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Letter of Credit Financing at India Bank

The case is written by Smita Roy Trivedi for the purpose for classroom discussion. The author does not want to illustrate either effective or ineffective handling of a managerial situation. For confidentiality all names have been changed, including those of the leading bank on which the case is based.

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Ms. Jayashree Deb has been recently been posted as the Chief Manager at the International Division of India bank at Pune, one of the fastest growing cities in Western India. In the three months that she has been here, Jayashree has been trying her best to learn the intricacies of the different trade financing mechanisms that exporters and importers use. However, given the difference in regulations applicable for different trade transactions, voluminous regulations surrounding most and the changing dynamics of the international trade market in general, Jayashree realizes her task is not going to be easy. Moreover, this branch had no senior officers to assist her in case of doubts and she needs to get the divisions running smoothly as quickly as possible following recent retrenchments. As she looks through the glass window at the sunny morning unfolding, she is brought back to her pressing concerns. Mr. Pingale from Foodies National is set to arrive soon and from his call the day before she had gathered that the company was a new entrant in the international trade scene. She quickly skimmed through the file sent by the credit department on the company before Pingale arrived.

The Client: Foodies National Ltd.

Foodies National Ltd. is a client of India Bank for the last five years and Mr. Pingale is a first-generation entrepreneur. The company is engaged in producing frozen vegetables and supplied this throughout India. Freezing of foods is one of the earliest known technologies to man for food preservation. Freezing is not only a natural form of preservation, it can help to retain essential nutrients, if performed optimally. Besides it was convenient to use for time-constrained consumers today. Again, frozen food if properly handled before freezing and during distribution ensures that there is no possibility of growth of microbial

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² The views or opinions presented do not, in any way, reflect the views and opinions of the institution the author represents.

contaminants between freezing and thawing. While for a long time, the frozen food industry saw little qualitative improvements, reinforced by low margins and generally low expectations from consumers, the last few decades have seen the growth of a highly demanding quality conscious consumer ready to pay higher for a better quality. This has led to greater investment in technological up gradation at each level of freezing and packaging as well as research in freezing technology³.

Even after the post-pandemic slowdown, the frozen fruits and vegetables segment has continued to expand globally. Recent industry forecasts estimate that the global frozen fruit & vegetable market is expected to reach about USD 36.8 billion by 2030, supported by rising retail penetration, convenience consumption, and cold-chain capacity expansion ([Grand View Research, 2024](#)). Importantly, India's presence in this industry has strengthened in the last few years: domestic frozen-food market was estimated at INR 191 billion in 2024, and is projected to reach INR 593 billion by 2033, reflecting an expected CAGR of roughly 13.4% ([IMARC Group, 2024](#)). However, despite being one of the world's largest producers of vegetables, fruits, dairy, and meat products in absolute output terms, India's export realization in this area remains far below its potential because cold-chain infrastructure, pre-shipment freezing capacity, and certification compliance are uneven across states ([Cooling India, 2024](#)).

Foodies National Ltd. has been establishing a market presence in different cities of India. Foodies specialize in providing Frozen Indian Vegetables which can hold their nutritional value for two years if stored at -18° C or below. Besides they have forayed into preserved dairy products including paneer cubes, Ras Malai and Gulabjamun. Foodies have a state of the art factory at Satara, near Pune, Maharashtra with facilities spreading over three acres, and expansive storage capacity, helping to maintain a yearly production of 9000 tons. Since the last two years 'Foodies' have been getting small export orders from neighboring countries of Bangladesh and Srilanka and is slowly venturing into the global market. The credit proposal from the Credit Department showed Foodies have recently applied for an enhancement in working capital limits (Fund based and Non-fund based) which has been granted by the Credit department. This includes an enhancement of L/C limits from 3 to 4 (Rs. Crore) and Bank Guarantees from 2 to 3 (Rs. Crore)

Financing Foodies trade

Ms. Jayasree was going through the Credit Department file when Mr. Pingale arrived. A man in his mid-forties Mr. Pingale looked quite unassuming but his sharp eyes gave away a first generational entrepreneur with dreams to expand his enterprise globally.

Mr. Pingale said, "Madam, need to discuss a few issues: As you know, my company is into food preservation. I have been doing well and have been receiving a few international orders but I must upgrade my technology. Especially I need two spiral freezer machineries, a cutting-edge product, from ABC Food Tech, US. We haven't imported previously from them and they have asked for a prepayment. However, we can negotiate and go for a L/C, but you know, I am not sure if it is worth going for an L/C. The company is quite sound, though post covid there have been adverse market reports. However, an L/C would mean an increase in costs. I am really not sure what to do".

³ See Kennedy, C. (2000). Managing frozen foods. USA: Woodhead Publishing Ltd; PR Web (12.1.2011). Global Frozen Fruits and Vegetables Market to Reach 22.6 Million Tons by 2015, According to a New Report by Global Industry Analysts, Inc., Retrieved from www.prweb.com/.../frozen.../frozen_vegetables/prweb80581, accessed 11.12.12012.

Ms. Jayshree was pleased at the client questioning closely the import financing decision. She would have preferred a letter of credit transaction, but she knew it was important for clients to consider their options before taking a decision of import financing. She pointed out that while prepayment is possible, a prepayment involved substantial risks. Mr. Pingale also admitted he was a little unsure of going for the prepayment given some recent adverse market reports and some instances of late deliveries from this company. There were many crucial export orders pending for Foodies and late delivery of these machines could disrupt Foodies' competitive edge. On the quality front too, he wanted to be sure.

Explaining the letter of credit procedure

Ms. Jayshree felt it would be good to talk to the client first about the kind of risks the letter of credit is meant to address and underline clearly the comparative advantage of a L/C as well as the associated problems (Please see Appendix A for a detailed discussion on LC mechanism). A letter of credit (L/C) is an instrument issued by a bank on behalf of the importer (buyer) promising to pay the exporter (beneficiary) upon presentation of complying documents in accordance with terms of the credit. As compared to a prepayment, it was much safer for the importer to have a letter of credit, especially for a new counterparty or when counterparty credit risk or the country risk is high. Here of course the counterparty credit risk is low but business association was new.

While L/Cs meant increase in costs, it would be a comfort factor given the new business relationship. Moreover, under prepayment, late delivery of goods cannot be ruled out. However, what was difficult to ensure under a letter of credit was that the quality of the goods would be as envisaged by the importer. While the importer could incorporate in the credit the requirement of a certificate of inspection/certificate of quality, there were certain things to take care of if these conditions were incorporated. Ms. Deb clarified the details about the various payment mechanisms so that the client could take an informed decision (See Appendix A).

Pingale's decision

The next day Mr. Pingale followed up by sending the L/C application form, L/C agreement and pro forma contract (Appendix 2: information in the pro forma contract) in an hour. He informed ABC Food tech, US wanted the credit to be available with State Bank of India, New York, with whom they had an account. Ms. Deb called her junior Ms. Sampath to draft the L/C also telling her to go through the UCP 600 guidelines and Incoterms for clarifying doubts (Please refer to reading material for UCP 600 Articles and Incoterms). Ms. Sampath was quick on processing the L/C and by late noon, she had the draft document ready for a final go ahead (Appendix 3).

Did the banker and the customer take the right decisions in going ahead with Letter of credit? Are any modifications necessary? If so, why?

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Appendix A

Trade finance mechanisms⁴:

Firms require working capital to finance their production activities. An international trade transaction is either financed by the buyer (importer) or seller (exporter) or one or more financial institutions (Madura, 2003). The buyer or seller may finance the entire trade cycle, beginning with the procurement of raw materials, production of goods/ services, shipping of goods/ transfer of services and final receipt of goods by the buyer in his country. Generally, there are five types of payment terms: prepayment/ payment in advance, open account, letters of credit, draft and consignment.

I. Payment in advance/ Prepayment

Payment in advance, prepayment or advance payment, refers to a situation in which the exporter (seller) ships the goods only after the importer (buyer) has made the payment for the goods or services. Payment is usually made via international wire transfer to the exporter's bank account or through a foreign bank draft. With technological progress, electronic commerce allows firms engaged in international trade to make electronic credits and debits through an intermediary bank.

Prepayment gives the supplier the greatest degree of protection, and it is normally requested of first-time buyers whose creditworthiness is unknown or of buyers from countries with economic and/or political difficulties. Prepayment usually occurs if there is seller's monopoly or the bargaining power of the seller is more than that of the buyer or there is a long established trade relation between the buyer and seller. Moreover, it must be underlined that in this case the buyer is extending credit to the seller by paying in advance to fund his production cycle.

II. Open account

Under an open account transaction the exporter ships the merchandise and expects the buyer to make payment according to the agreed-upon terms. The seller in this case is relying fully upon the financial creditworthiness and integrity of the buyer. Mutual trust between the seller and buyer is an essential prerequisite for this transaction.

It must also be pointed out that in both the cases, the client is either getting a credit from the counterparty or advancing credit terms to the counterparty. Under a prepayment arrangement, finance is provided by the importer to the exporter, while under the open account arrangement, it is the exporter who is extending credit to the importer.

III. Consignment

Under a consignment arrangement, the exporter ships the goods to the importer but retains the actual title to the merchandise. The importer has access to the inventory and needs to pay for the goods only after they have been sold to a third party. It underlines trust placed in the buyer by the seller, as if the importer fails to pay, the exporter has limited recourse. Consignments are mostly used for affiliated and subsidiary companies trading with the parent company. Under a consignment arrangement also there is an evident extension of credit facilities by the seller to the buyer.

⁴ Madura, J. (2003). International Financial management. USA: Thomson: South-Western

IV. Drafts

Drafts represent formal demand for payment by the exporter, instructing the buyer to pay the face amount of the draft upon presentation. Drafts provide the exporter less protection than a Letter of credit since the banks are not obligated to honor payments on the buyer's behalf. Trade transactions handled on a draft basis are processed through banking channels and are called documentary collections in banking terminology.

Sight Draft or documents against payments:

Under a sight draft, the exporter is paid once shipment has been made and the draft is presented to the buyer. The bank will not release shipping documents needed by the buyer for collection of his goods until the buyer has paid the draft. This is known as documents against payment.

Time Draft or documents against acceptance:

Under a time draft, the exporter gives instructions to the importer (buyer)'s bank to release the shipping documents against acceptance (signing) of the draft. This method of payment is sometimes referred to as documents against acceptance. By accepting the draft, the buyer is promising to pay the exporter at the specified future date. The buyer here is able to obtain the merchandise prior to paying for it, and thus it represents an extension of credit to the buyer by the seller. If the seller's bank is purchasing the documents, with the seller obtaining the discounted value of the draft, the seller's bank is in effect extending the credit to the buyer.

The exporter is here depending upon the buyer's financial integrity to pay the draft at maturity though there is some comfort with banks at both ends stepping in as collection agents. A draft is also a binding financial obligation and can be used by the exporter for litigation on uncollected receivables.

V. Letters of Credit (L/C)

A letter of credit (L/C) is an instrument issued by a bank on behalf of the importer (buyer) promising to pay the exporter (beneficiary) upon presentation of complying documents in accordance with terms of the credit.

The process flow for a letter of credit starts with the exporter and importer entering into a contract deciding the terms of payment and other details regarding the commercial transaction. The importer will then apply to its bank, termed as the Issuing bank, to issue a letter of credit in favor of the overseas seller subject to specified terms and conditions. Importer submits the application, along with the contract and agreement to the bank, for whom again issuing an L/C is equivalent to a credit decision as the Issuing Bank is giving a conditional undertaking to pay the beneficiary the agreed value against presentation of complying documents. In fact, it is the credit department of the bank who will sanction the limits for L/C on the basis of which the trade financing cell or international banking division issues the L/C.

After the issuance of the L/C the importer's bank forwards the L/C to its Correspondent Bank, also referred to as the Advising Bank in the exporter's country. It requests the correspondent bank to 'advise' the L/C to the Beneficiary, which involves checking the genuineness of the credit and advising terms and conditions to the exporter.

The correspondent bank on receiving the documentary credit from the issuing bank, advises the credit to the beneficiary. The seller/ exporter may however be unsatisfied with/ unaware of the financial status of the issuing bank. In that case, the issuing bank will request a bank in the seller's country or a third country, for 'confirming' the credit. The confirming bank steps into the position of the issuing banks and gives an undertaking to affect payment, if the issuing bank fails to do so, on submission of complying documents by exporter. Such a credit will be called as a 'confirmed credit'. While every L/C transaction must have an advising bank, the same is not true of a confirming bank.

The exporter ships the goods within the specified period and collecting the documents submits the same to the negotiating bank. The negotiating bank may be a specified bank 'nominated' by the issuing bank, implying that credit is available only with that bank. If no particular bank is specified as having credit available with by the L/C, it could be any bank. The advising or confirming bank could themselves serve as a nominated bank. The nomination of a bank by issuing bank, does not comply an obligation on its part to effect payment unless it has confirmed the credit.

On receipt of documents, and examining of the same, if documents are found to be discrepancy free, the negotiating bank will pay a discounted amount to the seller (exporter), also forwarding the documents to the issuing bank, who after examination of the same will affect payment to the exporter's bank. The L/C requires the involvement of the Reimbursing bank which will be instructed by the Issuing bank to affect payment to the exporter's bank. Issuing bank releases documents to importer either with immediate payment (documents against payment) or with importer promising to pay later at an agreed date (documents against acceptance). It is on the basis of these documents that the goods can be collected.

Evidently, the buyer is assured of payment being made only if the goods are shipped and documentary evidence of such shipment is produced by seller. It will also ensure that goods are shipped within a specific period of time as the letter of credit would specifically mention the last date of shipment and presentation of documents, which must be adhered to by the exporter. If the exporter fails to comply with any conditions, the payment would not be affected.

The exporter is assured of receiving payment from the bank that issues the L/C provided it submits documents in accordance with the L/C. The bank that issues the L/C (Issuing Bank) is obligated to honor drawings under the L/C even if the buyer (importer) fails to make a payment. Again, while the importer does not pay for the goods until shipment has been made and complying documents are presented, he/she must still rely upon the exporter to ship the goods according to specifications.

Appendix 2 **Pro forma Invoice Details**

Buyer: Foodies National Ltd, National Road, Pune-06, India

Seller: ABC Food Tech, 70 West Madison, Suite 2000, New York, USA

Product: Spiral freezer

Appendix 3
Draft of L/C in SWIFT Format

- 40 A: Form of documentary credit
REVOCABLE
- 20: Documentary credit no
1234567
- 31C: Date of issue
250301
- 40E: Applicable rules
Current version of UCP
- 31D: Date and place of expiry:
250828
New York
- 51 A: Applicant bank
India bank, Pune, India
- 50: Applicant
Foodies National Ltd, National road, Pune-06, India
- 59: Beneficiary:
ABC Food Tech,
United States
- 32B: Currency Code and Amount
USD 500,000
- 42 C: Drafts At
Sight
- 43 P: Partial shipments
NOT ALLOWED
- 43 T: Transshipment
NOT ALLOWED
- 44E: Port of Discharge / airport of departure:
US SEA PORT / ANY AIRPORT
44B: Place of final destination /Place of delivery:
NAVA SEVA, Mumbai, MAHARASHTRA

- 44C: Latest date of shipment
250815
- 45A: Description of goods or / services
EQUIPMENT as per Proforma Invoice, CIF, New York
- 46 A: Documents required:
- SIGNED COMMERCIAL INVOICE IN TRIPLICATE
- FULL SET OF 'CLEAN' SHIPPED ON BOARD OCEAN / MARINE BILL OF LADING WITH 3 NON NEGOTIABLE COPIES, DRAWN TO ORDER OF INDIA BANK, PUNE
- CERTIFICATE OF ORIGIN ISSUED BY THE CHAMBER OF COMMERCE STATING THAT GOODS ARE OF US ORIGIN
- PACKING LIST AND WEIGHT CERTIFICATE IN TRIPLICATE CONTAINING DETAILS OF EACH PACKING
- CERTIFICATE OF ANALYSIS FROM COMPETENT AUTHORITY 'ABC INTERNATIONAL'
- INSURANCE DOCUMENT COVERING RISKS FOR 110% OF CIF VALUE
- 47 A: Additional Conditions
ALL DOCUMENTS SHOULD INDICATE OUR CREDIT NUMBER
- 71 : Charges
BANK CHARGES OUTSIDE THE INDIA WILL BE TO THE ACCOUNT OF BENEFICIARY
- 48: Period of presentation
WITHIN 21 DAYS FROM DATE OF SHIPMENT BUT NOT LATER THAN THE EXPIRY DATE
- 49: Confirmation Instruction:
CONFIRM
- 57A: Advise through bank:
SBI, New York