Difference between bill of exchange and letter of credit

There are a number of payment mechanisms that are used when conducting international business. Letters of credit and bills of exchange are two such mechanisms commonly used in international trade that facilitate lines of credit for the buyer. The major similarity between the two is that the seller will be guaranteed of payment as long as all documentation is provided, and terms and conditions are met. The following article takes a closer look at letters of credit and bill of exchange and shows how these payment mechanisms are similar and different to one another.

What is a letter of credit?

Letters of credit are used to provide credit in international payment transactions. A letter of credit is an agreement in which the buyer's bank guarantees to pay the seller's bank at the time goods/services are delivered. Once the buyer and seller agree to do business, the buyer requests for a letter of credit from the issuing bank to ensure that international transaction is secure and guaranteed. Once the seller ships the goods (in accordance to the contract), the issuing bank sends the Letter of credit to the advising bank. Once goods are delivered and a request for payment (with or without documentation – depending on types of letter of credit) is made, the issuing bank pays this amount to the seller's bank. Finally, the issuing bank obtains the payment from the buyer and releases documents so that the buyer can now claim the goods from the carrier.

There is a little risk in a letter of credit as the seller can obtain payment (from the issuing bank) regardless of whether the buyer is able to pay. A letter of credit will also ensure that all standards of quality agreed upon in the letter of credit will be met by the seller. There are few types of letters of credit, which include documentary credit and standby letters of credit. When a standby letter of credit is used, the seller may not have to submit all documentation to receive payment, and a mere request for payment should ensure that the funds are transferred from buyer's bank (issuing bank) to the seller's bank.

What is a bill of exchange?

Generally, a bill of exchange is used in international trade activities where one party will pay a fixed amount of funds to another party at a predetermined date in the future. The bill of exchange will facilitate a line of credit for international traders. The party who writes up the bill of exchange is known as the drawer, and the party that is to pay the sum of money is known as the drawee. The drawee will accept the terms laid out in the bill by signing it, which will then convert this into a binding contract. The seller can discount their bill of exchange with the bank and obtain immediate payment. The bank will then obtain the funds from the drawee. A bill of exchange facilitates secure transactions by ensuring that the bank will accept the bill of exchange written up by drawee, which means that the seller will receive the funds regardless of whether the buyer pays or not.

What is the difference between bill of exchange and letter of credit?

Both letter of credit and bill of exchange facilitate international transactions between buyers and sellers. Both letters of credit and bill of exchange facilitate lines of credit for the buyer and provide assurance to the seller that the payment will be made regardless of whether the buyer is able to meet his payment obligations. The main difference between the two is that a letter of credit is a payment mechanism whereas a bill of exchange is a payment instrument. The letter of credit will set up the conditions that are to be met in order for the payment to be made, and is not the actual payment itself. On the other hand, a bill of exchange is a payment instrument where the seller can discount the bill of exchange with the bank and receive payment. At maturity, the bill of exchange will become a negotiable payment instrument that can be traded, and the holder of the bill of exchange (either the seller or the bank) will receive payment.

Summary:

Bill of exchange vs letter of credit

- Letters of credit and bill of exchange both facilitate international transactions between buyers and sellers.
- Both letters of credit and bill of exchange facilitate lines of credit to the buyer and provide assurance to the seller that the payment will be made regardless of whether the buyer is able to meet his payment obligations.
- A letter of credit is an agreement in which the buyer's bank guarantees to pay the seller's bank at the time goods/services are delivered.
- A bill of exchange is generally used in international trade activities where one party will pay a fixed amount of funds to another party at a predetermined date in the future.
- The main difference between the two is that a letter of credit is a payment mechanism whereas a bill of exchange is a payment instrument.