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permalink: / layout: page

**title: Dai Credit System Simplified, v0.8**

# The Dai Credit System

<https://makerdao.com/>

Rune Christensen, Nikolai Mushegian, Daniel Brockman, Kenny Rowe, Andy Milenius, Ryan Zurrer

*This is a condensed overview of the Dai Credit System as defined in the "Purple Paper": <http://stablecoin.technology/purple.pdf>. The Purple Paper is a formal specification and reference implementation that is modified by an RFC process.*

## Abstract

We propose a new cryptocurrency called Dai that automatically reacts to emergent market conditions in order to stabilize its value against the major world currencies. Dai is created by the Dai Credit System, a decentralized platform that runs on the Ethereum blockchain. The Dai Credit System ensures that Dai is always backed in excess by a collateral portfolio of other Ethereum-based digital assets. An autonomous feedback mechanism continuously modifies the incentives for borrowing and holding Dai, matching supply with demand. The risk of the collateral portfolio is managed by holders of a separate digital asset called Maker (MKR). The value of MKR is directly tied to the performance of their risk management, giving MKR holders a direct financial incentive to act as responsible regulators of Dai solvency and price stability.

## Introduction

The blockchain revolution has long been touted as the key to many seemingly intractable global problems, from mundane topics like international remittances to lofty ambitions like global financial inclusion. However, the process of mainstream adoption has been slow due to one harsh reality: price volatility of decentralized digital assets.

Hayek postulates that the most successful form of money in an economy of competing private currencies would be the one with the most stable value, i.e. the one that has least volatility against a consumer price index. A cryptocurrency with price stability is a crucial component of the blockchain economy as the majority of interesting Decentralized Applications require a stable medium of exchange to be usable. Popular digital assets such as Bitcoin (BTC) and Ether (ETH) are too volatile to allow individuals and businesses plan long term activities. As such, it will be necessary to have cryptocurrencies with price stability before widespread adoption of blockchain technology can occur. In the competition for blue ocean market share amongst these currencies

there will likely be a single winner: the one with the highest degree of price stability.

While there are a range of projects in the blockchain space aiming to create a cryptocurrency with price stability, the majority use a centralized custodian of the funds. This erases many of the benefits offered by the decentralized platforms on which they are used, limiting their ability to interconnect and synergize in a permissionless manner. For a cryptocurrency with price stability to fit coherently into the decentralized ecosystem, it must adhere to the principles of decentralization.

## Basic Mechanics

Dai is a cryptocurrency backed by other digital assets as collateral. Regular users of Dai can use it as money without having to interact with the advanced mechanics of the Dai Credit System. From their point of view, Dai will just be another cryptocurrency obtained from a cryptocurrency exchange or broker, but with the unique feature of having price stability.

Any user is able to create Dai by borrowing against collateral which they cryptographically lock inside the Dai Credit System. The collateral and Dai-denominated debt becomes locked in a smart contract called a Collateralized Debt Position (CDP); the collateral can only be retrieved if the CDP user pays down the debt of the CDP, by destroying an equal amount of Dai. CDPs are owned by Ethereum accounts, and can be freely transferred to other users like any digital asset. However, CDPs are not fungible with each other.

Immediately after borrowing Dai through a CDP, the CDP user will sell it on the market to regular stability-seeking users who demand Dai for use as money. Hence, CDP users are not themselves interested in price stability. On the contrary, they are seeking leveraged exposure to the assets used as collateral in their CDP (see Example 2 below for an explanation on how leverage is achieved with CDPs).

The solvency of the Dai Credit System is protected by a set of Risk Parameters, which are directly controlled by holders of the MKR digital asset through voting - one MKR gives one vote.

The price of Dai in the open market is kept stable around a variable Target Price, denominated in SDR. At launch the Target Price is initially set to be equal to approximately 1 USD (~0.75 SDR).

The stability of the Dai around the Target Price is maintained by a fully automatic subsystem, known as the Target Rate Feedback Mechanism, which continuously modifies the incentives for borrowing and holding Dai. This feedback mechanism dampens the volatility of Dai and enables it to maintain liquidity even during demand shocks.

As such, Dai is not a pegged currency: it does not maintain a constant peg to an existing fiat currency. Rather, it is a free-floating currency that experiences low volatility against other currencies, comparable to the volatility of major currency pairs such as USD vs EUR (although Dai will likely be more volatile during its early stages).

## Liquidation and Shoring-up Liquidity

To ensure there is always enough collateral in the system to cover the value of all outstanding Dai (according to the Target Price), a CDP can be liquidated if it is deemed too risky. The Dai Credit System decides when to liquidate a CDP by comparing a Risk Parameter called the Liquidation Ratio with the actual collateral-to-debt ratio of the CDP.

Each type of collateral asset has its own unique Liquidation Ratio controlled by MKR voters and decided based on the risk profile of that particular asset. The Dai Credit System uses Oracles to measure the market price of collateral held in CDPs. Oracles are trusted external actors tasked with providing continuous price data.

Liquidation means that the Dai Credit System automatically buys the collateral of the CDP and subsequently sells it off in an automatic auction. The auction mechanism enables the system to settle CDPs even when price information is unavailable.

In order for the system to take over the collateral of the CDP so it can be sold off, it first needs to raise enough Dai to cover the CDP debt. This is called a Debt Auction, and works by diluting the supply of the MKR digital asset and selling it to the bidders of the Debt Auction. In this auction, the system is trying to dilute MKR as little as possible while still covering the debt.

In parallel, the collateral of the CDP is sold off in a Collateral Auction where all proceeds (also denominated in Dai) up to the CDP debt amount plus a Liquidation Penalty (another Risk Parameter determined by MKR voting) is used to buy up MKR and remove it from circulation (directly counteracting the MKR dilution that happened during the Debt Auction). If enough Dai is bid to fully cover the CDP debt plus the Liquidation Penalty, the Collateral Auction switches to a reverse bid mechanism and tries to sell as little collateral as possible; any leftover collateral is returned to the original owner of the CDP.

During normal operation of the Dai Credit System, CDP's continually accumulate a Stability Fee (the rate of accumulation is determined by the Stability Fee Risk Parameter). When a CDP is closed by the CDP user during normal operation, the Dai accumulated by the Stability Fee is used to perform "Buy&Burn", automatically buying up MKR from the market and permanently removing it from circulation. This results in a continuous cash flow from CDP users to MKR holders as long as the system remains solvent.

Liquidations aren't guaranteed to be profitable even if triggered when the collateral-to-debt ratio of the CDP is positive. Slippage during a market crash could cause the Collateral Auction to burn less MKR than what was diluted from the Debt Auction, resulting in net loss for MKR holders due to a net increase of the MKR supply.

## Target Price, Target Rate, and the Sensitivity Parameter

The Dai Target Price is used to determine the collateral-to-debt ratio of a CDP, and thus the Target Price represents the price at which Dai is backed by collateral in the long term. The Target Price is

continuously adjusted according to the current Target Rate. Automatic Target Rate adjustments continuously ensure that the Dai market price remains stabilized around the Target Price in the short term.

When the market price of Dai is below the Target Price, the Target Rate increases. This causes the Target Price to increase at a higher rate, causing borrowing Dai to become more expensive. This leads to CDP users covering their CDPs and leaving the ecosystem, causing the outstanding supply of Dai to decrease. At the same time, the increased Target Rate causes the capital gains from holding Dai to increase, leading to a corresponding increase in Dai demand. This combination of reduced supply and increased demand causes the Dai market price to increase, pushing it up towards the Target Price.

The same mechanism works in reverse if the Dai market price is higher than the Target Price: the Target Rate decreases, leading to an increased demand for borrowing Dai and a decreased demand for holding it. This causes the Dai market price to decrease, pushing it down towards the Target Price.

This mechanism is a negative feedback loop: Deviation away from the Target Price in one direction increases the force in the opposite direction. The magnitude of the Target Rate adjustments depends on how long the market price remains on the same side of the Target Price. Longer deviations result in aggressive adjustments, while shorter deviations result in small adjustments.

The Target Price and the Target Rate are entirely determined by market dynamics, and thus not directly controlled by MKR voters. Voters can only set the feedback mechanism's Sensitivity Parameter. This is a global parameter that determines the magnitude of target rate change in response to Dai target/market price deviation, which allows tuning the rate of feedback to the scale of the system. The Sensitivity Parameter is not considered a Risk Parameter because it does not impact Dai solvency.

## Risk Management of The Dai Credit System

The MKR asset allows holders to vote to perform the following Risk Management actions:

- Add new CDP type: Creates a new CDP type with a unique set of Risk Parameters.
- Modify existing CDP types: Change the Risk Parameters of one or more Existing CDP types that were already added.
- Modify the Sensitivity Parameter.
- Choose the set of trusted oracles. The Dai Credit System derives its internal prices for collateral and the market price of Dai based on the median of the set of trusted oracles. This ensures consistent operation of the system even in the event that up to half of the oracles suffer a technical failure.

## Risk Parameters

Collateralized Debt Positions of The Dai Credit System have multiple Risk Parameters. Each CDP

Type has its own unique set of Risk Parameters, and these parameters are determined based on the risk profile of the collateral used by the CDP Type. The parameters are directly controlled by MKR holders through voting, with one MKR giving its holder one vote.

## Debt Ceiling

Debt ceiling is the maximum amount of debt that can be created by a single type of CDP. Once enough debt has been created by CDPs of a given type, it becomes impossible to create more unless existing CDPs are closed. The debt ceiling is used to ensure sufficient diversification of the collateral portfolio.

## Liquidation Ratio

Liquidation ratio is the collateral-to-debt ratio at which a CDP becomes vulnerable to Liquidation. A low Liquidation Ratio means MKR voters expect low price volatility of the collateral, while a high Liquidation Ratio means high volatility is expected.

## Stability Fee

The Stability Fee is a fee paid by every CDP. It is defined as a yearly percentage that is calculated on top of the existing debt of the CDP. When the borrower covers their CDP, the Dai used to cover the CDP debt is destroyed, but the Dai used to pay the Stability Fee is instead sent to Buy&Burn. A higher Stability Fee represents a higher expected rate of sudden death for the collateral (such as a hack or severe disaster instantly rendering the asset completely worthless).

## Penalty Ratio

The penalty ratio is used to determine the maximum amount of Dai raised from a Liquidation Auction that goes to Buy&Burn, with excess collateral getting returned to the borrower who originally created the CDP. This is achieved with a two-way auction. The penalty ratio is used to cover the inefficiency of the liquidation mechanism.

## Limbo Duration

A CDP enters limbo in the unlikely event that price information for collateral is not available (such as if all the oracles simultaneously suffer a technical failure). The limbo duration determines how long before all CDPs of that type can be liquidated.

## Examples

*The Dai Credit System can be used by anyone without any restrictions or sign-up process.*

**Example 1:** Bob wants to borrow 100 Dai. He locks an amount of ETH worth significantly more than 100 Dai into a CDP and uses it to borrow 100 Dai. The 100 Dai is instantly sent directly to his Ethereum account. Assuming that the Stability Fee is 1% per year, Bob will need 101 Dai to cover the CDP if he decides to retrieve his ETH after one year.

*One of the primary use cases of CDPs is margin trading by borrowers.*

**Example 2:** Bob wishes to go margin long on the ETH/Dai pair, so he borrows 100 SDR worth of Dai by posting 150 SDR worth of ETH to a CDP. He then buys another 100 SDR worth of ETH with his newly borrowed Dai putting him at a net 1.66x ETH/SDR exposure. He's free to do whatever he wants with the 100 SDR worth of ETH he obtained by selling the Dai, while the original ETH collateral (150 SDR worth) remains locked until the debt plus the Stability Fee is covered.

*Although CDPs are not fungible with each other, the ownership of a CDP is transferable. This allows CDPs to be used in smart contracts that perform more complex methods of borrowing (for example, involving more than one actor).*

**Example 3:** Alice and Bob collaborate using an Ethereum OTC contract to issue 100 SDR worth of Dai backed by ETH. Alice contributes 50 SDR worth of ETH, while Bob contributes 100 SDR worth. The OTC contract takes the funds and creates a CDP, thus borrowing 100 SDR worth of Dai. The newly borrowed Dai are automatically sent to Bob. From Bob's point of view, he is buying 100 SDR worth of Dai by paying the equivalent value in ETH. The contract then transfers ownership of the CDP to Alice. She ends up with 100 SDR worth of debt (denominated in Dai) and 150 SDR worth of collateral (denominated in ETH). Since she started with only 50 SDR worth of ETH, she is now 3x long ETH/SDR.

*Liquidations ensure that in the event of a price crash in the collateral that backs a CDP type, the system will automatically be able to close CDPs that become too risky as result, ensuring that the outstanding Dai supply remain fully collateralized and solvent.*

**Example 4:** Let's assume that we have an Ether CDP type with a liquidation ratio of 145%, a penalty ratio of 105%, and our Ether-CDP is outstanding at 150% of the collateral ratio. Then, the Ether price crashes 10% against the Target Price. This causes the collateral ratio of the CDP to fall to ~135%. As it falls below its liquidation ratio, traders can trigger its liquidation and begin bidding with Dai for buying MKR in the debt auction. Traders can also begin bidding with Dai for buying the ~135 Dai worth of collateral in the collateral auction. Once there is at least 105 Dai being bid on the Ether collateral, traders reverse bid to take the least amount of collateral for 105 Dai and the remainder is returned to the original borrower.

## **Keepers: Keeping the system rational and economically efficient**

A keeper is an independent (usually automated) actor that is incentivized by profit opportunities to contribute to decentralized systems. In the context of The Dai Credit System, keepers participate in the Debt Auctions and Collateral Auctions when CDPs are liquidated, and the Buy&Burn auctions that continuously happen during normal operation of the system.

Keepers also trade Dai around the Target Price. Keepers will want to sell Dai when the market price is higher than the Target Price. Similarly, keepers buy Dai when the market price is below the Target Price. This is in order to profit from the expected long-term convergence towards the Target Price.

## Oracles: Providing Price Feeds

Another crucial group of external actors that the Dai Credit System requires to function are price feed oracles. Oracles are independent external actors or decentralized applications that provide a data feed onto the blockchain for smart contracts to consume. The Dai Credit System needs information about the market price of the Dai and its deviation from the Target Price in order to adjust the target rate. It also needs information about the market price of the assets used as collateral in CDPs, in order to know when liquidations should be triggered.

## Design Goals

The current design of The Dai Credit System is the synthesis of several years of research regarding the concept of a cryptocurrency with price stability backed by digital assets as collateral. We take every opportunity to make reductions and simplifications based on things that are theoretically equivalent under an economic incentive analysis. For example, cash flow to MKR holders is represented as Buy&Burn rather than dividends, as their economic impact is equivalent but Buy&Burn is less complex to implement with smart contracts. This action later resulted in yielding returns when it enabled us to greatly simplify the CDP lifecycle and liquidation processes. An additional design goal was to ensure all operations were constant in both space and time complexity. This introduced some challenges as the system simulates multiple sets of continuously growing or shrinking balances and most state is actually a function of multiple real-time variables. The intention of this design goal was to create a system that scales well as the userbase of the Dai Credit System grows over time.

## Addressable Market

As mentioned above, a cryptocurrency with price stability is a basic requirement for the majority of decentralized applications, and as such the potential market for Dai is at least as large as the entire blockchain industry. The following is a short non-exhaustive list of some of the immediate markets (both blockchain industry and wider industry) for The Dai Credit System, in its capacity as a cryptocurrency with price stability and its use case as a decentralized credit platform:

**Prediction Markets & Gambling Applications:** It is logical to not want to increase one's risk by placing a bet with a volatile cryptocurrency. Long term bets become especially infeasible if the user also has to also gamble on the future price of the volatile asset used to place the bet. Instead, a cryptocurrency with price stability like Dai will be the natural choice for prediction market and gambling users.

**Financial Markets: Hedging, Derivatives, Leverage etc:** CDPs will allow for easier leveraged trading. Dai will also be useful as stable and reliable collateral in custom derivative smart contracts, such as options or CFD's.

**Merchant receipts, Cross-border transactions and remittances:** Foreign exchange volatility mitigation and lack of middlemen means the transaction costs of international trade can be significantly reduced by using Dai.

# Primary Risks and their Mitigation

There are many potential risks facing the successful development, deployment, and operation of the Dai Credit System. It is vital that both the Maker community and the Dai Foundation take all necessary steps to mitigate these risks as much as possible. The following is a list of the primary risks identified and the accompanying plan for risk mitigation:

## Malicious hacking attack against the smart contract infrastructure

The greatest risk to the system during its early stages is the risk of a malicious programmer finding an exploit in the deployed smart contracts, and using it to break or steal from the system before the vulnerability can be fixed. In a worst case scenario, all decentralized digital assets that are held as collateral in The Dai Credit System, such as Ether or Augur Reputation, could be stolen without any chance of recovery. The part of the collateral portfolio that is not decentralized, such as Digix Gold IOU's, would not be stolen in such an event as they can be frozen and controlled through a centralized backdoor.

**Mitigation:** During the early stages of deployment, The Dai Credit System will have emergency security features that allows oracles to enact global settlement of the system if they detect a security breach. Global settlement will mean that all dai is destroyed, and dai holders are automatically transferred digital assets from the CDPs with a value equal to the Target Price of the dai they were holding (with the leftover collateral going to CDP users, as if their CDP had been liquidated). This feature will allow the system to deflect attacks that enable the attacker to slowly drain assets out of the smart contracts, but does not defend against attacks that enable the attacker to instantly drain all the collateral at once.

The more general and long term mitigation strategy is to invest heavily in an in-house team of world class programmers who specialize in developing secure smart contracts while also continuously performing independent security audits in parallel. Contract security and best practices have been the highest priority of the Dai development effort since its inception. The codebase has already undergone two independent security audits by arguably some of the best security researchers in the blockchain industry.

In the very long term, the risk of getting hacked can theoretically be completely mitigated through formal verification of the code, which means using functional programming to mathematically prove that the codebase does not contain any exploits. While complete formal verification is a very long term goal, significant work towards it has already been completed, including creating a full implementation of The Dai Credit System in the functional programming language Haskell.

## Black Swan Event in one or more Collateral assets

The highest impact risk is a potential Black Swan event on collateral used for the Dai. This could either happen in the early stages of Dai Credit System, before MKR is robust enough to support inflation moments, or after the Dai Credit system supports a diverse portfolio of collateral.



**Mitigation:** CDP collateral will be limited to ETH in the early stages with the debt ceiling limited initially, growing gradually over time. In addition, one of our experimental projects called Simple Stablecoin will provide pertinent lessons learned, potentially including new Stability Levers.

## **Competition & The Importance of Ease-of-Use**

As mentioned previously, there is a large amount of money and brainpower working on cryptocurrency with price stability. By virtue of having “true decentralization”, The Dai Credit System is by far the most complex model being contemplated in the blockchain industry. A perceived risk is a movement among cryptocurrency users where the ideals of decentralization are exchanged for the simplicity and marketing of centralized digital assets.

**Mitigation:** We expect that Dai will in fact be quite easy to use for a regular crypto-user. Dai will be a standard Ethereum token adhering to the ERC20 standard and easily available with high liquidity across the ecosystem. The system has been designed in such a way that the average user need not understand the underlying mechanics of the system in order to use Dai.

The complexities of the Dai Credit System will need to be understood primarily by Keepers and sophisticated capital investment companies that use the Dai Credit System for advanced financial purposes, and these types of users have enough resources to onboard themselves as long as there is abundant and clear documentation of every aspect of the systems mechanics, which the Maker community and Dai Foundation will ensure is the case.

The Dai Foundation will also invest heavily in core branding and international educational material during the initial launch of the system. If resources permit, the Dai Foundation will use the surplus of its MKR holdings on charity projects, which if done correctly and on a large enough scale, will guarantee positively biased exposure in mainstream media and growth of the Dai brand.

## **Pricing Errors, Irrationality & Unforeseen Events**

A number of unforeseen events could potentially occur, such as a problem with the price feed from the Oracles or other unexpected events such as irrational market dynamics that cause variation in the value of Dai for an extended period. If confidence is lost in the system, the deflation rate adjustment or even MKR dilution could hit extreme levels and still not bring liquidity and stability to the market.

**Mitigation:** The Maker community will need to incentivize a sufficiently large capital pool to act as Keepers of the market in order to maximize rationality and market efficiency as well as grow the Dai Credit System gradually at a steady pace. The Dai Foundation will also deploy its large capital reserves to act as a keeper, ensuring that even in the complete absence of any other well capitalized early-stage keepers, the Dai Foundation alone will be able to keep the system rational.

## **Failure of centralized infrastructure**

The Dai Foundation will play a major role in the development and governance of the Dai Credit System in its early days - budgeting for expenses, hiring new developers, seeking partnerships and

institutional users, and interfacing with regulators and other key external stakeholders. Should the Dai Foundation fail in some capacity, for legal reasons or due to internal problems with management, the future of the Dai Credit System could be at risk without a proper backup plan.

**Mitigation:** The Maker community exists partly to act as the decentralized counterparty to the Dai Foundation. It is a loose collective of independent actors who are all aligned by holding the MKR digital asset, giving them a strong incentive to see the Dai Credit System succeed. During the early phases of MKR distribution, great care was taken to ensure that the most important core developers received a significant MKR stake. In the event the Dai Foundation is no longer able to be at the forefront of continued development of the Dai Credit System, large individual MKR holders will be incentivized to fund developers, or develop themselves, in an effort to protect their investment.

## Conclusion

The Dai Credit System was designed to solve the crucial problem of stable exchange of value in the Ethereum ecosystem and wider blockchain economy. We believe that the mechanism through which Dai is created, transacted and retired along with the direct Risk Management role of MKR holders will allow for self-interested Keepers to maintain the price stability of Dai over time in an efficient manner. Early economic modelling has resulted in positive feedback around this hypothesis and we expect the SimpleCoin research platform to yield even more informative data points. The founders of The Dai Credit System have established a prudent governance roadmap that is appropriate for needs of agile development in the short term, but also coherent with the ideals of decentralization over time. The development roadmap is aggressive and focused on widespread adoption of Dai in a responsible fashion. We are excited about the prospects of The Dai Credit System and hope to get feedback and contribution from the entire blockchain community, as it will be crucial in realizing such a grand project.

## Glossary of Terms

**Collateralized Debt Position (CDP):** A smart contract whose users receive an asset (Dai), which effectively operates as a debt instrument with an interest rate. The CDP user has posted collateral in excess of the value of the loan in order to guarantee their debt position.

**Dai:** The cryptocurrency with price stability that is the asset of exchange in the Dai Credit System. It is a standard Ethereum token adhering to the ERC20 standard.

**Debt Auction:** the continuous MKR reverse-auction to cover Emergency Debt needs.

**Surplus Auction:** the continuous MKR buy-and-burn auction using collected fees (interest from CDPs) and also proceeds from collateral auctions.

**Collateral Auction:** An auction designed to prioritize covering debt owed by a CDP, then to give the owner the best price possible for their collateral refund.

**The Dai Foundation:** A non-profit foundation based in Zug, Switzerland, registered as MakerDai Stiftung which exists to support the development of The Dai Credit System software infrastructure.

**Keepers:** Independent economic actors that trade Dai, CDPs and/or MKR, create Dai or close CDPs and seek arbitrage on The Dai Credit System and as a result help maintain Dai market rationality and price stability.

**MKR:** The ERC20 token that is used by MKR voters for voting as well as used as a backstop in the case of insolvent CDPs.

**MKR Voters:** MKR holders who actively manage the risk of The Dai Credit System by voting on Risk Parameters.

**Maker:** A name used to refer to the aggregate agency of the community of active MKR holders and voters.

**Oracles:** Ethereum accounts (contracts or users) selected to provide price feeds into various components of The Dai Credit System.

**Risk Parameters:** The variables that determine when the Dai Credit System automatically judges a CDP to be Risky, allowing Keepers to liquidate it.

**Sensitivity Parameter:** The variable that determines how aggressively the Dai Credit System automatically changes the Target Rate in response to Dai market price deviations.

**Target Rate Feedback Mechanism:** means the way the Dai Credit System adjusts the Target Rate to cause market forces to maintain stability around the Target Rate.

**SDR:** The Special Drawing Rights, a basket of national currencies maintained by the International Monetary Fund. Widely seen in finance as the most stable reference point for real world values.

## Links

[Chat](#) - Primary platform of community interaction

[Forum](#) - For debate and proposals

[Subreddit](#) - Best place to get latest news and links

[Wiki](#) - Learn about the Dai Credit System in greater detail

[GitHub](#) - Repository of the public Dai Credit System code

[TeamSpeak](#) - For governance meeting conference calls

[SoundCloud](#) - Governance meeting recordings

[Oasis](#) - MKR and Dai decentralized exchange