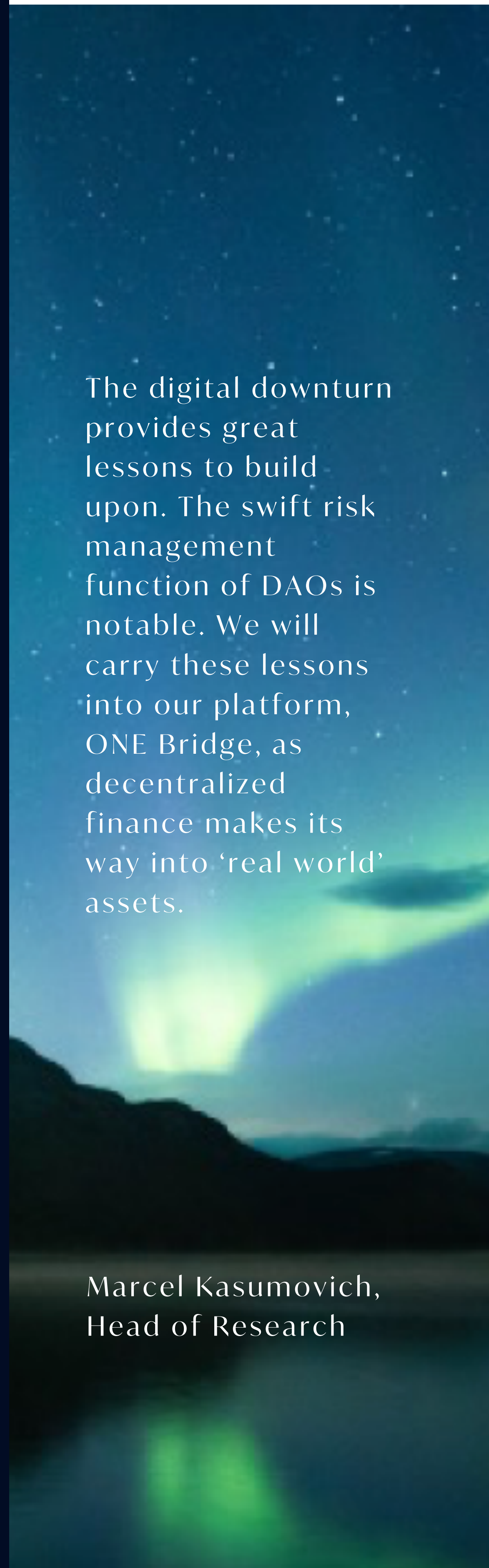
OneRiverDigital
ASSET MANAGEMENT

market notes: DAOs Risk Managing Digital-GFC

July 15, 2022



The digital downturn provides great lessons to build upon. The swift risk management function of DAOs is notable. We will carry these lessons into our platform, ONE Bridge, as decentralized finance makes its way into ‘real world’ assets.

Marcel Kasumovich,
Head of Research

1. "If the actual token holders of a DAO aren't empowered to be in charge and to actively participate and understand its inner workings, it simply becomes a game of extraction by the bureaucratic class. There's no legal obligations, so there are no consequences for corruption." Rune Christensen studied complex chemistry machines to make chemistry simpler. He co-founded Maker with the same target in mind for finance – make complex systems simpler.

2. MakerDAO was founded in 2015. It is the creator of Dai, the first algorithmic stablecoin that runs on the Ethereum blockchain by way of smart contracts, dynamically adjusting to market conditions to maintain stability. The vision was greater than Dai, focused on Maker's Decentralized Autonomous Organization (DAO) and financial applications.

3. The latest downturn in digital asset markets gives a terrific case study in resiliency. But asset returns during downturns are not useful for separating the good from the bad – it is all ugly in those periods. The market capitalization of Maker declined from a peak of $6 billion last year to less than $1 billion now, falling back to January 2021 levels. The low correlation between Maker and the One River Digital Indices, 40% on daily returns since the start of 2018, was not representative of the downturn. Maker's daily returns had an 88% correlation to Bitcoin during the June swoon.

   It was all the same trade.

4. Was the market wrong to penalize Maker so harshly? No. Let's work through its economics. A user creates Dai by depositing collateral worth 2-times the value of the Dai (or anything more than 1.5-times). The stablecoin acts as a US dollar loan backed by collateral posted to the Maker vault. The interest paid on the loan incorporates a spread revenue to Maker. A penalty fee is charged on the liquidation of collateral when margin calls on the loan are not met – the second way Maker earns revenue. A capital buffer is saved – a 'system surplus' – to guard against losses in liquidation.

5. The power of decentralized platforms is the availability of information. We can see all on-chain. Assets, revenues, capital are available at any time (e.g., Dune Analytics). Maker's market value soared to 33-times its book value last year alongside an asset increase of 9-times. It was priced for rapid growth. That changed in the first half of 2022, with assets down by one-third this year. Maker's price-to-book plunged to 8.7-times through June, and the price-earnings ratio fell to 10-times (Figure 1). The market has been reassessing both the growth trajectory and the quality of earnings, with liquidation revenues now driving profits rather than recurring lending revenues (Figure 2).

   But it isn't all the same trade.

6. Behind the numbers, the financial stability of the protocol is differentiating. Maker's book value of equity has risen 35% since year end to $97.3 million through profit retention to guard against loss. The first line of defense for financial stability is collateral liquidation. When collateral falls below 150% of the loan's value, assets are auctioned to meet the margin requirement. The Dai stablecoin held by the debtor is extinguished. Of course, as digital assets like ether and bitcoin dominate collateral, there is "jump risk" that may lead to liquidation at less than 100% of the loan's value. The second line of stability defense adds a "surplus buffer" of equity capital to lean against loan losses.

7. So, who decides on issues like capital buffers, collateral assets, margining thresholds? It is democratized through the DAO. It is the token owners. And the carnage of market value in Maker did not lessen the resilience of the DAO, despite navigating a period of severe tension. Three periods of interest showcase this strength.

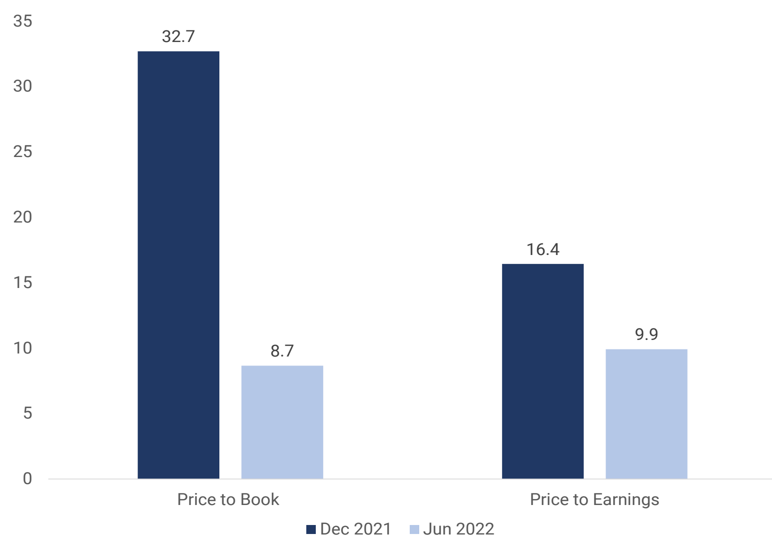
8. First, capital buffers were proactively increased twice last year during the sharp rise in Maker lending. In November 2021, a "Polling Contract" was published to the Ethereum blockchain proposing an increase in the system surplus buffer. The poll provided a range of options, including no change in the buffer. No Maker token holder voted to keep the buffer unchanged. This buffer reduced short-term benefits to token owners in the interest of long-term stability.

9. Second, counterparty restrictions were introduced during the June downturn. On June 15, 2022, the Governance Facilitator issued an urgent executive proposal to limit exposure to Aave and, by extension, Celsius. There were $200 million Dai borrowed through the Aave protocol with $100 million traced back to Celsius. Aave was proposing a relaxation of collateral rules, which was argued to be an unacceptable risk to the Maker protocol. Complete analyses and discussions were available in a public forum. Aave's direct deposit to Maker was suspended temporarily. The logic is public for all to see and learn from.

10. Third, governance proposals to streamline management were rejected. On June 27, 2022, an overhaul of the management structure was proposed to the community. Among other changes, an advisory board would be created with the goal of improving decision-making, which was deemed too slow and poorly informed. It was driven by the engineering unit of the protocol. The highest-ever voter turnout and the overhaul of the management structure was resolutely rejected. Expense is almost surely part of the decision, with the proposal coming at a time when operating costs run around the same as lending revenues, at $30 million annualized.

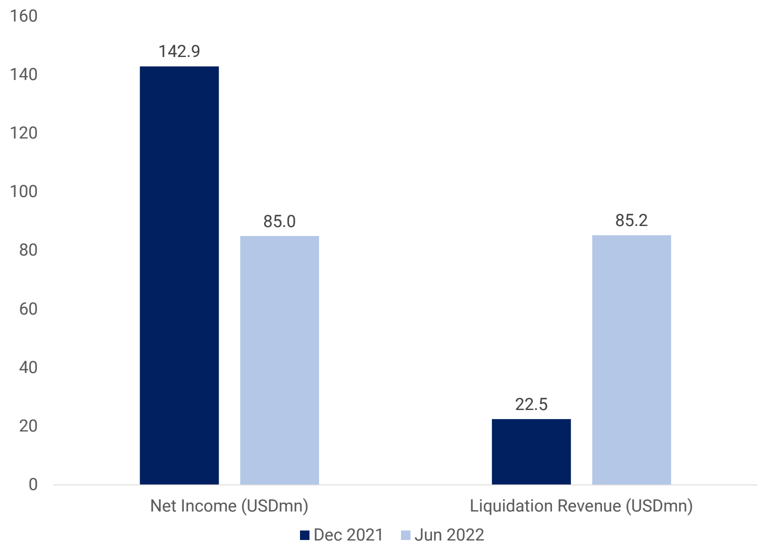
11. The digital ecosystem is early in its proof-of-concept phase. New financial technologies are being tested. Fault lines are being found. Resiliency is being revealed. The lessons learned will carry forward into new growth. The market downturn brought challenges to protocols that were met with timely, productive reflection. Future improvements center on the governance process – the ability to be clear, structured, and versatile to change from auction parameters to risk rules and collateral types. These lessons will be integrated into new versions of decentralized finance, such as our ONE Bridge protocol. The lessons will also inform future activities as decentralized DAOs engage in 'real world' assets. Defi doesn't have to be degenerate after all.

Figure 1: Maker Multiples Decline Alongside Asset Growth



Source: One River Digital Calculations. Dune Analytics.

Figure 2: Less and Lower Quality Net Income



Source: One River Digital Calculations. Dune Analytics.

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