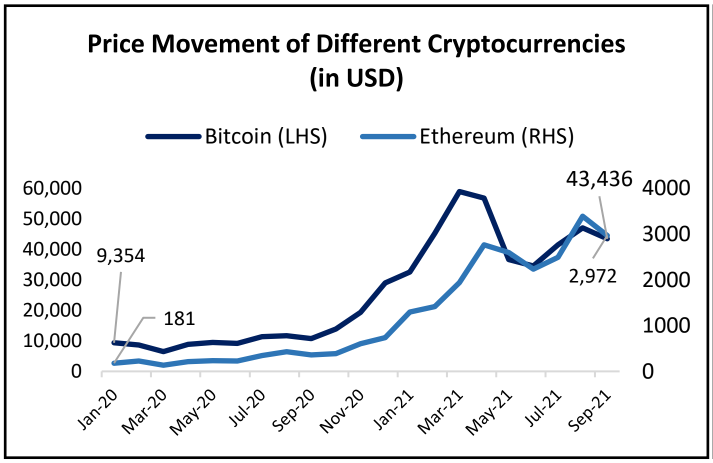
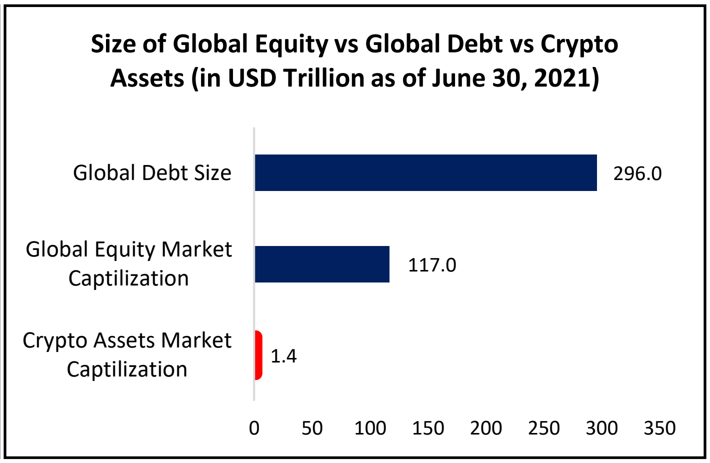
October 12, 2021

HDFC Mutual Fund's Tuesday's Talking Point: Crypto Assets – Are You Aware of the Risks?

As per a recent report by International Monetary Fund (IMF) highlighting the crypto ecosystem and its key risks, crypto assets have surpassed US $2 trillion in market capitalization as of September 2021. The growth of crypto assets has taken place on the back of "Blockchain Technology" - the brains behind the crypto ecosystem.

Blockchain technology has been developed around the thought that there would be a world, where every contract, agreement, process, or task would have a digital record, stored with an identifiable signature in transparent, shared databases. By virtue of this, the records would be protected from deletion, tampering and revision.





Source: Bloomberg, Statista, Institute of International Finance, CoinMarketCap

Built on this technology, it is envisioned that crypto assets will make payments and other financial services cheaper, faster, more accessible, and allow them to flow across borders swiftly. As the crypto ecosystem continues to expand, there has been the entry of Indian retail investors who might be oblivious to the risks involved. Some of these risks include:

- Regulatory Risks:
  - Data gaps for regulators due to the anonymity of crypto assets, creating an open unwanted door for unscrupulous activities like money laundering
  - Possibilities of illicit transactions due to difficulty in tracing the parties to such transactions
  - Different regulatory frameworks for crypto ecosystem in various countries
- Operational Risks:
  - Significant increase in downtime when failures and disruptions prevent the use of services and even result in large losses of customer funds
  - Coinciding with periods of high transaction activity resulting from poorly designed systems and controls
- Cyber Risks:
  - Rise in high-profile cases of hacking / theft of customer funds

- Attacks on not only the centralized elements of the ecosystem (for example, wallets and exchanges), but also on the processes that underpin the operation of blockchains

Many other challenges are being highlighted by the Financial Stability Board (FSB) – an international body for monitoring and making recommendations about the global financial system. Some of them are:

- Small market capitalisation relative to the size of the Government bond and stock markets in major advanced economies (see the chart above), making it difficult to consider crypto assets as core holding in asset allocation
- Higher fluctuations in valuations of crypto assets – For some perspective, standard deviation for NIFTY 50 TRI stood at 8% as against Bitcoin's 23% between January 2020 and September 2021
- Advent of other crypto assets posing a threat to traditional monetary system and policy making

In India, for aiding a better regulated digital currency environment, the Reserve Bank of India (RBI) is working on a phased launch of its digital currency called Central Bank Digital Currency (CBDC). CBDC is a legal tender issued by a central bank in a digital form. With some semblance with fiat currency, RBI believes that payments using CBDCs would be final, reducing settlement risk in the financial system. Moreover, it could potentially enable a more real-time and cost-effective globalization of payment systems.

Hence, investors need to understand the potential risks in crypto assets before taking a plunge.

Sources: International Monetary Fund, Bloomberg, Statista, Institute of International Finance, CoinMarketCap, MFI Explorer, Reserve Bank of India, and other publicly available information.