

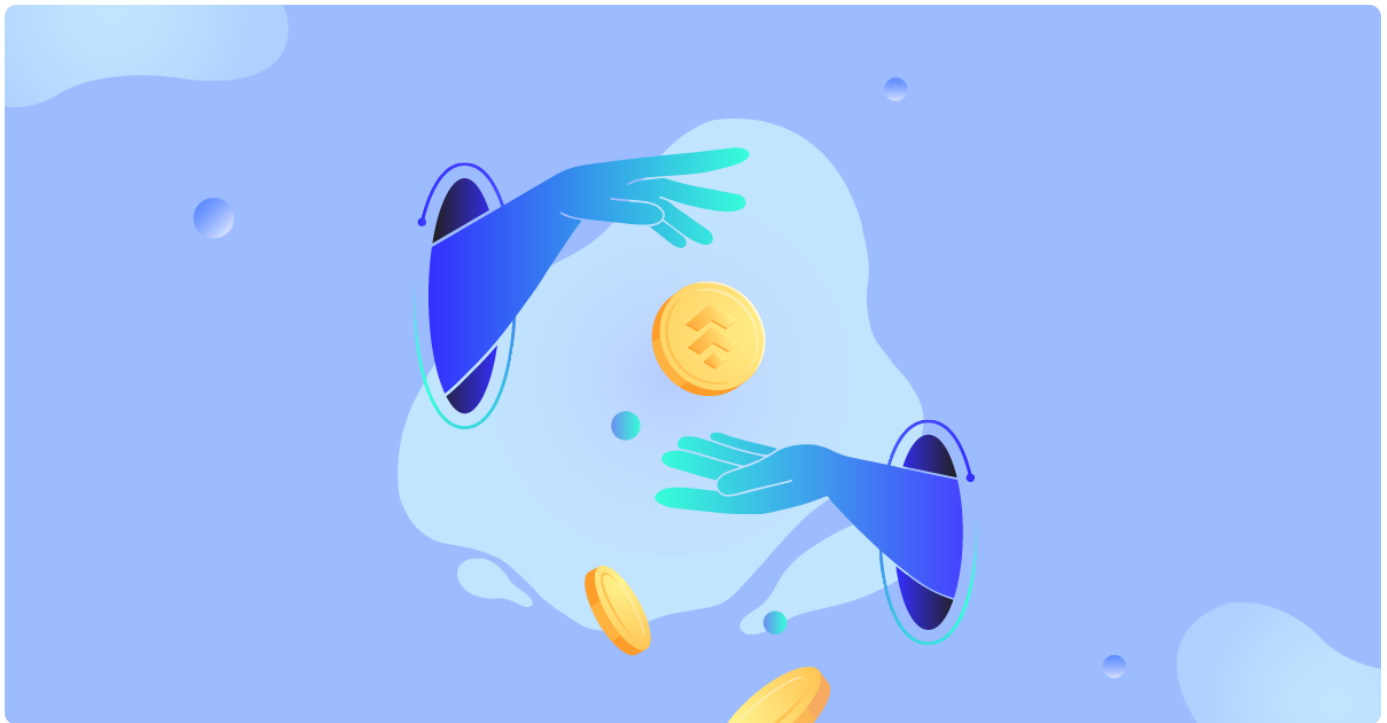


Learn DeFi >

How Does DeFi Lending and Borrowing Work?

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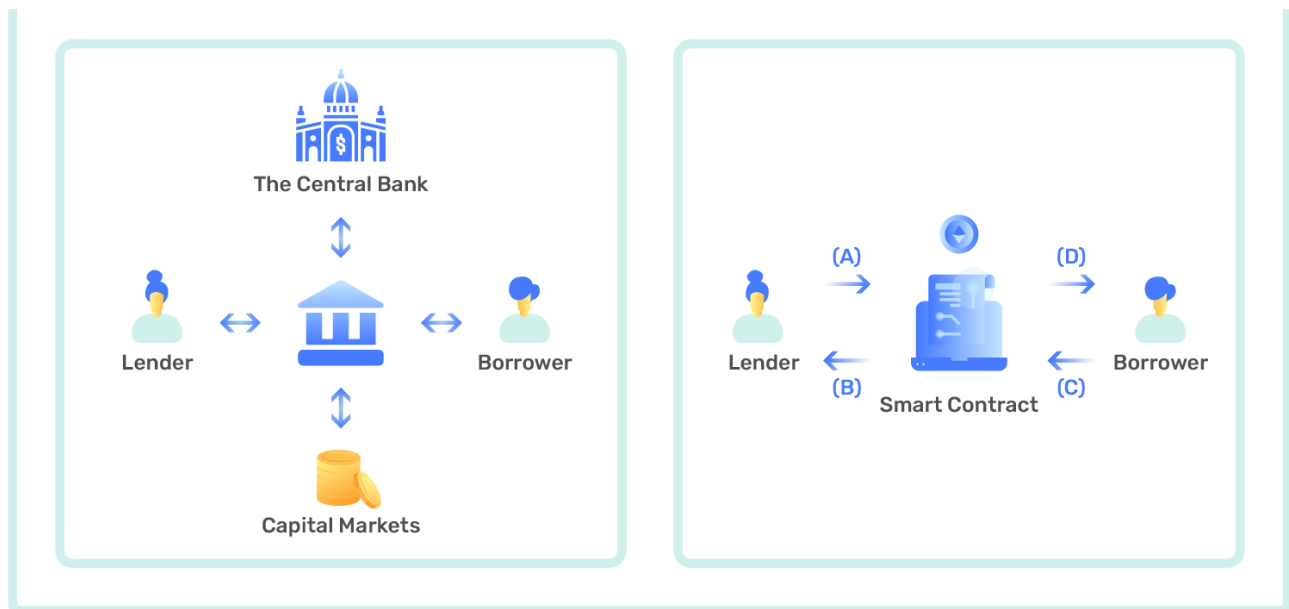


This article aims to provide insight into the what, why, and how of DeFi borrowing and lending. It references cryptocurrencies, blockchain technology, staking, and farming. If you are unfamiliar with crypto, read our articles on [blockchain](#), [crypto](#), and [DeFi](#) before reading this article.

Traditional Finance (TradFi) has used a fractional banking approach of lending capital to receive interest payments using an intermediary, i.e., banks and other financial institutions. However, this centralized system is not open to all and requires participants to go through stringent/structured procedures and verification processes to acquire loans, mortgages, and other forms of capital.

Decentralized Finance (DeFi) is an open, permissionless, and transparent space where users can acquire loans without the need for external parties such as banks and other centralized financial institutions. Compliance with the terms of loans by both parties is ensured through smart contracts, which are employed on the blockchain instead of conventional financial risk functions.





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How Is DeFi different from TradFi?

DeFi can provide financial services to a broader audience because it socially includes participants who cannot access TradFi services. It is less intrusive on privacy while allowing users flexibility regarding access to their funds. TradFi has achieved both to a considerable degree in terms of interoperability and integration. However, due to the overall centralized nature of TradFi, achieving a high level of cross-chain interoperability in DeFi remains one of the most imperative goals to drive this sector forward.

Why Participate in DeFi Lending and Borrowing?

Lenders can gain value on their already owned crypto assets by lending them out to earn interest. Lending also helps to offset inflation risk on their investments. Borrowers can receive the funds provided by the lenders so long as they can over-collateralize the said amount in the form of other digital assets. Borrowing more capital in the form of [stablecoins](#) or protocol tokens to farm or stake tokens is an effective method to earn additional income.

Where Does DeFi Stand as Compared to TradFi markets?

DeFi protocols have remarkably contributed to the overall crypto markets in the past few years. The TVL (Total Value Locked) of DeFi was less than USD 20 billion at the start of 2020 and currently sits at over USD 209 billion in TVL at the time of writing (DeFi Llama, 2022). The TradFi services market is [expected to grow to \\$28.5 Trillion by 2025](#) and is



Why Are Interest Rates So High in DeFi?

Similar to how a user can deposit funds into a TradFi savings account to accrue interest, crypto holders can do the same while receiving interest rates that are significantly greater than the TradFi space, which leads to an attractive way to generate passive income. TradFi interest rates usually range from 0-3% depending on the amount deposited, but DeFi can provide you with higher rates of interest, varying from 5-10%, which is possible due to the elimination of intermediaries.

[Curve \(CRV\)](#), [Maker DAO \(MKR\)](#), and [Lido \(LDO\)](#) are currently the three biggest protocols with a combined TVL (Total Value Locked) of over [USD 53 billion](#).

Collateralization in DeFi Borrowing

As most DeFi lending applications do not require traditional credit and background checks, potential borrowers are required to over-collateralize their loan to hold them accountable for repaying the debt. Over-collateralization means that the collateral value will exceed the loan value. This requirement helps mitigate risk.

Possible Risks in DeFi Borrowing

Borrowing from protocols can often be risky as the loan-to-value ratio (LTV) needs to be cautiously monitored to ensure that the collateral requirement which was previously agreed upon is steadily maintained. Due to the volatile nature of crypto assets, the posted collateral is constantly subjected to price fluctuations. Volatility leads to the problem of loan liquidations as borrowers are often not protected against these circumstances by loan insurance.

Centralized Lending in DeFi

Many centralized crypto companies can provide stable returns on crypto assets. Users who interact with these centralized exchanges have to go through verification and KYC compliance. Stable returns are guaranteed as the exchanges set them instead of relying on supply and demand, which are affected by market conditions.

Tools You Can Use to Navigate DeFi

Due to the ever-changing and fast-paced nature of the DeFi space, users interact with a range of platforms, protocols, and assets. It can be overwhelming when new users first





- Crypto Twitter (CT) is a great place for users to interact with DeFi builders, traders, investors, and more.
- [CoinMarketCap](#) and [CoinGecko](#) provide up-to-date prices, charts, and watchlist features.
- Wallets such as [Metamask](#) and [Coinbase](#) help you hold your assets (Wallets can be Custodial and Non-Custodial).
- [Brave Browser](#) is a web browser extension that helps you provide you with data privacy.
- [DeFi Pulse](#) is a great resource for keeping track of rankings, TVL (Total Value Locked), analytics, and data on various DeFi protocols.
- There are a ton of great DeFi Dashboards, such as Zapper.Fi, Zerion, Debank, and [Harvest](#) help you track your Profit/Loss of assets, liquidity investments, and lending/borrowing transactions.

We at Treehouse Finance make sense of transactions and public blockchains to provide you with the most meaningful and comprehensive insights to power and support your next move.

Future Outlook

The heights that the DeFi space has ascended to would not have been thought possible just a couple of years ago. Still, despite the waves it has created on the financial industry as a whole, the system and processes in place do not come without some drawdowns, which can be instrumental in either propelling or halting the rapid progress of this space.

Overcollateralization of loans is an aspect that needs to be addressed, as demands for loans fall as numbers of lenders increase and borrowers decrease. Underutilization of assets in regard to lending also contributes to the problem of limited interoperability. While trying to attract more interest and drive more attention to this space, it is also essential that users actively operate across chains with minimal complications while performing actions such as token transfers. Collaboration and simplification of the current process will be pivotal to better user experience and accessibility.

There are also many technical, regulatory, and asset risks that need to be cleared before the gap can be bridged to TradFi. Having taken into account current and future risks and use-cases, DeFi seems to be poised to take off to start competing with TradFi.

New to DeFi? If you found this useful, check out our other [Learn DeFi](#) articles to dive deeper into the wonderful world of DeFi! Alternatively, browse our [Insights](#) section to read more in-depth analyses on the DeFi space. You can also try out our flagship product, [Harvest](#), to get a comprehensive analysis of your DeFi assets. Lastly, subscribe to newsletter updates in the box below!

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