Aave for Beginners: What Is DeFi Lending Protocol Aave?

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DeFi lending protocol Aave is one of the biggest crypto lenders, and its AAVE token boasts a higher market cap than its competitors Compound and Maker. Read on to find how it works.

Quick Takeaways

- Aave is a defi lending protocol which allows people to lend or borrow cryptos without having to go through a centralized intermediary.
- Users deposit digital assets into “liquidity pools,” which become available for lending by the protocol.
- Aave’s community approved the launch of GHO, a decentralized collateralized stablecoinin July 2022.

Aave is a decentralized lending protocol which allows users to lend and borrow cryptos and real-world assets (RWAs) with no need to go to a a centralized intermediary. When they lend money, they earn interest; when they borrow money, they pay interest.

Aave was originally built on the Ethereum network, with all the tokens on the network also using the Ethereum blockchain to process transactions; they are known as ERC20 tokens. Aave has since expanded to other chains, including Avalanche, Fantom, and Harmony.

The protocol itself uses a decentralized autonomous organization, or DAO. That means it’s operated and governed by the people who hold—and vote with—AAVE tokens.

How does Aave lending work?

Traditionally, to get a loan, you'd need to go to a bank or other financial institution with lots of liquid cash. The bank will ask for collateral—in the case of a car loan, that would be the car title itself—in exchange for the loan. You then pay the principal to the bank every month, plus interest.

DeFi is different. There is no bank. Instead, smart contracts (which are computer codes that automate transactions, such as selling if a token price reaches a certain threshold) do the heavy lifting. DeFi removes the middlemen from asset-trading, futures contracts, and savings accounts.

In practice, that means that you can get a loan—in cryptocurrency—from people instead of financial institutions. However, you still have to put up collateral. In a DeFi system that tries to be fiat-free, that means other cryptocurrency tokens.

And because cryptocurrency is so volatile, many DeFi platforms demand overcollateralization. So, for a $500 crypto loan on Aave, you'd need to put up more than that amount in a different cryptocurrency. If the price plummets and the amount in collateral no longer covers the amount you've borrowed, your collateral can be liquidated, meaning the protocol takes it to cover the cost of your loan.

Aave currently has pools for 30 Ethereum-based assets, including the stablecoins Tether, DAI, USD Coin, and Gemini dollar. Other markets include Avalanche, Fantom, Harmony, and Polygon, among others.

Aave also provides pools for real-world assets, like real estate, cargo and freight invoices, and payment advances. For such pools, a partner company called Centrifuge helps brick-and-mortar businesses tokenize aspects of their operations. Once tokenized, investors can purchase (or hold as collateral) these tokens, which behave similar to bonds and earn a yield on their holdings. Thus, these assets can be used as collateral for real-world businesses to borrow cash.

Why may borrowing crypto be needed?

While it often makes more sense to buy or sell cryptos, there are certain situations where it is practical to borrow them. The most obvious of these is for arbitrage. If you see a token trading at different prices on different crypto exchanges, you can profit by buying in one platform and selling out in another.

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