A scenario in which DeFi projects are governed in a truly decentralized manner is currently difficult to imagine. How are compliance and regulatory requirements addressed by a decentralized form of governance? What if the majority of token holders in a decentralized decision making model simply don't vote for compliance updates or financial anti-money-laundering (AML) requirements? Both the regulator as well as the DeFi sector have yet to come up with viable and sustainable solutions in that regard. Since many DeFi supporters nowadays still refuse the idea of clear regulatory responsibilities in favour of concepts around security/compliance by design, we expect these incompatible perceptions of responsibility and regulation to further clash in the coming years.

Furthermore, most DeFi Apps currently rely on oracles, third party services that send and verify real world data and submit this information to smart contracts. Generally, the centralisation problem raises the following question: if you (today or in the future) rely in any way on third parties, then why not just rely on trusted and regulated third parties to manage your money, while also offering valuable things like a help number and recourse in case of erroneous transactions?

Future DeFi governance models as well as regulatory approaches will show whether DeFi will be able to overcome the central risk and challenge of (de-)centralization.

Liquidity risks

Liquidity is crucial for efficient pricing in the financial industry. Currently, liquidity in DeFi protocols is largely outpaced by central alternatives with many low-fee liquidity providers that stabilize traditional finance. The liquidity risk is closely related to technical risks, i.e. the aforementioned technical scalability and congestion issues on the Ethereum platform. In times of crisis, the Ethereum network (Bitcoin as well) becomes so congested that arbitrageurs and liquidity providers cannot keep prices in line across venues, causing massive dislocation on individual exchanges, which then triggers uncertainty and the markets to drop.

On Tuesday, March 12, crypto markets dropped nearly 40%, coinciding with a global stock market decline due to the Covid-19 virus. When volatility picks up and markets drop, a few things happen concurrently: liquidations in DeFi projects such as in Maker's smart contracts accelerate, arbitrageurs that don't have enough capital on each venue begin shuttling assets between the exchanges in order to arbitrage the price discrepancies, and demand for blockspace explodes upwards. Transaction fees on Ethereum skyrocket, and transactions don't get included in a block for minutes, or even hours.

At the same time, as prices collapse, miners start turning off their machines because mining revenues fall below the cost of electricity, which in turn further slows the rate at which new blocks are produced, increasing latency and decreasing aggregate throughput[8].

8   ↗https://multicoin.capital/2020/03/17/march-12-the-day-crypto-market-structure-broke/