “a bank is a joint stock company with its registered office in the Republic of Serbia, which has a license to operate from the National Bank of Serbia and performs deposit and credit operations, and may also perform other operations in accordance with law“, while a foreign bank is “A legal entity with its registered outside the Republic of Serbia, in accordance with the regulations of the country of origin, and is established and registered as a bank, which has a license to operate from the regulatory body of that country and therefor performs deposit and credit operations.“

According to Čatak (2013), “banks are the most visible financial intermediaries in the economy. Their importance derives from the place and

role in the economic and financial system of each national economy. Banks operate trades in the financial markets, not only by providing services to their customers, but also by trying to make a profit for their owners" (p. 94).

It should also be emphasized "that it the characteristic of highly developed financial markets put banks in the forefront when it comes to market relations and their participation in financial markets. The share of the banking sector of developed countries in the overall market relations of financial markets ranges from 25% to 70%. Such relations indicate that the development path of financial markets is directly related to the development of the banking sector" (Čatak, 2013, p. 96).

According to Čorić (2019), "the financial sector in Serbia is dominated by banks as financial institutions, which make up about 90% of the total assets of the financial sector, and still represent the most important channel of financial intermediation in the country. Although it started from a very low base, in recent years non-banking financial intermediation has experienced rapid growth and expansion along with banks. Such developments stimulate the economy's demand for financial resources, increase household incomes and improve corporate finances as a result of economic efforts and enterprise restructuring (privatization). On the supply side, the interest of foreign investors in the Serbian financial market is growing due to higher profit margins and the prospect of EU membership, as well as the restrictive approach of the National Bank of Serbia to monetary and regulatory policy in recent years" (p. 146).

The following table will present the structure of the financial sector in Serbia, for the period 2014-2018, and then the SWOT analysis of financial institutions in Serbia in 2018 will also be presented in a table.

Table 1. Structure of the financial sector in Serbia, for the period 2014-2018

Description	2014	2015	2016	2017	2018
Number of institutions% in total funds of the financial sector					
Banking sector	29 (92,0)	30 (91,6)	30 (91,2)	29 (90,7)	28 (90,4)
Insurance sector	25 (5,2)	24 (5,8)	23 (6,1)	21 (6,6)	21 (6,5)
Financial leasing sector	16 (2,0)	16 (1,8)	16 (1,9)	16 (2,0)	17 (2,1)
Private pension funds	6 (0,7)	7 (0,9)	7 (0,9)	7 (1,0)	7 (1,0)
In total	100,0	100,0	100,0	100,0	100,0

Source: Čorić, G. (2019). p. 146.

Table 2. SWOT analysis of financial institutions in Serbia in 2018

Strength <ul style="list-style-type: none"> – Most banks benefit from capital reserves and sufficient liquidity; – In the insurance sector, the market benefits from the presence of multinational operators; – The Belgrade Stock Exchange, although small, benefits from SEE Link membership; – Growing consumer confidence, looser credit standards for new loans and low borrowing costs increase credit growth; – Non-banking financial sector – stable and profitable, with potential for further development. 	Weaknesses <ul style="list-style-type: none"> – The level of non-performing loans in the banking sector, although reduced, remains high; – The number of listings on the Belgrade Stock Exchange is limited (and state ownership in many companies remains high).
Opportunities <ul style="list-style-type: none"> – The upcoming EU membership will open numerous ways to invest in the financial market in Serbia; – Increasing the rate of ownership of houses, cars, will stimulate the demand for non-life insurance; – The recent entry of a new fund management company indicates growth potential in the investment sector. 	Threats <ul style="list-style-type: none"> – Support for the EU process is declining in some sectors, potentially jeopardizing membership; – The economy relies heavily on the EU and Russia, and a decline in any market could hamper growth; – Costs of receivables can reduce margins and force smaller insurance companies to leave the market; – Unresolved relations with Kosovo could negatively affect investor confidence and bank stability.

Source: Čorić, G. (2019). p. 148.

6. Conclusion

Market globalization and internationalization of trade significantly affect regional and national ways of doing business, economic trends, economic balances, as well as competitive positions in the world knowledge and capital market. The topic of letters of credit as a service of banking business is very current, scientifically and socially justified, and important for domestic and foreign trade payments.

Banks as important financial institutions, due to globalization, deregulation and expansive development of information and communication technologies.

They have passed the development path from traditional business (in which they had the primary role of financial intermediary) to modern banking business framework in which they maintained their competitive positions, but have expanded their business to other, more profitable activities. As can be seen in the research part of the paper, in the financial sector in Serbia, banks dominate as financial institutions, which make up about 90% of the total assets of the financial sector, and still represent the most important channel of financial intermediation in the country.

An important issue that is analyzed in this paper is the legal relations between the subjects, having in mind several important facts. Namely, letter of credit is primarily conditioned business, because in every specific business through letters of credit there is a need for certain documents, on the basis of which specific business is enabled. Then, letter of credit is also a rather complex banking business. The complexity of which is reflected, among other things, is in the number and type of legal relationships that are formed between the participants. In this regard, the paper analyzes several significant legal relations between entities in the letter of credit: legal relationship between the principal and the letter of credit bank, legal relationship between the principal and the beneficiary, legal relationship between the letter of credit and the beneficiary, legal relations between participating banks in letter of credit operations and the legal relationship between the correspondent bank and the letter of credit user.

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PRAVNI ODNOŠI IZMEĐU SUBJEKATA U AKREDITIVU SA OSVRTOM NA ULOGU I ZNAČAJ BANAKA U STRUKTURI FINANSIJSKOG SEKTORA U SRBIJI

REZIME: Banke su najvidljiviji finansijski posrednici u ekonomiji. Njihov značaj proizilazi na osnovu mesta i uloge u privrednom i finansijskom sistemu svake nacionalne ekonomije. U finansijskom sektoru u Srbiji banke su najznačajnije finansijske institucije i čine oko 90% ukupne imovine finansijskog sektora. Tema akreditiva kao uslužnog bankarskog posla je izuzetno aktuelna, naučno i društveno opravdana i značajna za unutrašnji i spoljnotrgovinski platni promet. Akreditivno poslovanje je složen bankarski posao, čija se složenost ogleda između ostalog i u broju i vrsti pravnih odnosa koji se formiraju među učesnicima. Imajući u vidu rečeno, u radu su analizirana pitanja pojma i klasifikacije bankarskih poslova, zatim pravnog posla akreditiva, te pravnih odnosa u akreditivu. Istraživački deo rada se bavi ulogom i značajem banaka u strukturi finansijskog sektora u Srbiji.

Ključne reči: akreditiv, pravni odnosi u akreditivu, bankarski poslovi, finansijski sektor, Republika Srbija.

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