

## Lesson 21: DeFi Fundamentals

### Module 2: Blockchain Fundamentals

Digital Finance

# DeFi: Decentralized Finance Revolution

## Traditional Finance (TradFi):

- Banks, brokers, exchanges
- Intermediaries control access
- Centralized custody
- Limited hours, geographic restrictions
- KYC/AML required

## DeFi:

- Smart contracts replace intermediaries
- Permissionless access (anyone with wallet)
- Self-custody
- 24/7 global access
- Pseudonymous (no KYC)

charts/lesson\_21/tradfi\_vs\_defi.pdf

`charts/lesson_21/defi_stack.pdf`

# Decentralized Exchanges (DEXs): The Problem

## Centralized Exchanges (CEXs):

- Order book model
- Custodial (exchange holds funds)
- Counterparty risk (FTX collapse)
- KYC requirements
- Single point of failure

## Challenges for DEX:

- On-chain order book too expensive
- Liquidity fragmentation
- Constant price updates

charts/lesson\_21/orderbook\_gas\_costs.pdf

[charts/lesson\\_21/amm\\_concept.pdf](#)

## Constant Product Formula: $x \times y = k$

### Uniswap V2 Model:

$$x \times y = k$$

where  $x$  = reserve of token A,  $y$  = reserve of token B,  $k$  = constant

**Example:** ETH/USDC pool with 100 ETH and 200,000 USDC

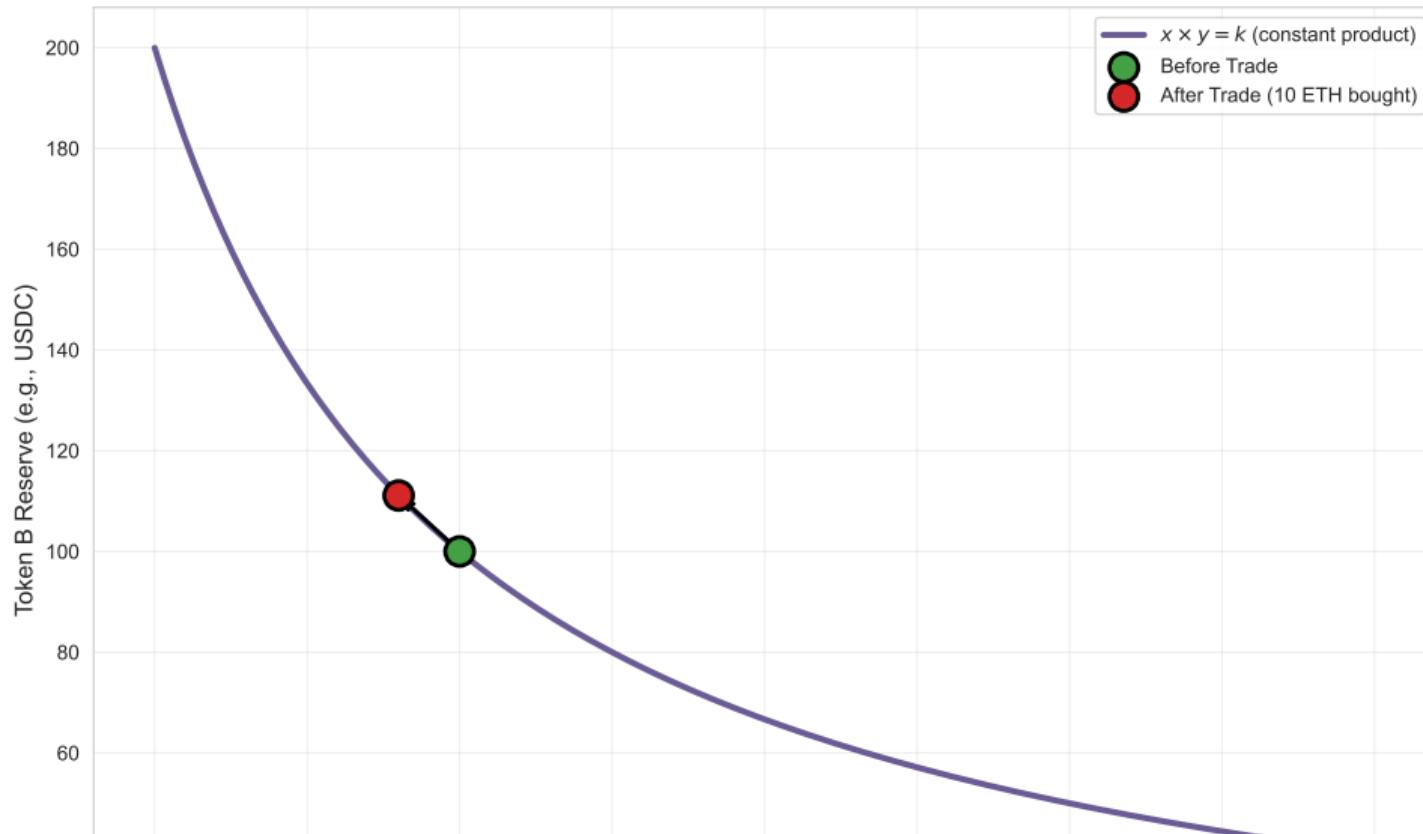
$$k = 100 \times 200,000 = 20,000,000$$

**Trade:** Buy 10 ETH

- New ETH reserve:  $x' = 100 - 10 = 90$
- New USDC reserve:  $y' = k/x' = 20,000,000/90 = 222,222$
- USDC paid:  $222,222 - 200,000 = 22,222$  (effective price  $\sim \$2,222/\text{ETH}$ )

# AMM Bonding Curve Visualization

Automated Market Maker: Constant Product Curve



# Price Impact and Slippage

## Price Impact:

- How much your trade moves the price
- Larger trade → worse price
- Function of trade size relative to pool depth

## Slippage:

- Difference between expected and executed price
- Set slippage tolerance (e.g., 0.5%)
- Trade reverts if exceeded

charts/lesson\_21/slippage\_curve.pdf

# Liquidity Providers: Earning Fees

## How it Works:

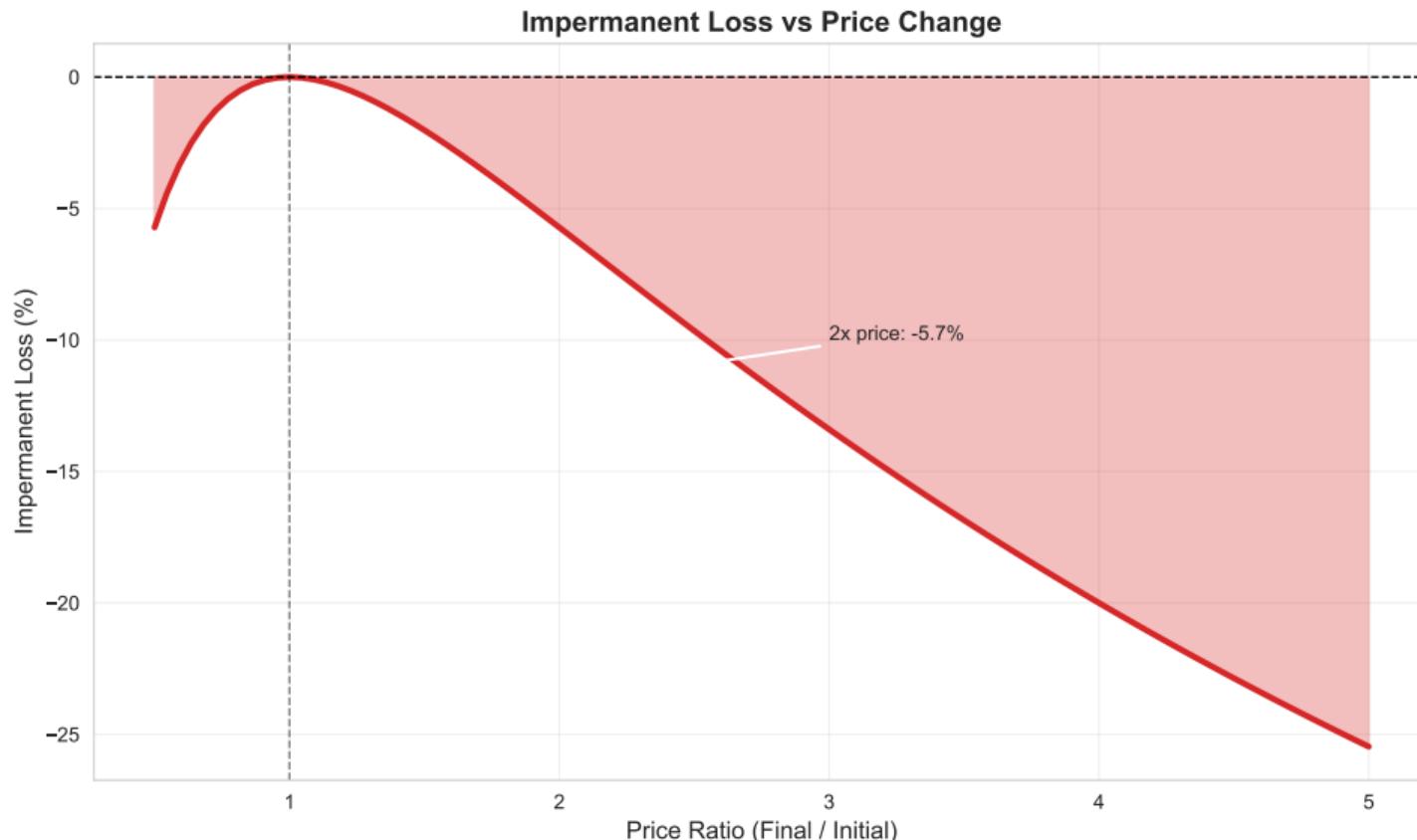
- ① Deposit equal value of both tokens
- ② Receive LP tokens (claim on pool share)
- ③ Earn 0.3% of all trades (Uniswap V2)
- ④ Withdraw anytime (burn LP tokens)

## Example:

- Pool: 1,000 ETH + 2M USDC
- You deposit: 10 ETH + 20K USDC (1%)
- Daily volume: 500K USDC
- Your daily fees:  $500,000 \times 0.003 \times 0.01 = \$15$

[charts/lesson\\_21/liquidity\\_provision.pdf](#)

# Impermanent Loss: The Hidden Cost



Definition: Loss compared to holding tokens vs providing liquidity

**Exact Formula:**

$$IL = \frac{2\sqrt{r}}{1+r} - 1$$

where  $r$  = price ratio change (final price / initial price)

Price Change	Ratio ( $r$ )	Impermanent Loss
+25%	1.25	-0.6%
+50%	1.5	-2.0%
+100% (2x)	2.0	-5.7%
+400% (5x)	5.0	-25.5%
-50%	0.5	-5.7%

**Mitigation:** Fees earned over time can offset IL (especially in high-volume pairs)

# Uniswap V3: Concentrated Liquidity

## V2 Limitation:

- Liquidity spread across entire price range
- Capital inefficient
- Most liquidity never used

## V3 Innovation:

- Concentrated liquidity in price ranges
- LPs choose custom ranges
- Up to 4000x capital efficiency
- Active management required

charts/lesson\_21/uniswap\_v3\_ranges.pdf

## Lending Protocols: Aave and Compound

`charts/lesson_21/lending_protocol_architecture.pdf`

# Over-Collateralization Requirement

## Why Over-Collateralize?

- No credit checks (permissionless)
- Price volatility protection
- Liquidation buffer

## Example (Aave):

- Deposit: 10 ETH (\$20K)
- Max LTV: 80%
- Borrow: 16K USDC
- Liquidation threshold: 85%

charts/lesson\_21/collateral\_ratio.pdf

`charts/lesson_21/interest_rate_curve.pdf`

# Flash Loans: Zero-Collateral Instant Loans

## Concept:

- Borrow any amount
- No collateral required
- Must repay within same transaction
- If not repaid, entire transaction reverts

## Use Cases:

- Arbitrage (exploit price differences)
- Collateral swaps
- Liquidations
- Refinancing

[charts/lesson\\_21/flash\\_loan\\_flow.pdf](#)

# Flash Loan Attack Example

## Scenario: Exploit Price Oracle Manipulation (2020, bZx attack)

- ① Flash loan 10,000 ETH from dYdX
- ② Swap 5,000 ETH for WBTC on Uniswap (moves price)
- ③ Use manipulated WBTC price to borrow over-collateralized assets on bZx
- ④ Repay flash loan, keep profit
- ⑤ Exploit: \$350K profit

## Defense:

- Time-weighted average price (TWAP) oracles
- Multiple oracle sources (Chainlink)
- Borrow caps

**Note:** Flash loans are not inherently bad, but enable rapid exploitation of vulnerabilities

# Yield Farming: Chasing Returns

## Strategy:

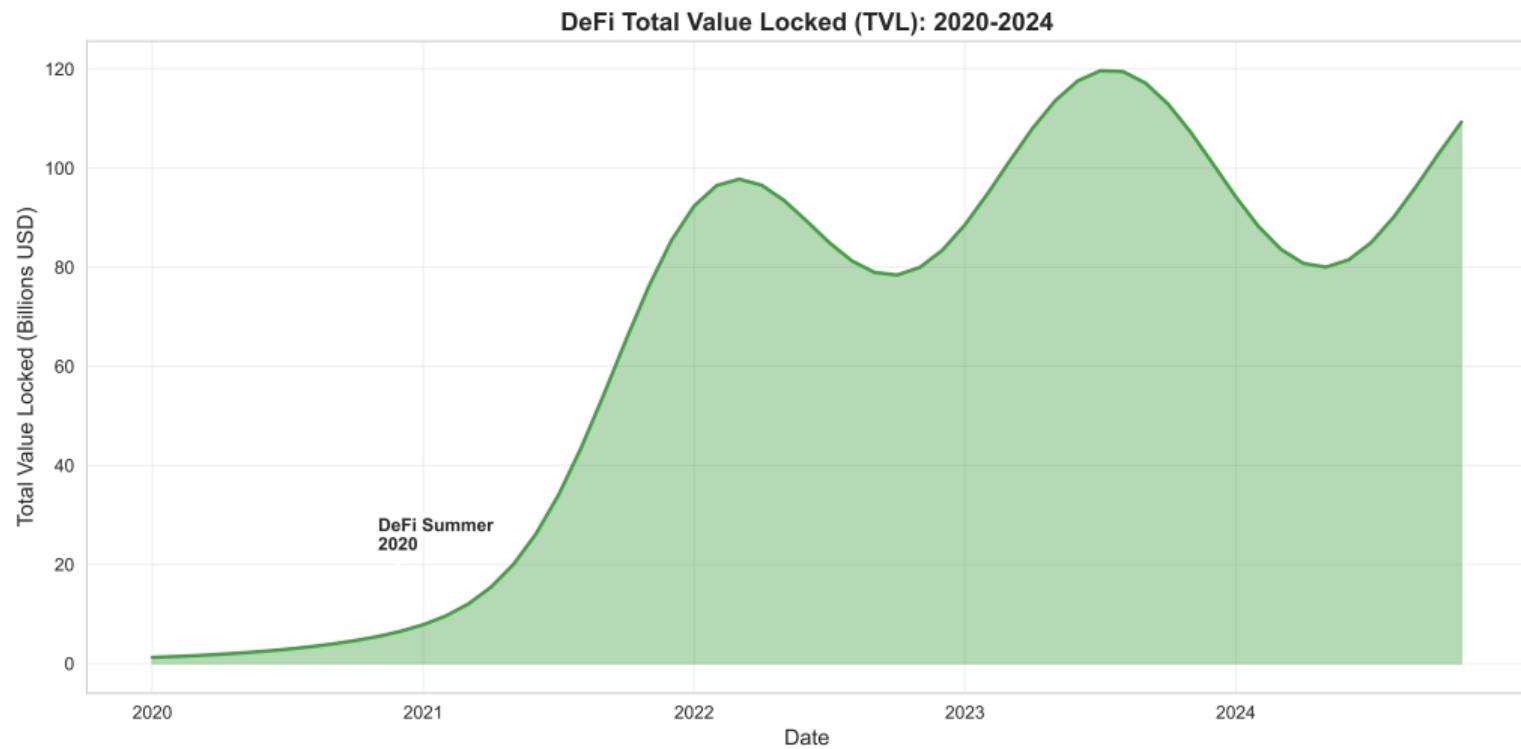
- Provide liquidity or lend assets
- Earn fees + protocol token rewards
- Compound yields (reinvest)
- Move capital to highest APY

## Yield Sources:

- Trading fees (0.3% on Uniswap)
- Borrow interest (Aave, Compound)
- Token incentives (governance tokens)
- Staking rewards

charts/lesson\_21/yield\_farming\_stack.pdf

# DeFi Summer 2020: Liquidity Mining Explosion



**Catalyst:** Compound launches COMP token distribution (June 2020)

**Result:**

- Total Value Locked (TVL): \$1B → \$100B+ (2021 peak)

- **Smart Contract Risk:** Bugs, exploits (e.g., The DAO, bZx)
- **Impermanent Loss:** Price divergence reduces LP returns
- **Oracle Manipulation:** Flash loan attacks on price feeds
- **Liquidation Risk:** Volatile collateral leads to forced sales
- **Rug Pulls:** Developers drain liquidity (unaudited projects)
- **Regulatory Risk:** Securities classification, AML/KYC future requirements
- **Composability Risk:** Cascading failures (one protocol exploited affects others)

**Mitigation:** Use audited protocols, diversify, understand risks, start small

## DeFi vs CeFi: Trade-offs

Aspect	DeFi	CeFi
Custody	Self-custody (your keys)	Custodial (exchange holds)
Access	Permissionless (anyone)	KYC/AML required
Transparency	Open-source, on-chain	Opaque (trust exchange)
Execution	Slower (block time), higher fees	Instant, low fees
Risk	Smart contract risk	Counterparty risk (FTX)
Liquidity	Fragmented across DEXs	Concentrated on CEX

- **DeFi:** Permissionless financial services via smart contracts
- **AMMs:** Constant product formula ( $x \times y = k$ ), liquidity pools replace order books
- **Impermanent Loss:** LPs lose vs holding when prices diverge
- **Lending:** Over-collateralized loans, algorithmic interest rates, liquidations
- **Flash Loans:** Uncollateralized loans repaid in same transaction
- **Risks:** Smart contract bugs, IL, oracle manipulation, liquidations

**Next Lesson:** Stablecoins and Terra/Luna collapse case study