Bird & Bird & Decentralised Finance

Introduction

Decentralised Finance, or "DeFi", refers to the world of financial applications that are built on blockchain networks. They are 'decentralised' as the inherent nature of blockchain allows these applications to operate without intermediaries, in this case, financial institutions.

Many DeFi applications operate on the Ethereum public blockchain as they involve the use of smart contracts, this enables them to operate on a peer-to-peer basis.

This briefing note is intended to be a high-level overview of DeFi, covering what it is, an example use case, and potential issues.

For more in-depth content on a variety of blockchain topics, please visit our [Blockchain in Focus webpage](#).

What is DeFi?

As stated above, DeFi is the collective term for decentralised finance applications built on blockchain networks.

Currently a whole host of financial applications are on offer, the common theme of which is a lack of centralised body or trusted intermediary that sits in the middle of the financial transactions that occur.

DeFi applications include:

- Banking services: traditional banking services such as money transfers and loans can all be effectively deployed over blockchain. The use of these products often involves stablecoins, crypto-currencies that are pegged to the value of real-world currencies, predominantly USD.

- Borrowing and lending: borrowing/lending applications allow for peer-to-peer lending without the need for a financial institution to determine a borrower's eligibility and process the transaction.

- Marketplaces: users of blockchain marketplaces can trade digital assets and financial products on a peer-to-peer basis. Parties can enter into smart-contracts to transfer digital assets, ranging from crypto-currencies to synthetic real-world financial products, directly between digital wallets, cutting out the need for a trusted intermediary such as a bank or clearing house.

DeFi use case – lending and borrowing

Perhaps the most popular use case currently in DeFi is lending and borrowing, as outlined simply below:

1. Party A deposits an amount of cryptocurrency into a DeFi lending protocol built on the Ethereum blockchain, accessed through an app on their phone.

2. Party B, seeking a loan, accesses the lending protocol and sees the availability of Party A's cryptocurrency deposit.

3. The two parties enter into a loan agreement in the form of a smart contract governing the terms of the loan including what collateral will be provided (usually in the form of another cryptocurrency or asset), the interest rate and the repayment date.

Both parties are able to negotiate flexible terms that are of a mutual benefit, at a much faster rate than a conventional bank loan.

DeFi – issues to consider

Despite the advantages that DeFi brings to the world of financial services, there are some issues that users need to be aware of.

1. Know Your Client ("KYC")

DeFi allows access to financial services for users who may otherwise be excluded due to circumstances such as a bad credit rating. Although this opens up the market to a wider pool of users than traditional financial models, participants should be wary when entering into peer-to-peer lending arrangements.

The general lack of KYC on public, permissionless blockchains means that users/institutions who lend crypto-assets should be aware that they may be lending to individuals who will use these crypto-assets for criminal purposes, or to individuals who may be unable to repay the loan.

In the absence of a trusted intermediary managing risk, we recommend that where possible, parties try to identify the counterparty that they are contracting with.

KYC with regards to cryptoassets and blockchain is an area that is gaining increasing attention from regulators and, currently in the UK, businesses carrying on cryptoasset activity need to be registered with the Financial Conduct Authority.

2. Smart Contracts

As discussed in our previous briefing note, whilst under English law smart contracts may constitute a legal contract, it remains to be seen if they are capable of acting as a complete substitute for natural language contracts.

Users of DeFi products should therefore make sure that they are comfortable and familiar with their rights of recourse and enforcement against the counterparty to a smart contract, as smart contracts often form the basis of DeFi transactions and govern what happens if something goes wrong.

We recommend that agreements between parties relating to smart contracts are based on a natural language contract which then incorporates by reference the relevant, agreed smart contract code. Off-chain dispute resolution procedures should also be considered.

Advantages of DeFi

There are some very tangible advantages of DeFi applications over traditional financial models, these include:

1. Speed: DeFi users who wish to obtain a loan, for example, can process this with far greater speed through a blockchain-based lending protocol than through a traditional bank loan.

2. Accessibility: DeFi on blockchain, particularly DeFi lending, will open up finance to a much wider market of users who might otherwise be excluded due to location or circumstance.

3. Transparency: blockchains are transparent and immutable. Once a financial transaction or smart contract has been recorded onto a blockchain, its terms are visible to participants and cannot be altered.

   This transparency and immutability also provides security to users, the clear audit trail makes it more difficult for funds to go missing.

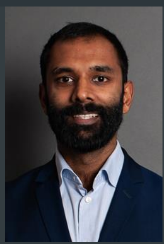
Bird & Bird & Decentralised Finance

For more information or a free initial meeting, please contact:

Key contacts

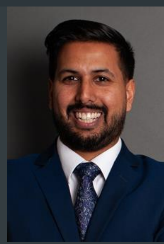
Jonathan Emmanuel
Partner

Tel: +442074156052
jonathan.emmanuel@twobirds.com



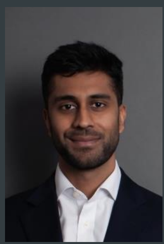
Gavin Punia
Senior Associate

Tel: +442030176884
gavin.punia@twobirds.com



Ash Shah
Associate

Tel: +442074156606
ash.shah@twobirds.com



Thomas Hepplewhite
Associate

Tel: +442074156777
tom.hepplewhite@twobirds.com

Charles Hill
Trainee Solicitor

Tel: +442074156745
charles.hill@twobirds.com

"The firm is at the forefront of some of the most cutting-edge mandates in the area, advising on innovative matters in payments, crowdfunding, open banking and blockchain."

Chambers FinTech UK, 2020

twobirds.com

Abu Dhabi & Amsterdam & Beijing & Bratislava & Brussels & Budapest & Copenhagen & Dubai & Dusseldorf & Frankfurt & The Hague & Hamburg & Helsinki & Hong Kong & London & Luxembourg & Lyon & Madrid & Milan & Munich & Paris & Prague & Rome & San Francisco & Shanghai & Singapore & Stockholm & Sydney & Warsaw & Satellite Office: Casablanca