

## **RISK MANAGEMENT AND INTER-BANK DEALINGS - COMMODITY HEDGING**

### **A.P. (DIR SERIES 2011-12) CIRCULAR NO. 68, DATED 17-1-2012**

Attention of Authorised Dealers Category-I (AD Category-I) banks is invited to the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000, dated May 3, 2000 [Notification No. FEMA 25/RB-2000, dated May 3, 2000], as amended from time to time and A.P. (DIR Series) Circular No. 32, dated December 28, 2010. Currently, resident entities in India, engaged in import and export trade or as otherwise approved by the Reserve Bank from time to time, are permitted to hedge the price risk of permitted commodities in the international commodity exchanges/markets. Further, AD Category-I banks satisfying certain minimum norms are **specifically authorised** by the Reserve Bank (please refer to Section E para 1 of the above mentioned Circular) to grant permission to :

- a. companies listed on a recognized stock exchange to hedge price risk on import/export in respect of any commodity (except gold, silver, platinum) in the international commodity exchanges/markets;
  - b. domestic companies engaged in refining crude oil to hedge the price risk on crude oil imports on the basis of past performance;
  - c. (i) domestic producers/users of aluminium, copper, lead, nickel and zinc listed on a recognized stock exchange;  
(ii) actual domestic users of Aviation Turbine Fuel (ATF) to hedge economic exposures in respect of ATF based on domestic purchases;  
(iii) domestic crude oil refining companies to hedge commodity price risk on domestic purchases of crude oil and domestic sales of petroleum products, which are linked to international prices; and
  - d. domestic oil marketing and refining companies to hedge commodity price risk on Inventory subject to guidelines as prescribed by the Reserve Bank.
2. It has now been decided to permit **all AD Category-I banks** to grant permission to companies to hedge the price risk in respect of any commodity (except gold, silver, platinum) in the international commodity exchanges/markets as specified under the delegated route.
3. Further, AD Category-I banks can also grant permission to **unlisted companies** to hedge price risk on import/export in respect of any commodity (except gold, silver, platinum) in the international commodity exchanges/markets subject to guidelines as specified in the Annexure.
4. AD Category-I banks may submit an annual report to the Chief General Manager-in-Charge, Reserve Bank of India, Foreign Exchange Department, Central Office, Forex Markets Division, Amar Building, 5th Floor, Mumbai – 400 001 as on March 31 every year, within one month (before April 30th), giving the names of the corporates to whom they have granted permission for commodity hedging and the name of the commodity hedged.

5. Applications from customers to undertake hedge transactions not covered under the delegated route may continue to be forwarded to the Reserve Bank by the Authorised Dealers for approval, as hitherto.

6. Necessary amendments to Notification No. FEMA.25/RB-2000, dated May 3, 2000, [Foreign Exchange Management (Foreign Exchange Derivatives Contracts) Regulations, 2000] are being notified separately.

7. AD Category-I banks may bring the contents of this circular to the notice of their constituents and customers.

8. The directions contained in this circular have been issued under sections 10(4) and 11(1) of the Foreign Exchange Management Act, 1999 (42 of 1999) and are without prejudice to permissions/approvals, if any, required under any other law.

### **Annexure**

Before permitting the corporates to undertake hedge transactions, Authorized Dealer would require them to submit a brief description of the hedging strategy proposed, namely:

- description of business activity and nature of risk,
- instruments proposed to be used for hedging,
- the names of the commodity exchanges and brokers through whom the risk is proposed to be hedged and the credit lines proposed to be availed. The name and address of the regulatory authority in the country concerned may also be given,
- size/average tenure of exposure and/or total turnover in a year, together with expected peak positions thereof and the basis of calculation.

along with a copy of the Board Risk Management Policy approved by its Management covering;

- risk identification
- risk measurements
- guidelines and procedures to be followed with respect to revaluation and/or monitoring of positions
- names and designations of officials authorised to undertake transactions and limits

Authorised Dealer may refuse to undertake any hedge transaction if it has a doubt about the *bona fides* of the transaction or the corporate is not exposed to price risk. The conditions subject to which ADs would grant permission to hedge and the guidelines for monitoring of the transactions are given below. It is clarified that hedging the price risk on domestic sale/purchase transactions in the international exchanges/markets, even if the domestic price is linked to the international price of the commodity, is not permitted, except certain specified transactions as approved/may be approved by the Reserve Bank. Necessary advice may be given to the customers before they start their hedging activity.

## **A. Conditions/Guidelines for undertaking hedging transactions in the international commodity exchanges/markets**

1. The focus of the hedge transactions shall be on risk containment. Only off-set hedge is permitted.
2. All standard exchange traded futures and options (purchases only) are permitted. If the risk profile warrants, the corporate/firm may also use OTC contracts. It is also open to the corporate/firm to use combinations of option strategies involving a simultaneous purchase and sale of options as long as there is no net inflow of premium direct or implied, subject to the guidelines as detailed at **Para B** below. Corporates/firms are allowed to cancel an option position with an opposite transaction with the same broker.
3. The corporate/firm should open a Special Account with the AD Category-I bank. All payments/receipts incidental to hedging may be effected by the AD Category-I bank through this account without further reference to the Reserve Bank.
4. A copy of the Broker's Month-end Report(s), duly confirmed/countersigned by the corporate's Financial Controller should be verified by the bank to ensure that all off-shore positions are/were backed by physical exposures.
5. The periodic statements submitted by the brokers, particularly those furnishing details of transactions booked and contracts closed out and the amount due/payable in settlement should be checked by the corporate/firm. Un-reconciled items should be followed up with the broker and reconciliation completed within three months.
6. The corporate/firm should not undertake any arbitrage/speculative transactions. The responsibility of monitoring transactions in this regard will be that of the AD Category-I bank.
7. An annual certificate from Statutory Auditors should be submitted by the company/firm to the AD Category-I bank. The certificate should confirm that the prescribed terms and conditions have been complied with and that the corporate/firm's internal controls are satisfactory. These certificates may be kept on record for internal audit/inspection.

## **B. Conditions for allowing users to enter into a combination of OTC option strategies involving a simultaneous purchase and sale of options for overseas Commodity hedging :**

**1. Users** – Listed companies or unlisted companies with a minimum networth of Rs. 100 crore, which comply with the following:

- Adoption of Accounting Standards 30 and 32 (for companies not complying – those companies which follow the accounting treatment and disclosure standards on derivative contracts, as envisaged under AS 30/32.
- Having a risk management policy and a specific clause in the policy that allows using the above mentioned combination of OTC option strategies.

## **2. Operational Guidelines, Terms and Conditions**

- a.* Writing of options by the users, on a standalone basis is not permitted. Users can however, write options as part of cost reduction structures, provided, there is no net receipt of premium.
- b.* Leveraged structures, Digital options, Barrier options and any other exotic products are not permitted.
- c.* The delta of the options should be explicitly indicated in the term sheet.
- d.* The portion of the structure with the largest notional should be reckoned for the purpose of underlying.
- e.* AD Category -I banks may stipulate additional safeguards, such as, continuous profitability, etc., depending on the scale of operations and risk profile of the users.