Circular C-IRS-07/2023

Default protocol. Auctions

BME CLEARING

20 November 2023

Segment: IRS
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The clearing house's procedure in the event of a default is explained, as well as the auctions to be carried out and the method of distributing possible losses. The additional specific resources of BME CLEARING are introduced as a loss absorption measure and, additionally, the section " Failure to award an auction portfolio" is modified to refer to the regulation now provided for in the General Conditions of the Segment under the heading "Specific rules on recovery and resolution in BME CLEARING".

A. GENERAL PRINCIPLES OF DEFAULT PROTOCOL

BME CLEARING uses this default resolution procedure of a Clearing Member (CM) to be applied when BME CLEARING sends notification of a default under Articles 39 and 41 of the Rule Book.

The basic principles of this procedure are detailed in this Circular, which implements Articles 42, 43 and 45 of the Rule Book and the General Conditions of the Segment, due to the special characteristics of the IRS Segment.

The principles set out in this Circular will be applied by analogy or by extension to all situations not envisaged herein and not regulated by the General Conditions of the Segment that may arise in cases of default and in the organisation and operation of Auctions.

In the event of a default of a CM, BME CLEARING has the obligation of maintaining the integrity and service of the IRS segment and future settlements of transactions registered in BME CLEARING by non-defaulting CMs. CMs have the obligation to provide impartial advisory through the Default Management Group (DMG) and make reasonable bids in auctions of the positions of a defaulting CM.

In the event of a default of a CM, a meeting will be called of the DMG. The latter will act in accordance with its operating rules and procedures as described in the Circular on the Default Management Group, and with the provisions in this Circular.

B. PROCESSING OF CLIENT POSITION ACCOUNTS THAT HAVE NOT BEEN TRANSFERRED

If the Defaulting CM has Client position Accounts, BME CLEARING will handle them in accordance with Article 35 of the Rule Book relating to "Closing of Positions and Transfer of position Accounts" in the event of a Declaration of Default.

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The process of closing Client position Accounts that could not be ported will be the same as that of the Proprietary position Accounts of a Defaulting CM set out in this Circular.

In consultation and collaboration with the DMG, BME CLEARING may group the Positions of position Accounts that could not be transferred with the Position of the Defaulting CM's Proprietary position Account, or, if not, in addition to the auction(s) for the Position of the Defaulting CM's Proprietary position Account, in consultation and collaboration with the DMG BME CLEARING may carry out an auction:

- For the totality of the Position of each Client that has not been ported.

- Split the Position of each Client into several portfolios ("Auction Portfolios").

- Group the Position of multiple Clients into a single Auction Portfolio.

- Group the Position of multiple Clients into multiple Auction Portfolios.

The Position of the Clients of a Defaulting CM that could not be ported may be auctioned on a date subsequent to the auction of the Position of the Defaulting CM's Proprietary position Account.

C. RISK NEUTRALISATION

BME CLEARING, as the case may be with the assistance of the DMG, will reduce as much as is possible and reasonable the market risk of the positions of the Defaulting CM by means of Hedging Trades on behalf of the Defaulting CM with IRS trades at market price that can be registered in the IRS segment of BME CLEARING.

The objective of this neutralisation is to reduce and maintain market risk within tolerance limits expressed in terms of sensitivity or other market risk measures previously set out by BME CLEARING in agreement with the DMG once a Default has been declared. These hedging transactions will be performed by BME CLEARING in accordance with separate arrangements between BME CLEARING and other CMs. Hedging transactions may be carried out prior to or at the same time as the splitting of the Defaulting CM's Portfolio, as the case may be.

D. SPLITTING OF THE POSITION OF THE DEFAULTING CLEARING MEMBER

BME CLEARING, with the assistance of the DMG, will determine the composition of each Auction Portfolio and, at its absolute discretion, may split the Defaulting CM's position into one or more Auction Portfolios with the aim of enhancing the efficiency of the auction, or decide the composition of any of the Auction Portfolios.

BME CLEARING, with the assistance of the DMG, may split the position into multiple Auction Portfolios (AP), with the aim of assuring a resolution process of a CM default that more efficiently protects BME CLEARING and the non-defaulting CMs. BME CLEARING and the DMG are not obligated to split the position, and may proceed with a single auction (regardless of the number of transactions of the position of the Defaulting CM).

BME CLEARING, with the assistance of the DMG, may also determine whether the Auction Portfolio(s) arising from the default of a CM will be carried out under a single-winner or multiple-winner model. In the single-winner model, each AP will have one winner, namely the Clearing Member making the best bid. In the multiple-winner model, each AP may have more than one winner.

If an Auction Portfolio has an excessive number of Contracts so that the winning Clearing Member(s) may not have the capacity, or may have difficulties, in their back-office systems to manage excessive number of Contracts:

- BME CLEARING, with the assistance of the DMG, may split the Auction Portfolio into sub-portfolios. The total position of the sub-porfolios will contain the whole position of the Auction Portfolio. Such sub-portfolios will be called Similar Auction Portfolios.

- Similar Auction Portfolios must have similar values in Nominal, Current Net Value, Initial Margin and Sensitivity to one basis point.

- If the Similar Auction Portfolios option, with multiple winners, is used, the Auction Units, as defined in section E below, allocated to the CM can be allocated to the totality of Similar Auction Portfolios.

Nevertheless and subject to risk criteria, BME CLEARING, with the assistance of the DMG, should endeavour to ensure that the configuration of each of the Auction Portfolios is not materially different than that set in any auction Simulations to be performed in the event of a default. However, BME CLEARING, in collaboration with the DMG, may adopt criteria that differs from general auction criteria in view of the specific conditions of the default and risk criteria.

E. PROCEDURE PRIOR TO AUCTIONS

Following the Risk Neutralisation process and any portfolio splitting of the position of the defaulting CM, BME CLEARING will auction the Auction Portfolio(s) among non-defaulting CMs with the aim of rebalancing its position and to determine the net settlement value of the Position in order to distribute losses in accordance with Article 37 of the Rule Book that is implemented in this Circular. BME CLEARING, in coordination with the DMG, will determine the specific details of the auction to be performed.

If an auction model with multiple winners has been chosen and the Position has been splitted into multiple Auction Portfolios, BME CLEARING will allocate a number of Auction Units (AU) to each CM for each Auction Portfolio. The procedure for allocating Auction Units will be as follows:

- The position of non-defaulting CMs will be divided into sub-portfolios similar to the Auction Portfolios ("Similar Sub-Portfolios").

- The risk will be calculated of each non-defaulting CM in each sub-portfolio that is similar to Auction Portfolios.

- Auction Units of each non-defaulting CM will be allocated for each Auction Portfolio in relation to the risk of the CM in each Similar Sub-Portfolio of the Auction Portfolio and the total risk of all non-defaulting CMs in each Similar Sub-Portfolio. The Auction Units are calculated by multiplying the result obtained per risk by a ratio of at least 1.2 and a maximum of 3, in order to attain more competitive auctions.

The Auction Units allocated to each CM in each Auction Portfolio set out a minimum AUs for which the CM will have to bid in each Auction Portfolio. CMs may bid for more AUs than are allocated to them.

Different Auction Portfolios can be auctioned at different times or on different dates, or simultaneously.

CMs may delegate bidding to another CM or another entity. An Instruction of BME Clearing may set the maximum number of CMs that may delegate to a single CM.

BME CLEARING will notify all non-defaulting CMs of the specific details of the auction reasonably in advance of the auction:

i. All details of the Auction Portfolios.

ii. Whether the auction is carried out with a single-winner or multiple-winner model,

iii. As the case may be, the total Auction Units for each Auction Portfolio, and for each of the non-defaulting CMs, the Auction Units corresponding to each non-defaulting CM for each Auction Portfolio.

iv. Details on all the Similar Auction Portfolios, as applicable.

v. The format of the Auction.

vi. The date, scheduled start and end time of the auction for each Auction Portfolio.

vii. The scheduled date and time of resolution of the auction.

viii. The settlement date of the result of the auction.

ix. And any other general terms and conditions of the auction.

F. AMOUNT OF AVAILABLE FUNDS ALLOCATED TO EACH AUCTION PORTFOLIO

If there is more than one Auction Portfolio, BME CLEARING will calculate the Amount Allocated to each Auction Portfolio (AAAP). The purpose of AAAP is to report the initial distribution of potentially available funds in the event of losses in the auction of each Auction Portfolio. Notwithstanding this initial distribution, the final funds will be distributed according to the rules set out in "Distribution of losses with funds in possession of BME CLEARING".

For each Auction Portfolio, there will be an Amount Allocated to each Auction Portfolio at three levels, which will be distributed as follows.

- Level 1. Collateral posted by the defaulting CM in the form of Initial Margin, Individual Margin, Extraordinary Margin, if any, Default Fund Contributions of the IRS segment and any other Collateral provided by the defaulting CM allocated to the IRS Segment, in accordance with the regulations of BME CLEARING, and contributions of the defaulting CM in Default Funds not used in all other Segments if available, and any other type of collateral the Defaulting Member has posted with BME CLEARING. The total amount posted by the defaulting CM will be distributed among each Auction Portfolio (AP) in accordance with the ratio of the risk of each AP to the total risk of all Auction Portfolios, as per the following formula:

$$\text{Distribution percentage} = \frac{\text{AP Risk}_i}{\text{Total AP Risk}}$$

- Level 2. BME CLEARING`s dedicated own resources (skin in the game) in the IRS segment. This amount will be distributed among each Auction Portfolio in accordance with the ratio of the risk of each AP to the total risk of all Auction Portfolios, as per the following formula:

$$\text{Distribution percentage} = \frac{\text{AP Risk}_i}{\text{Total AP Risk}}$$

- Level 3. The amounts contributed to the Default Fund of each non-defaulting CM in the IRS segment. The Default Fund of each CM will be distributed for each Auction Portfolio as follows:

  - The portfolio of non-defaulting CMs will be divided into sub-portfolios similar to the Auction Portfolios.

  - The risk will be calculated of each CM in each sub-portfolio that is similar to the Auction Portfolio.

  - The amount contributed by each non-defaulting CM to the Default Fund will be distributed in each Auction Portfolio in relation to the risk of the CM in each Similar Sub-Portfolio of the Auction Portfolio and the total risk of all Similar Sub-Portfolios, as per the following formula:

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$$\text{Distribution percentage} = \frac{\text{CM Subportfolio Risk}}{\text{Total CMs Risk in all Subportfolios}}$$

- If a Similar Auction Portfolios model is being used, the amount allocated to each Auction Portfolio can be allocated to the totality of Similar Auction Portfolios.

G. AUCTION

Non-defaulting CMs will submit bids to the Secretary of the DMG, who will ensure that CM representatives in the DMG can see the bids and the bidding process generally, but without knowing which CM is making each bid.

CMs are obligated to bid in the auction. If Auction Units have been allocated, CMs must include the AUs they are bidding for in the bid. A CM may not set different prices for different AUs for the same Auction Portfolios. A CM that represents another CM may set prices for the represented CM's AUs that differ from the prices of the CM's own AUs or those of another represented CM. CMs will submit bids in the Auction's established format and in the time period allowed for the same. Bids may be positive or negative.

- A positive bid means that a winning CM will pay BME CLEARING for the Auction Portfolio (or for the Auction Units, as the case may be) for which it has bid and won.

- A negative bid means that BME CLEARING will pay a winning CM for the Auction Portfolio (or for the Auction Units, as the case may be) for which it has bid and won.

In either case, the winning CM purchases the Auction Portfolio for which it has bid (or the Auction Units, as the case may be), and incorporates the Position won to the Position of its Proprietary position Account becoming the owner of the Position won at the auction at that moment.

BME CLEARING, following consultations with the DMG, may reject a bid for reasons of risk when the amount of the bid is significant in relation to the Initial Margin held by the CM making the bid. BME CLEARING may reject bids that do not follow the auction format or the rules of the Auction.

If an Auction Portfolio receives no bids, or if a multiple-winner model is used, and an Auction Portfolio does not receive sufficient bids for the total Auction Portfolio, BME CLEARING will again auction such Auction Portfolios. These auctions may be carried out on days other than those of the original auction.

H. DETERMINATION OF WINNING BIDS

If a single-winner model has been used, the totality of the portfolio of each Auction Portfolio will go to the CM making the best bid. The Auction Portfolio then becomes an Auctioned Portfolio.

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If a multiple-winner model has been used, the CM making the best bids will win the Auction Units for which it has bid at the bidding price made by each winning CM. The DMG will allocate the winners, from the best price winning bid to the worst price winning bid. In the worst winning bid, the volume of the AUs offered can be adjusted downwards so that the total AUs allocated are equal to the AUs of the Auctioned Portfolio.

In either case, if more than one CM should bid at the same price and this price wins, BME may select the bid received first and reject other bids.

The CM purchases the Auctioned Portfolio for which it has bid and won (or the Auction Units, as the case may be) in accordance with the stipulations in "Registration of Positions won in the Auction" from the moment BME CLEARING confirms that the bid has been declared the winner.

BME CLEARING will inform all CMs of the result of each auction. The winners of each Auctioned Portfolio will be anonymous, except for the winners themselves with respect to the Auctioned Portfolio, or the Auction Units they have won.

I. REGISTRATION OF POSITIONS WON IN THE AUCTION

Following the auction of an Auction Portfolio, and regardless of whether other Portfolios are pending auction, BME CLEARING will transfer the Position of the Auctioned Portfolio to the Proprietary position Account of the CM(s) whose bids have won. The transfer may be carried out i) in order to technically facilitate the transfer, registering new Position in the winning CM Proprietary position Account or ii) by transferring the original Positions of the Auctioned Portfolio of the defaulting CM to the winning CM. If a CM has won multiple Auction Units in an Auctioned Portfolio, BME CLEARING will aggregate the AUs of each Contract. Winning CMs will cooperate with BME CLEARING in registration of the Positions won in the auction.

BME CLEARING will send confirmation to the winners of each Auctioned Portfolio of the date and settlement amount of the auction result.

To avoid any doubts, payment of Coupons, Additional Payments and PAI of Auctioned Portfolio are to be made by the defaulting CM (or the Defaulting Client in case of a CM Default with Client position Accounts that have not been ported) until the Position won is registered in the winning CM.

Winning CMs will be obligated to pay BME CLEARING any amounts resulting from positive bids, and to post an Initial Margin related to the Position won in the auction.

BME CLEARING will be obligated to pay winning CMs the amounts resulting from negative bids. The Position will be Registered simultaneously with the net payment of the auction (Initial Margin related to Position won in the auction to be posted by winning CM, less the amount of the winning bid to be paid by BME CLEARING).

J. DISTRIBUTION OF LOSSES WITH FUNDS IN THE POSSESSION OF BME CLEARING

Following the end of all auctions, BME CLEARING will determine if any losses have occurred therein, and whether the AAAP are to be used. In the event of such losses, BME CLEARING will make a distribution of losses based, first, on the order of distribution of the portfolios (if there is more than one portfolio) and, second, on the distribution method itself.

The distribution order and distribution method is as follows:

1. Auctioned Portfolios with gains.

    a) If gains have been made in an Auctioned Portfolio, none of the three-level AAAP need to be used, and the gains and the AAAP allocated to the Auctioned Portfolio with gains can be used to offset losses in other Auctioned Portfolios where losses have occurred in the auction. The distribution of the gains and of Level 1 AAAP, on the one hand, and of Level 2 AAAP on the other, among Auctioned Portfolios with pending losses will use the same algorithm used for allocation of Level 1 and 2 AAAP, as set forth in the section "Amount of available funds allocated to each Auction Portfolio". Gains will be considered Level 1 AAAP for these purposes. Level 3 AAAP are not distributed yet, and they are left over for each CM as unused Level 3 AAAP pending distribution in a Level 3 AAAP `fund` in the event such a distribution becomes necessary.

2. Auctioned Portfolios whose losses are offset with part of the Level 1 AAAP.

    a. If losses have occurred in an Auctioned Portfolio, but these are lower than the Level 1 AAAP allocated to the Portfolio, part of the Level 1 AAAP will have to be used in this Portfolio.

    b. Unused amounts of Level 1 AAAP and all Level 2 and 3 AAAP amounts will be distributed among Portfolios incurring losses greater than the Level 1 AAAP. Leftover AAAP from Level 1, Level 2 and Level 3 will be distributed as set out in subsection 1.a).

3. Auctioned Portfolios whose losses are not offset with Level 1 AAAP, but which are offset by using part of the Level 2 AAAP.

    a. If losses have occurred in an Auctioned Portfolio, but these are greater than the Level 1 AAAP, but lower than the sum of Level 1 and Level 2 AAAP, all Level 1 AAAP and part of the Level 2 AAAP will have to be used in this Portfolio.

    b. Unused amounts of Level 2 AAAP and all Level 3 AAAP amounts will be distributed among Portfolios incurring losses greater than the Level 1 and Level 2 AAAP. Leftover Level 2 and Level 3 AAAP will be distributed as set out in subsection 1.a).

4. Auctioned Portfolios whose losses are not offset with Level 1 and Level 2 AAAP, but which are offset by using part of the Level 3 AAAP.

   a. If losses have occurred in an Auctioned Portfolio, but these are greater than the Level 1 and Level 2 AAAP, but lower than the sum of Level 1, Level 2 and Level 3 AAAP, all Level 1 and Level 2 AAAP and part of the Level 3 AAAP will have to be used in this Portfolio.

   b. Unused amounts leftover from Level 3 AAAP will be distributed among Portfolios incurring losses greater than the the sum of Level 1, Level 2 and Level 3 AAAP.

   c. The following order will be used to determine the use of Level 3 AAAP corresponding to contributions by non-defaulting CMs:

   – Level 3.1. The AAAP of CMs that did not bid on the Auctioned Portfolio will be used first.

      – 3.1.1) If a CM bids for a number of Auction Units that is lower than the number allocated, the AAAP of this CM in the Auctioned Portfolio will be distributed according to the total AUs allocated to this CM. The portion corresponding to allocated AUs and not bid will be joined to Level 3.1, and the portion corresponding to actual AUs bids will be joined to either Level 3.2 or Level 3.3., according to whether the bid wins or not.

      – 3.1.2) If the Level 3.1 AAAP of this Auctioned Portfolio are sufficient to cover the pending losses, used amounts will be distributed and prorated by multiplying the loss to be offset by the AAAP posted by each CM at this level, divided by the total AAAP posted by all CMs at Level 3.1.

      – 3.1.3) Unused Level 3.1 amounts (if any) and all Level 3.2 and Level 3.3 amounts are not distributed yet, and they are left over for each CM as unused Level 3 AAAP pending distribution in a Level 3 AAAP `fund` in the event such a distribution becomes necessary.

   – Level 3.2. If the use of Level 3.1 as described above is insufficient to cover the losses, the AAAP of CMs whose bids were accepted but which did not win in the auction of the Auctioned Portfolio will be used. If Level 3.2 AAAP of this Auctioned Portfolio are sufficient to cover the pending losses, the following distribution criteria will be followed:

      – 3.2.1) The distribution will be made by multiplying the pending losses in Level 3.2 by the square difference (variance) between the non-winning CM bid and the winning bid in the corresponding auction (the best winning bid if there were multiple winners with different prices) and divided by the sum of the variances (calculated as explained above) of all the CMs that bid and did not win in the Auctioned Portfolio.

- 3.2.2) If the value of using a CM's AAAP, calculated in accordance with the preceding paragraph, is greater than the AAAP allocated to this CM in the Auctioned Portfolio, only the total AAAP allocated to this CM will be used.

- 3.2.3) If pending losses are left over following the distribution set out in section 3.2.2, there will be a further use of the AAAP of CMs that bid but did not win, and whose AAAP allocated in the Auctioned Portfolio, in particular, were greater than the use calculated in accordance with subsection 3.2.1). This further use will be calculated with the mechanism set out in sections 3.2.1) and 3.2.2), using the AAAP pending use at Level 3.2.

- 3.2.4) BME CLEARING will repeat this process until all losses have been distributed using the Level 3.2 AAAP.

- 3.2.5) Unused Level 3.2 amounts (if any) and all Level 3.3 amounts are not distributed yet, and they are left over for each CM as unused Level 3 AAAP pending distribution in a Level 3 AAAP `fund` in the event such a distribution becomes necessary.

- Level 3.3. If the Level 3.2 AAAP is insufficient to cover the losses, use will be made of AAAP of CMs who bid and won and, if any, of the AAAP of CMs who bid and did not win but whose price was equal to the best winning price in the auction.

    - 3.3.1) If there are multiple winners with different prices in the Auctioned Portfolio, the distribution will be made by multiplying the loss to be cleared at Level 3.3 by the square difference (variance) between the bid of the winning CM and the best winning price in the auction, and divided by the sum of the variances (calculated as explained above) of all CMs that bid and won.

    - 3.3.2) If the value of using a CM's AAAP, calculated in accordance with the preceding paragraph, is greater than the CM's AAAP, only the CM's total AAAP will be used.

    - 3.3.3) If there are still pending losses following the distribution discussed above, there will be a further use of the AAAP of those CMs whose AAAP in the specific Auctioned Portfolio were greater than the use calculated in accordance with preceding paragraphs. This further use will be calculated with the mechanism set out in sections 3.3.1) and 3.3.2), using the AAAP pending use at Level 3.3.

    - 3.3.4) BME CLEARING will repeat this process until all losses have been distributed using the Level 3.3 AAAP.

- 3.3.5) If the distribution set out in the preceding sections is insufficient to offset the pending losses, or there is a single winner in the Auction Portfolio or multiple winners with the same winning price or a CM bid at the winning price but did not win the auction, use will be made of the AAAP of CMs of the Auctioned Portfolio that have leftover AAAP in that Auctioned Portfolio. This use will be calculated by multiplying the pending losses by the bid of each CM and the total bids of CMs in this situation. BME CLEARING will repeat this process until all losses have been distributed.

- 3.3.6) Unused Level 3.3 amounts are not distributed yet, and they are left over for each CM as unused Level 3 AAAP pending distribution in a Level 3 AAAP `fund` in the event such a distribution becomes necessary.

5. Auctioned Portfolios whose losses are not covered with Level 1, Level 2 and Level 3 AAAP, but that can be covered with the AAAP left over from other Auctioned Portfolios obtained in accordance with application of subsections 1.a), 2.b), 3.b) and 4.c.3.1.3), 4.c.3.2.5) and 4.c.3.3.6)

    a. First, AAAP left over from other Auctioned Portfolios are to be distributed among Auctioned Portfolios whose losses exceed the sum of Level 1, Level 2 and Level 3 AAAP allocated in accordance with the foregoing rules. The method of distribution is set out in the section "Amount of available funds allocated to each Auction Portfolio" for Level 3, using the leftover AAAP of each CM and the Auctioned Portfolios in this situation.

    b. Once new AAAP has been allocated to Auctioned Portfolios with pending losses, the distribution processes detailed in subsection 4 above will be repeated, through Levels 1 (CMs that have not bid on the Auctioned Portfolio), Levels 2 (CMs that have bid but not won the Auctioned Portfolio) and Levels 3 (CMs that have bid and won the Auctioned Portfolio) in the order set out in subsection 4.

    c. If Portfolios remain with pending losses and there is still AAAP left over from other Auctioned Portfolios, the losses will no longer be distributed portfolio by portfolio from that moment onwards:

        1. All pending losses of Auctioned Portfolios will be added up.

        2. All AAAP left over from other Auctioned Portfolios will be added up.

        3. AAAP used at this time of leftover AAAP of each CM with leftover AAAP will be calculated by multiplying the total pending losses calculated in c.1) by the leftover AAAP of the CM, and divided by the sum of all leftover AAAP.

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K. ADDITIONAL RECOVERY MEASURES

Pursuant to the provisions of article 45.8.C) of the Rule Book, BME CLEARING may adopt the following measures:

a) DISTRIBUTION OF PENDING LOSSES AGAINST BME CLEARING's ADDITIONAL SPECIFIC RESOURCES (*Second skin in the game*)

If there are still pending losses following the distribution processes detailed in section J above, "Distribution of losses with funds in the possession of BME CLEARING", it would mean that the Clearing Member Default will have consumed:

i) all the Collateral posted by the Defaulting Clearing Member (Initial Margin, Individual Fund, Extraordinary Margin -if any- Contribution to the IRS Segment Default Fund and any other Collateral posted by the Defaulting CM assigned to the IRS Segment in accordance with BME CLEARING's regulations as well as the unused contributions -if any- of the Defaulting Clearing Member to the Default Fund of all the other Segments, as well as any other Collateral, of whatever type, that the Defaulting Member has posted in favour of BME CLEARING),

ii) the dedicated own resources of BME CLEARING assigned to the IRS Segment (*Skin in the game*), and

iii) the total amount of the contributions to the IRS Segment Default Fund made by the non-defaulting Clearing Members of the IRS Segment.

In this situation, the remaining pending losses would be covered by the additional specific own resources of BME CLEARING (*Second skin in the game*) allocated to the IRS Segment.

b) DISTRIBUTION OF PENDING LOSSES WITH ADDITIONAL DEFAULT FUND ASSESSMENT

In the event that there are still pending losses following the distribution processes detailed in section J) above "Distribution of losses with funds in possession of BME CLEARING" and following the application of the additional Recovery Measures provided for in section K, a), above on "Distribution of pending losses against BME CLEARING's additional specific resources (*Second skin in the game*)", it would mean that the CM default has consumed:

i) all the Collateral posted by the Defaulting Clearing Member (Initial Margin, Individual Fund, Extraordinary Margin -if any- Contribution to the IRS Segment Default Fund and any other Collateral posted by the Defaulting CM assigned to the IRS Segment in accordance with BME CLEARING's regulations as well as the unused contributions -if any- of the Defaulting Clearing Member to the Default Fund of all the other Segments, as well as any other collateral, of whatever type, that the Defaulting Member has posted in favour of BME CLEARING),

ii) the dedicated own resources of BME CLEARING assigned to the IRS Segment (*Skin in the game*).

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iii) the total amount of the contributions to the IRS Segment Default Fund made by the non-defaulting Clearing Members of the IRS Segment, and

iv) the additional specific own resources (*Second skin in the game*) of BME CLEARING assigned to the IRS Segment.

In this situation, BME CLEARING would make an additional request to contribute to the IRS Segment Default Fund (Assessment) to cover pending losses, in accordance with BME CLEARING rules.

The total amount requested for this purpose from the Segment CM would be the lower of the following two amounts:

i. Pending losses

The amount requested from each non-defaulting CM will be calculated by multiplying the pending losses by the CM's prior contribution to the Default Fund and dividing it by the total contributions of all non-defaulting CMs to the Default Fund.

ii. The maximum amount that BME CLEARING can seek in an additional request from the Default Fund in this segment.

In the case provided for in this subparagraph K.b), if pending losses would still remain following use of the additional Default Fund assessment, such pending losses will be offset with the contributions to the continuity of service and voluntary contributions provided for in the General Conditions of the Segment, under the heading "Special Rules on Recovery in BME CLEARING".

If losses continue to exist, they will be covered by BME CLEARING's own funds, excluding regulatory capital and other own resources required to be maintained at all times by the applicable regulations.

c) FAILURE TO AWARD AN AUCTION PORTFOLIO

In cases where several unsuccessful attempts have been made to auction an Auction Portfolio. BME CLEARING may apply the closing recovery measure due to early termination and cash settlement (*Tear up in recovery*) provided for in the General Conditions of the IRS Segment, under the heading "Special rules on Recovery in BME CLEARING".

L.   CLIENT DEFAULTS

If the Client of a CM defaults, the CM shall apply the corresponding default management measures provided for in the BME CLEARING Rule Book, including those provided for in Articles 41, 42 and 43.

In addition, the CM may also request BME CLEARING to close the Defaulting Client's Position by means of the transfer of such Position to the CM's Proprietary Account.

In the event that the volume of the Defaulting Client's Position is very large, the CM may request BME CLEARING to apply the auction mechanisms and tools provided by the CCP to facilitate the closing out of the Position and BME CLEARING's Specific Default and Recovery Rules shall also apply, in accordance with the provisions of the General Conditions of the Segment and the present Circular.