The stablecoin MakerDao Dai only allows users to "borrow" from themselves instead of lending out cryptocurrencies to other people. This is why DeFi apps, such as Compound and dYdX, are gaining traction. They allow investors to lend out cryptocurrencies to other people, which competes with the traditional service of pooling risks provided by banks. Although the process is complicated, sophisticated investors are locking up Ether and other cryptographic assets in MakerDao smart contracts, "creating" Dai. That Dai is then sent to the Compound smart contract in order to lend out to borrowers and earn interest. Dai already accounts for double digit percentages of volume on the lending platforms Compound and dYdX.

In 2020, arbitrage between debt markets and staking markets will lead to a narrowing of the spread in crypto interest rates on lending and staking returns. Investors can borrow coins from low-interest decentralized lending platforms and lend them out on high-interest centralized lending platforms. Investors can also borrow 32 Ether for low rates on DeFi platforms and set up Ethereum nodes earn approximately 4 % per annum after the switch to proof of stake in Q1 of 2020. However, lending and staking have different liquidity profiles and risks. Different lending and staking applications require investors to locks up coins for varying periods of time. Centralized solutions have credit risk while decentralized solutions have technical risks, such as a bug in the smart contract code. Also, staking Ether requires technical expertise and nodes that are not online all of the time will be punished by Ethereum's slashing mechanism that will take ETH from the node's staked coins and kick out the validator from the network.

In fact, The Block is working on a LIBOR-type rate for decentralized finance called DIPOR.[15] In 2020, DIPOR is expected to provide a smart contract-based interest rate for each cryptocurrency, based on the volume-weighted interest rates for that cryptocurrency that are being offered on the various DeFi lending platforms.[16] The MakerDao governors that hold MKR tokens and decide when to increase and decrease the MakerDao Dai stability fee could use the DIPOR rate as benchmark. For example, if Dai is trading at $0.95 cents, this means that the supply of Dai on the market is too high relative to the demand. The governors could raise Dai's stability fee above the DIPOR rate in order to encourage users to borrow Dai from other lenders instead of opening up new Dai vaults that add more Dai into circulation.

The disadvantages of decentralized lending platforms include capital inefficiency, because trustless smart contracts require over-collateralization. DeFi lending suffers from the same trilemma as stablecoins discussed in the previous section. The average amount of collateral invested in MakerDao Dai vaults is currently 319.83 % and has been as high as 600 % during 2019. Development teams are working on a smart contract-based way to take collateral above the 150 % requirement and automatically invest that collateral in Compound so that the depositors of over-collateralized debt positions can earn interest on their deposits. This is referred to as "superfluid" liquid in the cryptocurrency space because the same collateral is pledged for multiple contracts. This development is expected to increase the interconnectivity of the decentralized finance applications and increase the overall systemic risk similar to rehypothecation and over-leveraged collateralized debt positions during the subprime mortgage crisis of 2008.

Conclusion

The DeFi movement in 2020 is expected to witness the emergence of new smart contract applications such as synthetic tracking of all financial assets, such as gold, shares, and bonds, via collateralized debt positions on Ethereum, staking of fractional amounts of cryptocurrencies with wallets that allow users to hold private keys, and decentralized credit ratings for pseudonymous accounts based on the user's repayment record and details of the loan, such as duration, amount, and interest rate. An exciting area that is expected to impact asset management is the "social trading" trend. Social trading apps like settle.finance and TokenSets allow asset managers to share the performance of their crypto portfolios on social media, and their followers can automatically execute the same trades that their asset manager makes while still controlling the private key to their funds.

Overall, DeFi applications that are simple to use and understand like stablecoins are expected to gain adoption by the broader market of non-crypto retails investors that live in countries with high inflation and capital controls, whereas DeFi applications that are difficult to use and understand like minting synths on Synthetix and total return swaps on UMA and Rainbow Network can be expected to gain adoption by large cryptocurrency holders and traditional hedge funds.

[15] The London Interbank Offered Rate (LIBOR) is the average interest rate that banks are willing to lend to other banks for in the London interbank market.
[16] https://www.theblockcrypto.com/genesis/19324/introducing-dipor-libor-for-open-finance