

REPORT OF THE COMMITTEE ON HEDGING THROUGH INTERNATIONAL COMMODITY EXCHANGES (Summary of Recommendations)

Exposure of Indian entities to commodity price risks has been accentuated by the growing integration of the Indian economy with the rest of the world and increasing volumes of cross border trade. In order to examine the various issues relating to hedging against price risk through International Commodity Exchanges, the Reserve Bank of India appointed a committee under the Chairmanship of Shri R.V. Gupta on "**Hedging through International Commodity Exchanges**", with the following terms of reference:

Terms of Reference

- (A) To identify important import/export commodity groups where price volatility affects Indian corporates, and where such risks can be hedged through recognised International Commodity Exchanges,
- (B) To carry out a review of the financial instruments available on the said Commodity Exchanges, and examine their appropriateness with reference to the stated objective of risk reduction, attendant costs and constraints associated with internal control systems and position-tracking,
- (C) To examine/identify the important facets of an appropriate corporate-level Risk Management policy/strategy and make suitable recommendations, examine the extent to which 'ex ante' and 'ex post' scrutiny/verification can be undertaken by the regulatory authorities, and finally suggest a set of operational parameters with reference to which the use of such financial instruments can be regulated/overseen.
- (D) To examine the nature and extent of legal impediments, if any, which bar the recourse of Indian entities to international commodity exchanges, and the steps that need to be taken in this behalf.

The Committee submitted its Report on November 21, 1997.

Conclusions and Summary of Recommendations

1. Due to the inherent volatility of the commodity markets, more often than not, entities associated with these markets are in greater need to hedge against price risk than their counterparts in other markets including those dealing in financial instruments. This realisation was perhaps one of the major reasons for which instruments of price risk management were initially devised exclusively for these markets.

2. According to the institutional set up governing the trading process, instruments of commodity risk management can be classified into two categories—over-the-counter (OTC) products and exchange-traded products. While the OTC products can be innovative and tailor-made in accordance with the need of the user, most of these products face the problems of

limited liquidity and large counter-party risks. In comparison, exchange-traded products are generally highly standardised.

3. Composition of exchange-traded commodities has changed over the years. Given the present level of availability, commodities that are traded in futures and options exchanges can be classified in four broad categories. These are : (i) agricultural and allied commodities, (ii) energy related products, (iii) metal and metal products, and (iv) other commodities. The current trend in commodity exchanges shows that among the exchange-traded commodities the volume of energy products is generally the highest followed by metals. Agricultural commodities come as a distant third.

4. Broadly speaking there are two types of regulations or norms that shape the functions of the futures and options markets. The first set of norms is self-regulating measures devised and adopted by the exchanges and other related parties themselves. The other form of regulations come from the Government because it assumes the role of apex regulator and the supervisor of commodity exchanges situated within its territory. Though there is no uniform universal framework for regulation of the futures exchanges, such framework in countries which have their own international futures exchanges generally try to establish a transparent and rule based system and take steps to guard against manipulative practices and excessive speculation. Most of the countries, including the developing countries, irrespective of whether they have their own commodity exchanges or not, allow their domestic entrepreneurs to access offshore commodity futures exchanges.

5. In spite of the relatively higher rates of tariffs and quantitative restrictions

imposed in India on imports, prices of a large number of primary products broadly follow the movements in international prices. In the absence of access to commodity derivatives, marked price fluctuations introduce an uncertainty factor which affects the operational efficiency of corporates.

6. Limitations and restrictions imposed by the Forward Contracts (Regulation) Act (FCRA), 1952, the Act governing the regulation of the commodity derivative markets in the country, is the legal constraint for Indian parties to participate in international commodity exchanges for the purpose of price risk management. It should be pointed out that the provisions of the FCRA, 1952, have intra-territorial jurisdiction, that is they are applicable to contracts executed within the Indian territory. Even so, the locus of the party who is entering into the contract is also crucial for this purpose. If an Indian entity wants to enter into futures and options contracts, *albeit* in offshore commodity exchanges, this has additionally to be consistent with the provisions of the FCRA, 1952.

7. Articles 15 and 17 of the Act specify the restrictions that the Government can impose under the Act on forward contracts in commodities. In the context of options, Article 19 Section IV of the Act has put a blanket prohibition on any such transaction. However, irrespective of other provisions of the FCRA, 1952, Article 27 Section VI of the Act empowers the Central Government to exempt, subject to such conditions as may be specified, any contract or class of contracts from operation of all or any of the provisions of the Act. Therefore, through a notification in a Gazette under Article 27 of the FCRA, 1952, the Central Government can allow Indian entities access to offshore futures/options products.

8. Price-risk is a function of the extent to which corporates are price takers and the extent to which input/output prices are volatile. On this basis, groups of Indian importers/corporates exposed to price risk can be identified. Progressive deregulation, reduced relevance of price influencing state interventions and the consequential greater role of market forces, has meant more uncertainty in asset prices. Viewed thus, giving freedom to hedge against price risks is an integral part of the process of economic reform and liberalisation.

9. A consistent policy-stance on risk management should not differentiate among different types of risk. If companies can access off-shore financial markets for hedging interest/currency risks, similar access to off-shore derivative products should be permitted to those seeking to reduce commodity price risk. Hedgers and speculators (traders) as participants on futures markets have different objectives; there is, however, a measure of interdependence between these two sets of players which has to be recognised. Regulation of futures markets should strike a balance between the interests of these two players. Regulation of overseas futures markets and exchanges is, however, the responsibility of the countries where such markets are domiciled. Indian regulator's area of concern will not extend beyond ensuring orderly use of select derivative products for the purpose of risk management only.

10. Successful hedging requires that two pre-conditions must be satisfied—(a) the new position assumed on the commodity exchange seeks to address a genuine/authentic underlying risk, and (b) the hedge transaction is correctly executed and monitored. In the event either or both these

conditions are not met, hedging will acquire a speculative hue and in the process may increase the firm's exposure to risk. Three basic types of hedge operations which Indian corporates are likely to use would be - (A) Offset Hedge, (B) Price-Fixing Hedge, and (C) Options. In offset hedge, the physical exposure precedes or is co-terminus with the financial exposure assumed on the futures market. Price-fixing hedge arises when hedgers are not balancing their books against physical contracts but are securing (protecting) profits on anticipated business. In the process the firm tries to remove the uncertain element from its business by buying or selling goods at prices that will allow them to make profits given their own business circumstances. It has to be recognised that if physical exposure to the anticipated extent does not materialise, the firm would effectively be overhedged/underhedged. There is sometimes a thin dividing line between hedging and speculation. Companies will have to frame definite policies on the matter of overhedging or underhedging as both are a form of speculation, and clear procedures have to be laid down as to how to get out of the situation.

11. The superior flexibility of options in commodity hedging lies in enabling the user to capitalise on profitable market movements. For risk-reduction per se, options do not provide protection that is superior to futures : the advantage of the former is that the potential increase in profit is not forfeited. There seems to be a clear justification on balance for regulatory focus to remain firmly fixed on helping Indian corporates with authentic price exposures to achieve risk-reduction, and NOT potential price participation with a view to making extra profits. This need be so only for the initial period of about one year or so, which

could be termed as Phase-I. In due course, as corporates develop core risk management skills, acquire some experience and in-house expertise, they can be permitted access to a more sophisticated hedging strategy combining use of futures and options.

12. Futures contracts on Exchanges are standardised, easy to transact, reflect widely disseminated transparent prices, cost of participation is low and there is assured convenience of moving in and out of market. The initial access of Indian users can be limited to standard futures contracts issued by broker-firms which must be clearing members of the Exchange. A broker-firm that is a clearing member of a commodities Exchange has to meet stricter financial requirements than those applicable to non-clearing brokers, and are subject to capital-based position limits in the Exchange's contract markets. OTC products are more flexible and can be tailored to suit the Buyer's precise risk configuration-which means that basic risks can be eliminated to an extent which may not be possible for exchange traded products. Being non-standardised, efficient and risk free use of OTC products is predicated upon the user-firm possessing a measure of sophisticated understanding of the product and the nature of risk cover it affords. For certain types of commodity price risks, effective hedging may not be possible with the help of exchange traded instruments. During Phase-I, user-firms should ordinarily be permitted access to exchange traded risk management products, while OTC products can be availed of where either exchange traded products are not available or efficient hedging is demonstrably not possible if reliance is solely on exchange traded products. However, the relative OTC markets must necessarily have some depth, liquidity, transparency and equitable access. During Phase-I, use of OTC products can be

restricted to vanilla swaps. OTC-options can be permitted in Phase-II.

13. Hedging in off-shore futures markets involves certain costs. From exchange control angle, these costs and related foreign exchange outflows will have to be permitted. Cost of hedging can consist of margin requirements, or guarantees/stand by LCs in lieu thereof, or negotiation of credit-limits with Broker-firms operating on commodity Exchanges, transaction costs including commission, and losses on closing out the futures contracts on settlement dates.

14. Where hedging is conducted on off-shore commodity Exchanges, the Indian regulatory authorities have no role of any nature vis-a-vis these Exchanges which function under the jurisdictional authority of their own regulators. Indian regulatory authorities do possess the 'negative' right to 'not participate' i.e., forbid access to the domestic users.

15. Derivatives can sometimes generate high losses. When measured against the enormous volume of business undertaken in derivatives worldwide, these losses have been comparatively few in number. Among factors which have commonly contributed to these losses are excessive position taking in high risk instruments, ineffective internal risk management procedures and operational controls, inadequacies in corporate policy regarding use of derivatives and, not least, insufficient understanding of the nature and risks of derivatives. There does exist an imbalance between the development/availability of such fairly sophisticated instruments and the capacity of end-users to fully understand and employ the same without collateral financial damage. During the initial 'transitional' period, the said imbalance in respect of the

Indian-user (wholly new to this type of activity) could prove to be a source of concern. Given this context, it does not seem appropriate to opt for an approach that wholly dispenses with any form or type of 'ex-ante' scrutiny and relies upon corporates to formulate, implement, and oversee prudent hedge strategies. Even if some general parameters of operational nature could be set-out for the guidance of end-users it would not be advisable to assume that Indian corporates interested in hedging overseas will be either sufficiently knowledgeable or sufficiently careful. A brief period of transition/acclimatisation is necessary wherein the company boards and senior management get an opportunity to internalise risk management techniques.

16. There is substantive rationale for hedge-freedom to be given to Indian end-users in two distinct Phases; Phase-I, which can be for one year (up to end 1998), and Phase-II commencing from the January 1999. Phase-I, the period of acclimatisation, has to provide for a modicum of regulatory oversight to see that genuine underlying exists, the proposed hedge instruments are appropriate in relation to the stated objectives, and risk management process is/will be in place. The regulatory input in Phase-I will be neither intrusive nor transaction-specific. The scope of regulatory input during Phase-I can be said to consist of—(i) a simple diligence exercise at pre-eligibility stage to see that the concerned corporate has authentic underlying exposure, a clear-cut Board-approved risk management policy has been formulated, and the corporate is prepared to put in place a well-designed system of internal controls and ensure periodic oversight by the Company Board on an on-going basis, (ii) periodic scrutiny of actual hedge operations based principally on Review reports put up to the Board, supplemented by Chartered

Accountant Certificates about the adequacy or otherwise of the company's internal controls and accounting systems. During Phase-II, stage (i) can be dispensed with, while stage (ii) can continue which consists only of periodic ex-post scrutiny of actual hedge-operations. During Phase-I, corporates can be permitted access to exchange traded futures and select commodity OTC derivatives, if warranted. Exchange-traded options and select commodity OTC options can be permitted in Phase-II.

17. Operationalisation of hedge strategy requires end-users to—(a) keep track of the adequacy of accounting systems and procedures to record, summarise and report the results of hedging operations, (b) monitor the financial statement effects of realised and unrealised gains and losses, (c) determine the extent to which internal operational and accounting controls can be relied upon to prevent unauthorised trading. Board of Directors (or its equivalent) and the senior management have to be actively involved in hedge operations and to accept in writing certain specific responsibilities in connection therewith. There are five important core principles for managing derivatives risk. These are:

- (A) The board of directors (or its equivalent) should establish and approve an effective policy for the use of derivatives which is consistent with the strategy, commercial objectives and risk appetite of the organisation and should approve the instruments to be used, and how they are to be used,
- (B) Senior management should establish clear written procedures for implementing the derivatives policy set by the Board, covering such matters as dealing authority, reporting lines, risk limits,

counterparty and documentation approvals and valuation procedures, and should regularly review their operation and effectiveness under report to the board of directors.

- (C) Senior management to ensure that derivative activities are properly supervised and are subject to an effective framework of internal controls and audits to ensure that transactions are in compliance with both external regulations (including the capacity to enter into such transactions) and internal policy (including procedures for the execution, confirmation recording, processing and settlement of transactions).

(D) Senior management should establish a sound risk management function—a framework of reporting, monitoring and controlling all aspects of risk, valuing exposures, assessing performance, monitoring, enforcing position and other limits, stress testing and contingency planning.

- (E) Procedures should be in place to provide for a full analysis of credit risk to which organisation is exposed.

Practical steps should be taken to implement these in a form suitable to the precise circumstances of the user, including the size, frequency and purpose of transactions.