tldr:

If USDC peg breaks, Aave will anyway suffer (as will all of DeFi). We might as well fully absorb the risks of a USDC peg break. Borrowing will become as efficient as buying, and USDT will be shortable without locking up capital.

USDC currently has a maximum LTV (loan to value) of 80% and a liquidation threshold of 85%. This is in place so that if the USDC peg breaks, liquidators can hopefully liquidate all USDC collateral, before on-chain liquidity disappears. Unlike most assets, a peg break will likely be gradual, and then rapid, so it is questionable whether liquidation will even be possible. At this time, all of DeFi will be trying to sell off their assets on places like Uniswap and Curve, including LPs themselves who are pulling liquidity. Even if liquidation is possible, DeFi will enter a bear market that affects AAVE holders.

Instead of this, Aave could consider a system where they fully inherent the risks of a USDC peg break, in return for increased capital efficiency.

Instead of buying asset X using USDC, users will now consider using Aave to borrow the same asset X against their USDC. Since no excess USDC is “wasted” to maintain LTV ratios, the latter will be as appealing as the former. Interest rates will more closely resemble the real demands for assets, and Aave usage will increase.

Additionally this can be used by on-chain actors to short stablecoins. One can imagine a scenario where all users who do not believe in the USDT peg will borrow USDT against their USDC collateral. They can then use USDT to buy whatever assets they want to, as before. If USDT peg breaks, they owe back nothing and essentially double their money. If USDT peg does not break, they pay an annual interest rate of a few %, but they will still be able to buy all the other assets they wanted to. Aave can become the ultimate destination to short USDT without

locking up your capital in the short.