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DISB CONSUMER ALERT

Bank to the Future: Beware of Decentralized Finance (DeFi)

Decentralized finance, or DeFi, is a relatively new blockchain-based set of financial services gaining popularity and acceptance. This alert discusses DeFi and its risks and how you can protect yourself from falling victim to a DeFi scam.

WHAT IS DeFi?

First, it is important to understand the current centralized financial infrastructure within which most financial transactions take place. Financial services markets are traditionally overseen by different regulators. To gain access to money, one must work with financial intermediaries for auto loans, mortgages, brokerage accounts, investment accounts, stocks and bonds. Regulators set the guidelines and rules that consumers must meet to get a bank account, access loans and invest. As users of these services, consumers must comply with these laws and rules to access money. The providers of traditional financial services also must follow the laws and rules governing financial transactions.

DeFi refers to financial services provided by an algorithm on a blockchain, without a financial services company. It is an alternative approach that largely operates outside the traditional centralized financial infrastructure. Some believe that DeFi's decentralized framework offers certain benefits. However, investors should be aware that it also presents significant risks. Unlike traditional banks and investment firms, DeFi financial services firms use digital assets, instead of the U.S. dollar and other currencies, to provide banking and financial services such as depository services, lending, investing and management services. Some of these services may be operated outside current regulatory frameworks.

HOW DOES DeFi LENDING WORK?

In the current centralized system, a customer opens a savings account and earns interest on the deposit. The bank lends the money customers have deposited to another customer or business at a higher interest rate and takes a profit on the difference.

Using DeFi, a borrower can get a loan based entirely on an algorithm that matches peer-to-peer borrowers and lenders. Lenders may find this appealing because they expect to earn the full amount of interest paid by the borrower instead of some lesser amount set by the bank. Currently, this credit risk is managed by overcollateralizing loans.

Overcollateralization is when the borrower provides collateral that exceeds the loan amount.

HOW CAN I PROTECT MYSELF FROM DeFi SCAMS?

DeFi is an emerging technology and as such, its risks differ from those in traditional markets:

1. Most jurisdictions do not regulate these types of depository accounts or products under banking laws because they are predicated on cryptocurrencies and not the U.S. dollar and other currencies. Without the protections that traditional, regulated markets offer, it is especially important not to invest more than you can afford to lose.
2. There are no restrictions or guidelines on who can use DeFi, so anyone can have a crypto wallet or use a smart contract. Do your homework and understand the technology. Although it may be accessible to everyone, it may not be right for everyone.
3. Be wary of representations of full transparency and security and understand the actual risks. While a blockchain may be nearly impossible to alter, most of DeFi's potential use cases rely on software systems that are vulnerable to hackers and other risks.
4. Because DeFi entities and arrangements are anonymous, investors should understand that the persons with whom they are dealing may not be who they claim.
5. DeFi does not offer many of the consumer protections and remedies available for traditional financial transactions. Users may have little recourse if a transaction goes wrong, and the parties involved in the transaction could literally be located anywhere in the world.
6. Too good to be true? Given the complexity of the various lending and borrowing mechanisms at play with DeFi, an average investor may find it hard to distinguish between DeFi opportunities that have real value and those that are scams. If it sounds too good to be true, it probably is.
7. Should it be regulated? If it looks like an investment, lending, or banking opportunity, there is a good chance the service and the people selling it should be registered. Use caution before you put your money at risk in an unregulated marketplace that may be operating illegally.
8. Contact DISB to verify whether a security is registered or if the entity offering the security is licensed.

REPORT FRAUD

If you believe you have been the victim of a DeFi scam, you may file a report with the Federal Trade Commission (FTC) at ReportFraud.ftc.gov or call the FTC's Consumer Response Center at 877-382-4357. You may also contact the DISB Enforcement and Consumer Protection Division at 202-727-8000.

DISB Mission

Our mission is three-fold: (1) cultivate a regulatory environment that protects consumers and attracts and retains financial services firms to the District; (2) empower and educate residents and (3) support the development and expansion of business.

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