

# Documentation for Blockchain-Based Liquidity Risk Prediction Model

## Model Overview

This model is developed to predict the likelihood of liquidation events for loans taken on decentralized finance (DeFi) platforms. Liquidation occurs when the value of the collateral deposited for a loan drops relative to the borrowed amount, triggering a liquidation threshold. The model aims to predict such events, providing risk management insights for DeFi lending protocols. It uses various cryptocurrency-related data, including loan and asset prices, to simulate and estimate liquidation events.

## Model Architecture

The core model architecture is based on the **XGBoost Classifier**. XGBoost is a highly efficient, decision-tree-based ensemble machine learning algorithm that implements gradient boosting. It is designed to handle structured/tabular data and excels in both classification and regression tasks. For this classification problem, it predicts whether a liquidation event occurs (binary outcome).

- **Key Model Parameters:**
  - **n\_estimators:** 1000 (number of boosting rounds)
  - **learning\_rate:** 0.2 (the step size at each iteration while moving toward a minimum of the loss function)
  - **max\_depth:** 3 (the maximum depth of the trees)
  - **colsample\_bytree:** 1 (the fraction of features to consider during each split)
  - **gamma:** 1 (the minimum loss reduction required to make a further partition on a leaf node)
  - **random\_state:** 42 (to ensure reproducibility and consistency in results)

XGBoost constructs weak learners (decision trees) iteratively, improving their performance by correcting errors made in the previous rounds. This boosting approach increases the model's overall accuracy, especially in imbalanced classification problems, where one class (liquidation events) is underrepresented compared to the non-liquidation class.

## Training Process

### 1. Data Preprocessing:

- **Time-based Feature Extraction:** Features related to loan start dates, such as the year, month, and day, are extracted from the raw dataset.
- **Standardization:** Numerical features were standardized using **StandardScaler** to ensure that they all share a common scale, which benefits models like XGBoost that are sensitive to feature scaling.

### 2. Handling Class Imbalance:

- Given that liquidation events are rare in comparison to non-liquidations, the dataset is imbalanced. To address this, we use **RandomOverSampler** to oversample the minority class (liquidation events) in the training data. This ensures that the model learns to identify liquidation risks effectively.

### 3. **Model Training:**

- The oversampled, preprocessed, and standardized dataset is used to train the XGBoost model. It iteratively improves its performance through 1000 boosting rounds, optimizing the log loss (detailed below).
- **Boosting:** Each tree added by XGBoost focuses on correcting the errors made by the previous trees, leading to stronger performance as the boosting iterations continue.

### 4. **Prediction:**

- Once trained, the model predicts the probability of a loan being liquidated. This probability is output as part of the test dataset evaluation, which provides insights into the likelihood of liquidation for new loans.

## **Performance Metric – Log Loss**

The model's performance is evaluated using the **log loss** metric, which is commonly used in binary classification problems. Log loss measures how uncertain the model's predicted probabilities are, penalizing incorrect predictions more heavily.

The formula for log loss is:

$$\text{Log Loss} = -\frac{1}{N} \sum_{i=1}^N [y_i \log(p_i) + (1 - y_i) \log(1 - p_i)]$$

Where:

- $N$  is the number of samples.
- $y_i$  is the actual binary outcome (1 for liquidation, 0 for no liquidation).
- $p_i$  is the predicted probability of a sample belonging to the liquidation class.

A lower log loss value indicates a better-performing model. It accounts for how well the predicted probabilities match the actual labels, providing insight into both classification accuracy and prediction confidence.

## **Model Application**

This model specifically predicts liquidation risks for loans on DeFi platforms using assets like WETH, WBTC, and USDC as collateral and borrowed amounts. By analyzing the Health Factor and price changes in these assets over time, the model provides a probability estimate of whether a loan will be liquidated. This information can be used by lenders or borrowers to mitigate risks and optimize asset management strategies.

## Conclusion

The **XGBoost Classifier** employed for this task provides an effective tool for predicting liquidation events in DeFi lending. With its robust architecture, detailed training process, and the use of log loss for performance measurement, the model is well-equipped to assist in managing liquidity risks, ultimately contributing to more efficient and safer lending practices on blockchain platforms.