

November 6, 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, A.P. (DIR Series) Circular No.03 dated July 23, 2005 and A.P. (DIR Series) Circular No.66 dated May 31, 2007. Currently, residents in India are permitted to hedge their commodity price risk after obtaining specific approvals from the Reserve Bank or from select ADs which have been authorised by the Reserve Bank for the purpose.

2. In view of the volatility in global oil prices, domestic oil refining and marketing companies have been representing to the Reserve Bank for permission to hedge commodity price risk on inventories as well in international exchanges/markets, to modulate the impact of adverse price fluctuations on their margins.

3. As announced in the Mid – Term Review of Annual Policy Statement for the Year 2007-08 (para 135), it has been decided to permit domestic oil marketing and refining companies to hedge their commodity price risk to the extent of 50 per cent of their inventory based on the volumes in the quarter preceding the previous quarter. The hedging may be undertaken through AD Category – I banks, which have been authorised by Reserve Bank in terms of A.P. (DIR Series) Circular No. 03 dated July 23, 2005. The hedges may be undertaken using over-the-counter (OTC) / exchange traded derivatives overseas with the tenor restricted to a maximum of one-year forward.

4. AD Category – I banks should ensure that the entities hedging their exposures should have Board approved policies which define the overall framework within which derivatives activities should be undertaken and the risks contained. AD Category-I banks should approve this facility only after ensuring that the Board's approval has been obtained for the specific activity (i.e. hedging of inventories) and also for dealing in OTC markets. The Board approval must include explicitly the mark-to-market policy, the counterparties permitted for OTC derivatives, etc. The entities must put up the list of OTC transactions to the Board on a

half yearly basis, which must be evidenced by the AD before permitting continuation of hedging facilities under this scheme. The AD Category – I banks should also carry out due diligence regarding “*user appropriateness*” and “*suitability*” of the hedging activity of the customer.

5. 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. 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.

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

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.

Yours faithfully,

Salim Gangadharan
Chief General Manager