Can crypto investments be safe and liquid?

Even in the volatile space of crypto markets, investors look for safe asset alternatives. Some DeFi lending pools can provide stability.

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Every financial system depends on safe assets, investments that people trust to hold their value and get some returns. Traditionally, these have included government Treasury bills, bank deposits and money market funds. They are the financial world’s safe harbors, used to preserve wealth, provide collateral and be a reliable place to park cash.

Which brings us to the crypto world, where no government stands behind the assets, and price swings are the norm. Can safety and liquidity services be provided to the crypto ecosystem?

Research by IESE's Tammaro Terracciano and coauthors Murillo Campello, Angela Gallo and Lira Mota examines whether stablecoin lending pools can perform some of the same functions as traditional safe assets.

Looking for a safe asset in the crypto market

Investors who have already committed capital to the crypto ecosystem cannot always move easily into traditional assets without incurring costs or disrupting investment strategies. Many crypto-focused funds are also restricted to investing exclusively in digital assets. As a result, investors often need a safe place to store value without leaving the crypto market.

Decentralized finance, or DeFi, has created one possible solution.

Unlike many crypto investments, DeFi lending pools are designed to minimize risk and facilitate lending. Borrowers must typically provide collateral worth more than the amount they borrow, creating a buffer against defaults. Collateral is also pooled across many users, spreading risk throughout the system. When investors deposit stablecoins, they benefit from the stability of the stablecoins themselves. Most major stablecoins are backed largely by reserves invested in U.S. Treasuries.

To understand whether investors actually treat these lending pools as safe assets, the researchers developed a theoretical model comparing them with traditional private safe assets such as money market funds. The first of its kind, the model predicts that if DeFi lending pools provide similar safety services, their returns should respond to changes in the U.S. Treasury markets.

The team then tested this prediction using detailed data from hundreds of DeFi lending pools spanning multiple blockchains, protocols and tokens.

What they found was that returns on stablecoin lending pools consistently moved alongside the so-called Treasury premium. This is a widely used measure of demand for safe assets in traditional financial markets. They also responded to changes in the supply of Treasury securities and to shifts in broader market liquidity. In other words, investors appeared to value these crypto lending pools in much the same way that traditional investors value other private safe assets.

The findings held across several major stablecoins, despite differences in their reserve structures, transparency and regulatory oversight. This suggests segmentations across different groups of investors rely on different stablecoins while seeking similar forms of safety within crypto markets.

How safe are stablecoins?

Of course, stablecoin lending pools aren't as safe as Treasury bills or bank deposits. They remain private, unregulated financial instruments that can be vulnerable during periods of market stress. But the evidence suggests they can replicate some of the economic functions of traditional safe assets, providing investors with liquidity and a relatively stable place to hold funds without exiting the crypto ecosystem.

More broadly, the research highlights the increasingly close connections between decentralized finance and conventional financial markets. As stablecoins become more deeply linked to U.S. Treasury markets through their reserve holdings, changes in traditional financial markets increasingly ripple through crypto as well.

For policymakers, investors and market participants, the findings point to an emerging reality: Even in one of the world's most volatile financial environments, investors still seek safety, and the crypto ecosystem is beginning to develop its own alternatives to satisfy such a demand.

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Tammaro Terracciano

Assistant Professor of Financial Management at IESE. His research focuses on international finance, monetary economics, fintech and digital currencies.

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