



Can decentralized finance offset the Wall Street losses due to coronavirus?

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We are all feeling the trickle-down of the short-term effect of coronavirus on Wall Street markets. But don't worry, decentralized finance — the closest thing crypto has to a global marketplace — is insulated from fiat-based economic phenomena, right? Not so fast....

The world of decentralized finance, or "Defi," suffered a body blow when market forces, driven in part by coronavirus fears and a clever trader, pushed the most prominent Defi player, MakerDao, against the ropes. The Maker token, MKR, lost approximately 45% of its value over a period of eight hours. In addition, the MakerDao smart contract platform lost USD\$4.5 million worth of Ethereum being held by the platform as collateral. Ethereum is the world's second most prominent cryptocurrency behind bitcoin. Maker's smart contract platform runs on top of the Ethereum (ETH) blockchain, as do most Defi platforms.

Decentralized finance allows holders of various cryptocurrencies to: (a) earn interest by lending to liquidity pools that make loans to borrowers; and/or (b) borrow money by staking their cryptocurrency as collateral. Defi is becoming an increasingly popular alternative to traditional markets because lenders can earn much higher interest rates than traditional banks pay, routinely 5-13% depending on the platform and the tokens used. Likewise, borrowers can borrow against their own assets to bet for or against the market fluctuations that are a hallmark of cryptocurrency trading. As recently as the first week of March, over a billion USD were tied up in decentralized finance, a small amount by Wall Street standards, but not bad for a nascent market that didn't exist a couple years ago. Most of that collateral was tied up in Maker.

Maker's problems appear to have resulted from a combination of high volume on the Ethereum platform (that causes an increase in the amount of transaction fees ("gas") which are denominated in

ETH), faulty pricing oracles that set the interest rates used on the platform, and a problem with its liquidation auction, the mechanism that provides for the sale of loan collateral if the collateralization ratio of Maker loans falls below 150%. At the same time, gas fees were increasing because of a high volume of Ethereum trading, and several Maker loans were being liquidated because of the declining value of ETH. Each time a loan is liquidated the underlying collateral is auctioned to pay off the loan. The high transaction fees, and perhaps a problem with Maker's pricing oracles, resulted in almost no bids for the underlying Ethereum collateral. Either by luck or by stealth, one bidder managed to win the bidding auction for \$4.5 million worth of Ethereum collateral with a bid of \$0, apparently without breaking any laws or violating the rules of the platform. If Maker's pricing mechanism was part of the problem, there are likely more troubles ahead for Defi, because most Defi platforms base their lending and borrowing rates on Maker's benchmark.

Beyond the challenges facing Maker. Crypto watchers are right to be puzzled by the effects of COVID-19 on crypto markets. After all, the mothership of crypto, bitcoin, was created in 2008 specifically to provide an alternative to government-controlled banking systems which, in the eye of the pseudonymous bitcoin creator, Satoshi Nakamoto, allowed the 2008 financial crisis and ensuing global economic downturn. Why then are the decentralized markets, which by their very design are governed by their own users without the interference of governments or central banks, affected by the downturn of the centralized markets like Wall Street?

Conventional thinking among many crypto enthusiasts is that a downturn in traditional markets should benefit the crypto markets, particularly bitcoin, which views itself as a store of value, a sort of digital gold. When stock values go down, the theory goes, investors should retreat to the relative safety of bitcoin. Likewise, low stock prices and bond yields should push investors into the world of Defi because of the higher interest rates and sexy opportunities for arbitrage.

Like Maker, traditional thinking has taken a beating this week. In the overnight hours, bitcoin fell 34% on the day to a one-year low of \$4,100, after which it recovered to \$5,500 at the time of this writing.

Ethereum also fell about 35% on the day and is currently 8.5% off yesterday's high. So why do these decentralized currencies appear to reflect the instability of traditional investments when they were designed to be immune to that influence?

There are several theories. The first is that Defi is not affected by fiat markets; it is simply reacting to the same market stimuli: nervous investors and an uncertain economy in the face of a pandemic. The second is that the markets are not directly linked, but they share many of the same players. Traditional market investors suffering heavy losses need cash, and to the extent those investors hold cryptocurrency or invest in Defi, one way for them to get cash is to liquidate their crypto. Liquidation by institutional investors, who are thought to hold a significant percentage of bitcoin as a hedge against traditional market downturns, could have a disproportionate effect on the already volatile crypto market if several of them moved at the same time. Finally, there is no escaping the fact that decentralized finance is still an immature market. Over the last three weeks, there have been two significant Defi hacks in addition to the problems with Maker. As impressive and sophisticated as the Defi markets have become, they are largely self-regulated, and bad actors (or clever ones) are always looking for methods to identify and exploit system vulnerabilities.

If there is good news in the challenges facing Defi and the crypto markets, it is that they are proving resilient. While I'm certain Maker is not happy to have lost \$4.5 million, they had significant reserves to cover part of the loss, and they are likely to sell more Maker tokens to cover the rest. The lessons learned in this Maker episode will ripple quickly through other Defi platforms, resulting in better protections for all. Despite its ups and down, the price of bitcoin has continued to rise faster than the rate of growth of this year's bull market, even before this week's market crash. Like the traditional markets, I expect the Defi market to continue to increase in size and popularity even as it overcomes the coronavirus and the other growing pains common to new technologies. The question is whether government regulation, which is surely coming, can be introduced in a way that bolsters rather than stifles this exciting new way of looking at finance.

*To provide guidance and support to clients as this global public-health crisis unfolds, Frost Brown Todd has created a **Coronavirus Response Team**. Our attorneys are on hand to answer your questions and provide guidance on how to proactively prepare for and manage any coronavirus-related threats to your business operations and workforce.*

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