

# The Rise of Decentralized Finance (DeFi): Challenging Traditional Banking Models and Regulatory Frameworks

Decentralized Finance (DeFi) represents one of the most significant disruptions to the traditional financial system in decades, leveraging blockchain technology to reimagine how financial services are developed, delivered, and accessed. This rapidly evolving ecosystem has grown from a niche concept to a multi-billion dollar market segment, challenging long-established banking paradigms and regulatory approaches across the globe. DeFi's promise of greater accessibility, efficiency, and transparency contrasts sharply with traditional banking models, creating both opportunities and challenges for various stakeholders in the financial ecosystem. The following report examines DeFi's emergence, its fundamental mechanisms, how it challenges conventional banking, and the complex regulatory considerations it presents.

## Understanding Decentralized Finance: Foundations and Evolution

Decentralized Finance, commonly known as DeFi, represents a paradigm shift in financial services delivery, operating as an umbrella term for peer-to-peer financial services built on public blockchains, primarily Ethereum. At its core, DeFi enables users to engage in traditional financial activities—earning interest, borrowing, lending, trading assets, purchasing insurance, and more—without relying on centralized intermediaries such as banks or financial institutions<sup>[1]</sup>. This financial ecosystem functions through smart contracts, which are self-executing agreements with terms directly written into code lines, automating financial arrangements without intermediaries and ensuring adherence to predetermined rules<sup>[2] [3]</sup>. The decentralized nature of DeFi provides several inherent advantages over traditional finance, including faster execution, reduced paperwork, global accessibility, pseudonymous transactions, and open participation without discriminatory barriers<sup>[1]</sup>.

The development of DeFi has followed an evolutionary path that can be conceptualized in four distinct phases. While Bitcoin in 2009 provided the first blockchain-based peer-to-peer digital money system, DeFi's true inception occurred in December 2017 with the launch of MakerDAO, marking a turning point for blockchain-based financial applications<sup>[4] [5]</sup>. The first phase represented a "Big Bang" where entrepreneurs recognized that traditional financial products could be implemented on blockchains, though these initial efforts served primarily as proof-of-concept protocols<sup>[5]</sup>. The second phase saw the development of crypto-native financial products that leveraged decentralization as an advantage rather than a liability, similar to how companies like Yahoo! and Netscape created native applications for web users in the 1990s<sup>[5]</sup>. The third phase marked a return to traditional products but with exponential advantages gained through decentralization, while the speculative fourth phase anticipates revolutionary financial concepts and products that remain difficult to imagine at present<sup>[5]</sup>.

## The Current DeFi Landscape

DeFi has experienced remarkable growth since its early days, developing into a substantial market despite periodic fluctuations. The global decentralized finance market was estimated at USD 20.48 billion in 2024 and is projected to grow at a compound annual growth rate (CAGR) of 53.7% from 2025 to 2030, potentially reaching USD 231.19 billion by the end of the decade<sup>[6]</sup>. This explosive growth trajectory reflects increasing adoption across various sectors and geographies, with North America currently dominating the market with a 36.32% share in 2024<sup>[6]</sup>. The total value locked (TVL) in DeFi protocols has increased by an astounding 6,900% since 2020, demonstrating the rapidly growing confidence in these systems despite experiencing a 76% drop throughout the challenging market conditions of 2022<sup>[7]</sup>. Unique DeFi users have risen by 40% in 2022 alone, growing from 4.7 million at the start of the year to more than 6.5 million, representing a nearly 700% increase over a two-year period from the 940,000 users at the start of 2021<sup>[7]</sup>.

The DeFi ecosystem encompasses a diverse array of platforms and protocols, each specializing in different financial services and applications. Leading lending platforms like Aave have accumulated approximately \$5.49 billion in total value locked (TVL), offering borrowing and lending services with innovative features such as flash loans that allow users to borrow without collateral as long as repayment occurs within a single transaction<sup>[8] [9]</sup>. Decentralized exchanges (DEXs) like Uniswap have captured \$3.31 billion in TVL, facilitating token exchanges and providing liquidity without traditional intermediaries<sup>[8]</sup>. Staking services like Lido lead the ecosystem with \$16.36 billion TVL, allowing users to participate in network validation while maintaining liquidity<sup>[8]</sup>. Other significant protocols include Compound, which utilizes an autonomous interest rate system adjusting based on supply and demand dynamics; Curve, which specializes in stablecoin exchanges; and specialized platforms like dYdX for derivative trading<sup>[8] [9]</sup>. This diverse ecosystem continues to evolve rapidly with innovations in cross-chain interoperability, layer-2 scaling solutions, and novel governance mechanisms enhancing functionality and user experience<sup>[9]</sup>.

## The Traditional Banking Model: Structure and Limitations

Traditional banking operates on a fundamentally different model than DeFi, serving as intermediaries between depositors and borrowers while maintaining centralized control over financial services. The traditional banking landscape is characterized by established institutions with physical branch networks, recognized brand identities, comprehensive service offerings, strict regulatory oversight, and an emphasis on building long-term customer relationships<sup>[10]</sup>. These institutions function by accepting deposits from customers and using that capital to make loans such as mortgages, auto loans, business loans, and personal loans, profiting from the interest rate spread—charging higher interest to borrowers than they pay to depositors<sup>[11]</sup>. This intermediary role has been the cornerstone of banking for centuries, with banks adding layers of services and products over time while maintaining the same fundamental business model.

The revenue structure of traditional banks relies primarily on two streams: interest income derived from loans and fee-based income from various charges imposed on customers. Banks typically offer minimal interest rates on deposits (such as 0.25% on savings accounts) while charging substantially higher rates to borrowers (such as 4.75% on mortgages), creating a

profitable spread that forms the foundation of their business model<sup>[11]</sup>. Additionally, banks generate significant revenue through various fees, including account maintenance charges, minimum balance fees, overdraft penalties, ATM usage costs, and transfer fees<sup>[11] [10]</sup>. These fee structures can be substantial—for cross-border payments, banks typically charge \$15-30 per transaction in base processing fees, with currency conversion markups sometimes comprising up to 80% of the total transaction cost<sup>[12]</sup>. The combination of interest spreads and fee income has created a highly profitable model for banks that has proven resilient despite technological changes and economic fluctuations.

Despite their established position, traditional banking systems exhibit several significant inefficiencies and limitations that create opportunities for disruption. Cross-border payments exemplify these inefficiencies, typically requiring three to five days to settle while costing up to 10% of the transaction value in fees, creating substantial barriers to international trade and economic growth, particularly in developing countries<sup>[13]</sup>. Financial inclusion represents another major challenge, with approximately 1.7 billion adults worldwide lacking access to banking services, often citing prohibitive costs as a primary barrier<sup>[13]</sup>. The operational structure of banks creates additional inefficiencies—the concentration of power (with the five largest U.S. banks controlling 45% of banking assets) leads to concerns about systemic risks and market distortions<sup>[13]</sup>. Furthermore, traditional financial institutions rely on legacy technology systems that limit innovation capacity, creating friction in service delivery and adaptation to changing consumer expectations<sup>[10]</sup>. These limitations collectively highlight the structural constraints that have created openings for alternative financial models to emerge.

## **How DeFi Challenges Traditional Banking**

Decentralized Finance fundamentally challenges the intermediary role that defines traditional banking by eliminating the need for centralized institutions in financial transactions. Unlike traditional banks that position themselves between savers and borrowers, DeFi platforms utilize blockchain technology and smart contracts to enable direct peer-to-peer interactions, removing intermediaries entirely from the equation<sup>[14] [3]</sup>. This disintermediation represents a profound paradigm shift—while traditional banks leverage customer deposits to fund lending activities and profit from the spread, DeFi platforms connect borrowers and lenders directly through automated protocols that execute transparently according to predetermined rules encoded in smart contracts<sup>[14]</sup>. The elimination of intermediaries drastically reduces operational costs and overhead, allowing for more efficient capital allocation and potentially higher returns for participants on both sides of financial transactions.

The efficiency advantages of DeFi over traditional banking manifest in multiple dimensions, particularly regarding transaction speed and cost structures. While traditional cross-border transfers may take days to settle and incur substantial fees, DeFi platforms like Stellar and Ripple enable near-instantaneous remittances at a fraction of the cost, operating independently of correspondent banking relationships that typically slow such transactions<sup>[3]</sup>. Traditional banking's fee-based revenue model—with complex charges for account maintenance, transfers, and currency conversions—contrasts sharply with DeFi's significantly lower cost structure achieved through automation and disintermediation<sup>[13] [12]</sup>. American merchants, for instance, pay average interchange fees of 1.76% compared to 0.96% in most European nations, illustrating the substantial costs embedded in traditional payment systems that DeFi aims to

reduce<sup>[15]</sup>. The elimination of multiple intermediaries in transaction chains creates considerable cost savings that benefit end users, particularly for cross-border transactions where traditional systems involve numerous parties each applying their own fees.

DeFi's open architecture promotes financial inclusion and accessibility that contrasts sharply with traditional banking's more restrictive approach. While traditional financial systems have left 1.7 billion adults globally without banking access due to geographic, economic, or identification barriers, DeFi platforms require only an internet connection to participate, dramatically lowering entry barriers<sup>[13]</sup>. DeFi services operate 24/7 globally, eliminating geographical restrictions and time zone limitations that constrain traditional banking hours<sup>[1]</sup>. The pseudonymous nature of many DeFi platforms enables participation without extensive identity verification procedures that often exclude individuals lacking formal documentation, creating opportunities for financial services in underbanked regions<sup>[1]</sup>. Additionally, DeFi platforms typically lack minimum balance requirements or credit score assessment that commonly restrict access to traditional financial services, making them particularly valuable for populations historically excluded from conventional banking systems.

## **Key DeFi Innovations Disrupting Banking Functions**

DeFi has introduced innovative alternatives to core banking functions, most notably in lending and borrowing mechanisms that operate without traditional credit assessment processes. Platforms like Aave and Compound have developed lending protocols that enable users to deposit cryptocurrencies as collateral and borrow against them, or lend their assets to earn interest, with rates determined algorithmically based on supply and demand dynamics rather than centralized decision-making<sup>[2] [9]</sup>. Unlike traditional loans that require extensive documentation, credit history checks, and days or weeks for approval, DeFi lending offers instant liquidity with loan terms executed automatically through smart contracts<sup>[3]</sup>. This over-collateralized lending model mitigates default risk through automatic liquidation procedures when collateral values fall below specified thresholds, creating a self-regulating system that functions without human intervention<sup>[2]</sup>.

The exchange of assets—traditionally facilitated by banks and brokerages—has been revolutionized by decentralized exchanges (DEXs) that enable direct trading without intermediaries. Platforms like Uniswap and SushiSwap utilize automated market maker (AMM) models that replace traditional order books with liquidity pools, allowing users to trade directly against cryptographically-secured reserves<sup>[8] [9]</sup>. SushiSwap additionally offers yield farming features that enable users to supply liquidity to various pools and receive SUSHI tokens as rewards, providing incentives for participation and liquidity provision<sup>[8]</sup>. The elimination of centralized gatekeepers democratizes trading by removing discriminatory access barriers while providing continuous 24/7 operation without the time constraints of traditional exchanges<sup>[1]</sup>. These technological innovations have created more efficient asset exchange mechanisms with reduced counterparty risk and enhanced accessibility compared to conventional financial systems.

DeFi platforms have reimagined payment systems in ways that challenge traditional banking's dominance in money transmission and settlement. DeFi payment gateways utilize blockchain technologies to enable businesses to accept cryptocurrency payments directly, bypassing

intermediaries and their associated costs while using smart contracts to automate payment processes and ensure faster transaction speeds, reduced fees, and increased transparency<sup>[14]</sup>. Cross-border payments particularly highlight the contrast between systems—while traditional international transfers typically require correspondent banking relationships with multiple intermediaries each applying fees, DeFi platforms enable direct cross-border value transfer in near real-time with minimal cost<sup>[13] [3]</sup>. Stablecoin-based payment channels, coupled with Layer-2 scaling solutions, further enhance this capability by providing the stability of traditional currencies combined with the efficiency of blockchain networks, enabling faster, cheaper, and more transparent cross-border settlements than possible through conventional banking channels<sup>[14]</sup>.

## **Regulatory Challenges and Responses**

The rise of DeFi presents profound regulatory challenges that stem primarily from its decentralized architecture, which fundamentally conflicts with existing regulatory frameworks designed for centralized financial institutions. Traditional financial regulation operates on an "entity-centric" model, targeting identifiable institutions with physical presence requirements, licensing obligations, and accountability mechanisms that become difficult to apply in DeFi's distributed environment<sup>[16]</sup>. The difficulty in identifying accountable entities for enforcement creates significant regulatory complications—when financial services operate through autonomous smart contracts without clear ownership or control, determining liability becomes exceptionally challenging<sup>[16] [17]</sup>. This accountability gap represents perhaps the most fundamental regulatory challenge posed by DeFi, as enforcement actions typically require identifiable targets, which DeFi's architecture often obscures. The U.S. Treasury has noted that many DeFi services claiming to be "fully decentralized" may still qualify as financial institutions under the Bank Secrecy Act but fail to comply with AML/CFT obligations, creating vulnerabilities that illicit actors can exploit<sup>[17]</sup>.

Regulatory approaches to DeFi vary significantly across jurisdictions, reflecting different philosophical approaches to innovation and consumer protection. In the United States, agencies have primarily pursued regulation through enforcement, as evidenced by the Commodity Futures Trading Commission (CFTC) recently settling enforcement actions against operators of three DeFi protocols for violations of the Commodity Exchange Act<sup>[18]</sup>. The European Union has developed the Markets in Crypto-Assets (MiCA) regulation, which adopts a technology-neutral approach ("same risks, same rules") but faces implementation challenges regarding how to apply entity-centric provisions to decentralized systems<sup>[16]</sup>. Asia-Pacific jurisdictions display widely varying approaches—Singapore requires DeFi platforms to register with the Monetary Authority of Singapore (MAS) and comply with AML/KYC regulations, while China has banned all DeFi activities outright<sup>[19]</sup>. These divergent approaches create a fragmented global regulatory landscape that complicates compliance for DeFi projects operating across borders.

## **Emerging Regulatory Solutions**

Innovative regulatory approaches are beginning to emerge that seek to balance innovation protection with consumer safeguards in the DeFi ecosystem. The Bermuda Monetary Authority recently launched a groundbreaking initiative exploring "embedded supervision" within DeFi, aiming to integrate regulatory oversight directly into blockchain-based financial ecosystems

through automation<sup>[20]</sup>. This approach envisions regulatory decentralized autonomous organizations (DAOs), smart contract compliance mechanisms, and real-time automated reporting to enable effective oversight without compromising the benefits of decentralization<sup>[20]</sup>. The initiative acknowledges DeFi's unique regulatory challenges, including decentralization complexity, KYC/AML implementation difficulties, global operations, and rapid innovation cycles, while seeking creative solutions to address these issues through technology rather than traditional regulatory mechanisms<sup>[20]</sup>.

Decentralized compliance solutions are developing in parallel with regulatory frameworks, offering technical approaches to meeting regulatory requirements within DeFi architectures. Self-sovereign identity (SSI) solutions enable users to maintain control of their digital identities without centralized authorities, facilitating privacy-preserving KYC processes where users can share verifiable credentials without disclosing sensitive information<sup>[21]</sup>. Zero-knowledge proofs (ZKPs) similarly allow individuals to prove identity or asset ownership without revealing underlying data, offering powerful tools for satisfying KYC and AML requirements while preserving privacy<sup>[21]</sup>. Blockchain analytics tools further enhance compliance capabilities by tracing transactions across networks to identify patterns indicative of money laundering or other illicit activities, while decentralized oracle networks provide access to external compliance data such as sanctions lists<sup>[21]</sup>. These technological approaches to compliance may bridge the gap between traditional regulatory requirements and DeFi's decentralized architecture.

The regulatory future of DeFi will likely involve balance between innovation protection and appropriate oversight, requiring collaboration between industry and regulators. The Financial Action Task Force (FATF) has acknowledged that under global standards, DeFi services lacking an entity with sufficient control or influence may not be explicitly subject to AML/CFT obligations, potentially creating regulatory gaps<sup>[17]</sup>. This recognition has prompted recommendations to enhance regulatory frameworks by closing identified gaps in definitions that allow certain DeFi services to fall outside existing regulatory perimeters<sup>[17]</sup>. Industry self-regulation presents another potential approach, with community-driven initiatives emerging to develop standards for responsible DeFi practices that could complement official regulatory frameworks<sup>[21]</sup>. The evolution of DeFi regulation will require nuanced approaches that recognize the fundamental differences between centralized and decentralized finance while ensuring adequate consumer protection, market integrity, and financial stability.

## **Traditional Banking Responses to the DeFi Challenge**

Traditional financial institutions are developing multiple strategic responses to the competitive threat posed by DeFi's disintermediation of core banking functions. Many established banks have recognized blockchain technology's potential and are exploring integration into existing systems to enhance efficiency, transparency, and security<sup>[22]</sup>. JPMorgan exemplifies this approach through its blockchain initiative Onyx, which has developed JPM Coin to facilitate instant cross-border payments and settlement processes<sup>[22]</sup>. Other institutions are building partnerships with DeFi platforms to expand their service offerings, enabling customers to access innovative financial products like high-yield savings, crypto-backed loans, and decentralized trading options without requiring the banks to develop these technologies from scratch<sup>[22]</sup>. These collaborative approaches allow traditional institutions to leverage DeFi innovations while

providing a bridge between conventional finance and decentralized systems that eases customer transition between these ecosystems.

The development of hybrid financial products that combine traditional banking elements with DeFi capabilities represents another significant response strategy. These hybrid offerings aim to harness decentralization's efficiency and transparency advantages while maintaining the customer experience, regulatory compliance, and security associations that traditional institutions have cultivated over decades<sup>[22]</sup>. Goldman Sachs exemplifies this approach by offering investment products linked to digital assets, entering the crypto and DeFi space through Bitcoin futures trading and providing institutional clients access to crypto investment funds<sup>[22]</sup>. Payment networks like Visa have similarly embraced hybrid approaches by partnering with crypto platforms like Circle and integrating stablecoins (USDC) into their payment networks, enabling businesses to settle payments directly with digital currencies<sup>[22]</sup>. These adaptations reflect traditional institutions' recognition that incorporating DeFi elements may be necessary for long-term competitive viability in an evolving financial landscape.

Traditional financial institutions face substantial challenges in adapting to the DeFi paradigm that extend beyond technological implementation. Regulatory compliance represents a primary hurdle, as banks must navigate complex regulatory landscapes surrounding DeFi while maintaining compliance with strict guidelines regarding Anti-Money Laundering (AML), Know Your Customer (KYC) processes, and securities laws that don't always align with decentralized systems<sup>[22]</sup>. Cultural and technological resistance within traditional institutions creates additional friction, as legacy systems are often ill-equipped to handle DeFi's rapid innovation cycles, while employees and stakeholders accustomed to centralized hierarchical structures may resist transitions to decentralized models<sup>[22]</sup>. Security concerns and risk management complexities further complicate adaptation efforts, as DeFi's nascent stage has witnessed numerous hacks and exploits that make traditional institutions wary of exposing clients to potential losses in environments lacking established consumer protection mechanisms<sup>[22]</sup>.

## **Future Outlook and Implications**

The future relationship between DeFi and traditional banking will likely involve both competition and convergence, with each model influencing the other's evolution. DeFi protocols will continue driving innovation in financial services through rapid experimentation and iteration, forcing traditional institutions to adapt or risk disintermediation in key business segments. The competitive pressure from DeFi may accelerate technological modernization in traditional banking, compelling institutions to improve efficiency, reduce fees, and enhance user experiences to remain competitive<sup>[14] [3]</sup>. Simultaneously, traditional banking's emphasis on regulatory compliance, security, and customer service may influence DeFi's development trajectory, particularly as the sector matures and seeks broader mainstream adoption<sup>[22]</sup>. This mutual influence will likely produce a financial ecosystem where centralized and decentralized models coexist, serving different market segments and use cases while borrowing beneficial features from each other.

Regulatory frameworks will continue evolving to accommodate DeFi's unique characteristics while ensuring adequate market protections. The current fragmented regulatory landscape will likely consolidate toward more consistent international approaches as global standard-setting

bodies like the Financial Action Task Force develop specialized frameworks for decentralized systems<sup>[17]</sup>. Technology-embedded regulation ("embedded supervision") may emerge as a dominant paradigm, with regulatory compliance built directly into blockchain protocols and smart contracts rather than imposed externally<sup>[20]</sup>. This evolution would represent a fundamental shift in regulatory philosophy from entity-based supervision to activity-based oversight, potentially creating more effective and efficient regulatory mechanisms for decentralized systems. The development of these regulatory frameworks will significantly influence DeFi's growth trajectory and mainstream adoption potential in coming years.

The long-term implications of DeFi for global financial inclusion and economic development appear promising but remain dependent on several evolving factors. DeFi's ability to provide financial services to the 1.7 billion unbanked adults globally could substantially reduce financial exclusion and promote economic development in underserved regions<sup>[13]</sup>. The reduction of intermediary costs in cross-border transactions could similarly stimulate international trade and remittance flows, particularly benefiting developing economies where traditional banking services remain expensive and inaccessible<sup>[13]</sup> <sup>[12]</sup>. However, realizing these benefits requires addressing significant barriers including internet access limitations, cryptocurrency volatility concerns, user experience complexities, and regulatory uncertainties that currently restrict mainstream adoption<sup>[14]</sup>. The evolution of layer-2 scaling solutions, user interface improvements, and regulatory clarity will collectively determine whether DeFi fulfills its potential for democratizing financial access or remains primarily confined to tech-savvy early adopters in developed economies.

## **Conclusion**

Decentralized Finance represents a paradigm shift in financial services delivery that fundamentally challenges traditional banking models through disintermediation, enhanced efficiency, and expanded accessibility. DeFi's elimination of centralized intermediaries through blockchain technology and smart contracts has created an alternative financial ecosystem capable of providing core banking functions—lending, borrowing, trading, and payments—without the structural limitations and costs associated with traditional institutions. The rapid growth of this sector, from approximately \$1 billion in early 2020 to projected values exceeding \$230 billion by 2030, demonstrates both the market demand for these innovations and their disruptive potential for conventional financial systems.

The contrast between DeFi and traditional banking extends across multiple dimensions: transaction speed, cost structures, accessibility requirements, operating hours, and governance models. Where traditional cross-border transfers require days and substantial fees, DeFi enables near-instantaneous global value transfer at minimal cost. Traditional banking's reliance on credit scores and identification documentation creates significant barriers to financial inclusion, while DeFi requires only internet access and cryptocurrency holdings to participate. Traditional institutions operate during limited hours with centralized decision-making processes, while DeFi functions continuously with community governance through token-based voting systems. These fundamental differences highlight why DeFi represents more than incremental improvement—it constitutes a reinvention of financial service delivery.



The regulatory challenges posed by DeFi's decentralized architecture necessitate innovative supervision approaches that balance innovation protection with appropriate oversight. Traditional regulatory frameworks designed for centralized entities struggle to address systems without clear accountability structures, operating across jurisdictional boundaries with minimal intermediation. The emerging solutions—embedded supervision, technology-enabled compliance, and self-regulation initiatives—represent promising directions for effective oversight without compromising DeFi's core benefits. Traditional financial institutions meanwhile are responding through blockchain integration, strategic partnerships, and hybrid offerings that incorporate DeFi elements within conventional banking frameworks. As these parallel developments unfold, the financial system appears headed toward a synthesis incorporating both centralized and decentralized elements, potentially delivering greater efficiency, inclusivity, and resilience than either model could achieve independently.



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