APR 06
Victor Chatenay

Lack of regulation hinders DeFi's disruptive potential in modern finance

Article

Decentralized finance (DeFi) could be a more disruptive blockchain use case than Bitcoin in finance, according to a recent Bank of America (BofA) report, per Insider. The most common

blockchain application so far is cryptocurrencies, like Bitcoin, which act as alternative investment products or means of payment. DeFi is also a blockchain use case, but acts as an alternative to a wider range of financial services by doing away with financial intermediaries.

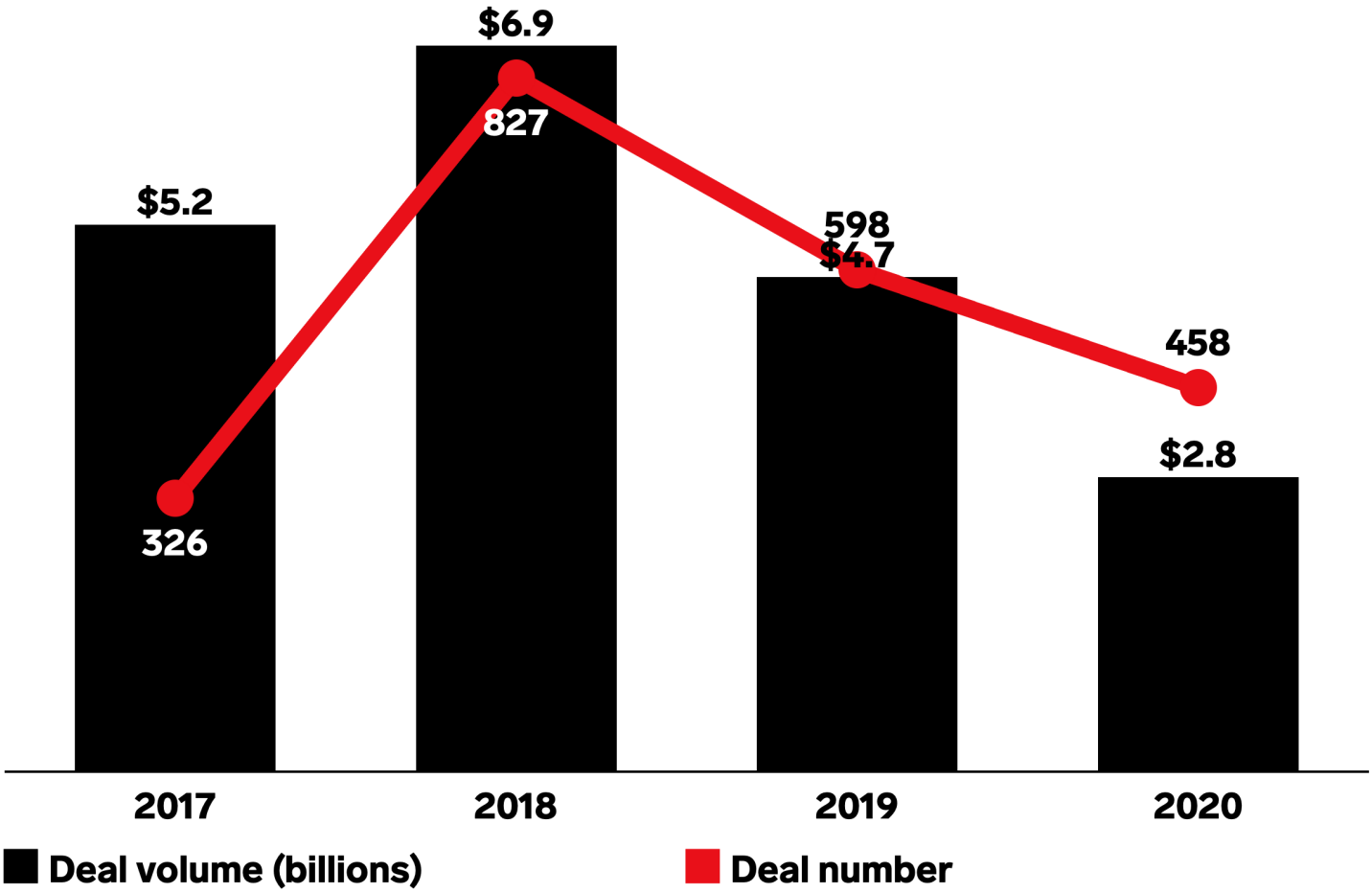
DeFi applications aim to bring greater efficiencies to modern finance, and VC funds are starting to be convinced of their potential.

- **The current financial system relies on trusted entities to enable access to financial services, but DeFi removes the need for these middlemen.** DeFi leverages "smart contracts," which are agreements automatically enforced via code on a blockchain, typically Ethereum. BofA identifies a number of financial use cases where smart contracts could reduce friction and lower costs, including when exchanging securities. Such transactions traditionally require a host of intermediaries—like banks, law firms, and accounting firms—to update ownership records and manage counterparty risk. But DeFi automates all these functions and processes them in real time so that the transaction and settlement occur at the same time, and the blockchain is automatically updated to record the change of ownership.
- **VC funding is pouring into DeFi startups to help scale these applications.** The sector has mirrored cryptocurrencies' rapid rise in popularity over the past year, with the total value enforced through smart contracts reaching $44 billion at the time of writing, up from $1 billion last February. And some VCs aren't waiting any longer to back DeFi projects: VC funding in DeFi crossed the $500 million mark for the first time in September across 34 startups. And funding activity will likely accelerate further this year, with UK-based fund Augmentum fintech allocating part of its £193 million ($247.5 million) treasure chest to invest in DeFi firms in January, while a month later, Siam Commercial Bank launched a $50 million blockchain fund that will also target the subsector.

However, DeFi's disruptive potential will not be realized in the wider financial sector anytime soon, as the space remains unregulated for the foreseeable future. Financial firms that act as intermediaries in the current financial system are heavily regulated, and consumers can rely on bodies like the Securities and Exchange Commission (SEC) to police the sector and remedy any faults. But there are no legally recognized, centralized entities that can be held responsible for smart contract problems, such as a mistake in the code. The SEC has not mentioned DeFi in planned crypto-specific regulations, while the UK Treasury's latest consultation specifically states that DeFi will not be in scope of any upcoming regulations. The lack of protection will likely hinder DeFi adoption as most consumers and financial institutions

are unlikely to put all their trust in blockchain technology to safeguard their money until such services are brought in scope of regulations.

Global Private Investment in Blockchain and Cryptocurrency



Source: KPMG, "Pulse of Fintech H2 2020," February 2020
Methodology: Data is from the February 2021 KPMG report titled "Pulse of Fintech H2 2020." The data was provided by Pitchbook Data on December 31, 2020. Due to the private nature of many of the transactions, the data set cannot be definitive, but is an estimate based on information available to PitchBook.

1024068059718 InsiderIntelligence.com