What Is DeFi? How Will Decentralized Finance Impact Your Industry



Decentralized Finance is a financial system powered by a decentralized network of computers as opposed to a single server. DeFi is an emerging digital financial infrastructure that aims to eliminate the need for central government agencies or banks to approve transactions.

Many consider DeFi as an umbrella term for the new wave of financial services Innovation since it is intertwined with the blockchain.

The blockchain is a decentralized public ledger. Most commonly associated with cryptocurrencies such as Bitcoin and Ethereum, the blockchain can be used for a variety of technological purposes.

The blockchain allows all computers on a network to maintain a copy of historical transactions. This prevents any single entity from having control over or being able to alter the transaction ledger.

Today’s Centralized Finance

Currently, nearly every aspect of banking, lending, and trading money are managed by a centralized system operated by Gatekeepers and governmental bodies.

Consumers have to deal with a ton of financial middlemen to access everything from mortgages and car loans to trading stocks and bonds.

In the United States, regulatory bodies such as the Federal Reserve and Securities and Exchange Commission set the rules for centralized financial institutions. Congress changes the rules over time.

Because of this, consumers have very few options to access financial services and capital directly. They cannot bypass the banks, exchanges, and lenders who earn a commission on every transaction as profit.

How Decentralized Finance Changes the Game

Decentralized Finance aims to disrupt the balance of power taking it away from the centralized governing bodies and middlemen and passing it to everyday people through peer-to-peer exchanges.

DeFi takes key elements of work done by financial institutions such as lending, borrowing, and trading funds, and puts them in the hands of the consumers.

Though it’s still early in the game and we have to speculate about how this could play out, here’s an example:

Right now, you’re putting money into an online savings account and earning 0.50% interest on the funds. The bank lends that money to another customer at 3% interest and keeps the remaining 2.5% as profit.

With the DeFi model, You’ll end your savings directly to another person so that you can earn the full 3% return on your money.

If you’re thinking you already do this when you send money to friends and family

via cash app, PayPal, Venmo, or another service, you're not quite right.

You still have to have a bank account linked to these apps or a debit card to send funds so your peer-to-peer payment still relies on centralized finance and intermediaries to work.

DeFi and the Blockchain

Blockchain technology and crypto are the main drivers that make decentralized finance possible.

When you make a transaction through your checking account, it's recorded in a private Ledger. Your banking transaction history is owned and managed by a large financial institution.

Blockchain on the other hand provides a decentralized distributed public ledger where all financial transactions get recorded in computer code.

By distributed, we mean all parties that use a defy application have an identical copy of the public ledger that records every transaction with encrypted code.

That keeps the system secure by giving users anonymity and verifies payments with a record of asset ownership that's almost impossible to alter with fraudulent activity.

When we say the blockchain is decentralized, that means there are no gatekeepers or middlemen managing the system.

Transactions are recorded and verified by the parties to use the same black chain with a process of solving complex math problems and adding new blocks to the chain.

Advocates maintain that the decentralized blockchain makes financial transactions more transparent and secure than the private systems that centralized finance uses.

> *DeFi is a long way from becoming the norm, but it is becoming more mainstream as people look for ways to keep more control over their finances.*

How We Use DeFi Now

DeFi may be in its early stages, but it’s certainly making an impact on both simple and complex financial transactions.

It’s currently powered by decentralized apps, or DeFI applications, known as dapps and other programs known as protocols.

Dapps and protocols take care of transactions in two main cryptocurrencies Bitcoin (BTC) and Ethereum (ETH).

Bitcoin is the more popular cryptocurrency but Ethereum is more adaptable for a wider variety of uses. That means much of the protocol and dap landscape rely on Ethereum base code.

Traditional Finance Transactions

This involves the financial transactions you’re already familiar with – anything from trading securities and insurance to lending and borrowing money, and making payments.

Anyone with an internet connection can use it without approval, and funds can be transferred within a matter of minutes – sometimes seconds. It eliminates fees that many banks charge for accessing their services.

E-Wallets

Developers are working to create digital wallets that operate independently from cryptocurrency exchanges to give investors access to everything from blockchain-based games to cryptocurrency.

Decentralized Exchanges (DEXs)

Currently, many cryptocurrency investors use centralized exchanges such as Gemini or Coinbase. DEXs, however, facilitate these peer-to-peer financial transactions while allowing users to retain control over their finances.

Yield Farming or Harvesting

With DeFi, it’s possible for speculative investors to lend cryptocurrency and possibly reap large rewards when proprietary coins DeFi borrowing platforms pay them for agreeing to the loan.

Stable Coins

Cryptocurrency is known for its volatility. Stable coins, on the other hand. attempt to stabilize their value by tying them to non-crypto currencies such as the US dollar.

Flash Loans

Flash loans are cryptocurrency loans that borrow and repay funds in the same transaction. Though it may sound counter-intuitive it works like this:Borrowers have the potential to make money by going under contract on the Ethereum blockchain. The smart contract borrows funds, executes the transaction, and repays the loan instantly.

If the transaction isn’t able to be executed, or it will be at a loss, the funds automatically go back to the person who loaned them. If you do make a profit, you can keep it in your pocket minus any fees or interest charges.

Non-Fungible Tokens

Non-fungible tokens, or NFTs, create digital assets out of things that aren’t traditionally tradable, such as videos or the first social media post on a social network. What was previously uncommodifiable can now become a commodity thanks to NFTs. A lot of people are using NFTs to create collectibles.

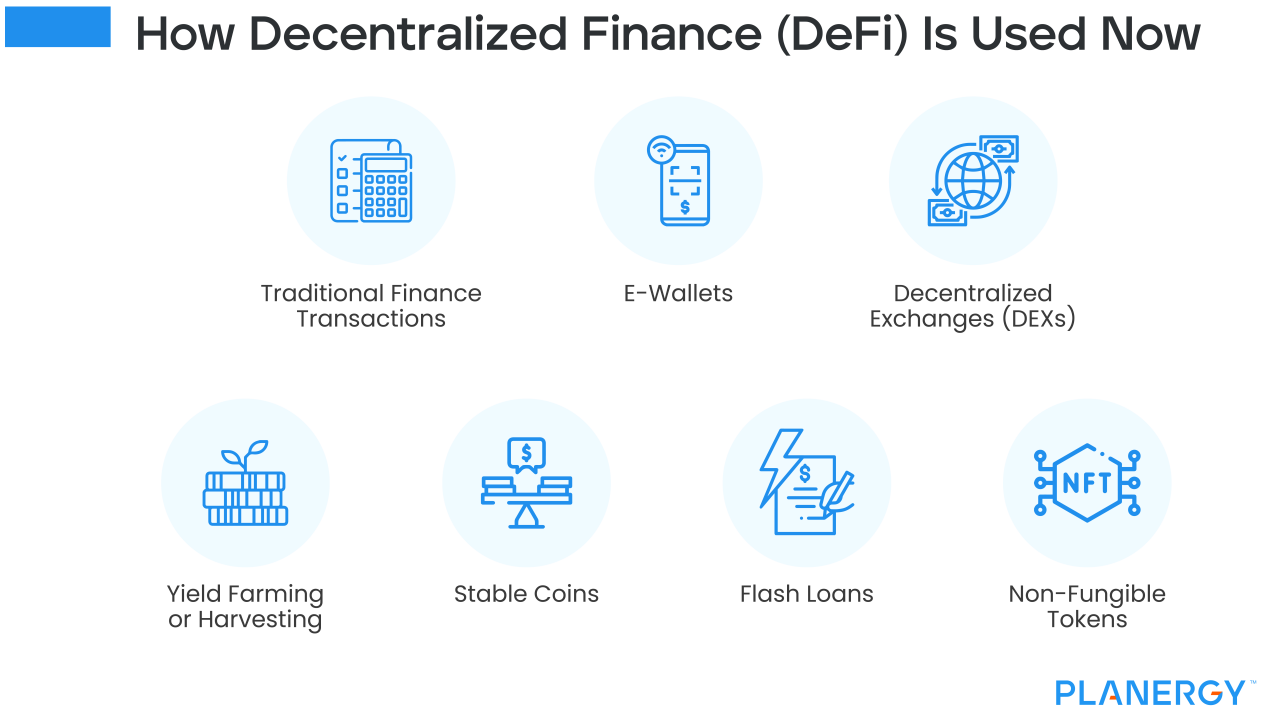
The DeFi market gauges adoption by measuring “locked value”. This calculates how much money is currently working across DeFi protocols. Now, the total locked value (TLV) is worth nearly $43 billion.

DeFi adoption is powered by the blockchain’s nature. The same moment a dapp is

encoded on the blockchain, it becomes available globally.

The majority of centralized financial products and technologies become available slowly over time, governed by a variety of regulations across regional economies.

Apps exist outside of the rules which increases the potential reward but also leads to increased risk.



DeFi Risks

As an emerging technology, defy comes with many risks. Since it is such a recent Innovation, we haven't been able to test it with long-term or widespread use.

As national governments are taking a closer look at the systems DeFi is putting in place an attempt to regulate it, what we know it to be now may not be how it is used as we move toward the development and execution of Web3.

Lacks Consumer Protection

DeFi continues to be successful despite the fact that there are no governing rules and regulations in place. While this can be seen as a good thing, the lack of

governance also means consumers don’t have any protection in the event that a transaction goes wrong or someone falls victim to a scam.

Though unlikely, if and when a bank fails, the Federal Deposit Insurance Corp (FDIC) reimburses deposit account holders up to $250,000 each. Legally, banks are required to hold a certain amount of their capital in reserve to maintain stability and provide you the liquidity to cash out your account anytime you need it.

There are no similar protections with decentralized finance.

Private Key Requirements

In DeFi and cryptocurrencies, you have to secure the wallets you used to store your crypto assets. These wallets are secured with private keys. Private keys are unique, long code known only to the wallet’s owner.

if you lose the private key for your crypto wallet, you lose access to your funds with no way to recover it.

Collateralization

Collateral is something of value used to secure a loan. When you get a mortgage, the home itself is the collateral. When you get an auto loan, the vehicle you’re buying serves as collateral.

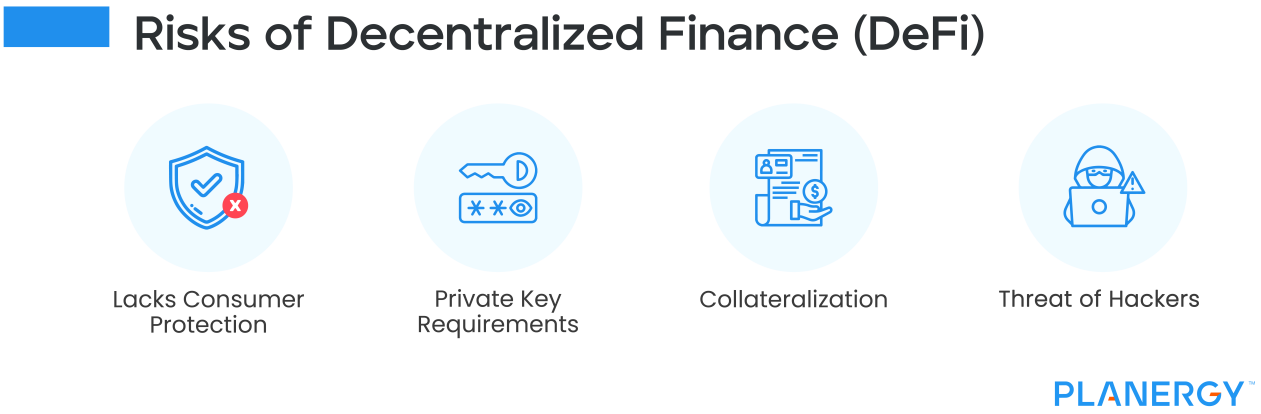
Most DeFi lending transactions require collateral equal to at least 100% of the value of the loan, if not more.

The requirements greatly restrict eligibility for many types of these loans. While traditional banks may require some form of collateral for high-risk borrowers, many consumers can get low-interest rates on unsecured loans.

Threats of Hackers

Though the blockchain is nearly impossible to change, other parts of DeFi are susceptible to hacking, which can lead to theft and loss of funds. All the

decentralized finance infrastructure's potential use cases rely on systems that are particularly vulnerable to hackers.



How DeFi May Impact Business in the Future

Though there are still many unknowns and quite sometime before decentralized Finance becomes the norm, applying the decentralized peer-to-peer model to all types of financial transactions on a global basis, has a significant impact on the existing global financial system and its intermediaries.

Because defy empowers individuals and gives them more control over their assets, along with the financial freedom to choose how to invest their assets without relying on an intermediary such as a brokerage, what we know today won't be what we see in the future.

Individuals will still need financial guidance and traditional financial institutions may not necessarily become obsolete, but the way institutions and individuals interact with one another within the financial system and make financial decisions has the potential to look vastly different.

DeFi will also impact B2B transactions.

As more institutions join the blockchain ecosystem and tokenize financial assets like Securities and derivatives, there is potential for smart contract-based decentralized applications to act as intermediaries between institutions.

As real-world assets become tokenized on public black chains, this unlocks liquidy

for firms by allowing assets that once were illiquid, such as commercial real estate, to be represented by fractionalized tokens on the public blockchain that are tradable.

The tokens could be posted as collateral or included in investment pools on DeFi protocols.

This approach also applies to existing supply chains, allowing for more open smart contract-driven marketplaces. Entities can make transactions with privacy-preserving technology on a public blockchain while prices are dictated by market conditions.

Since DeFi is in its infancy, institutions still have a prominent role in its development.

There are plenty of financial opportunities, including the development of new products and services, as well as the chance to improve operational efficiency by leveraging existing DeFi infrastructure.

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