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What are the risks of investing in cryptocurrencies?

An explainer on the do’s and don'ts you may not have focused on for the volatile asset class

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Cryptocurrencies have taken the world of investing by storm.

People from all walks of life — from college students to superannuated people — are dabbling in crypto trading.

Interestingly, some people, who have never invested in stocks, have taken the high-risk plunge.

Any guesses on how much the price of bitcoin went up?

Data shows that the price of a single bitcoin has gone up from around $300 (Dh1,1019) in 2014 to over $60,000 (Dh220,36) plus lately.

Of course, the ride has been anything but smooth with several plunges, including up to a whopping 85 per cent.

Crypto has been a very volatile asset class, and I have extensively written about it in the recent past as well.

The price volatility is likely something the investors trading in cryptocurrencies know about but that is not the only risk of dabbling in this space.

Here are some of the other risks of the crypto space that you may not have focused on:

Exchange Risk, or where are you transacting?

Have you come across names such as Koinex or CoinDelta in recent times? Probably not, because these crypto exchanges, which were once highly active, have been shut down due to payment denials, crypto bans, blocking transactions, etc.

Also, it is seen that there have been many instances where the crypto exchanges faced tech outage issues following which investors and traders lost billions of dirham worth of assets in the bargain,

What are the regulatory risks?

No Central Bank likes an unregulated currency.

Currency notes or other forms of currency (example debit or credit cards transacting in the currency of the country) are used as a medium of exchange.

For example, one can use Dh10 to buy vegetables or similar goods.

These currencies are regulated by the government/Central Bank of the country where the currency is being used as legal tender.

On the other hand, cryptocurrencies are decentralised, not issued by any central authority and are unregulated, meaning that they are not controlled by anybody.

Hence, this is not something that central banks like or want to allow to flourish as it takes away their regulatory role.

In September, China's Central Bank announced that all transactions of crypto currencies are illegal, effectively banning digital tokens.

From Algeria to Egypt and Russia to Vietnam, there are over a dozen countries — literally from A to V — that have clamped down on cryptocurrencies over the last few years.

Hacking and forever lost currency

A key concern is that of security. There has been a long history of crypto hacks. Poly Network Exchange breach led to loss of $600 (approx Dh2200) million. Similarly, Tether and Japanese crypto wallets fell victim to $31 (Dh114) million and $97 (Dh356.28) million due to hacking.

There are two types of wallets to store crypto assets — hot and cold wallets.

For the uninitiated, hot wallets are like any online account. The nomenclature ‘hot’ traces its origin to incessant involvement in trading activities.

While cold wallets are usually maintained as separate offline hardware devices like paper/pen drives. Cold wallets possess a private key akin to a password.

You need to safeguard the password because once lost, it would be impossible to access your crypto assets again. There have been cases where people have died or have forgotten their passwords, resulting in losses running into millions of dirhams.

Key person price volatility

In February, serial entrepreneur Elon Musk shared in one of Tesla’s legal filings that it had bought $1.5 (Dh5.51) billion worth of crypto currencies and that the company would start accepting payments in bitcoin.

Initially, this sparked a rally in most cryptocurrencies.

But later in mid-May, Musk swayed away and re-tweeted that Tesla decided to halt bitcoin payments due to its “insane” energy usage.

The move led to the dip in the price of bitcoin by about five per cent in minutes after Musk’s announcement.

Cryptos remain highly exposed to the risk of volatility, if not deliberate manipulation, from key personalities, which can significantly impact market movements.

The environmental cost of crypto

Just as Central Banks print currency notes to keep the currency circulating in an economy, a crypto fanatic can do crypto mining in a bid to generate new crypto coins that circulate in the crypto economy. Crypto mining consumes massive electricity while mining operations produce significant carbon di-oxide emissions.

Bitcoin’s annual electronic waste generation, which is estimated at 30.7 metric kilotonnes, is comparable to information technology equipment waste produced by a country such as the Netherlands. As per a Digiconomist report on the Bitcoin Energy Consumption Index, a single bitcoin transaction consumes power equivalent to that of an average US household over 63.53 days. Annualised Total Bitcoin Carbon Footprints are found equivalent to that of the carbon footprints of Chile — the South American nation — or the power consumption of Thailand — the southeast Asian country.

No wonder, such high consumption of power poses a significant threat to the environment and consequently a further heightened risk of a crackdown.

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