

EU Report May Influence Regulation Of Decentralized Finance

By **Hubert de Vauplane and Hugo Bordet** (February 25, 2025, 3:12 PM GMT)

While the implementation of the Markets in Crypto-Assets Regulation, known as MiCA,[1] across the European Union has introduced the first harmonized regulation of crypto-asset markets in Europe, discussions are currently underway regarding the feasibility and necessity of regulating decentralized finance, or DeFi.

In this context, the European supervisory authorities, or ESAs — in particular, the European Banking Authority and the European Securities and Markets Authority — have published a joint report on DeFi,[2] a notable development that will likely influence the European Commission's decision to initiate, or not, a legislative proposal concerning this ecosystem within the EU.

On Jan. 16, approximately 15 days after MiCA came into application, the ESAs published a detailed report on recent developments in the crypto-asset markets. This report follows a call for contributions sent by the commission to the ESAs on Feb. 9, 2024, and explores the development of DeFi markets as well as the staking, borrowing and lending of crypto-assets.

In this article we provide an overview of the current DeFi landscape in the EU, including regulatory challenges, current consumer and business engagement, and potential specific risk concerns. We also review the recently published report from the ESAs that may set the scene for future regulation in this space.

ESAs' Perspectives On Decentralized Finance

Explaining DeFi

DeFi refers to a system of financial applications built on blockchain networks, offering a variety of use cases that mirror traditional financial systems in an open and permissionless manner, eliminating traditional financial intermediaries and centralized institutions. Article 142 of the MiCA Regulation mandates the commission, with the assistance of the ESAs, to explore the necessity and feasibility of regulating this ecosystem.

Regulatory Challenges

Generally, traditional financial regulation in the EU focuses on the regulation of issuers of securities and



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financial products, distributors of these securities and products, and market infrastructures. This regulatory model, based on service intermediation, appears ill-suited to DeFi.

Engagement of European Consumers and Businesses

The report specifies that the DeFi market remains a niche phenomenon, representing around 4% of the total crypto-asset market capitalization, with activities concentrated on a few major protocols. The EU has approximately 7.2 million DeFi users, but only 15% are actively engaged. The evaluation of DeFi activities in the EU is hindered by transaction anonymity and the absence of centralized intermediaries. The exposure of European financial institutions to DeFi remains marginal, with less than 1% of banks supervised by the single supervisory mechanism actively participating. Despite an evolving regulatory framework, no significant trend toward increased adoption by EU financial institutions is observed in the short term.

Businesses Providing Access to DeFi Services

The report also notes that access to DeFi activities relies on three main services: DeFi application interfaces, self-custodial wallets and centralized trading platforms. DeFi interfaces simplify interaction with protocols, including via anonymous bots on instant messaging platforms.

Self-custodial wallets offer exclusive control over assets, but pose risks related to private key loss and the absence of regulatory oversight. DeFi aggregators optimize access to opportunities across multiple blockchains, representing 45% of decentralized exchange volumes.

Finally, centralized platforms facilitate user entry into DeFi through fiat-crypto conversion tools and intermediation, raising significant issues of interconnection with the regulated financial system. From a legal perspective, this analysis is interesting. It demonstrates the authorities' intent, even when a service is provided centrally, to link it to intermediaries offering technical services related to the protocol, thereby facilitating access for European users. These parts of the report do not have a legal purpose, but they demonstrate the interest shown by European regulators in this ecosystem and their growing expertise over time.

Specific IT Risks Associated With use of DeFi Protocols

The report also highlights the increased technological and cybersecurity risks in DeFi markets, mainly due to their complex architecture, as well as the lack of robust regulatory frameworks for anti-money laundering and counter-terrorist financing.

Attacks on DeFi protocols, which have risen since 2021, primarily target smart contract exploits, private key theft and oracle manipulation attacks, leading to losses exceeding 50% of crypto-asset thefts. Open-source development and blockchain dependency increase vulnerabilities, particularly with cross-chain bridges and scaling solutions.

User anonymity complicates the traceability of financial flows, fostering illicit activities and money laundering via DeFi. In response to these substantial risks, several initiatives are underway to strengthen security measures related to DeFi protocols.

Notably, the work of the French regulators, Autorité des marchés financiers and L'Autorité de contrôle prudentiel et de résolution, on smart contract certification is expected to inform the commission's

potential legislative initiative.[3]

Monitoring Risk

Beyond considerations related to smart contract standardization and auditing, the report suggests securing oracles and bridges through enhanced audits and real-time monitoring mechanisms to mitigate DeFi-related risks. Incident response and disaster recovery solutions, inspired by the Digital Operational Resilience Act framework, are proposed to limit losses in the event of attacks.

Additionally, integrating on-chain monitoring mechanisms, with decentralized identity solutions, is explored to combat illicit flows, alongside educational initiatives to raise user awareness of risks. Finally, the real-time supervision of protocols by competent authorities through public blockchain data is studied as an opportunity. Again, the report provides valuable insights into what a potential MiCA Regulation II, regulating DeFi, might look like.

Maximum Extractable Value

Regarding maximum extractable value, the ESAs precisely highlight the significant risks posed by these new practices, without formally indicating how to regulate maximum extractable value.

However, they suggest technical and industry-based approaches that could inspire regulatory frameworks. Authorities identify measures such as proposer-builder separation to mitigate centralization effects and fair sequencing solutions to limit transaction manipulation.

The technical complexity of maximum extractable value and the lack of uniform standards complicate direct supervision, although integrated monitoring approaches based on public blockchain data are being explored.

ESA Perspectives on Crypto Staking, Borrowing and Lending

Business Models

Crypto-asset lending and borrowing services in the EU operate through both centralized and decentralized models. Centralized loans rely on over-collateralization ratios — loan to value ratio between 20% and 80% — and automatic liquidation mechanisms in case of collateral depreciation.

DeFi protocols, meanwhile, operate via smart contracts, using peer-to-peer models or liquidity pools. The absence of creditworthiness assessments and asset volatility increases liquidation risks. Lenders' revenues derive from interest, origination fees and liquidation fees.

Potential Risks

The report highlights major regulatory challenges related to crypto-asset lending, borrowing and staking services in the EU. It points to significant information asymmetries, hindering users' ability to assess risks related to fees, interest rates, collateral requirements, and rights in case of disputes or insolvency. Over-collateralization and the procyclicality of DeFi markets heighten risks of rehypothecation and excessive leverage, necessitating regulatory safeguards.

The concentration of DeFi markets exposes systemic risks, justifying enhanced oversight. Finally, the

absence of robust anti-money laundering and counter-terrorist financing frameworks leaves substantial vulnerabilities, calling for harmonized compliance obligations across the EU.

Once again, the ESAs do not give any precise recommendations on how to regulate lending borrowing and staking, but the guidelines they provide regarding the risks posed by these products will probably be of interest to the commission in its reflections.

Next Steps

The publication of this report is just the first step in the potential regulation of DeFi in Europe. As such, the commission will incorporate the conclusions of the report into its own report to the European Parliament and the council in accordance with Article 142 of MiCA.

This document should guide the EU's regulatory strategy for DeFi and determine the appropriateness of a possible additional framework — MiCA II.

In parallel with these EU-level considerations, developments regarding DeFi regulation continue at the national level. In France, the Autorité des marchés financiers and L'Autorité de contrôle prudentiel et de résolution, having just published the conclusions of their work on smart contract certification, have launched a public consultation on the subject. This runs until March 10.

Finally, this first contribution from the ESAs on developments in the crypto-asset markets will likely provide useful guidance to market participants on how DeFi could be regulated in Europe. Following the internet era and rise of digitization, regulating a decentralized and innovative sector could raise questions about the effectiveness of legal principles.

European institutions seem determined to certify protocols and guide the main parties involved in the construction of these financial innovations in order to limit potential risks for the protection of European investors and markets, such as concerns around money laundering and the financing of terrorism or cybersecurity risks.

While a small proportion of the crypto-assets market engages in DeFi, these recent developments from the EU indicate potentially further regulation. It would be prudent for lawyers and those engaged in the DeFi space to acquaint themselves with the findings of the report and identify potential areas for concern within their own operations, particularly around provisions relating to money laundering and the financing of terrorism, or cybersecurity risk, and the creditworthiness assessments and asset volatility increases liquidation risks.

It would also be prudent to keep abreast of future developments that will continue to feed into the EU's future regulatory strategy such as the current consultations on smart contract certification by the French regulatory authorities, which will inevitably influence thinking at the EU level.

Lawyers should also be mindful that — beyond the money laundering, cybersecurity and credit risk issues mentioned in this report — certain ordinary law requirements, such as consumer law and the continued focus on addressing unfair commercial practices, may continue to apply to a decentralized finance project.

Finally, given the absence of specific EU regulation on decentralized finance and lending, it would also be prudent for lawyers and those engaged in the DeFi space to determine whether they fall within the

scope of this exemption, or, conversely, whether the provisions of MiCA are likely to apply to them.

This would notably involve ensuring that crypto-asset services are provided by DeFi arrangement operators in a fully, rather than partially, decentralized manner, and considering the implementation of alternative compliance methods mentioned in this report, such as the use of decentralized identification tools or the certification of their protocol to limit technological risks.

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[1] Regulation (EU) 2023/1114 of the European Parliament and of the Council of 31 May 2023 on markets in crypto-assets.

[2] "Joint Report on recent developments in crypto-assets (Art 142 MiCAR)", ESMA and EBA – January 13, 2025.

[3] "The ACPR and the AMF publish the findings from the Working Group on Smart Contract Certification, and launch a Public Consultation.", AMF and ACPR – February 3rd, 2025.