

The Impact of Risk Mitigating Tools adopted by Importers and Exporters on International Trade Finance: The Case of a High-Trade dependent Economy

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Abstract

Though it is trade finance is considered as the oxygen of trade worldwide, yet to the best of our knowledge the only available surveys on trade finance are the Association for Financial Professionals (AFP) (2007) Trade Finance Survey, focusing only on developed economies and the International Chamber of Commerce (ICC) survey 2009, where Africa represents a mere 6% out of 59 countries surveyed. Hence to bridge this gap this study examines how importers and exporters effect (address) payment and manage their risk exposure for international transactions via the use of “international trade finance tools” in the Mauritian context. The choice of this small island developing economy as a case study lies in the fact that one of the factors that has helped Mauritius to crop up as a highly traded economy, is the provision of various international trade finance payment and risk-mitigation tools by financial institutions which in turn has allowed importers and exporters to integrate the world trading system in a secured and equitable manner. The main results originating from this research indicate that most international traders use a combination of payment tools to address their payment issues in international trade though the most commonly used payment tool is the Open account (O/A) tool. Alongside the factors determining the use of international trade finance payment tools are: the size of the organizations, the bargaining power of the organization on international market as well as the level of competition prevailing in international market. To mitigate risks of non-payment exporters have recourse to payment guarantee, while importers commonly use cargo insurance to mitigate transportation risk.

Introduction

The international trading system has undergone considerable changes over the years. Macro and socio-economic factors such as globalization, advancement in technology coupled with fall in transportation and communication costs, have catalyzed cross-border trading, significantly altered its modus operandi and raised the level of global competition in international market. Besides, the increased complexity of the global trading system has raised the issue of how international traders should effect (address) payment for international transactions. In this spectrum, a series of international trade finance payment tools more precisely O/A, Bill for Collection (B/C), Letter of Credit (L/C), Payment in Advance (PIA) and countertrade have been developed to enable international traders to handle their payment issues.

Ultimately, owing to the fact that today's cross-border trading system entail lot of risks, financial institutions that have traditionally dealt in the mobilization of cross border finance now faces the challenge of providing alongside a combination of international trade finance risk-mitigation tools designed to make it more secured and equitable for those who trade. Moreover according Auboin (2007) international trade finance is the lifeline of trade given that more than 90% of international trade transactions involve some form of credit, insurance or guarantee.

Despite its importance in international trade, very empirical studies have been dealing with international trade finance and less so in developing countries. In fact surveys in this field are strictly undertaken by commercial banks international trade finance department, to build their international trading banking business strategy which best meet the needs of these international traders and as such the results derived from these studies are highly confidential and strictly confined within the bank itself as it impacts on the latter's competitive advantage. The only survey whose results are published, we are aware of, is the AFP (2007) Trade finance survey which assesses the evolution of trade finance (supply chain finance) practices in US and Canada, to provide an overview of

how international traders handle the use of international trade finance tools to address their payment issues and manage their risk exposure associated with cross border transactions. To cater for this gap in the literature this study analyses how Mauritian exporters and importers address their payment issues for international transactions and mitigate their risk exposure faced while trading in the international arena via the use of international trade finance payment and risk mitigating tools. Mauritius turns out to be a compelling choice for this study since first it has expanded international trading within every sphere of its industry and has also established a well developed international trade finance infrastructure to support international trade, despite being part of Sub-Saharan Africa.

The rest of the paper is organized as follows: section II highlights the literature on international trade finance, with emphasis on the payment tools as well as risk-mitigating tools. The next heading focuses on the methodology, followed by an analysis of the research findings. The final section concludes.

2.0 International Trade Finance

International trade finance encompasses the financing of imports and exports. In fact, it is closely related to the provision of an international payment mechanism and a series of tools designed to mitigate risks encountered in overseas trading as shown in figure 1.1.

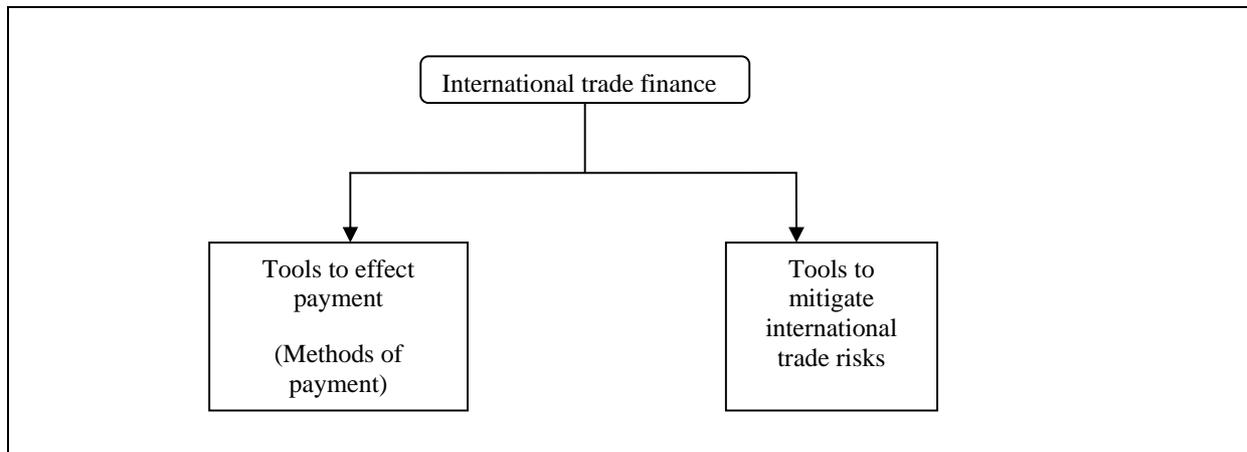


Figure 1.1: Classification of International trade finance

Source: Author

2.1 Tools to effect payment

Giovannucci (2007) identifies five payment tools as depicted below in Figure 1.2 which are not mutually exclusive and can be used as part and parcel of a package to cover the making and receiving of payment of various activities a firm undertakes in the field of importing and exporting.

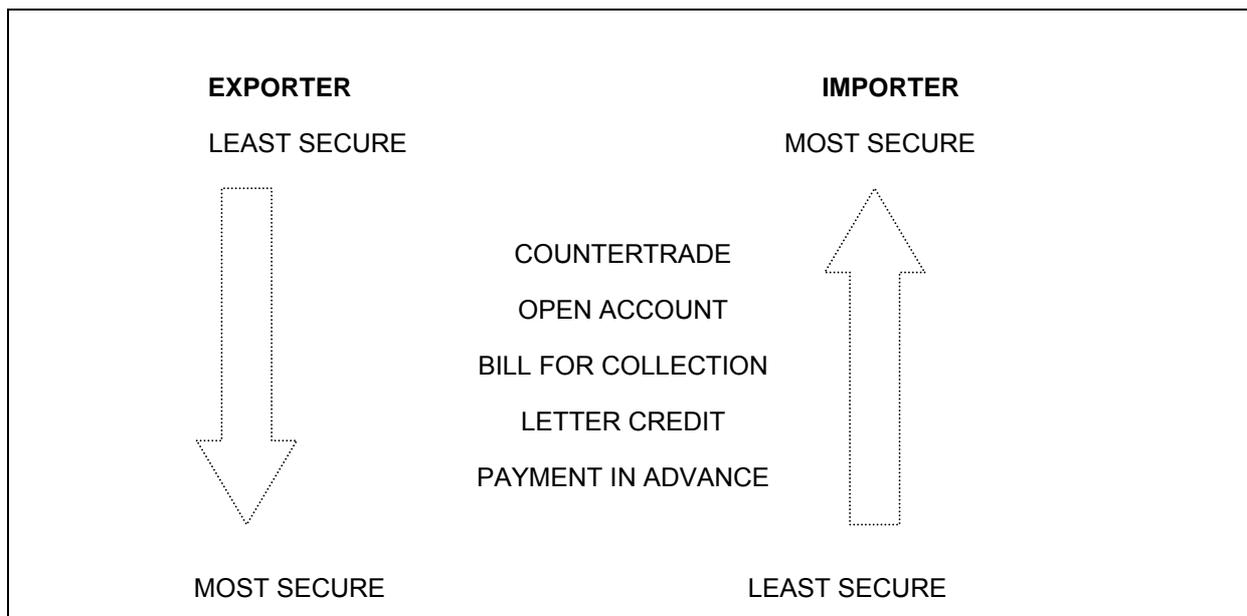


Figure 1.2: International trade finance tools to effect payment.

Source: adapted from SITPRO financial guide

2.2 Tools to mitigate risks.

Overseas traders may as a result of their risk philosophy refrain from undertaking international trade transaction because their profitability and solvency might be threaten by inherent international trade risks. Thus, a series of tools have been developed to permit traders to have access to the international arena in a more secured manner thereby preserving the international trade process from disruption. Table 1.1 below summaries the different categories of international trade finance risk-mitigation tools, with a brief description for each category, together with their respective associated types of tools.

Table 1.1: Types of risk-mitigation tools

Categories of international trade finance Risk-Mitigation tools	Brief Description	Types of risk-mitigation tools
Insurance Cover (INS)	International traders may contract an insurance policy from commercial banks or private insurance institutions to cover their international trade transaction against risks. Such contractual agreement is normally undertaken against the payment of an insurance premium prior to shipment of merchandise or from the date the contract is entered into. Insurance cover can be of two types mainly an open cover policy which covers shipment during a specific period or a close cover policy which is one which covers one-off shipment of merchandise.	Credit insurance
		Country (political) risk insurance
		Cargo insurance
	Currency hedging is a risk management strategy used to manage the degree of risk that arises from volatile movement in the price of a currency by limiting or	External currency hedging techniques

<p>Currency hedging</p>	<p>offsetting the probability of loss via external or internal risk management techniques. There exist both external and internal hedging techniques. Buckley (2004) stipulates that international traders can have recourse to external currency management techniques to reduce the risk of foreign exchange loss. Such techniques normally “resort to contractual relationships outside a group of companies” (page 224).</p>	
	<p>Buckley (2004) also specifies that external currency risk management techniques might be very costly and restricted within the scope of big companies. In such instances, international traders may resort to internal currency risk management techniques which rely on the firm regulatory financial management to reduce the risk of foreign exchange loss.</p>	<p>Internal currency hedging techniques</p>
<p>Bank guarantee</p>	<p>A bank guarantee is an arrangement whereby a principal request his bank to pay a pre-specified sum of money to a beneficiary if it (principal) does not perform in accordance with the terms and conditions outlined by an international commercial contract. Bank guarantee can be two-fold whereby the principal may either be the exporter who request his bank to guarantee the importer (beneficiary) against timing risk and/or the risk of obtaining delivery of goods not in accordance with the commercial contract or the importer who asks his bank to guarantee the exporter (beneficiary) with respect to payment risk in a situation of default.</p>	<p>N/A</p>

<p>Standby L/C</p>	<p>Grath (2008) posits that SBLC was developed by banks in the USA as an alternative to bank guarantee because they were barred by law from issuing certain types of guarantees to third party. Simply defined, a SBLC is one which is issued by a bank at the bequest of its customer (may be the importer or exporter depending upon the type of SBLC) to guarantee the beneficiary against non-performance of the applicant under an international commercial contract. According to Baker (2005), "SBLC are based on the underlying principle of letters of credit where payment is made against presentation of documents- whatever documents the applicant, beneficiary, and issuing bank may agree to, not necessarily documents showing shipment of goods." (Source: www.closesooner.net).</p> <p>Hence, an importer dealing on O/A terms may ask his bank to issue a SBLC in favor of the exporter to guarantee the latter against the importer performance towards payment. Conversely, an exporter dealing on PIA may ask his bank to issue a SBLC in favor of the importer to guarantee the latter against the exporter performance under the international commercial contract (especially to allow the importer to recover partly the amount which has already been paid in advance to the exporter to finance initial stages of the contract, in the event the exporter fail to perform as expected).</p>	
<p>Factoring</p>	<p>Pereira (2008) defines factoring as an arrangement whereby the exporter sells its short term (usually 120 days or less) account receivable arising from international sale of goods to the factor. According to Bhogal <i>et al.</i> (2008) factoring is done on a with or without recourse basis and permits the exporter to transfer default</p>	

	<p>risk arising from the sale of merchandise on credit to the factor and ultimately improve its cash flow position. In addition, Buckley (2004) posits that factoring arrangement allow the exporter to mitigate transaction exposure associated with the international sales of goods on credit since sale of export receivables to the factor permit the exporter to home currency in return (which is arrived at by taking the amount of foreign currency denominated export receivables less the factor charges and convert it at spot rate).</p>	
<p>Forfaiting</p>	<p>Bhogal et al (2008) posits that “the word “forfait” is a French word meaning surrendering rights” (page 137). Under such an agreement, the forfaiter (whose business is to purchase of a series of credit instruments such as BOE, promissory notes, draft drawn on usance, L/C or other freely negotiable instruments) will purchase the exporter negotiable credit instrument at a discount on a non-recourse basis and hold the instrument till maturity. At maturity, the forfaiter will approach the availing bank for payment of the negotiable instrument. It is to be noted that these negotiable credit instrument can be denominated in the exporter’s domestic currency or in the importer’s domestic currency depending upon negotiation made at the outset pertaining to the currency in which the importer is to effect payment for goods and services bought form the exporter.</p>	

In terms of empirical findings, the AFP survey which was carried out among the AFP members and their trading partners which constitute of corporate practitioners, banks and other financial providers located in US and Canada, reveals that among organization that use a combination of payment tools, 90% of them posit that most of

their organization international trading activities are covered by O/A tool. Alongside, 43% of organizations surveyed declare that they expect to increase the use of O/A tool in the next three years. Moreover 55% and 51% of organizations surveyed claim that trading relationship with their trading partner, is a very determinant factor that influences their choice towards payment tools while 51% advocate that cost of payment tool is a determinable factor that influences their choice towards payment tools. Another interesting revelation is that, 57%, 24% and 22% of organizations surveyed respectively posit that they use forward, swaps and option to manage their foreign exchange risk exposure.

3.0 Methodology

International trade finance payment and risk-mitigation tools find its pure relevance, applicability and use in the Mauritian commerce sector whereby companies undertake international trading activities by either importing goods for resale on domestic market or produce goods which are meant for resale on international market. Hence, the target population for this research comprises of companies undertaking import or export activities in the “Commerce sector” of Mauritius.

Moreover, owing to the fact that it is difficult to determine with exact precision the whole population of importers and exporters in Mauritius, the Mauritius chamber of Commerce (MCC) was solicited to derive the target population of importers and exporters in the commercial sector of Mauritius. The MCC provided a list of its registered members in the commerce sector which in all consisted of 152 companies undertaking import or export activities in the Commerce sector of Mauritius. Out of the 152 companies, 98 of them undertook only import and 54 undertook only export. A full list of these international traders is Annexed to Appendix 1. The response rate for the 152 questionnaires dispatched, was around 63.8% (97 questionnaires). The questionnaire was a mix of structured (multiple-choice, Dichotomous, Scales) and unstructured (open-

ended) questions. For analysis purpose the statistical package SPSS version 12.0 was used.

4.0 Research Findings

In terms of respondents 56 of them were importers and 41 exporters and 80% of importers and 88% of exporters acknowledge using a series of combinations of payment tool for their import and export activities respectively. It is to be noted that mostly used combination, among both importers and exporters, is that of "O/A, B/C and L/C". Surprisingly, international traders in Mauritius reported that they do not use countertrade to cover their import and export activities respectively. A rationale underlying this statement might be that the nature of countertrade itself poses problem in its use by international traders. For instance, in case of barter (a type of countertrade), exporters do not receive payment for goods sold but rather is being paid by other goods or services. Thus, it can be said that international traders will as far as possible refrain from using such methods.

Moreover 78% of importers and 72% of exporters posit that they expect to increase the use of O/A in the next three years, a result which corroborates with that of the AFP survey findings. A plausible rationale underlying the increase in O/A by international traders might be that with the prevailing financial crisis, exporters will have to offer more O/A terms to be able to compete under such circumstances, given its streamlining effect by decreasing the amount of documentation. Nevertheless it must be noted that employing such a tool requires greater technical capabilities, deeper market knowledge and stronger client relationships. L/C and B/C are not popular though they do provide legal protection since they tend to be costly and one proposed solution is a reduction in the price of the latter tools.

The AFP survey revealed that trading relationship (55%) and cost of payment tools (51%) are the two most important factors that organizations consider before choosing a

payment tool or a combination of payment tool. In Mauritius, a similar result was obtained, whereby 47% (include the response of both importer and exporter) and 44% of organization surveyed posit that their choice about using a payment tool or a combination of payment tools depend on these two factors.

In terms of factors affecting the choice of payment tools, the cross tabulation results point out that there is a significant relationship between bargaining power and use of payment tools ($\chi^2=0.021$), competition prevailing in international market and use of payment tools ($\chi^2=0.05$). In order the test the hypothesis of whether the use of a payment tools by importer and exporter also depend on the size of the exporter/importer, traders were classified as small, medium and large based on their annual income as illustrated in table 1.2.

Table 1.2: Size of Traders

Annual revenue	Size of Exporter	Size of importer
Under Rs 1 million	Small exporter	Small importer
Rs 1 million- RS 9.9 million		
Rs 10 million- RS 19.9 million		
Rs 20 million- RS 29.9 million	Medium-sized Exporter	Medium-sized Importer
Rs 30 million- RS 39.9 million		
Rs 40 million- RS 49.9 million		
Rs 50 million or more	Large Exporter	Large Importer

When the size of be it the exporter or that of the importer was cross-tabulated with the use of payment tools, χ^2 turned out to be zero in both cases, signaling a near perfect relationship between size of the trader and use of payment tools.

In terms of ability to manage risks of non-payment, the results disclose that out of 18 exporters who posit that they are highly exposed to the risk of non-payment (commercial risk), 9 of them are very effective at managing commercial risk while the other 9 exporters are effective at such undertakings. Furthermore the most favored combination of risk-mitigation tools among traders is insurance and currency hedging. More precisely, out of 17 importers that use insurance as a risk-mitigation tool, 100% of them use the cargo insurance, while out of 29 exporters that use insurance as a risk-mitigation tool, 44% use credit and cargo insurance. The high use of cargo insurance by importer demonstrates that the latter enjoy less bargaining power on international market because of the inability to make the shipper bear the cost of insuring the merchandise during its transportation. Alongside small organizations suggest that there should be some sort of level-playfield pricing which open up access of small organizations to the use of risk-mitigations that are accessible to large organizations.

Moreover, some organizations posit that though financial institutions provide risk-mitigation tools yet the criteria used to assess whether a user is entitled to the use of risk-mitigation tools is very often stringent and hence the cause behind clinging to only insurance and currency hedging as risk-mitigating tools.

Besides, out of 31 exporters that opt for currency hedging, most of them (44%) use short-term borrowing in foreign currency followed by 32% who use forward currency contract to manage their currency risk exposures. Conversely, out of 56 importers who opt for currency hedging, most of them (37%) use forward currency contract followed by 35% which posit that they use short-term depositing in foreign currency to manage foreign exchange risk.

5.0 Conclusion

The purpose of this study was to assess the use of payment and risk-mitigation tools among importers and exporters in Mauritius. Through this study, it was made clear that the majority of organizations that undertake import and export activities advocate using a combination of payment tools to address their payment issues for international transactions. As such, more than half organizations that use a combination of payment tool revealed that the O/A tool covers most of their organization international trading activities. Besides, it was found that in Mauritius the use of international trade finance payment tools depend significantly on the size of the organizations that is the organization's annual turnover, the bargaining power of the organization on international market and on the level of competition prevailing in international market. In addition, most organizations posit that their use of payment tool is driven by its cost and the trading relationship that the organizations share with its trading partner.

Practically most organization advocate using combinations of risk-mitigation tools to manage their risk exposure. Among exporters, the popular tool to manage the risk of non-payment were found to be payment guarantee followed by negotiated payment terms (internal hedging) and short term borrowing in foreign currency (external hedging)

for those who are significantly exposed to foreign exchange risk. Besides, it was noted that most importers use cargo insurance to mitigate transportation risk while a small number of exporter reporting the use of such tools. As such this demonstrate the extent to which exporter and importer bear the burden of shipment which is ultimately dictated by the latter's bargaining power on international market. Finally, it was found that the use of risk-mitigation tools depend significantly on the size of the international trader more specifically on its annual turnover.

Further research in this field may be directed towards assessing the use of these tools for a specific industry say for instance manufacturing and construction industry.

Appendix 1

LIST OF IMPORTERS AND EXPORTERS DERIVED FROM MCC

1. A & W Wong Ltd
2. A. Abdul Rahim Oosman & Co. (Magasin Bleu)
3. A. N. Li Wan Po Ltd.
4. Aashish Luthra Ltd.
5. ABC Motors Co. Ltd.
6. Abdullasonco Ltd.
7. Alcohol & Molasses Export Ltd.
8. Anthurium Export Co. Ltd.
9. Aquarelle Clothing Ltd
10. ATS Ltd
11. Axess Limited
12. Ayoob Cassim & Co Ltd.
13. Ayyappa International Products Agency Ltée.
14. B. Hassamal & Co.
15. B.E.M. Enterprises Ltd.
16. Beautés de Chine Ltd.
17. Bischem Co. Ltd
18. British American Tobacco (Mauritius) PLC.
19. Blanche Birger Co. Ltd
20. Chantier de Plaisance.
21. Charles Lee Jewellery Ltd.
22. Chemical Systems Ltd.
23. Chevron (Mauritius) Ltd.
24. Chue Wing & Co. Ltd.
25. CMT International Ltd.
26. Compuspeed Ltd.
27. Coroi Maurice Ltée
28. Dahal Trading Co. Ltd.
29. Delaflores Co. Ltd
30. Desbro Trading Ltd.
31. E. C. Oxenham & Co. Ltd
32. E. G. H. Co. Ltd.
33. Ebrahim Dawood Ltd.
34. Edendale Ltd.

35. Eincar Ltd.
36. Ets Aboobakar & Cie. Ltd.
37. Fafa & Son's Co. Ltd.
38. Federal Trading Ltd
39. Fine Foods Marketing Ltd
40. Fleurs des Tropiques Exports Ltée
41. Floreal Knitwear Ltd.
42. FTM (Mtius) Ltd.
43. Gazella Ltd.
44. GlaxoSmithKline Export Ltd
45. Grays Inc. Ltd
46. Grewals (Mauritius) Ltd
47. H.V. International Ltd.
48. Happy World Ltd
49. Hardy Henry & Cie. Ltée
50. Harel Mallac & Co. Ltd.
51. Hassam Moussa Rawat
52. Holcim (Mauritius) Ltd
53. Hong Kong Store Ltd.
54. IBL - Frozen Foods
55. Ibrahim Edoe & Sons Ltd.
56. Ideas Ltd.
57. Iframac Ltd.
58. Innodis Ltd
59. Indian Ocean Export Ltd.
60. International Motors Co. Ltd
61. Ireland Blyth Ltd.
62. Isen Ltd.
63. Jack Teller (International) Ltd
64. J. Kalachand & Co. Ltd.
65. J. M. Goupille & Co. Ltd
66. J. Vaulbert de Chantilly Ltd.
67. Jean Li Yin Tai Ltd.
68. Joonas & Co. Ltd
69. Kema Trading Ltd.
70. Knight Trading Agency Co. Ltd.
71. Lafarge (Mauritius) Cement Ltd.
72. Lampotang & Co. Ltd.

73. Le Pavillon Bleu Ltd.
74. Le Warehouse Ltd.
75. Leal & Co. Ltd.
76. Les Moulins de La Concorde Ltée
77. Li Wan Po & Co. Ltd.
78. Lising & Co. Ltd.
79. Marlin Exports Ltd
80. Mauritius Chemical & Fertilizer Industry Ltd
81. Mauritius Oil Refineries Ltd
82. M. C. Appavou & Co. Ltd.
83. M. I. Kathrada & Sons Ltd.
84. M. S. Lauthan (MSL) Ltd.
85. Mado Parfums & Co. Ltd.
86. Man Hin Bros International Ltd
87. Marshal Trading Ltd
88. Maurco Ltd.
89. Mayflower Centre Ltd.
90. Mechanisation Co. Ltd.
91. Medical Eye Centre Ltd
92. Medical Trading (IBL)
93. Mimosa Co. Ltd
94. Motorex Ltd
95. MSM Ltd
96. MSJ Ltd. - Unicorn Trading Company
97. Muneer-Ur-Rehman Ltd
98. Naya Ltd.
99. Nestlé's Products (Mtius) Ltd
100. Onsiong Bros & Co. Ltd
101. Palm Step Electronics Ltd
102. Panagora Marketing Co. Ltd
103. Pascal Computer Services Ltd.
104. Pharmacie Nouvelle Ltd.
105. Plasmo Ltd
106. Powertech Ltd
107. Précigraph Ltd
108. Phoenix Beverages Group
109. Quality Beverages Ltd
110. Rabroco Import and Export Ltd.

111. Raffray Brothers & Co. Ltd.
112. Rashid Moosa (Sons) Ltd.
113. Rey & Lenferna Ltd
114. Robert Le Maire Ltd.
115. Robert Yip Tong Enterprises & Co. Ltd. (Kawai Music Centre)
116. Roger Fayd'herbe & Co. Ltd
117. Royal Shipping Ltd.
118. S K C Surat & Co. Ltd.
119. Samlo Group (Samlo & Sons Co Ltd)
120. Soap & Allied Industries Ltd
121. SCETIA Ltée.
122. SCOMAT Ltée
123. Scott & Co. Ltd.
124. Sewraz Sons Ltd.
125. Shell Mauritius Ltd.
126. Shenton Trading Ltd.
127. Stanford Cove
128. Star Knit Trading Company Limited
129. Steelbirds Ltd.
130. Suchem Ltd.
131. Sugarex Ltd.
132. Sunsheel & Co. Ltd.
133. Super Hi Foods Ltd.
134. Superdist Ltd.
135. Supintex Ltd.
136. Tea Blenders Ltd.
137. Techtonic Ltd.
138. Thon des mascareignes
139. T & T International Foods Ltd
140. T-Printers Co. Ltd
141. Top Shop Co. Ltd
142. Total (Mauritius) Ltd.
143. Touchwood Ltd
144. Toyota (Mauritius) Ltd.
145. Tractor and Equipment (Mauritius) Ltd.
146. United Importers Ltd.
147. Universal Development Corp. (Pty) Ltd.
148. Wally Plush Toys Ltd

149. Winson Trading Ltd
150. Yiptong & Sons Ltd
151. Young Bros (Plastic) Co. Ltd.
152. Zaib-Un-Nisa & Co. Ltd.

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<http://www.sitpro.org.uk/trade/cargo.pdf>

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