

# Line of Credit vs Letter of Credit



## . Line of credit

- It allows the buyer to 'Purchase now pay later' which means it is a credit facility to a borrower extended by a bank. This lending totally depends upon the credibility and reliability of the borrower in terms of having adequate security. The line of credit is more or less like taking a loan from the bank and borrowers have to pay interest on the fund utilised.
- It may be in different forms as Overdraft protection, demand loan, purchase of commercial bills etc.

### **Example:**

AABB ltd is granted a line of credit worth 100 crores. Now, on the basis of requirement of the borrower form of line of credit will be decided.

## Letter of credit:

- It is issued by a bank in a particular format which assures payment of goods and services when the seller provides authentic documents.
- Basically, it is a mode of payment where security and financial trust between buyer and seller are established by a third party (banks or reputed financial institutions as banks are the most trustworthy organisations and they ensure that payment is received when the goods are supplied).
- Mostly, letter of credit is issued/used for International trade and commerce. Two different countries have different laws and huge

geographical distance and at the same time, it is impractical to know each party personally. So, in this scenario letter of credit plays a vital role.

### Elements of letter of credit:

- Beneficiary (who will get the payment)
- Buyer
- **Issuing bank** – The liability to pay and to be reimbursed from its customer is absolute upon the T&C of the letter of credit. The issuing bank also provides a guarantee to the seller that if, there would be any complaint document shown then a bank will pay the seller the due amount and cross check the document. The required documents are the Commercial invoice, transport docs( airways bill/logistics bill) and insurance document majorly.
- **Advising bank** – It is usually a foreign correspondent bank of the issuing bank
- Which works as an advisor to the beneficiary. Advising bank sends documents to the issuing bank but in case issuing bank is not making the payment advising bank is not accountable to pay.
- **Confirming bank** – this bank confirms the credit after evaluating the bank and the place of origin of the letter of credit. Usually advising bank acts as confirming bank.

### Characteristic of Letter of credit:

- **Negotiability** – It is negotiable in nature. The issuing bank is responsible to pay either to the beneficiary or the bank nominated by it.
- **Revocability** – It may be revocable or irrevocable in nature.
- Transfer and assignment.
- **Sight and Time draft** – Beneficiary has to present a draft and documents to get the payment.

The importance of letter of credit is to reduce the risk involved in international trade which has grown rapidly over the past few years.