USDe: Financial Innovation or Algorithmic Mirage?

A Critical Review of Ethena's Synthetic Dollar

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M2 104 – Research in Finance

Blockchain and cryptocurrencies

April 21, 2025

Introduction

In the rapidly evolving world of decentralized finance (DeFi), stablecoins play a foundational role. They form the underlying infrastructure that enables value exchange, borrowing, lending, hedging, and capital preservation in an ecosystem characterized by volatility. A stablecoin is a crypto-asset whose value is designed to remain stable over time, often pegged to the US dollar, offering users the dual advantages of blockchain operability and fiat-like price stability. While centralized issuers like USDC and USDT continue to dominate the market, new models aim to redesign stablecoins along decentralized, crypto-native lines.

In 2024, a novel and ambitious entrant emerged: USDe, issued by Ethena Labs. Distinct from previous designs, USDe is neither fiat-backed nor overcollateralized in the traditional crypto sense. Instead, it introduces a delta-neutral synthetic model, combining long exposure to staked assets (such as stETH) and offsetting short positions in perpetual futures markets. This financial engineering aims to maintain the dollar peg while producing native yield for its holders—sometimes exceeding 20% per annum.

USDe's model is therefore more than a technical proposition; it is a provocative answer to the question of whether a stablecoin can be trustless, scalable, and profitable at once, without falling into the traps that doomed past attempts like TerraUSD (UST). After reaching over $3.5 billion in capitalization within months, USDe has prompted a debate: is it the start of a new stablecoin paradigm, or a temporary illusion built on fragile foundations?

This paper presents a critical assessment of the USDe project, evaluating its financial structure, market positioning, performance drivers, and systemic risks. It also considers its legal sustainability in the context of emerging regulations. The analysis is organized into seven sections: a review of the stablecoin landscape, a technical explanation of the USDe model, its competitive positioning, observed benefits, inherent risks, regulatory tensions, and a concluding perspective.

1 Theoretical context: Stablecoins in a divided ecosystem

Stablecoins today fall into three broad categories:

1. Centralized fiat-backed stablecoins (e.g., USDC, USDT): These are issued by private companies and backed 1:1 by fiat reserves held in bank accounts or treasury bills. Their appeal lies in their liquidity, stability, and ease of redemption. However, they suffer

from centralization risks—freezing of addresses, lack of transparency, and vulnerability to state censorship or legal crackdowns.

2. Overcollateralized crypto-backed stablecoins (e.g., DAI, LUSD): These models seek decentralization by using on-chain collateral like ETH or BTC. To prevent undercollateralization, they often require collateral ratios of 150–200%, reducing capital efficiency and limiting their scalability. In addition, some such as DAI rely partially on USDC reserves, compromising their decentralization narrative.

3. Algorithmic or synthetic stablecoins (e.g., TerraUSD): These projects use on-chain mechanisms to maintain price stability without external collateral. Often, they involve a balancing act with a native governance token. While innovative, they have proven brittle in crisis conditions, as the 2022 collapse of UST demonstrated.

Ethena Labs' USDe proposes a hybrid architecture. It is fully backed by crypto assets and hedged through derivative positions, with no reliance on fiat reserves, and no requirement for overcollateralization. Instead, it maintains its peg through delta-neutral exposure and offers organic yield through two key revenue streams: staking rewards and funding payments in derivatives markets. This combination positions USDe as a capital-efficient, crypto-native yield-bearing stablecoin, a compelling concept that has few direct equivalents in the current landscape.

2 Mechanism design: Delta-neutral stability and yield integration

At the heart of USDe's innovation lies its synthetic dollar construction, which resembles a structured finance product more than a classical crypto token.

To mint USDe, a user deposits a collateral asset, typically `stETH` (Lido's staked ETH), into the protocol. Ethena then opens a short position in ETH perpetual futures of equal size, typically across centralized derivatives platforms (CEXs) like Binance, OKX, or Bybit. The long exposure to `stETH` and the short exposure in futures markets cancel out directional volatility: if ETH rises, the `stETH` collateral increases in value while the short position incurs a loss of equivalent magnitude, and vice versa.

This delta-neutral strategy is the backbone of the peg mechanism. Because the net value of the position remains constant in USD terms, Ethena can safely issue a dollar-pegged token without being exposed to price swings in the underlying asset.

Beyond stabilization, the model generates yield in two ways:

- Staking rewards from the deposited `stETH` (typically 3–5% APY),
- Funding rate payments from long traders in futures markets (in bull markets, short positions like Ethena's receive periodic payments from the long side).

These two sources of revenue allow Ethena to offer users a native yield, which is distributed via a secondary token, `sUSDe`. Users who stake their USDe receive `sUSDe`, which appreciates in value as yield is accumulated. For example, a 20% APY would result in a 1.2x exchange rate between `sUSDe` and USDe after one year.

This structure effectively transforms the stablecoin into a yield-bearing synthetic bond, sometimes referred to as the "Internet Bond" by Ethena. Importantly, this yield is not externally subsidized but endogenously generated, a critical distinction from the failed Anchor protocol that powered TerraUSD.

3 Market adoption and competitive positioning

USDe's performance in its first few months has been exceptional. From its launch in early 2024, it reached a capitalization of $3.5 billion by June, making it the fourth-largest stablecoin globally. This remarkable ascent is largely attributable to three factors:

1. **Attractive yield**: With APYs initially exceeding 25–30%, USDe offered a compelling alternative to both fiat-backed and crypto-native stablecoins.
2. **Aggressive go-to-market strategy**: Ethena orchestrated an effective launch campaign involving airdrop incentives, exchange listings, and integrations with protocols such as Pendle and MakerDAO.
3. **Strategic backers**: Investors such as Dragonfly Capital, Galaxy Digital, Brevan Howard, and Arthur Hayes (BitMEX founder) endorsed the project, not only providing capital but also lending it reputational credibility.

These factors created a network effect, where increasing integration into DeFi protocols reinforced USDe's perceived legitimacy and utility. USDe has also been used as reserve collateral in protocols like Maker, further entrenching its role within the ecosystem.

However, this growth remains procyclical: it is largely predicated on favorable market conditions. The ability of USDe to sustain demand, yield, and peg stability in a bear market is untested and central to the system's long-term viability.

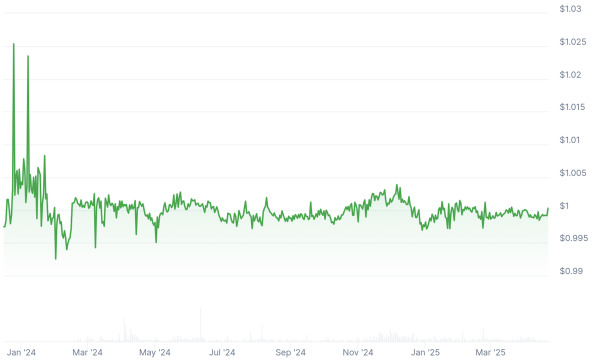

Figure 1: USDe market cap (Jan 2024 - Apr 2025)

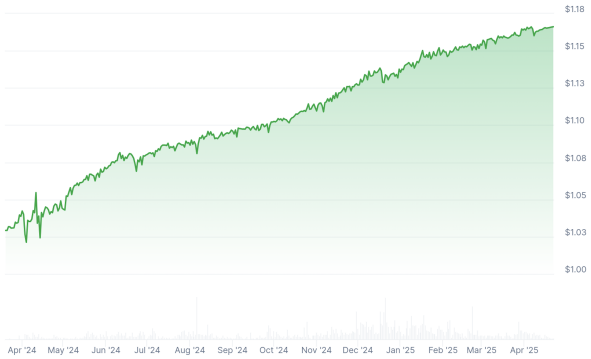

Figure 2: Staked USDe market cap (Jan 2024 - Apr 2025)

4 Functional advantages: Capital efficiency, yield generation, and partial decentralization

The primary advantage of USDe lies in its ability to generate yield natively, without the need for users to engage in complex DeFi strategies. The combination of staking rewards and funding rate payments allows Ethena to offer APYs that have regularly exceeded 20% in bullish market conditions.

This stands in contrast to fiat-backed stablecoins like USDC and USDT, which do not produce any intrinsic yield. Although these assets can be deployed in yield-generating strategies (e.g., in lending platforms or liquidity pools), the yield is neither guaranteed nor integrated into the asset itself.

In terms of capital efficiency, USDe also outperforms crypto-backed stablecoins like DAI or LUSD. DAI, for example, requires overcollateralization ratios exceeding 150%, meaning a user must deposit $1.50 or more to mint $1 of DAI. USDe, on the other hand, maintains a 1:1 collateralization ratio, thanks to its hedging strategy. This improves its scalability, as the same amount of capital can support a greater volume of stablecoins in circulation.

USDe also presents partial benefits in terms of decentralization and censorship resistance. It does not rely on fiat reserves held in traditional banks, nor is it subject to direct intervention by financial institutions. Its collateral is crypto-native, and its issuance does not require access to centralized monetary infrastructure.

However, these benefits are relative rather than absolute. Ethena's architecture introduces new forms of reliance—most notably on centralized exchanges (CEXs) for hedge execution, and on custodians like Copper and Fireblocks for collateral storage. The system, while less

bank-dependent, is not fully decentralized.

5 Systemic risks and structural fragilities

Despite its elegance and innovation, the USDe model is built upon a series of structural assumptions. If these break down, the stablecoin could lose its peg or even collapse under market stress.

5.1 Dependence on positive funding rates

USDe's yield model relies heavily on the assumption that funding rates will remain positive—that is, that long traders will continue to pay short positions in perpetual markets. In bullish periods, this is generally the case. However, in bear markets or flat conditions, funding rates may become negative, turning Ethena's hedges into a cost center rather than a revenue stream.

Historical backtesting suggests that, in 2022, this model would have yielded a net loss of around 0.6%, making it unattractive to users and potentially endangering the peg as capital flees the protocol. Such procyclicality means that USDe may perform well in uptrends but decay in adverse environments, exactly when stability is most needed.

5.2 Risk of liquidation and basis decorrelation

The delta-neutral structure assumes a tight correlation between stETH and ETH. However, this correlation is not absolute. In stress scenarios, stETH may decouple from ETH, as happened during periods of Lido unbonding congestion or liquidity crunches. If the price of stETH drops relative to ETH, the collateral may become insufficient to support the short, triggering margin calls or forced liquidations.

While Ethena claims that its setup avoids liquidation by dynamically adjusting positions and maintaining margin buffers, the possibility of collateral impairment through slippage, protocol bugs, or staking penalties (slashing) cannot be dismissed.

5.3 Centralized execution and custodial risk

Although Ethena presents itself as crypto-native, much of its architecture relies on centralized infrastructure. Hedging positions are placed on CEXs like Binance and OKX; collateral

is stored by custodians such as Fireblocks or Copper; and trade execution is coordinated through APIs and off-chain logic.

If an exchange fails (as FTX did), or if a custodian suspends withdrawals or faces legal challenges, Ethena may lose access to its hedges or even its collateral. While off-exchange settlement systems (OES) are designed to mitigate such risks, they do not eliminate them. These dependencies introduce a single point of failure that may contradict the principles of decentralization the project espouses.

5.4 Governance and token distribution

Another point of concern lies in governance centralization. The vast majority (over 95%) of ENA tokens, which represent governance rights in the Ethena ecosystem, are controlled by founders and early investors. This leaves little room for community-led parameter changes, risk management adjustments, or strategic shifts.

Such centralized control may accelerate development but poses accountability and transparency risks, especially if the protocol faces a liquidity crisis and users demand responsive governance.

5.5 Network effects and systemic exposure

USDe's rapid integration into DeFi protocols like MakerDAO and Pendle has created interdependencies. For instance, Maker invested up to $1 billion of DAI into USDe to capture yield. If USDe loses its peg or suffers a liquidity event, this could cascade across the ecosystem, prompting forced deleveraging, price dislocations, and liquidity shortages—especially in protocols with pooled risk.

This systemic exposure makes USDe a potential contagion vector in the event of a broader DeFi stress scenario, even if its design is fundamentally distinct from the circular logic of Terra/LUNA.

6 Regulatory uncertainty and legal challenges

6.1 Incompatibility with MiCA

The European Union's Markets in Crypto-Assets Regulation (MiCA), effective from 2024, mandates that stablecoin issuers:

- Are registered entities based in the EU,
- Maintain fiat reserves in euros or dollars with licensed custodians,
- Provide complete redemption rights and audited transparency on reserves.

USDe does not meet any of these requirements. It is not fiat-backed, is not issued by a regulated bank, and has no guaranteed redemption mechanism for dollars or euros. As such, it may be banned or severely restricted in European markets unless Ethena restructures its issuance model or relocates operations outside the jurisdiction.

6.2 Global concerns: Shadow banking and derivative exposure

Beyond Europe, regulators in the US and Asia may scrutinize USDe as a form of shadow banking. The protocol effectively issues a dollar-like instrument backed by leveraged exposure to derivatives markets, creating potential concerns about systemic risk, especially if widely adopted.

Additionally, the use of off-chain oracles, CEX dependencies, and opaque governance may draw attention from financial regulators seeking to prevent another "FTX moment" through proactive oversight.

While no specific ban has yet been announced, the regulatory grey zone surrounding synthetic stablecoins is likely to narrow. Projects like Ethena must anticipate this by improving transparency, decentralizing governance, and exploring compliance-compatible issuance pathways.

6.3 Critical perspective: Can yield and trustlessness coexist?

One lingering question concerns the very compatibility between high-yield dynamics and trustless decentralization in the context of stablecoins. USDe's model, while elegant, requires ongoing access to high funding rates and functioning CEXs — both of which are external to the protocol and vulnerable to market and regulatory changes. The promise of a self-sustaining, capital-efficient, and yield-generating dollar may face systemic contradiction: the higher the yield promised, the more fragile the system becomes in maintaining long-term confidence.

In this light, USDe may function less as a "stablecoin" in the strict monetary sense, and more as a new kind of crypto-native structured product — appealing, innovative, yet dependent on conditions that may not be structurally stable. Its success might not only hinge on the

smartness of its delta-neutral engineering, but on the collective willingness of markets to believe in its neutrality.

7 Conclusion: A bold financial experiment with uncertain equilibrium

USDe stands at a crossroads between financial innovation and algorithmic fragility. It combines smart contract execution, staking economics, and perpetual market strategies into a product that is elegant in its design and compelling in its promises. Its initial success is undeniable: explosive growth, high yield, and a wave of integrations have given it real traction.

But its sustainability is not guaranteed. The model functions well under a narrow set of conditions: bullish sentiment, positive funding, tight ETH/stETH correlation, and functioning CEX infrastructure. These assumptions may not hold in periods of market stress, regulation, or technological disruption.

USDe's strength lies in its innovation: it is the most credible attempt to date at creating a yield-bearing, crypto-collateralized stablecoin without circular dependencies. Its weaknesses lie in its procyclicality, operational centralization, and regulatory exposure.

The real test will come not in continued growth, but in how the system responds to declines in yield, liquidity shocks, or legal barriers. If Ethena can adapt—by diversifying revenue, decentralizing governance, and increasing transparency—USDe may become a blueprint for a new class of DeFi-native monetary instruments. If not, it may be remembered as a brilliant, well-funded experiment, ultimately undone by the same contradictions that have plagued algorithmic stablecoins before.

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