

Decentralized Finance

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Decentralized finance (DeFi) is the collective term for applications that theoretically provide financial services without centralized intermediaries by leveraging automated protocols and blockchain technology such as smart contracts. The landscape is quite complex, featuring nascent and fast-evolving technologies, abstract and novel concepts and paradigms, and limited regulation. While the space is developing rapidly, and has enormous potential, myriad risks and considerations must be addressed for the market to scale. This note provides a summary of the key themes from the discussion, respecting that the conversation was conducted under the Chatham House Rule and comments are unattributed.

The reasons for DeFi's recent surge are multifaceted. The DeFi market is still small—currently hovering between 1 to 2% of the total crypto market capitalization of nearly \$2 trillion—but it has more than quadrupled over the past 18 months. There are numerous reasons for the surge, including the venture-type returns for investors, the desire for market participants to diversify their activities, and efforts by blockchain communities to promote a proliferation of DeFi projects on their platforms. Whether those blockchains can scale fast enough to enable those projects to succeed is yet to be seen and may be challenging.

DeFi's potential is substantial, though the space has a long way to go. DeFi proponents argue that the space will revolutionize financial services thanks to quick and automated clearing and settlement, around-the-clock capabilities, and improved auditability. Smart contracts, which are automated contracts captured in code that run on blockchain technology, can be used for anything from borrowing and lending to escrow, gaming, payments, and other emerging uses. That said, upon close examination, there are limited differences today between DeFi and traditional financial services. Many of these new emerging services appear to be replicating more traditional financial services and activities and retain some degree of centralization, but with weaker regulation and increased risks for investors. Without demonstrating greater value and differentiation, DeFi will struggle to scale. Some observers claim that DeFi's main advantage is actually anonymity, which would conflict with regulators' goals around KYC/AML.

DeFi presents unique risks and considerations for regulators. After being caught by surprise a few years ago by a wave of initial coin offerings, regulators worldwide are keen to get ahead of the curve regarding DeFi. Authorities see significant vulnerabilities in the industry, including liquidity, disclosure, and KYC issues, highly leveraged trades, and a lack of institutions that are indeed prepared to absorb shocks when necessary, should the industry require. To the contrary, this is a function that banks have prepared themselves to undertake in many instances. Regulators are calling for proper frameworks to safeguard investors and consumers. Many regulators around the world are also racing to set clear “rules of the road” to attract innovators and entrepreneurs to their jurisdictions. Whether financial governance mechanisms should be decentralized, driven by the wishes of comparatively uninformed participants, remains to be seen.

The interconnectedness between DeFi and traditional finance is limited but growing. Financial institutions have begun to make loans to and investments in DeFi ventures. In some cases, traditional financial institutions hold assets of a stablecoin's reserve and may have relationships with centralized crypto exchanges through which investors on-ramp into the DeFi world. While recognizing the complications of integrating a DeFi system into the traditional architecture, ensuring proper interoperability between the two systems will be essential to avoiding a fragmented financial landscape and inefficiencies in the market.

Education and promoting a greater understanding of the space is needed. For the market to scale beyond sophisticated and technical investors, industry stakeholders will need to make a concerted effort to properly inform and educate a broader set of potential investors and consumers on what is an incredibly complex landscape featuring nascent technologies, abstract and novel concepts and paradigms, and limited/unclear regulation. The industry will also need to do a better job of sharing knowledge and educating regulators about the evolving landscape so that they can establish appropriate rules that do not stifle innovation while also ensuring investors and consumers are protected.