

The cryptocurrency *capacity challenge*



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Digital currencies are unsettling the global financial system as more investors and established financial institutions bolster their understanding and portfolios. Blockchain-based technology's net worth is expected to grow to over USD 2 billion by the end of this year, and more than 40 million people worldwide now use some type of cryptocurrencyⁱ. Yet, it is notoriously volatile, evidenced most recently by the market crash in May, which some analysts see as just a 'price correction' on the way to all-time highs in Q3/4 2021ⁱⁱ.

Insurance and risk management are becoming top priorities for this emerging industry as it seeks to instil investor confidence and ease regulator concern over its ability to meet financial standardsⁱⁱⁱ. Unfortunately, the insurance market is playing catch up, and demand for capacity far outstrips supply.

Challenges around market capacity

Most crypto players typically want all their assets under management fully insured; at present, the traditional specie insurance market cannot cater for this need. In addition, investors want the comfort of an insurance policy when they leave cryptocurrency with a custodian. Most custodians store tens of billions of dollars worth of digital assets, and the market isn't in a position to provide that kind of level of coverage. Currently, there is approximately USD 700 million in available capacity, and firms could potentially secure a full value policy up to that amount, but these are by no means guaranteed.

Cold storage coverage for cryptocurrency didn't really exist until 2014. At the time, a small exchange, now one of the largest, most well-established players, was the first in the market to challenge insurers to provide coverage for this risk. Back then, it requested cover in the region of USD 100 million, with options up to USD 200 million, but the market was immature and had limited appetite for this perceived new type of technology.

Yet, compare 2014 to now, and they are opposite ends of the rainbow. Initially, firms wanted dollar for dollar insurance, which was not a problem because the crypto-universe was quite small. But the market boomed as financial institutions came onboard using insurance solutions for risk transfer, while at the same time, trading became more accessible and app-based. Consequently, demand for insurance completely surpassed what the London market could provide.

Crypto-cover explained

Specie insurers cover physical loss or physical damage caused by natural named perils, deliberate and dishonest acts, and third-party physical theft. Insurers focus on custodians who have care, custody and control of the digital assets (as they hold the private keys). While insurers take into account the assets or the actual coins themselves, these never leave the blockchain. It's like cash in a vault; the risk is being unable to retrieve its contents. Insurers cover the keys to the vault – in other words, theft or destruction of assets while stored in secured locations, covering theft internally or externally.

The difference between hot and cold storage in terms of risk is marked. The insurance industry deems 'hot' to be online assets and can be traded and moved around. Hot storage is far more exposed to third party cyber-hacks and wider employee collusion. Therefore, hot wallet coverage is more costly. Clients tend to start with a crime policy, given its broader application. Then, invariably, once the capacity limitations within the crime market kick in, clients typically look to the specie market for cold storage to cover their offline/cold storage assets, allowing them to obtain larger limits at a much more competitive rate.

Nevertheless, cold storage insurance is not without its challenges. It is written on an aggregated basis – meaning that any one insured is capped at the market capacity, and once the limit is eroded for one client, it is gone. Aggregation is a genuine hurdle for firms hungry for growth in an intensively competitive market.

Risky business

Collusion is the most pressing exposure for cold storage within the specie market. Clients, prospects and insurers are most concerned about internal employee dishonesty; the greatest potential for loss is a group of bad apples within an organisation taking off with the keys.

It's not difficult to see why. In a physical bank vault, a criminal is restricted not only by the amount they can physically carry but also by the imminent arrival of the police. On the other hand, because of the digital nature of cryptocurrency, it may be possible to take off with a firm's assets in one go. This 'all or nothing' scenario is one of the reasons why a number of markets find it challenging to write this business. However, it is also why building critical mass and educating (re)insurers are key.

Educate to accommodate

Aon has utilised our wordings expertise, adapting and softening this coverage, with the benefit of being less onerous for our clients. Building a programme of up to USD 700 million and above is only available to those considered by all to be best in class.

We have spent time educating insurers on how these particular policies work and respond, increasing market capacity. A major element of the contract is a detailed roadmap of the client's operational procedures. It focuses on the custodian's security which helps identify such risks of collusion and what mitigation steps the insured has taken. As the broker, we concentrate on describing those facts to the market to increase its confidence in cold storage placements.

The education piece also applies to the clients themselves. They can be very focused on promoting themselves as best in class, with the top-rated cutting-edge technology, in a bid to secure the most capacity possible. We walk them through what is expected of them in terms of risk management protocol - can they explain the minimum number of individuals required to generate a fraudulent transaction? How could this happen, and what systems are in place to prevent this? Clients need to understand exactly what is covered and how this operates within the policy. There's no subtlety in premium; the bar is set high, and firms that fail to meet the criteria risk not obtaining coverage and requested limits.

Canopius is one of the market leaders in Lloyd's that has developed wordings and is prepared to lead cold storage risks. In response to capacity issues, Aon has developed an exclusive cold storage facility, led by Canopius which can offer limits of up to USD 625 million. We have created this bespoke facility to provide speed of service to our clients, generating tailored capacity for any one client. If you would like to find out more about this service, do not hesitate to contact us.

- i. <https://saasscout.com/statistics/cryptocurrency-statistics/>
- ii. <https://www.independent.co.uk/life-style/gadgets-and-tech/bitcoin-price-crash-crypto-prediction-b1852916.html>
- iii. <https://www.reuters.com/world/uk/uk-regulator-says-cryptoasset-firms-not-meeting-anti-money-laundering-rules-2021-06-03/>

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About Aon

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