Are You An Informed Investor?

Bank to the Future: Decentralized Finance (DeFi) Defined

Decentralized finance, or DeFi, is a relatively new blockchain-based set of financial services gaining popularity and acceptance. This alert discusses DeFi, the technology behind it, and how you can protect yourself from falling victim to a scam.

How might DeFi impact the financial services market?

The growing popularity of cryptocurrencies is one of the main drivers behind the development of alternative banking and business opportunities that may rely on DeFi models.

Companies entering this space are now offering banking and investing services that rely on cryptocurrencies instead of conventional fiat currencies, such as the U.S. or Canadian dollar or Mexican peso.

These alternative financial services providers distinguish themselves from mainstream companies by offering lending, banking and investing options that are decentralized or not dependent on traditional financial markets.

These alternatives tend to be unregulated or operate illegally in a regulated space. As a result, DeFi markets lack many of the protections offered by regulated service providers. Investors should use caution any time they consider investing in unregulated investment products on unregulated platforms. Even billionaires can lose out in the wild west that is the DeFi marketplace.

What is DeFi?

First, it is important to understand our current centralized financial infrastructure.

Financial services markets are traditionally overseen by different regulators. To gain access to money, one must work with financial intermediaries for auto loans, mortgages, brokerage accounts, investment accounts, stocks and bonds. Regulators set the guidelines and rules that consumers must meet to get a bank account, access loans and invest.

As users of these services, we must comply with these laws and rules to access money.

DeFi refers to financial services provided by an algorithm on a blockchain, without a financial services company. It is an alternative approach, based on the belief that the centralized approach is inefficient and that current banking systems are especially vulnerable to cyber-attack because of the centralized nature of the system and the use of outdated technology.

Unlike traditional banks and investment firms, DeFi financial services firms use digital assets, instead of fiat currency, to provide banking and financial services such as depository services, lending, investing and management services. Some of these services may be operated outside current regulatory frameworks.

How does DeFi lending work?

In the current centralized system, a customer opens a savings account and earns interest on the deposit. The bank lends the money you and other customers have deposited to another customer or business at a higher interest rate and takes a profit on the difference.

Using DeFi, a borrower can get a loan based entirely on an algorithm that matches peer-to-peer borrowers and lenders. Lenders may find this appealing because they expect to earn the full amount of interest paid by the borrower instead of some lesser amount set by the bank. Currently, this credit risk is managed by overcollateralizing loans.

What is the technology behind DeFi?

If you're familiar with cryptocurrencies, you've probably heard of Bitcoin, Ethereum, and blockchain. Bitcoin and Ethereum are

More

Issued: December 2021

To learn more, contact the ARKANSAS SECURITIES DEPARTMENT

1 Commerce Way, Suite 402, Little Rock, AR 72202

http://www.securities.arkansas.gov/

Phone - (501) 324-9260 | Fax - (501) 324-9268 | E-mail - ASDInfo@arkansas.gov

two of the most popular cryptocurrencies in an ever-growing and vast marketplace.

Bitcoin and Ether are cryptocurrencies built on blockchain technology, a decentralized digital ledger that reflects all transactions made on that blockchain. Blockchain technology allows users to — among other things — obtain, sell and invest in digital assets, like cryptocurrencies.

DeFi uses the blockchain to allow users to engage in financial activities to handle finances on a peer-to-peer level.

The DeFi blockchain technology is run using apps called dApps and "protocols", which are programs used to handle financial transactions using Bitcoin and Ethereum, and that allow users to access the applications from anywhere in the world.

Who sets the rules and governs how DeFi works?

A decentralized autonomous organization (DAO), sometimes called a decentralized autonomous corporation (DAC), is an organization represented by rules encoded as a computer program that is controlled by the organization's members.

A DAO's financial transaction record and program rules are maintained on a blockchain and it uses blockchain technology to provide a digital ledger. A blockchain digital ledger is a computer file where monetary and financial transactions are recorded — typically, digital ledgers are used to track all transactions that take place between cryptocurrency users to track financial interactions across the internet.

Smart contracts, a self-executing contract with the terms of the agreement between buyer and seller being directly written into lines of code, are used to handle DeFi transactions. The code and the agreements contained therein exist across a distributed, decentralized blockchain network. The code controls the execution, and transactions are trackable and irreversible.

Decentralized exchanges (DEXs), meanwhile, facilitate peer-to-peer transactions without the need for an intermediary that holds custody of the funds.

How can I protect myself from DeFi scams?

DeFi is an emerging technology and as such, its risks differ from those in traditional markets:

1. Most jurisdictions do not regulate these types of depository accounts or products under banking laws because they are predicated on cryptocurrencies and not fiat currencies. Don't invest more than you can afford to lose.
2. There are no restrictions or guidelines on who can use DeFi, so anyone can have a crypto wallet or use a smart contract. Do your homework and understand the technology. Although it may be accessible to everyone, it may not be right for everyone.
3. Be wary of representations of full transparency and security and understand what the actual risks are. While a blockchain may be nearly impossible to alter, most of DeFi's potential use cases rely on software systems that are vulnerable to hackers.
4. There are no DeFi consumer protections in place. Users may have little recourse should a transaction go wrong, and the parties involved in the transaction could literally be located anywhere in the world.
5. Is DeFi really accessible to everyone? The collateral required to use DeFi lending is typically equal to at least 100% percent of the value of the loan, greatly limiting who is eligible.
6. Understand DeFi technology. DeFi requires you to have a private key to secure your wallet that houses your cryptocurrency assets. A private key is a long, unique code known only to the owner of the wallet. If you lose your private key, you lose access to your funds—there is no way to recover a lost private key.
7. Too good to be true? Given the complexity of the various lending and borrowing mechanisms at play with DeFi, an average investor may find it hard to distinguish between DeFi opportunities that have real value and those that are scams.
8. Should it be regulated? If it looks like an investment, lending, or banking opportunity, there is a good chance the service and the people selling it should be registered. Use caution before you put your money at risk in an unregulated marketplace that may be operating illegally.

Bottom Line

As with any new technology an investor can expect to see many opportunities for investment. Always check with your state or provincial securities regulator before risking your money.