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BIS has a bone to pick with decentralized finance 'illusion'

Article

The news: The **Bank for International Settlements** issued a report on the risks that decentralized finance (DeFi) carries for consumers and the broader financial system.

What's in a name? DeFi takes the concept of unintermediated transactions that inspired Bitcoin and applies it to a whole range of financial services—from smart contracts and lending protocols to a comprehensive financial system underpinning the metaverse.

But BIS says there's just one problem: Most DeFi protocols *aren't actually decentralized*. They only create an "illusion" of decentralization, per the report.

- The paper cited decentralized autonomous organizations (DAOs) filing as LLCs in Wyoming. It also said that the governance token-based consensus mechanisms that control most DeFi protocols mirror the corporate shareholder system.
- This raises concerns about repeating a scenario like Ryan Cohen using his outsize share of **GameStop** stocks to get a position on the board and rework the company's business model. Similarly, a user who acquires a significant share of governance tokens for a particular DAO or DeFi protocol could exert control over that system.
- Similar centralization concerns have been raised in the past regarding mining pools, which have dramatically increased the scale at which cryptos like Bitcoin can operate. But they also run the risk of consolidating control of the crypto's liquidity and price—a single mining pool in China mines **3% of all Bitcoins**, according to Sunbird DCIM.

What's at stake: The problem with DeFi is not so much that it creates new problems unique to the system itself. Rather, it's that the solutions and safety rails already built into the traditional financial system have yet to be applied to the blockchain and are often harder to enforce.

- Leverage was one of the biggest concerns raised by the BIS. It notes that because DeFi isn't regulated like the traditional financial system, loans that at face value are overcollateralized can quickly become risky as that collateral gets used for simultaneous loans and investments. Margins on decentralized exchanges are often higher than regulated exchanges as well—**Binance** has allowed **up to 125-fold leverage**.
- Because of the "built-in interconnectedness among DeFi applications," a few defaults here and there can quickly metastasize into a system-wide breakdown, the report warned.
- Another main concern was that the majority of crypto assets are "geared predominantly towards speculation," which has invited a slew of more complex financial instruments like options and derivatives contracts that cause dramatic valuation swings.
- Those risks exist in the traditional financial system as well—as we saw with the fiasco that resulted from squeezing GameStop's more than 140% short interest. But no one's trying to use GME to collateralize a mortgage, and such volatility calls into question cryptos' usefulness in other financial services.

Resolving those issues will require new regulations and policies. As we've noted, US regulators are already coalescing around the idea of narrowly treating the bulk of crypto assets as securities, despite industry players like **Binance** and **Ripple** arguing differently.