



---

## **Default Fund Policy**

---

---

**FMDQ CLEAR LIMITED**

**Version 1.0 - September 2022**

---

**Table of Contents**

1. Definition of Key Terms ..... 2

2. Introduction ..... 3

3. Purpose of the Default Fund ..... 3

4. Composition of the Default Fund ..... 3

5. Use and Replenishment of the Default Fund ..... 4

6. Size of the Default Fund ..... 4

7. Maintenance of the Default Fund ..... 4

8. Valuation of the Default Fund ..... 5

## 1. Definition of Key Terms

The following terms and expressions shall, unless the context otherwise requires, have the following meanings in this Default Fund Policy.

Term	Definition
“Business Day”	means a day (other than a Saturday, Sunday or Federal Government of Nigeria declared public holiday) on which banks are open for business in Nigeria;
“Central Counterparty” or “CCP”	means an entity that interposes itself between counterparties to contracts/transactions traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the performance of open contracts/transactions;
“Clearing Member”	means a Trading Member that is either a General Clearing Member or a Direct Clearing Member of FMDQ Clear authorised to clear and settle transactions under the conditions set forth in the FMDQ Clear Clearing Member Rules;
“Client”	means a Trading Member or Trading Member whose transactions are cleared and settled by a Clearing Member of FMDQ Clear;
“Collateral”	means the securities or cash pledged by Clearing Members to secure the performance of their obligations with FMDQ Clear;
“Default”	means a failure by a Clearing Member to meet its obligations (financial and non-financial) as contemplated in the Default Events of the Default Management Policy or as may be prescribed by FMDQ Clear from time to time;
“Default Fund”	means a fund, comprising pre-funded financial resources provided by FMDQ Clear and its Clearing Members, to allocate any losses arising in the event that one or more Clearing Member Defaults on their obligations to FMDQ Clear and resources provided by the Defaulting Clearing Member(s) are not sufficient to cover such losses;
“Defaulting Clearing Member”	means a Clearing Member who is considered to be in Default;
“FMDQ Clear”	means FMDQ Clear Limited or the Central Counterparty;
“Initial Margin”	means Collateral deposited by Clearing Members to ensure performance of potential obligations arising from future price movement on open Positions;
“Non-Defaulting Clearing Member”	means a Clearing Member who is not considered to be in Default;
“Position”	means the amount of a particular derivative contract, security, commodity or currency owned or held by a Clearing Member on behalf of its Clients;
“Skin-in-the-Game”	means the CCP’s contribution to the mutualised Default Fund;

## **2. Introduction**

FMDQ Clear Limited maintains a Default Fund (“the Fund”) that is used in the case that a Clearing Member defaults, and Initial Margin, which represents the first prefunded line of defense, proves insufficient to cover losses. The use of a Default Fund is to further strengthen financial resources available in the case of a Default and to align incentives within the CCP.

## **3. Purpose of the Default Fund**

The Default Fund shall be established to provide protection to Non-Defaulting Clearing Members in the case of a Clearing Member default only. The risks that the Default Fund covers are those associated with liquidating a Defaulting Clearing Member’s Position in extreme market conditions. These include the potential market moves, crossing bid-offer spreads, moving market prices due to concentrated Positions and the reduction in Collateral value due to rapid selling of assets.

Specifically, the Default Fund is established to fully cover the losses not covered by a Defaulting Clearing Member’s Initial Margin in a wide range of potential stress scenarios that include, the default of the Clearing Member that will cause the largest plausible risk exposure for FMDQ Clear in extreme but plausible market conditions.

The Default Fund assists to align Clearing Member and CCP incentives:

- I. The Defaulting Clearing Member’s Initial Margin and contribution to the Default Fund shall be the first financial resources to be at stake. This is a major incentive as each Clearing Member is responsible to ensure they remain in a sound financial position and perform on their obligations with FMDQ Clear.
- II. FMDQ Clear’s Skin-in-the-Game shall be the difference between the size of the Default Fund and the value of the Clearing Members’ contributions to the Fund.
- III. As FMDQ Clear implements the Risk Management Framework and is accountable for the day-to-day management of the risks in the CCP, it is appropriate that the CCP bears the risk next, up to a reasonable amount, i.e., CCP’s Skin-in-the-Game. Thus, FMDQ Clear’s contribution to the Default Fund shall be at two (2) levels—the first and second tiers—to be utilised before and after the Default Fund contributions of Non-Defaulting Clearing Members respectively.
- IV. Clearing Members contribute to the Default Fund and have their resources at risk should the resources of a Defaulting Clearing Member and the first-tier contribution of FMDQ Clear not be sufficient to cover losses. Therefore, Clearing Members collectively and individually have an interest in ensuring that risk management standards are robust and appropriate irrespective of whether they default.
- V. The sharing of losses by Non-Defaulting Clearing Members lowers the overall cost of protection.

## **4. Composition of the Default Fund**

The Default Fund shall be made up of a funded portion and an unfunded portion. The funded portion of the Default Fund will be sized according to the results of FMDQ Clear’s stress testing regime as described in FMDQ Clear’s Stress Testing Policy. Should the funded portion of the Default Fund be utilised in its entirety for resolution of default of other Clearing Members, the Non-Defaulting Clearing Members shall be called to contribute a further amount not exceeding 100% of their initial contribution to the Fund. This is the unfunded portion of the Default Fund, and it is not expected to be paid to FMDQ Clear until it is required.

## **5. Use and Replenishment of the Default Fund**

The resources in the Default Fund shall remain the property of the entities who contribute the assets, namely Clearing Members and FMDQ Clear. The custody of the Default Fund shall however remain with FMDQ Clear to ensure the use of same to satisfy losses when and if required. When applying the Default Fund, the losses shall be allocated in proportion to each Non-Defaulting Clearing Member's contribution at the time of the default. After the Non-Defaulting Clearing Members' contribution is utilised, FMDQ Clear shall re-calculate the size of the Default Fund and inform Clearing Members of their new Default Fund contribution amount. Unused portions of Clearing Members' contributions shall be netted from the newly determined Default Fund amount for the respective Clearing Members. The new contribution will be required to be paid within three (3) business days of notification.

Where Clearing Members' pre-funded Default Fund contributions (including the prior layers of the default waterfall) are insufficient to cover all losses resulting from a member's default, Clearing Members will be required to provide the CCP with additional financial resources where applicable.

For a mutualised Default Fund, the maximum additional financial resources to be provided is two times each Clearing Member's Default Fund contribution at the time the default was declared. As a result, a Clearing Member's liability in case of another Clearing Member's default is limited to a total of three (3) times its currently applicable Default Fund contribution.

However, this is applicable within a capped period of three (3) months starting from the date a Default was declared by FMDQ Clear. Consequently, Non-Defaulting Clearing Members' contribution to the Default Fund beyond the stipulated liability within the capped period, will no longer be at risk to the Default of another Clearing Member and will only be used to fund their own Default.

Similarly, FMDQ Clear will contribute an amount equal to the part of its first contribution utilised and limited to one additional contribution within the capped period.

## **6. Size of the Default Fund**

The size of the Default Fund shall be computed to ensure sufficiency to cover the risks and losses described in Section 4 of this document. To determine the size, FMDQ Clear shall perform daily stress testing on the open Positions which it clears. The stress testing will be in line with the documented Stress Test Policy of FMDQ Clear.

The minimum coverage of the Default Fund—otherwise known as the minimum Default Fund contribution shall be set per Clearing Member—after considerations of the risks the Default Fund covers, the results of the stress testing regime, and the requirement for a level of stability in the size of the Default Fund.

## **7. Maintenance of the Default Fund**

In every given quarter, where the results of the stress test are greater than the size of the minimum Default Fund, the variance shall be requested from Clearing Members as additional contribution to the Default Fund in proportion to the risk they clear and manage as measured by the quarterly average aggregate amount of Initial Margin cleared by each Clearing Member, that is the quarterly average sum of the Initial Margin requirement for their house Positions and the accounts of all their Clients.

The amount of each Clearing Member's contribution will be recalculated quarterly. Where applicable, each Clearing Member will be notified of their new contribution within five (5) Business Days following

the end of each quarter and any deficits will be paid by each Clearing Member within the next three (3) Business Days from the day of notice. Any surpluses will be paid back to Clearing Members by the 2<sup>nd</sup> Business Day once all deficits have been received and upon receipt of a request for such surpluses by FMDQ Clear. The Default Fund will also be rebalanced following any utilisation or re-sizing of the Fund.

**8. Valuation of the Default Fund**

The CCP shall conduct daily valuation of Default Fund contribution to ascertain the market value of the contributions from Clearing Members in line with FMDQ Clear Collateral Policy.