

Difference between Letter of Credit and Bank Guarantee



Introduction

This two terminology looks similar but both are very different. When one wants to expand the business means beyond the national boundary or within, one needs assurance from the buyer side that after delivery of goods or services the payment will receive and this can be done by the bank only.

In short, both these terms are used while doing business or transactions with domestic or international companies.

So, both these services are facilitated by the bank but in a different way as per the need of seller party.

Letter of Credit

- It is used while there is a high level of risk involves in business.
- It is used while doing import and export transactions with international companies.
- L/C is a written commitment issued by the bank or some other financial institutions for payment assurance to the seller party from buyer's request.
- In L/C, the seller gets a guarantee of payment from the buyer's banks on the due date payment will receive only if the seller meets all the conditions of deal like timely delivery etc.

- Banks offer a service like L/C on the basis of proof provided by the buyer's party.
- If the buyer fails to make payment to the seller, the bank pays on behalf of a buyer and then the bank will recover it from a buyer anyhow.
- Banks will charge fees for this type of facilities.
- So in short, letter of credit is beneficial when product or service is delivered and payment is not done.
- It eliminates the financial risk involved in the business.

Types of Letter of Credit

Irrevocable Letter of Credit:

It is not modified or cancelled without the concern of all the parties.

Revocable Letter of Credit:

In it, the issuing bank can revoke or cancel the letter of credit any time without prior notice to the seller.

Confirmed Irrevocable Letter of Credit:

In it, the confirming bank gives more assurance to seller same as issuing bank.

Unconfirmed Irrevocable Letter of Credit:

In it, an advisory bank from the seller's side performs as an agent for the issuing bank without any responsibility to the seller.

Revolving Letter of Credit

This type of letter is used if in case regular transactions take place and remain valid for a long term without issuing the another letter of credit.

Bank Guarantee

- Bank guarantee is a service by which bank gives a guarantee to the seller on behalf of his client for assurance of payment.
- So, Bank guarantee has the same function as a letter of credit but with some differences.
- Bank guarantee generally used in domestic transactions.
- Bank guarantee is beneficial when contractual obligations are not fulfilled by the other seller party.

- Bank guarantee is used in infrastructure and real estate projects to reduce risk level.

Letter of Credit V/s Bank Gurantee

Basis	Letter of Credit	Bank Guarantee
Definition	A letter of credit is an obligation by the bank to the seller if the criteria met, the bank will make payment.	In bank guarantee, if the opposing party doesn't fulfil contractual obligations the Bank will make payment.
Boundary	It is used internationally.	It is used domestically.
Protection	It protects both parties but favours exporter.	It also protects both but favours buyer.
Industry	It is used by merchants.	It is used by real estate and infrastructure developer.

L/Cs are frequently used in international transactions compared with bank guarantees. When comparing the two instruments, the market for bank guarantees is much larger than that for L/Cs.