# Default Fund & Credit Insurance

Risk Management Committee
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Mike Wynder
Sr. Manager, Trade Surveillance
Kathy McElwaine
Corporate Insurance Manager

# FTR Market Residual Risk

**PJM has implemented several enhanced risk management tools to address counterparty risk such as:**

| “Know your customer” reforms | Tightened timelines for collateral call payments | Financial risk models | June 2022 FERC filing – HSIM |
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In order to even further manage the residual risk to protect the integrity of the FTR market, **additional changes and/or mitigations are necessary.**

- **One way is** to transfer the risk through a credit insurance policy that would mitigate a catastrophic loss and minimize the member socialization.
- **One underwriting requirement would be** for *a First Loss Layer (self-insured retention)* or *a Default Fund* that would sit below the insurance.

**We will discuss an illustrative “future state” default waterfall**
to include a member default fund and a credit insurance policy.

# Default Fund

# Clearing House Guaranty Fund

**Clearing houses are required to have an extensive trade guarantee structure** to protect the integrity of the clearing house in the event of default by a clearing member, which is not able to be satisfied by the collateral on hand.

**These protections, sometimes referred to as a "guarantee pyramid" or "default waterfall," often include:**

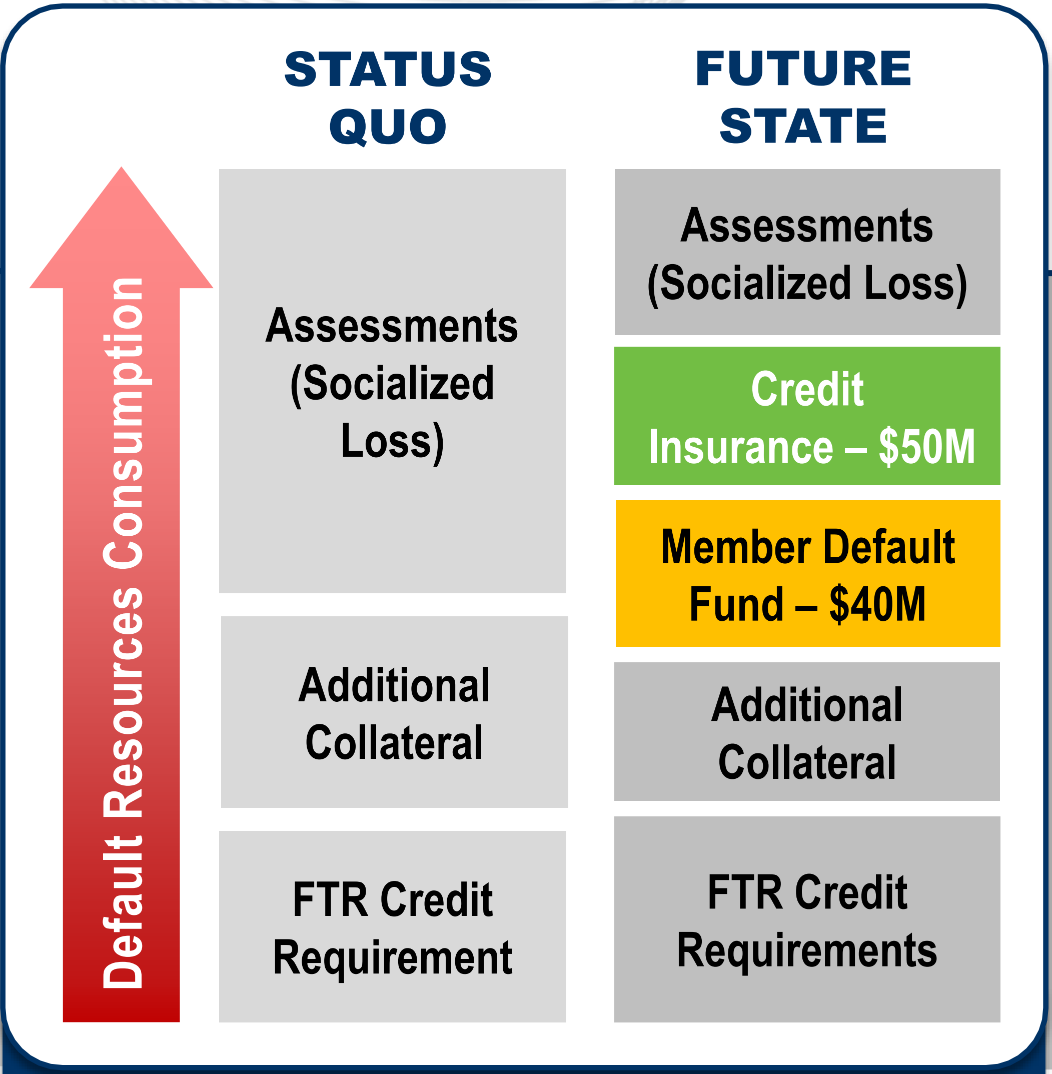
- A guarantee fund (also known as "default fund" or "reserve fund") contributed to by all FCMs. The defaulting FCM's contribution is consumed first, followed by those of the other FCMs on a pro-rata basis.
- Default insurance, as an intermediate layer of protection, not primary defense.
- Clearing house profits and/or capital, in instances where the clearing house is a for-profit entity with profits/capital to put at risk.
- Socialization of the default to the FCMs, generally through an assessment capped on a "per FCM, per default" basis. This is typically the last line of defense.

*Excerpt: External Clearing Overview for PJM FTR Market Sept. 2019*

# How Could This Work at PJM?

**The left-hand side of the box** represents coverage of a default today:

- FTR Credit requirement as calculated on a path basis
- Additional Collateral represents restricted collateral or excess collateral held
- Assessment refers to socialization under the OA for any remaining financial loss




For Illustrative Purposes Only

**The right hand side of the box** could be a future state:

- No change to FTR Credit Requirements or additional collateral where applicable
- Addition of a member funded Default Fund
- Addition of credit insurance
- No change in assessment as defined in the OA for any remaining financial loss

# Credit Insurance

# 2020–2021 Underwriting Efforts

**Marsh approached the credit insurance market in November 2020** seeking an insurance solution that would indemnify PJM in the event of a loss caused by the failure of one or more PJM members/participants to fulfill financial obligations associated with FTR Agreements.

Insurance market interest was tepid, given complex structure, lack of familiarity with risk, and inability to properly categorize risk being covered.

Extensive education on PJM, FTR Market, Credit Policy Amendments, Initial Margin, etc.

Exploratory conversations with two carriers (AXA XL & Tokio Marine) and, in conclusion, expressed an underwriting requirement for a first loss layer:

Attachment point such as a Default Fund as a first loss layer before triggering an insurance policy (catastrophic cover).

# Underwriting Requirements

Ultimate credit insurance (catastrophic) would be a bespoke solution tailored to PJM risk.

| | |
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| **Resolution of Initial Margin – FERC approved HSIM** | Insurers expressed a need for PJM to have a first loss layer to keep insurer/insured interests aligned.<br>*A self-insured retention (Default Fund) layer between initial margin and insurance* |

**Policy Limit would have to be in the area of $50M at a minimum** to provide a meaningful amount of risk transfer. It is estimated there is between $50M and $150M in total capacity if generated interest in the marketplace.

**Best estimate is that the insurance market would be looking for premiums to be in the range of 2% of limit**, for example, roughly $1M in premium for a $50M limit.

**Consider credit insurance across all of PJM's markets that would increase the spread of risk and possibly help attract potential insurers.**

As discussed in the beginning of the presentation and during last month's RMC meeting, PJM needs to determine if there are other measures that can mitigate tail and residual FTR risk.

Two measures talked about today are the creation of a default fund supplemented by FTR credit default insurance.

**PJM would like to receive your feedback today to determine our path forward to explore these options in more detail.**

# Contact

Facilitator:
Jim Gluck, Jim.Gluck@pjm.com

Secretary:
Emmy Messina,
Emmy.Messina@pjm.com

SME/Presenter:
Mike Wynder, Michael.Wynder@pjm.com,
Kathy McElwaine,
Kathleen.McElwaine@pjm.com

**Default Fund & Credit Insurance**

Member Hotline

(610) 666 – 8980

(866) 400 – 8980

custsvc@pjm.com


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