Summary

In its mission to analyze and advise the MakerDAO community, theMakerDAO ALCO, based on its research and internal discussions, proposes to evolve the liquidity management framework for MakerDAO. The proposed framework was discussed during the ALCO of February 19th, 2024. It intends to achieve two objectives: 1) increase highly liquid assets on the MakerDAO balance sheet and 2) increase the range of acceptable liquidity in order to reduce the load on both Clydesdale and Andromeda, which have recently required frequent rebalancing.

In short the proposal is:

- Keep the highly liquid assets, defined as the USDC PSM, between 20% and 30% of DAI liabilities (incl. DSR)
- When the ratio is between 20% and 30% no actions are needed
- When the ratio is above 30%, Andromeda and Clydesdale will draw from the PSM until it reaches 25%
- When the ratio is below 20%, Andromeda and Clysdale will return proceeds from t-bill maturities to the USDC PSM until it reaches 25%
- When the ratio is below 15%, Andromeda and Clysdale will sell the proportion of T-bills needed and deploy the proceeds to the USDC PSM to reach 20%

Context

The bull market for crypto-currencies is entering its speculative phase with many players trying to take leverage on crypto-currencies. The borrowing rate for USDC on Aave V3 Mainnet is now solidly above 10% while the TradFi risk-free rate, SOFR, is only 5.32%.

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This broader context makes the MakerDAO lending facilities (Maker Core and Spark) very attractive around 6-7%. This led to nearly a $1B increase in exposure to crypto-backed loans from $1.67B 6 months ago to $2.6B. Meanwhile the DAI funding decreased a bit as the DSR was no longer attractive for active users and saw some outflows.

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This led to a decrease in the Stablecoin section of the balance sheet mitigated from time to time by reduction of the Public Credit exposure (the T-bill ladders of Clydesdale and Andromeda). While working as intended, the fast-paced evolution of the crypto-landscape isn't well suited for those entities that need to coordinate between a lot of actors and use antiquated TradFi rails (wires take time and fail from time to time, adding even more delay). Moreover, all these sales and transfers are generating fees, decreasing the profit generation of MakerDAO.

Overall, these considerations make the protocol liquidity for the daily and weekly periodicity under the acceptable threshold defined by the ALCO(as a reference, the parameters of liquidity for the assets are defined here). Specifically, we are taking a conservative stance on the Coinbase Custody and the T-bill structures (Andromeda and Clydesdale). Work is underway by different ecosystem actors to improve the liquidity profile of Coinbase Custody.

This note mainly focuses on avoiding tail risk where DAI wouldn't no longer be liquid against USDC because of an empty PSM.

Current framework

The current framework, as defined in the Atlas, requires the DAO keep at least 18% of the Dai balance in the USDC PSM and the USDC financed by the DAI-USDC LP vault facility (less than 50M at this stage and is scheduled for deprecation).

The Atlas also defines an upper bound of 22% after which arrangers of Clydesdale and Andromeda should increase their exposure to T-bills.

The framework's initial implementation has demonstrated positive results in terms of liquidity. However, real-world experience has revealed limitations of traditional finance (TradFi) for such short liquidity windows. International wires are time-consuming, prone to failure, and corporate service providers require lengthy counterparty checks. Fiat to stablecoin conversion, while feasible, is not instantaneous at scale. This additional friction adds unnecessary transaction costs when Treasury bills need to be quickly sold and potentially repurchased within a short timeframe. Even under normal market conditions, we are already experiencing strain, suggesting potential challenges during periods of market stress.

Proposed framework

The ALCO suggests increasing the liquidity buffer of MakerDAO to better sustain the evolution of crypto-backed loans that could deplete the liquidity quite quickly in volatile times.

The proposed key elements are the following:

- Keep the highly liquid assets, defined as the USDC PSM, between 20% and 30% of DAI liabilities (incl. DSR)
- When the ratio is between 20% and 30% no actions are needed
- When the ratio is above 30%, Andromeda and Clysdale will draw from the PSM until it reaches 25%
- When the ratio is below 20%, Andromeda and Clysdale will return proceeds from t-bill maturities to the USDC PSM until it reaches 25%
- When the ratio is below 15%, Andromeda and Clysdale will sell the proportion of T-bills needed and deploy the proceeds to the USDC PSM to reach 20%

When using the term "USDC PSM", it should be understood as including the USDC part of the USDC-DAI LP funded by Maker loans. As they are deprecated and will only decrease in volume, we don't feel it is significant (it already represents less than 1% of DAI liabilities).

Regarding the case where the ratio would fall below 20% but Coinbase Custody, Andromeda and Clydesdale are depleted, we suggest increasing the stability fees. When the ratio falls below 20% we suggest an additional temporary increase of the stability fees based on a linear interpolation between a 0% rate addition at a 20% ratio and a 20% rate added at 0% ratio. That would increase the cost of borrowing DAI at makerDAO by 20% should the liquidity ratio fall to 0% . This could be implemented as a smart contract starting the layout of programmatic algorithm ALM. As reference, see the table below showing the additional Stability Fee given various USDC PSM ratios.

USDC PSM Ratio

20%

15%

10%

5%

0%

Addtl Stability Fee

+0%

+5%

+10%

+15%

+20%

Regarding the fee generation, increasing the USDC PSM at the expense of Coinbase Custody and the T-bill ladders would be a significant hit on the Maker profit generation. A $500M reallocation from T-Bills to the PSM (expected outcome) would lead to a decrease of $25M of profit generation on an annual basis assuming similar conditions totoday. Nonetheless, we are aware of ecosystem actors working to improve the PSM to merge it with Coinbase Custody (providing instant liquidity while having a significant yield). Such evolution would provide the best of both worlds and an adequate tradeoff.

Conclusion

As mentioned in our ALCO meeting notes, the ALCO suggests that a medium-term priority should be to improve the liquidity position.

This framework should be translated whole or in-part to the Atlas, and we remain at the disposal of Maker Governance to help in this regard, while remaining in our position strictly as advisors. Should such provision be incorporated, we also suggest establishing the justification in a Risk Appetite Statement to better communicate it to stakeholders.

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