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Risky Business - Opportunities and Challenges for Growth in the Crypto Insurance Market

March 19, 2019

On March 14, 2019, the Canadian Securities Administrators (CSA) and Investment Industry Regulatory Organization of Canada (IIROC) jointly published a consultation paper (the Consultation Paper) regarding the development of a regulatory framework for crypto-asset trading platforms (Platforms) in Canada.

Background

There is presently no overarching regulatory framework for Platforms operating in Canada. The CSA and IIROC are seeking input from stakeholders to craft a suitable regulatory framework for crypto-currency exchanges operating in Canada. On August 24, 2017, the CSA published Staff Notice 46-307 - *Cryptocurrency Offerings* (the CSA Notice) in response to an increase in crypto-currency offerings which clarified that exchanges permitting the trading of any crypto-currencies that qualify as “securities” (e.g., coins, tokens) under applicable securities legislation will be subject to Canadian securities law requirements much like any other securities exchange. The CSA Notice noted that new fintech business may not fit “neatly into the existing securities law framework.”

Reports on crypto-currency hacking are ever more common. Numerous sources reported nearly $1 billion in losses arising from hackers of crypto-currency exchanges in 2018. In October, Reuters reported that crypto-related theft increased approximately 250% from 2017 to 2018. In addition to the increase in exchanges and investors, cyber-security concerns have prompted regulators to consider new requirements.

Issues for Insurers

The Consultation Paper notes that many Platforms operate without insurance coverage for investor assets. Platforms that maintain custody of investor assets tend to have high exposure to liabilities. In recognizing the importance of insurance coverage for investor protection, the Consultation Paper requests feedback from stakeholders on the nature of insurance coverage that should be required.

There are several challenges to obtaining sufficient coverage for the above-noted risks, many of which are similar to obtaining cyber-security insurance coverage. Historically, insurance premiums have been determined based on actuarial data. Actuarial data for crypto-currency attacks is relatively scarce compared to other types of insurable losses. As a result, we expect some volatility in pricing for the time being. Policy applications tend to be lengthy, involve a high level of diligence, and require policyholders to provide comprehensive representations and warranties. Policies may also require a significant deductible. Similar to cyber insurance, insurers may partially control risk by offering lower policy limits. As a result, the market may be under-served in the short-term.

There is presently insufficient supply in the Canadian market to meet the demand for insurance coverage. Insurers in Canada have an opportunity to reduce the supply-demand gap, but must do so with caution and ensuring potential risks are appropriately managed. The primary challenge will be to manage adverse selection. Insurers must develop an underwriting process that ensures proper disclosure is provided for the underlying risk, which is inherently higher than many other business lines. Although most insurers have robust regimes to detect and prevent money laundering, anti-money laundering systems and policies should be tailored to address the unique challenges of the crypto-currency market.

Lloyd’s of London began offering insurance coverage for crypto-currency storage in 2018. Lloyd’s Market Bulletin (Ref: Y5196) published on July 6, 2018 (the Bulletin) provides useful guidance for writing insurance coverage for crypto-currencies and decentralized digital assets. The Bulletin sets out the expectations for underwriting, managing AML and fraud, and additional compliance risks associated with this class of business. Notably, managing agents are expected to be satisfied that the insured has proportionate anti-financial crime systems and controls in place. In our view, the requirements set out in the Bulletin are relevant considerations for the Canadian insurance market.

Key Takeaways

The crypto insurance market is a relatively new area with issues that are analogous to the D&O and cyber-security market. This business line represents a growth opportunity for insurers that are prepared to invest time and resources to understand the risks involved.

Policyholder demand will likely continue to increase, particularly in response to insurance coverage concerns in the Consultation Paper. In addition to coverage for the exchanges and investor assets, we anticipate that D&O coverage will represent an area for market growth. Insurers, brokerages and agencies should be mindful of any implications of changes in the underlying crypto-technologies. We would caution insurers to maintain high levels of scrutiny during the underwriting process to minimize exposure to financial crime risk, in particular.

As a point of interest, a unique use of crypto-currency in conventional insurance is the payment of claims. We are aware of cyber claims in Canada that have been settled using Bitcoin, for example.

Comments on the Consultation Paper should be submitted by May 15, 2019.

For more information, please contact any member of our Insurance & Reinsurance Group.

For further information regarding the Consultation Paper and the proposed regulatory framework for

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Platforms, please see The Spectre of Regulation Looms for Crypto Asset Trading Platforms by Brigeeta Richdale and David Kelman.
