

Getting Drawn Into DeFi? Here Are 3 Major Considerations

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If you've had even half an eye on the cryptocurrency space in 2020, then you can't have missed the surge of news stories and emerging projects around DeFi. Short for decentralized finance, the proponents of this segment hail it as a revolutionary new financial system in which anyone can become a borrower, lender, speculator or investor using decentralized smart contract protocols.

It's certainly true that there are no barriers to entry. Unlike a traditional financial setup where users would have to overcome several KYC barriers to open a bank account, request a loan or start trading stocks, decentralized finance is unregulated and, for the most part, free of any restrictions. And it's not just users who benefit. Anyone with programming skills, or the ability to procure them, can put their entrepreneurial skills to work by setting up a decentralized application and start issuing financial instruments on blockchain technology.

It sounds easy enough in principle. However, before entrepreneurs rush out and start building their own DeFi applications, or start researching their first DeFi investment, there are several considerations worth taking into account.

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1. Existing infrastructure can't necessarily cope with market volatility

Flagship DeFi project Maker suffered one of the most high-profile DeFi incidents of this year during crypto's "Black Thursday," when the value of the world's markets plummeted on March 12. Maker is the Ethereum-based project that issues a dollar-pegged stablecoin called DAI, based on smart contracts called Collateralized Debt Positions. Users deposit ether as collateral and take out DAI loans that they can stake in other DeFi applications to earn interest.

As the price of ether dropped dramatically, users of Maker suddenly found their DAI loans were undercollateralized and tried desperately to increase their ether deposits to stop the system from liquidating their positions. Ethereum is notoriously clunky during times of high traffic, and many of those who didn't make it on time had their loans liquidated. Some users lost hundreds of thousands of dollars due to the speed and scale limitations of the Ethereum Network. Some of those positions that should have been liquidated weren't, due to the fact that Ethereum couldn't update price information from external price oracles quick enough.

To make an already bad situation even worse, when Maker liquidates a contract, it doesn't cancel it. Instead, the loan is auctioned for DAI. Amid the chaos, the sharks started circling and managed to buy \$8.32 million worth of loans for zero DAI.

2. Ethereum scalability is a DeFi bottleneck

While the issue of smart-contract vulnerabilities isn't

necessarily specific to Ethereum, the platform has been struggling with scalability issues since 2017. An upgrade, dubbed Ethereum 2.0, has been in the pipeline for several years now. However, the phased implementation means that the scalability challenge is likely to persist for longer yet.

These scalability limitations make Ethereum vulnerable to other platforms developing more scalable blockchains. From a DeFi perspective, Ethereum's most significant advantage is that it's already home to so many applications, offering a high degree of interactivity. This is where competitor platforms such as EOS or Binance Chain tend to be at a disadvantage.

However, second-layer solutions developed on the Ethereum base layer offer the ability to scale without needing to depart from the overall Ethereum ecosystem. For example, Matic Network, which received early backing from Coinbase Ventures and launched its initial token sale on Binance's Launchpad platform. Compared to Ethereum chugging along at 15 transactions per second, Matic can handle 65,000. If Maker had been running on Matic, it could have perhaps avoided the cascade of issues it experienced on Black Thursday.

As second-layer solutions aim to solve the problems within the Ethereum network, many entrepreneurs are looking for greener pastures where the Ethereum blockchain falls short. Ethereum, a layer-one blockchain, is seeing some competition related to DeFi specific blockchains built using the Cosmos SDK. Because the Cosmos technology enables interoperability, blockchains powered by the technology are seeing an uptake in users who find the safety and security in a layer-one Ethereum alternative.

I reached out to the engineering team at on such blockchain built using the Cosmos SDK, Kava Labs, to find out why Ethereum has scale and security issues. Lead Engineer Kevin Davis blames the architecture, saying, " Every DeFi hack in

the past two years are a result of bugs in the code. Many would not have happened if they were written in a different language. Go is a reliable modern and safe language to use for a wide range of applications where you need security and reliability. Just like on Ethereum the base chain that supports these products, secures and stores the assets, becoming the foundation for DeFi as we know it.” However, this technology is in the early stages and DeFi is a new emerging market.

In the early 2000s, there was Internet Explorer, and it was hard to write websites to work well on it. Then came Firefox and Chrome. Both were rewritten from the ground up to be easier and safer. Then all these new websites came out like Google and Facebook, and now Chrome has become the defacto browser that everyone is building their websites to optimize for. No business today makes it a priority to optimize their website to run well in Internet Explorer.

3. Ethereum transaction fees are currently sky-high

Another reason for using a more scalable platform is the transaction fees on Ethereum. The current transaction pricing mechanism is a direct function of network congestion. The higher the volume of traffic, the more users will pay in transaction fees.

Due to a dependence on complex smart contract transactions, DeFi fees can reach exorbitant levels, as high as \$99, according to some reports. The founder of decentralized derivatives application Synthetix went as far as to warn that these high fees pose a risk to the growth of DeFi.

“Because of the limitations of the Ethereum network users don’t have the freedom to make all the decisions they want,” says Denali Marsh, an engineer at Kava Labs. “For example if a

user wants to diversify into 30 yield farming pools, it's going to cost them nearly \$3,000 in gas fees, and it's not worth their time unless they're yield farming with millions of dollars. A 3 percent yield on \$100 million is a great return on investment, but you have to be trading with at least a million for it to be worth your time. For the considerations of cost savings alone, blockchains built on the Cosmos SDK like Kava make DeFi scalable and affordable for everyone to participate, not just the highly capitalized users."

Better Infrastructure and More Transparency Are Key to DeFi's Future

DeFi is undoubtedly an exciting place to be right now and poses many attractive opportunities for intrepid entrepreneurs. Nevertheless, it's worth understanding the limitations of Ethereum and investigating the individual project as much as possible before playing with these products. As ever with cryptocurrency, the often-used advice to "do your own research" is in no immediate danger of becoming outdated.

Thankfully, there are those in the crypto space who recognize that there's an information gap particular to DeFi, as users don't have any easy or transparent means of researching up-and-coming projects. MarketPeak is a relatively new entrant to the sector, a fundraising platform for DeFi entrepreneurs. However, as part of an effective fundraising strategy, MarketPeak provides investors and market participants with in-depth research regarding the projects on its platform.

Even players from the centralized cryptocurrency space are seeing opportunities to get involved with DeFi from the perspective of helping to educate users. As Jack Tao, CEO of Singaporean-based exchange Phemex, told me, "DeFi opens a

brand new world with its own set of rules, creating an opportunity for established firms to participate as a source of education and knowledge on how to properly use these emerging products. The idea of decentralized finance does have a lot of inherent value. However, some of these governance tokens are simply overpriced, and it's important that market participants understand the risks."

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In the earlier years of cryptocurrency, it was often described as the "Wild West" of investing, and the same could be said of DeFi right now. However, the cryptocurrency segment quickly matured, and it seems like only a matter of time before DeFi does the same. With faster and more secure infrastructure, along with more transparency and accountability from project operators, DeFi stands a good chance of establishing a place for itself in the future of finance.

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