

May 31, 2007

To

All Authorised Dealer Category - I Banks

Madam / Sir,

Risk Management and Inter-Bank Dealings - Commodity Hedging

Attention of Authorised Dealer Category – I (AD Category – I) banks is invited to Regulation 6 of Notification No.FEMA.25/RB-2000 dated May 3, 2000, as amended from time to time and A.P. (DIR Series) Circular No.03 dated July 23, 2005. Currently, residents in India are permitted, with prior approval of the Reserve Bank, to enter into contracts in commodity exchanges or markets outside India to hedge the price risk in a commodity, subject to certain terms and conditions. Further, companies listed on a recognised stock exchange can be permitted by selected AD Category – I banks to hedge the price risk in respect of any commodity (except gold, silver, petroleum and petroleum products) in international commodity exchanges / markets. However, hedging the price risk on domestic sale / purchase transactions in the international exchanges / markets is not permitted, even if the domestic price is linked to the international price of the commodity.

2. Commodity Hedging for Domestic Transactions - Select Metals

Reserve Bank has been receiving representations from domestic producers and users of certain metals for permission to hedge the price risk on domestic purchases and sales in international exchanges, like London Metal Exchange (LME), in order to take advantage of greater depth and liquidity in such exchanges.

As announced in the Annual Policy Statement for the year 2007-08 (para 139), it has been decided that AD Category – I banks, which have specifically been authorised by Reserve Bank in this regard, may, henceforth, permit domestic producers / users to hedge their price risk on aluminium, copper, lead, nickel and zinc in international commodity exchanges, based on their underlying economic exposures. Hedging may be permitted up to the average of previous three financial years' (April to March) actual purchases / sales or the previous year's actual purchases / sales turnover, whichever is higher, of the above commodities. Further, only standard exchange traded futures and options (purchases only) may be permitted.

3. Commodity Hedging for Domestic Purchases - Aviation Turbine Fuel (ATF)

AD Category – I banks, which have specifically been authorised by Reserve Bank in this regard, may also permit actual users of aviation turbine fuel (ATF) to hedge their economic exposures in the international commodity exchanges based on their domestic purchases. Reserve Bank has received representations from domestic users of ATF for permission to hedge their economic exposure through OTC products as well since ATF or its close substitutes are not traded on the exchanges. According to the domestic users, the hedging of their exposures to price risk on ATF indirectly through the exchange traded products, such as crude oil, heating oil, etc., may not achieve perfect hedges. Accordingly, if the risk profile warrants, the actual users of ATF may also use OTC contracts. AD Category – I banks should ensure that permission for hedging ATF is granted only against firm orders and the necessary documentary evidence should be retained by them.

4. AD Category – I banks may approach Reserve Bank for permission on behalf of customers who are exposed to systemic international price risk, not covered under para 2 or 3 above.

5. AD Category – I banks should ensure that the entities entering into hedging activities should have Board approved policies which define the overall framework within which derivatives activities should be conducted and the risks controlled. All other conditions and guidelines contained in A.P. (DIR Series) Circular No.03 dated July 23, 2005 should be complied with. All transactions should be routed only through a designated AD Category – I bank.

6. AD Category – I banks that have already been authorised by Reserve bank to grant permission to companies listed on a recognised stock exchange to hedge commodity price risk should also apply afresh in respect of these new facilities.

7. AD Category – I banks which have been granted permission to approve commodity hedging are required to submit a monthly report to the Chief General Manager, Reserve Bank of India, Foreign Exchange Department, Central Office, Forex Markets Division, Amar Building, 5th Floor, Mumbai-400 001, within first week of following month, as per format given in the Annex.

8. Applications from customers to undertake hedge transactions not covered under the delegated authority may continue to be forwarded to Reserve Bank by the AD Category – I banks, for approval as hitherto.

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

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

11. 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.

Yours faithfully,

Salim Gangadharan
Chief General Manager