Risk bytes

Newsletter
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Ethereum merge watch

Markets are in prickly territory a few weeks away from Ethereum's move to Proof-of-Stake (PoS). The move away from Proof-of-Work (PoW) is seen as the network's largest upgrade that slashes daily mining rewards from around 13k ETH a day to zero. With less selling pressure coming from miners, the assumption is bullish for the world's largest smart contract protocol.

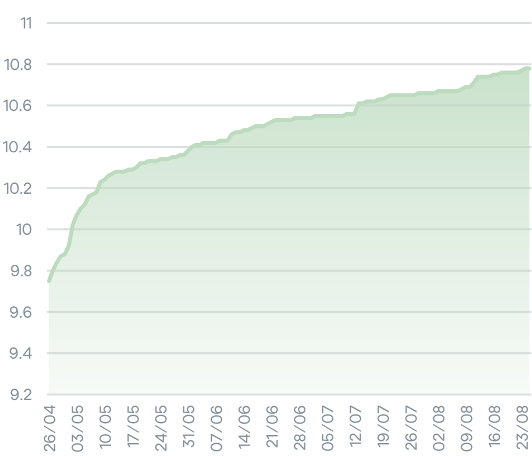
Add to the fact that lending rates have increased substantially, funding rates are flat, and with future premiums being negative, short investors might believe that markets will drop heavily.

They might not be wrong though. 'The Merge', expected to take place in mid-September, would align with the two-month anniversary of Ethereum's drop to $879. Within less than a month, the cryptocurrency rallied to over $2000, more than double. Bitcoin saw an increase of 43% over the same period.

Are we perhaps already in the middle of the 'sell the news' stage? With ETH2.0 staking rates at 10%, traders could still be long ETH raking in good yield but taking that short bet in the meantime however costly.

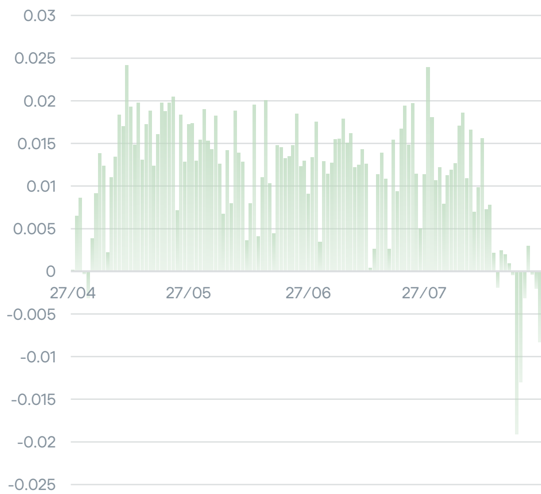
ETH 2 staking rate

Source: Nansen, The Block, Deribit metrics, 2022



ETH funding rates go deep red

Source: Nansen, The Block, Deribit metrics, 2022



HVB partner with MakerDAO to transform DAO stablecoins into interest-yielding assets

Huntingdon Valley Bank (HVB) and The MakerDAO Protocol(MakerDAO) pioneer the first commercial loan participation between a U.S. Regulated Financial Institution and the protocols own decentralized multi-collateral stablecoin (DAI).

This process will effectively convert a digital currency to a real-world asset that generates a stable yield for MakerDAO's DAI stablecoin, whilst simultaneously providing commercial loan funding to HVB for lending into the Philadelphia Market Service Area.

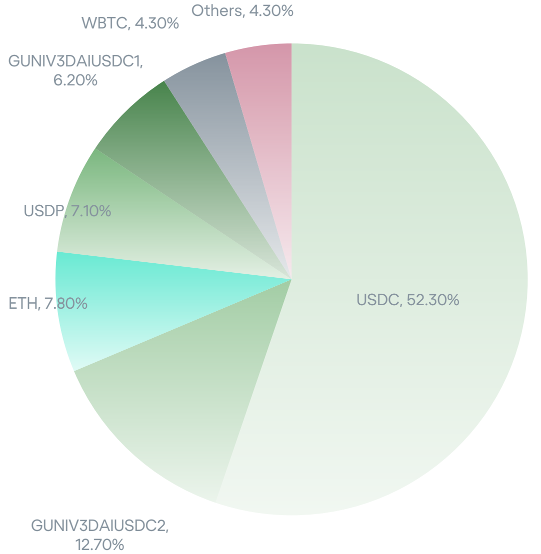
Through this transaction DAI stable coins were converted to US Dollars by a U.S. regulated broker-dealer and those funds were deposited into a Delaware Trust Account ("DTA") for the benefit of MakerDAO. The DTA Trustee uses these dollars to buy loan participations from HVB through a Master Loan Participation Agreement ("MLPA") approved by a successful vote of MakerDAO token holders.

MakerDAO will prefund the DTA with $100 million US Dollars converted from DAI stable coins and is making the balance of these funds available to HVB Lenders for future commercial loan funding in accordance with the MLPA.

The goal of the transaction is to allow DAI to be supported by yield-generating commercial assets originated through a U.S. regulated financial institution. With the MakerDAO program, HVB benefits by having a stable and consistent partner to sell loan participations. This transaction also enables HVB to expand its lending activities in the Greater Philadelphia area because it can now consistently syndicate portions of new loan originations to DTA.

The majority of the DAI collateral is in fact Circle's USDC stablecoin which has supported the decentralised coin to remain close to parity.

Dai generated by collateral, %



Source: financialit.net

Potential Ethereum PoW forks

With the Merge looming closer, ETH miners are still looking to capitalise on their hardware by forking Ethereum. There are currently two potential forked tokens: ETHS and ETHW.

1 ETH will be forked into both 1 ETHS and 1 ETHW, with users being able to swap their ETHS and ETHW into ETH at the same ratio before the Merge upgrade happens. After the upgrade event takes place (if successful), ETHS will be converted into ETH at a ratio of 1:1. Whichever PoW chain has the most hashrate will serve as the main chain of ETHW moving forwards.

Alongside this, Bitfinex has also said that these tokens could help users in three different ways to prepare for the Merge. If a consensus fails to be reached in changing the PoW chain, ETHS will expire, and Ether will be distributed to the ETHW holders. However, if consensus is achieved, the ETHW will expire, and Ether will be exchanged for EHS.

When the consensus change is successful and a fork happens, ETHW and ETHS tokens will be exchanged for ETH. The Ethereum Merge is slated to happen in mid-September, and the industry is already at the edge because of this news. Ethereum users are still waiting to see whether the Merge will happen during the given timeframe by the developers.

Source: insidebitcoins.com

Bluechip NFT binary loans?

Some owners of bluechip NFTs such as Bored Apes (BAYC) borrowed ETH against their NFTs on liquidity protocol BendDAO. NFT floor prices collapsed, and now a large number of NFTs (almost 3% of the BAYC supply) are up for liquidation auction.

This is causing issues, as there seems to be a fundamental design flaw with BendDAO. Instead of requiring more collateral as the NFT floor price drops, BendDAO have made the loans binary: if the loan value is 90% of the floor, the NFT will go straight to auction. This could potentially lead to fire sales and a negative feedback loop that further depresses the floor price.

Source: bloomberg.com

Tornado Cash OFAC censorship resistance

With Tornado Cash being sanctioned on the 8th of August, there has been large discussions around censorship resistance at the validator set level. Validators verify transactions that get recorded on each block. Validators are effectively the gatekeepers of the entire blockchain.

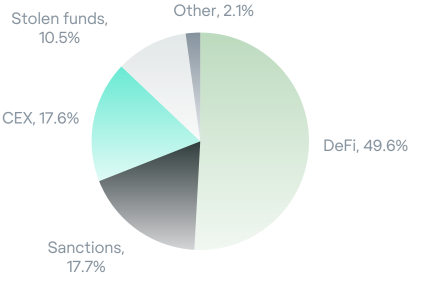
Well over half of Ethereum validators seem to be centralised exchanges and entities such as LIDO, which would comply with any OFAC requirements. The alternative to complying is to shut down their very lucrative staking business, as Coinbase suggested it might.

> **What if OFAC one day tells validators to censor certain transactions from addresses that interacted with a protocol they don't like? Is the US government effectively controlling Ethereum usage?**

Bear in mind, that while this is a direct risk of control, other cryptocurrencies and digital assets aren't immune either. Lack of privacy across even Bitcoin could also break it from within, for example, OFAC banning US exchanges from interacting with Bitcoin from a specific exchange or protocol.

This censorship effect could have a much broader reach if it were to hit stablecoins, as the Treasury Department also established that all transactions in the US that involve any Tornado Cash wallets or contracts are prohibited unless exempted by OFAC. The extent of the impact on DeFi from this rule may be much harder to track, as participants in the ecosystem do not necessarily have control or clarity over the source of funds received, depending on the transaction type. It's still unclear whether the risk is binary or based on the proportion of a given wallet's exposure. For example, decentralized exchange dYdX has started to flag accounts that have immaterial amounts associated with Tornado Cash.

According to Chainalysis, 49.6% of the US$7.6B in ETH that Tornado Cash received since August 2019 came from DeFi protocols, while 17.7% came from sanctioned entities and 10.5% from stolen funds. DeFiLlama reports that the total value locked on Tornado Cash as of August 11 is US$434M.



It's still unclear how far the effects of these sanctions could stretch, though they have reignited debates about privacy and the risks to infrastructure providers (like Infura) as well as decentralized applications more broadly. There are also both operational and introspective concerns about penalizing a protocol vs a natural person. This could make people reconsider their obligations before sending or transacting assets on DeFi platforms in the future.

Source: Chainalysis

Meet Copper Prime

Michael Roberts
Head of Prime
michael.roberts@copper.co
+44 (0) 203 836 9170

Franky Gonidis
Head of Financial Risk
fragkiskos.gonidis@copper.co
+44 (0) 203 836 9161

Jonathan Tse
Head of Trading
jonathan.tse@copper.co
+852 5285 2188

Ashley Moore
Senior Trader
ashley.moore@copper.co
+44 (0) 203 836 9322

Get in touch with Copper Sales

Mike Milner
Head of Sales EMEA
mike.milner@copper.co
+44 (0) 203 927 8494

Glenn Barber
Head of Sales Americas
glenn.barber@copper.co
+1 (332) 237 7691

Takatoshi Shibayama
Head of Sales APAC
takatoshi.shibayama@copper.co
+65-9060-0177

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