

Review

Banking Instruments as Risks Mitigation Mechanisms in International Trade

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Abstract: International trade transactions are exposed to numerous commercial, financial, political and operational risks that may jeopardize the successful execution of contractual obligations between trading partners. In such circumstances, banking instruments play a crucial role in reducing uncertainty and enhancing the security of international business operations. Therefore, the aim of this research is to analyze banking instruments that are used as risk protection in international business and foreign trade transactions such as letters of credit, bank guarantees, hedging, factoring and forfeiting in reducing commercial, financial, and political and other risks to which participants in international trade are exposed. The paper aims to review the importance of these banking instruments, their application in modern international transactions, as well as their contribution to the security of payments, protection of claims and improvement of international trade exchange. The authors conclude by that their usage can significantly contribute to the more secure realization of international trade transactions.

Keywords: *International trade; risks; letter of credit; bank guarantee; hedging; factoring; forfeiting.*

1. Introduction

Trade, as a special activity, has always had and still has the same task today. Trade organizes the regular exchange of goods between production and consumption. With its activities, it should ensure the supply of goods in the quantity and assortment that the market is looking for, at the place where it is looking for, at the time it is looking for and at prices and other conditions that the customer accepts. From this basic task of trade arises the concept of the market, the most efficient mechanism known so far for the voluntary exchange of goods. Throughout further history, the development of industrial society, various world crises and wars took place.

In 1946, the system named "Breton Woods" has been created. The goal of this system was to enable free trade and to break down the obstacles that prevented it. Twenty-three countries signed the General Agreement on Tariffs and Trade (GATT) to rationalize trade among nations. In 1995, the WTO - Free Trade Organization was formed with the aim of mediating free trade. With the reduction of tariffs in international trade, which occurred during the rounds of negotiations conducted under the auspices of the GATT, even their elimination, non-tariff barriers become more noticeable. The similarity of non-tariff barriers with customs duties is reflected in the fact that non-tariff barriers also lead to an increase in the level of prices on the domestic market, and the consequences are borne by consumers, while domestic producers, at least in the short term, receive a certain advantage [1].

From the moment when the first regional economic integrations appeared in the post-war period, their importance has been continuously growing. Factors that decisively influenced such developments are the strong influence of international political factors on the reconstruction and unification of post-war Europe, the process of decolonization during the sixties of the last century and the growth of the number of countries in the world, the efforts of underdeveloped and

developing countries to accelerate economic development through some form of regional integration, as well as the slow process of multilateral liberalization of international trade[2].

Following the 2008 global financial crisis, there has been a relative decline in economic globalization and the global trade has been also slowed down which has been further accentuated by the COVID-19 pandemic, with world merchandise trade decreased by 7.4% in 2020 relative to 2019 [3,4].

In addition to the traditional documentary instruments, which primarily serve to minimize commercial risks, transactional risks and risks of importing countries, it is sometimes necessary to provide international trade actors with additional support that is indirectly related to the transaction itself. For example, sometimes it is necessary to provide the exporter or importer with working capital in order for the exporter to prepare the goods for export, i.e. to complete the processing of the imported goods, or to pay for his exports ahead of time [5]. All actors in international trade are directed to the international foreign exchange market, where international means of payment are purchased while the demand for foreign exchange originates from domestic buyers of foreign goods and services, semi-finished products, capital goods and assets, while the supply of foreign exchange originates from foreign buyers [6]. For example, multinational companies combine the production and supply of large quantities of goods in several countries and are particularly important entities, but also factors in the development of the international trade flows [7].

On the other hand, due to the specificity of international financial flows, in the planning and implementation of foreign trade operations, a significant place belongs to the risks of collection of receivables, payments and other property interests. In foreign trade, there is a danger of commercial and non-commercial risks. The first is related to the problem of insolvency, and the second is related to sudden events and political risks.

“Capitalizing on opportunities and mitigating risks associated with international investment is crucial for maintaining sustainable international business operations” [8]. Banking instruments play a crucial role in reducing uncertainty and enhancing the security of international business operations. All banking transactions have certain specificities, namely that they are drawn up according to previously prepared and drawn up standard and standard contracts or according to the general rules of operation of a banking organization. In banking instruments in which one of the contracting parties is always a banking organization contracts are valid only if they are drawn up in writing [9].

Therefore, the aim of this research is to analyse banking instruments that are used as risk protection in international business and foreign trade transactions. Special attention is paid to the role of instruments such as letters of credit, bank guarantees, hedging, factoring and forfeiting in reducing commercial, financial, and political and other risks to which participants in international trade are exposed.

2. Risks in international trade

The international trade allows each country to focus on its area of comparative advantage in the production of goods and services. Workers in each country can produce a greater quantity of consumer and productive goods for the same amount of labour expended. A country specializes in production in areas of comparative advantage and exchanges its own production through foreign trade for goods and services where it has no comparative advantage [5]. The factors of competitiveness in the modern era are [10]:

- a) factors of production,
- b) demand conditions,
- c) the level of development of related and supporting industries,
- d) the strategy, structure and rivalry of firms.

International trade is very important for the economic development of any country. However, in order to survive on the international market, it is necessary to know that there are many factors that affect the realization of international trade deals. Participants in this type of business must also

face numerous risks. Usually, risk is defined as a danger that threatens a person or property from the occurrence of an economically harmful event. From an economic point of view, risk represents the probability of the occurrence of an economically harmful event, while from a legal point of view, risk has been defined as the possibility of an uncertain event occurring that does not depend on the will of the interested parties and whose realization is permitted by public order and morality.

The risks in international trade are numerous. "The analysis of risk characteristics, their correct identification and the development of methods for their avoidance play a key role in promoting the healthy development of international trade" [11]. The main risks that exist in international trade can be divided into two main groups:

- a) Economic risks and
- b) Political risks.

The economic risks faced by participants in international trade are:

- a) The risk of customer insolvency,
- b) Risk of non-payment - if the buyer does not pay for the goods even 6 months after the due date,
- c) Risk of non-acceptance of goods,
- d) Loss of economic sovereignty,
- e) Exchange rate risk.

The political risks would be:

- a) Risk of cancellation or non-renewal of import or export permits,
- b) Risk of war,
- c) Risk of expropriation or confiscation of the importer's company,
- d) The risk of introducing an import ban after the goods have already been delivered,
- e) Transfer risk – introduction of foreign exchange controls or lack of convertible currency in the importer's country,
- f) Loss of political sovereignty.

3. Banking instruments against risks in international trade

Banking operations can be classified into three basic groups: 1. active banking operations - banking operations in which the banking organization appears in the role of a creditor; 2. passive banking operations - banking operations in which the bank appears in the role of a debtor; 3. 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 a creditor nor in the role of a debtor in relation to monetary claims [12]. In the context of international trade, banking instruments belonging to these groups play an important role in reducing and managing the various risks.

Business entities in transition economies rely on different financial instruments to mitigate risks in international trade. However, the underdevelopment and ongoing transformation of financial markets often restrict the availability and effectiveness of risk management mechanisms, limiting firms' opportunities to adequately protect themselves against risks inherent in international transactions [13]. Most often, risk insurance in international trade is provided by following banking instruments:

- a) letter of credit,
- b) bank guarantee,
- c) hedging,
- d) factoring and
- e) forfeiting.

3.1. Letter of credit

A letter of credit is a letter or payment instrument by which the person ordering the letter of credit, through the bank, makes available to the user of the letter of credit a certain amount. This amount can be charged by the user when he fulfills certain obligations towards the principal of the letter of credit. A letter of credit is often used as a payment instrument in trade, because it suits both parties [14] as a letter of credit is a legal transaction that arises from the conclusion of a contract on the opening of a letter of credit, on the basis of which a notification on the opening of a letter of credit is given. Letters of credit are very common in international trade, where they are most often divided into:

- a) Nostro (import) letters of credit - opened by domestic importers in favor of a foreign seller (exporter),
- b) Loro (loro) letters of credit - opened by a foreign buyer to a domestic exporter (seller),
- c) Revocable letters of credit - which can be changed or revoked at any time without informing the user. It is extremely important for the user to immediately check whether it is a revocable or irrevocable letter of credit when opening a letter of credit in his favor.
- d) Irrevocable letters of credit - cannot be revoked without the user's consent.
- e) Transferable and non-transferable letters of credit - indicate whether they can be transferred from the user of the letter of credit to another person. A transferable letter of credit exists when it is expressly marked as transferable, if it is not marked, the letter of credit is considered non-transferable.
- f) Ordinary (one-time) letters of credit - serve for a one-time withdrawal of the letter of credit amount and are used in practice for one-time delivery of goods.
- g) Rotating (revolving) letters of credit - letters of credit that do not cease to be valid upon withdrawal of the letter of credit amount, but are restored to the initial amount after collection. This renewal (revolving) lasts until the maximum amount is reached, which is determined either by the amount or by the number of revolving.
- h) Letters of credit at sight - paid immediately after submission of documents.
- i) Term letters of credit - letters of credit whose collection is tied to a certain time.

If one observes the international level of regulation of the documentary letter of credit, there is still no convention that regulates relations related to it. The uniform rules and customs for documentary letters of credit govern the affairs related to this context. The rules have been revised several times since they were adopted in Paris by the International Chamber of Commerce in 1933. They apply to every documentary letter of credit, when it is defined that the letter of credit belongs to these rules. The uniform rules specifically define the following terms [15]:

- a) letter of credit bank,
- b) confirming bank,
- c) principal,
- d) user,
- e) remuneration,
- f) negotiation,
- g) presentation, etc.

A letter of credit is defined as any arrangement, regardless of name or description, which is irrevocable and which constitutes the definitive obligation of the letter of credit bank to honor the agreed presentation. The uniform rules also contain provisions on:

- a) the obligations of the banks that participate in the documentary letter of credit business,
- b) changes to the documentary letter of credit,
- c) presentation of proper documents,
- d) review of documents,
- e) handling in case of non-compliance of documents,
- f) original documents and copies.

3.2. Bank guarantee

Bank guarantee is often used in international trade. The reason for this is primarily the development of the market, which initiates entering into business relations with unknown partners. Many business entities see security in a bank guarantee, which today has become an irreplaceable security instrument in international goods and payment transactions, because it is a safe and sufficiently effective means of security in case of non-payment or partial payment of contractual obligations. A bank guarantee implies legal relations between at least three persons [16]:

- a) the relationship between the creditor and the debtor from the basic contract,
- b) the relationship between the bank and the principal (debtor from the basic contract),
- c) the relationship between the bank and the beneficiary of the guarantee (creditor from the basic contract).

The bank that issues the bank guarantee insures the user of the guarantee against the possibility of non-fulfillment of the assumed obligations specified in the contract, i.e. bank guarantee. In this way, the bank guarantees that the obligations will be performed either by the contractual party, i.e. the guarantor or the bank itself. The bank can give a guarantee only for work that is possible, and in order to be realized, it must be issued before the occurrence of the guaranteed event.

The content of the bank guarantee expresses the will of the participant of the guarantee business, which means that it should be conditioned by the specific elements of the conditions of the business for which the guarantee is issued. Therefore, the content of the bank guarantee must be agreed already in the clause of the basic contract. What content the bank guarantee will have depends primarily on the will, that is, the agreement of the parties from the basic contract. In international sources, the practical needs of modern business were taken into account, so guarantees (in the same way as letters of credit) were determined as a unilateral legal transaction, which simplified their issuance as much as possible, but also defined that the guarantee produces a legal effect from the moment of issuance, unless explicitly stated otherwise[17].

The bank guarantee must contain [18]:

- a) name and headquarters of the guarantor,
- b) name and headquarters of the recipient of the guarantee,
- c) the purpose of issuing a bank guarantee,
- d) the amount of the bank guarantee,
- e) the validity period of the bank guarantee,
- f) place and date of issuance of the bank guarantee,
- g) seal and signature of the authorized person issuing the bank guarantee.

Bank guarantees can be classified according to several criteria. According to the criterion of the conditions that must be met for the payment of the guaranteed amount, there are: conditional and unconditional bank guarantees. In relation to the dependence of the bank guarantee on the basic business, the guarantees are divided into: independent, and accessory bank guarantees. According to the criteria of the number of banks participating in the guarantee business, there are the following bank guarantees: super guarantees and counter guarantees. Apart from these divisions, there are a number of other criteria on the basis of which the types of bank guarantees can be defined. However, the most significant of the other type of bank guarantees are:

- a) guarantees in foreign affairs and domestic guarantees,
- b) covered and uncovered guarantees,
- c) consortium and individual guarantees,
- d) direct and indirect guarantees,
- e) effective and payable guarantees,
- f) nostro and loro guarantees,
- g) abstract and causal bank guarantees,
- h) other types of guarantees.

3.3. Hedging

On the international market, there is an increasing need to reduce risk due to the unpredictability of the market and large price fluctuations. Reducing those types of risks in business is hedging. Hedging is an investment that serves to reduce or eliminate the risk associated with another investment. Financial policy, with the hedging mechanism, plays an integral role in risk management [19]. Hedging exists to minimize exposure to undesirable business risk. It can be said that a hedging mechanism is a strategy for reducing possible losses in the real business of the company. Hedging is insurance against risks arising from business operations. When a firm decides to hedge, it insures itself against negative events. This in no way prevents a negative event from happening, but if it does happen and the company is properly insured, the impact of the negative event will be reduced and completely negligible. Types of business risk that can be hedged are:

- a) Risk of exchange rate changes,
- b) The risk of changes in the price of goods,
- c) Risk of interest rate changes,
- d) The risk of changes in the value of shares,
- e) Credit risk.

For example, hedging foreign exchange risk includes activities related to the assessment of expected changes in exchange rates, as well as the application of appropriate strategies to control the impact of those changes on cash flows and the value of the company and if it decides to apply foreign exchange risk hedging, the company should determine the hedging ratio (that is the degree of coverage of the basic position with a currency forward) [20].

3.4. Factoring

Debts are bought by factoring, by immediately paying the seller the amount of his claim minus the agreed percentage. Factoring is done by banks and insurance companies, as well as some other specialized companies. The main subjects that appear in factoring are:

- a) client - an entity that produces goods or that provides a service,
- b) customer - entity that buys goods from the manufacturer,
- c) factor – an organization that buys invoiced amounts from its clients.

International factoring implies that the seller and the buyer are located in different countries and the transaction is import-export in nature. It can be done in a one-factor or two-factor system, regulated by the UN Convention on International Factoring.

The client of the factoring institution (a company that exports goods) offers for sale to the factor (intermediary organization) its short-term receivables for the delivery of products and services, but before their maturity. When the factor accepts the offer, with or without notifying the debtor about the transfer of claims, he immediately pays part of the claims to the client (most often 70%). The rest of the claim is made available to the client, minus the value adjustment, when the claim is collected. For its factoring service, which includes the risk and interest of crediting the client from the moment of purchase of the receivable until the collection of the receivable, the factor charges a commission. Therefore the main asset in factoring is a claim from the customer, which the factor (lender) buys at a discount. For example, the seller (borrower) could receive from the factor 70% of the value of his claim, and the remaining 30% (minus the interest and manipulative costs of the loan) after they are paid by the buyer [21].

3.5. Forfeiting

Forfeiting is similar to factoring, i.e. uses the same "technique", with the fact that it is about buying out long-term receivables. The essence of the forfeiture contract is reflected in the fact that the bank (forfeitor) takes over from its client a claim that the latter has against a third party (buyer-investor), which the client (producer-seller) assigns to it with the transfer of instruments for the collection of claims on the due dates agreed with the buyer (promissory note, documentary letter of credit, third-party guarantee, etc.). The bank accepts the assignment of receivables and pays the nominal value of the transferred receivables to the seller (producer) as its client, with the deduction

of discount interest, commission and costs related to the transaction. At the same time, the bank undertakes to bear the risk of collection of ceded receivables, that is, it will not seek regression of unpaid receivables from the producer-seller.

The participants in the forfeiting business are:

- a) domestic exporter - actually seller-producer,
- b) foreign importer,
- c) the importer's buyer's bank and
- d) forfeiter.

In the process of performing the forfeiting work, several legal and financial-banking relationships are established between the aforementioned participants, with the fact that each of them produces its legal effect only between the persons participating in it. For example, the domestic exporter is in a direct legal relationship with his customer based on the contract on the purchase and sale of goods, that is, the contract on the execution of investment works abroad or some other contract with permanent execution of performance (obligation). Also, the domestic exporter has a legal relationship with his bank (forfeitor) based on the conclusion of the contract on forfeiture. Finally, the foreign buyer is in a direct legal relationship with the bank, which, on his behalf, performs banking operations related to forfeiture.

The main advantage for the importer is that he can get up to 100% financing of the import of goods through forfeiture, precisely when other usual sources of funds are not available to him. Forfeiting is a flexible way to offer the exporter/importer options in terms of currency selection, maturity dates and "grace" periods. On the other hand, the importer must be ready to pay a slightly higher price for the products he imports, because that price generally includes forfeiture costs that most exporters, depending on their negotiating position, try to pass on to the importer. The importer should also pay the bank's commission for the validation of the bill of exchange or the issuance of the letter of credit (or guarantee) [22].

5. Conclusions

Trade plays a particularly important role in the process of building a market economy, since it ensures the continuous exchange of goods and services between producers and consumers. The goal of trade is to adapt the characteristics of the goods and services offered, quantities, prices, assortment, as well as other conditions to the needs, desires and capabilities of consumers. Trade affects economic flows, which is manifested through relations with other sectors, and also contributes to increasing the standard of living of citizens. International trade is an important economic activity. It implies the exchange of goods, services and intellectual property products, which economic subjects (companies) perform across the borders of national economies and which is significantly regulated by national economies and international economic organizations. The Law on Foreign Trade Business of the Republic of Serbia regulates foreign trade operations in accordance with the rules of the World Trade Organization (WTO) and the regulations of the European Union (EU) [23].

The importance of international trade is primarily reflected in the fact that an increasing percentage of gross national income is brought by international trade, and gross national income is the total value of all products and services produced by residents of a country during the year, including net income from factor services provided abroad. Therefore, it is important for the economy of every country to achieve the highest possible gross national income, because it is an indicator of the standard of living in the country. It is crucial for the economy of any country to be a participant in international trade. We can also outline that the COVID-19 pandemic gave a special impetus to the digital transformation of banking, spurring the transition from traditional to digital business models[24].

Considering the fact that by entering the international market, economic subjects are not bypassed by numerous risks, it is very important to adequately protect themselves from them, because they can contribute to many negative consequences for business. Risk management assumes

the use of hedging financial instruments in order to eliminate or reduce financial risks, as well as the control of various risk factors [25]. Other banking instruments such as letters of credit, bank guarantees, factoring and forfeiting have a prominent role in reducing commercial, financial, and political and other risks to which participants in international trade are exposed. We can conclude that in modern business conditions, characterized by globalization, increasing market interconnectedness, and growing economic uncertainty, the importance of these banking instruments as mechanisms for protection against risk is becoming even more pronounced. Their proper selection and application can significantly contribute to the successful realization of international trade transactions and the achievement of long-term business goals.

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