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MARKET INSIGHT

February 2018

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THE FLIPSIDE OF THE (CRYPTO) COIN

At the end of 2017, crypto currencies were on everyone lips and screens, with Bitcoin, Ripple and Ethereum boasting incredible performances of 1,400%, 36,000% and 9,100% respectively for the year. Those numbers were difficult to ignore, and the fear of missing out drove demand, account opening and trading volume. Cryptocurrencies featured heavily in the media and everyone, from professional investors to students, wanted to a piece of the action. Even CNBC launched a show dedicated to cryptocurrency providing its viewers with a step-by-step guide on how to buy Ripple, and updates on the hottest cryptocurrency. Exchanges were flooded with opening requests, and investors experienced extended delays. However, the cryptocurrency space is paved with hidden landmines that investors should consider carefully, so what type of drawbacks and issues should investors be considering?

The first hurdle for anyone who decides to gain exposure to cryptocurrency comes with the choice of instrument. Similar to gold, investors can access synthetic or physical exposure. Synthetic exposure is achieved by buying an ETF or a fund that gives exposure to cryptocurrency prices. Given that some of the key underlying principles of cryptocurrencies are privacy, protection and decentralisation, there is something contradictory in buying an ETF and leave it in the hands of a custodian. It is the same reasoning that has always pushed perma-bears into buying gold bullions and storing it in specific facilities rather than buying into the XAU. However, in early 2018, finding the right financial instrument to gain exposure to the space is not as straightforward as with other more mainstream asset classes, as only a handful of products are available. Most funds are managed by first time teams with little experience in money management, while being registered in offshore places such as the BVI or Cayman Islands. In the era of UCITS and AIF, investing in a BVI to gain exposure to crytpocurrency seems like a serious U-turn on risk and good governance principles!

The alternative to an ETF is to open an account with a platform that offers cryptocurrency trading. Platforms and exchanges haven't had the best press of late and are developing a reputation of being vulnerable to hacking and heists. Most recently, Japanese platform Coincheck had a hefty $400 million in bitcoin and other cryptocurrencies stolen. However, for most cryptocurrency investors, the fear of missing out outweighs the risk of losing it all, and this has pushed many market participants to open accounts on platforms without fully vetting their security. Nevertheless, platforms offer easy money transfers from a credit card or a bank account to an exchange account to buy a choice of the top four cryptocurrencies: Bitcoin, Ethereum, Litecoin, Bitcoin cash. Anyone looking to trade in alternative coins such as Iota, Ripple, Augur or Factom must first open an account on platforms that can only be funded in cryptocurrencies, adding some complexity in the process. Some exchanges of alternative coins are often questionable, and account opening can be a tedious process.

Another real-life problem that large investors face is in storing cryptocurrency. Because exchanges are notorious for being not very reliable, anyone who has accumulated a large amount of coins must consider a safer solution, similar to a vault in a bank. Storage can be roughly classified by three levels of risk, the riskiest of which consists of leaving coins on the exchange. In this scenario, the coins are technically the property of the exchange and access can only be done through the exchange; this becomes impossible when a platform is down. The second storage system is in a wallet - an application designed to store private keys. Through this, the coins are held outside of the exchange, but remain on the network and can still be at risk of an attack. The third and most secure storage system involves taking the coins off the network and putting them in 'cold storage'. The simplest form of this is in the form of a piece of paper with the private key, while more complex systems might include hard drives disconnected from the internet held in physical vaults. Although cold storage ranks as the most secure storage protocol, it removes most of the liquidity for the investor because the private key to the coins is off the network. Cold storage would therefore be poorly suited to investors who require swift access to their cryptocurrency.

The fiscal treatment of cryptocurrencies is also a point of contention. Consider a scenario in which a miner has mined a large amount of coins. In order to be monetized, the cryptos must be exchanged against fiat such as EUR or USD and subsequently deposited into a bank account. The fiscal problem comes to declaring this bank account's existence. Is the amount in the account the result of work, in which case it should be treated as income and taxed as such? Or should it be considered existing wealth and taxed at the appropriate rate? This remains an open question, but it's likely that fiscal authorities will tackle this issue any time soon.

This list of potential potholes for investing in cryptocurrencies is non-exhaustive, and one can add the low-quality of execution on some exchanges, potential delays in transactions being confirmed on the blockchain during congestion, as well as high transaction fees on the bitcoin blockchain. However, cryptocurrencies are the most visible part of a technological innovation that is likely to radically change the way business is conducted. Take, for example, the ability that initial coin offerings and tokenisation have to disrupt the access to venture capital for new companies in need of financing.

There is much around cryptocurrencies that is not yet clear, but what's certain is that blockchain will shake up many industries, including financial services. Despite the risks and volatility, cryptocurrencies are a reflection of the tectonic shift in how business is conducted, and so a few little earthquakes are to be expected...

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