BHARAT SCHOOL OF BANKING

Letter of Credit

Letter of Credit (L/C)

It is a **guarantee** in the form of a **letter,** issued by a **buyer's bank**. Suppose you want to **buy** or **sell** some **goods** from or to a **foreign** country. It is very much possible that you **don't** know the **seller** or **buyer**. And also the **laws** regulating the **trade** may be **different**. Therefore, both the **seller** and the **buyer** need some kind of **guarantee** to seamlessly perform the **trade**. Here **Letter of Credit** comes into action.

The steps involved is very much as follows -

Step 1 **-** First a **contract** is signed between the **buyer** and the **seller**.
Step 2 - The **buyer** comes to his **bank**, and the bank issues a **Letter of Credit,** on behalf of the **buyer**, to the **seller**.
Step 3 - After getting the **Letter of Credit**, **seller** knows that he will be **paid** surely. So he **consigns** the **goods** to a **Carrier,** in exchange of a **Bill of Lading** (Carrier provides it to the Seller)
Step 4 - **Seller** takes the **Bill of Lading** and provide it to his **bank** (i.e., **seller's bank**), who eventually transfers it to **buyer's bank**, who then provides it to the **buyer**.
Step 5 - **Buyer** takes the **Bill of Lading,** and gives it to the **Carrier**. The **Carrier** then getting his own **Bill of Lading**, **delivers** the **goods** to the **buyer**.
Step 6 - **Carrier** then asks his **payment** from the **Seller,** by providing his **Bill of Lading**, that he has actually **delivered** the **goods**.
Step 7 - **Seller** then asks his **bank** (i.e., **sellers bank**) for payment, who eventually asks the **buyers bank.** The **buyers bank** settles the **payment.**

Now you can see that the **risks** involved is much minimized by using the **Letter of Credit**, as the **seller** is **guaranteed** to be **paid** by the **buyers bank** upon **delivery** of **goods**.

Even in case, if the **buyer** doesn't pay the full amount to his **bank** (**buyers bank**), the **buyers bank** is obliged to **pay** the **amount** to the **sellers bank**. The buyers bank can later settle the amount with his **buyer,** as happens in **loans** or **advances**.

Since **bank guarantee** also provides a type of **guarantee.** Then what is the **difference** between a **Letter of Credit** and **Bank Guarantee?**

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	Letter of Credit	**Bank Guarantee**
Nature	Paid only if the contract is **satisfied**	Paid only if the contract is **breached**, i.e., not **satisfied**
Use	**Ensures** a **transaction** proceeds as planned	**Insures** a **buyer** or **seller** from **loss** or **damage**due to non-performance by the other party