Bank Guarantees & Letter of Credit Compared

(Original Work Reproduced – See Credits Below)

Bank Guarantees and LC's are financial instruments often used in inland or international trade when suppliers or vendors do not have established business relationships with their counterparts. The difference between the two instruments is the position of the bank relative to the buyer and seller of goods or services. The difference is as explained below.

A letter of credit is a bank's DIRECT undertaking to the supplier (called the beneficiary) to pay. When a letter of credit is in use, the issuing bank does not wait for the buyer to default, and for the seller to invoke the undertaking.

In contrast, a guarantee is a written contract stating that IN THE EVENT the primary party (the buyer) is unable or unwilling to pay its dues to the supplier , the bank as guarantor to the transaction and the issuer of the BG, would pay (the client's debt) to the supplier.

In other words, a bank guarantee is an undertaking of a bank on behalf of its customer. But this comes into play ONLY WHEN the principal party (the buyer) has failed to pay its supplier. (Do note this key point.)

Essentially, the bank becomes a co-signer for its customer's purchases.

Hence, in a BG the initial claim is still settled primarily (i.e., first) against the bank's client, and not the bank itself. Should the client default, ONLY THEN would the bank (which has issued the BG) agree to pay for it's client's debts on behalf of its client. This is a type of contingent guarantee.

A bank guarantee, therefore, is more risky for the merchant and less risky for the bank. But this is not the case with a letter of credit (LC).

With a bank guarantee, if a client defaults the bank assumes liability. With a letter of credit, liability rests solely with the issuing bank (this being the key difference and the key advantage in an LC) which then must collect the money from its client.

Therefore, the principal character of an LC is that it is a potential claim against the bank, rather than a bank's client. An LC substitutes the bank's credit for its client's. The seller's risk is mitigated from the risk that the buyer will not pay to the risk that the BANK will be unable to pay, which is unlikely.

A letter of credit is less risky for the merchant, but more risky for a bank, though banks accept full liability in both cases.

(1) An LC is a *direct* responsibility of the issuing bank. The buyer does not at all come into the picture (his relation is with the issuing bank and no further). The LC is the primary instrument in a transaction.

(2) In contrast, a BG comes into operation (is invoked) *only when* the buyer has failed to perform his bit. The BG issuing bank is therefore the *second* line of defense, it is not the primary party.

Source

www.google.com
www.alibaba.com

Please check his complete list of brilliant articles.

Reproduced here with kind permission of Mr R N Bose – original source www.alibaba.com

Completed conversation is available at following URL

http://resources.alibaba.com/topic/191089/LC_and_BANK_GUARANTEE_COMPARED_.htm

Mr Rupnarayan Bose Can be reached via his website

http://www.instituteofbankingstudies.org/index.htm and http://www.rnbose.net