On this day, not only the crypto market suffered this downward cascade, but DeFi particularly failed and suffered. Maker, the largest DeFi protocol and the foundation on which much of the rest of DeFi is built, nearly imploded. As a result of crypto markets crashing, many Collateralized Debt Positions (smart contracts holding the collateral) were liquidated, but as the Ethereum network congested, many liquidation transactions were not included in blocks. Therefore, as far as the Maker protocol was concerned, no one was bidding in the collateral auctions. Someone realized that by just increasing transaction prices, she would be the only auction participant, and could therefore bid as low as 0 USD for the collateralized Ether. So in a Maker auction she bid $0 for $8M worth of ETH collateral (paying an unusually high transaction fee), and got it.

Additionally, the software that powers the Maker oracles was not configured to run in a highly congested network. Many of the oracles simply stopped sending prices to the Maker contracts. Had the oracles conveyed that the Ether price had dipped down to $88 around 7pm on the 12th, many more of these collateral debt positions holding the Ether would have been liquidated, and Maker could have become insolvent, with dramatic consequences on the stability of »stablecoin« DAI and other DeFi protocols, including Compound or Lendf.me that use DAI as collateral for loans. As such, the interdependencies between DeFi protocols, and particularly the current reliance on the DAI stablecoin, represent a potential systemic risk for the whole DeFi space.

As of today, the Ethereum network as well as arbitrageurs and liquidity providers in the crypto space are not yet able to provide global-scale capital markets activity and liquidity. A potential remedy for future liquidity shocks could be the Ethereum 2.0 Update that improves throughput and latency, or also more professional and powerful arbitrageurs and liquidity providers that have the necessary resources on all major crypto exchanges.[9]

Regulation risk

Decentralized projects operate without a license in most jurisdictions, regardless of where the end-user is based. With regards to taxation, the handling of DeFi assets is also not clearly outlined in most jurisdictions. Today, DeFi activity is about 1% of the total crypto market activity, which itself is tiny in comparison with global financial markets. In the same way that regulators around the world are currently addressing regulatory questions regarding crypto-assets – such as establishing new license regimes for crypto custody like in Germany[10] – DeFi assets and products will certainly fall under stronger regulatory scrutiny given that the user base and locked-in-assets will further grow. Financial regulation will necessarily require some kind of responsible counterpart, which makes a truly decentralized governance and decision making process for DeFi products not yet imaginable. The Libra association, renouncing to move towards a fully permissionless system in view of the political and regulatory pressure, seems to support this ideas.

9 ↗https://multicoin.capital/2020/03/20/march-12-the-day-crypto-market-structure-broke-part-2/

10 ↗https://www.coindesk.com/germanys-bafin-clarifies-licensing-process-for-foreign-crypto-custodians