

2.2.3 Decentralized Finance (DeFi) Layers

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The [Decentralized Finance \(DeFi\)](#) have defined layers 0 through 3¹⁾

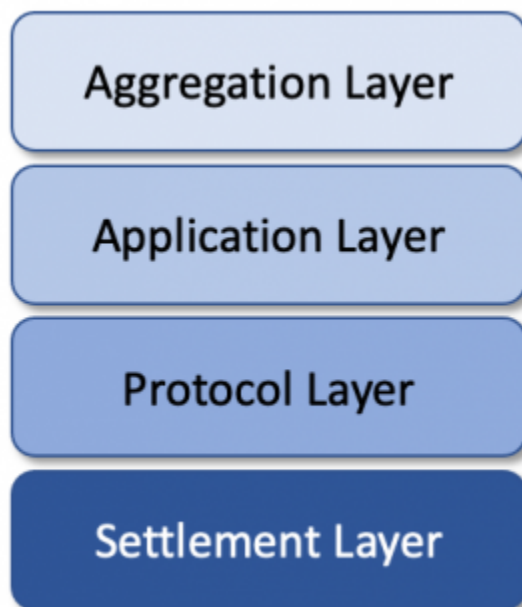


Figure 1: The Layers used in Decentralized Finance (DeFi).

Sharma defines the four layers as:

- **Settlement Layer** is also referred to as Layer 0 because it is the base layer upon which other DeFi transactions are built. It consists of a public [blockchain](#) and its native digital currency or [cryptocurrency](#). Transactions occurring on DeFi apps are settled using this currency, which may or may not be traded in public markets. One example of the settlement layer is [Ethereum](#) and its native token [ether \(ETH\)](#), which is traded at crypto exchanges. The settlement layer can also have tokenized versions of assets, such as the U.S. dollar, or tokens that are digital representations of real-world assets. For example, a real estate token might represent ownership of a parcel of land.
- **Protocol Layer** are the standards and rules written to govern specific tasks or activities. In parallel with real-world institutions, this would be a set of principles and rules that all participants in a given industry have agreed to follow as a prerequisite to operating in the industry. DeFi protocols are interoperable, meaning they can be used by multiple entities at the same time to build a service or an app. The protocol layer provides liquidity to the DeFi ecosystem. One example of a DeFi protocol is Synthetix, a derivatives trading protocol on Ethereum. It is used to create synthetic versions of real-world assets.
- **Application Layer** as the name indicates, is where consumer-facing applications reside. These applications abstract underlying protocols into simple consumer-focused services. Most common applications in the cryptocurrency ecosystem, such as decentralized cryptocurrency exchanges and lending services, reside on this layer.
- **Aggregation Layer**, is the aggregation layer consists of aggregators who connect various applications from the previous layer to provide a service to investors. For example, they might

enable the seamless transfer of money between different financial instruments to maximize returns. In a physical setup, such trading actions would entail considerable paperwork and coordination. But a technology-based framework should smoothen the investing rails, allowing traders to **switch** between different services quickly. Lending and borrowing is an example of a service that exists on the aggregation layer. Banking services and crypto wallets are other examples.

1)

Rakesh Sharma, Investopedia, 24 March 2021, [Decentralized Finance \(DeFi\) Definition](#), Accessed 24 May 2021, <https://www.investopedia.com/decentralized-finance-defi-5113835>

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