The Liquid Staking Rush

DeFi Scientist

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Liquid Staking: the New Crypto Narrative

The long-awaited Shapella upgrade, expected to go live in early spring, will enable validators to exit. The upgrade is set to increase the number of ETH validators going forward, as staking will become safer, and validators will no longer have to lock their capital for an undetermined amount of time. The anticipated changes have given rise to a new crypto narrative around liquid staking — strong overall growth in the sector, with opportunities for new entrants to challenge Lido's and CEXes' domination. The staking narrative is built around:

- Low staking ratio

on Ethereum. Only 14% of total ETH is currently staked, which is far below that of other chains like Polygon and Solana.

- Yield opportunities.

Staking yields are currently between 4–5%. Ourprevious research article, analyzed the wallet activity of the top 1,000 ETH holders. We noticed that a large proportion of these (~20% of total ETH supply) would benefit from staking ETH due to having idle ETH balances and little spending needs. This is a strong potential driver for staking in the upcoming months.

- Possibility of increased incentives.

Allowing withdrawals in the Shapella upgrade enables the churn between liquid staking providers. This should reduce barriers to entry, encouraging protocols to increase incentives and attract more stakers.

- The integration of liquid staking tokens

(such as stETH, rETH) into DeFi

protocols should accelerate post-Shapella. Liquid staking tokens are more composable, improving capital efficiency and returns for users.

According to DefiLlama, liquid staking is currently the second largest DeFi category in terms of total value locked (TVL), with $14 billion in assets, the majority of which are staked ETH. Dominating this market could prove to be quite lucrative and a number of new projects have recently launched and are set to compete with the already established protocols. 2023 also saw the introduction of the first staking ETP (Exchange Traded Product) by 21Shares andon-chain index](https://indexcoop.com/dseth-diversified-staked-eth-index.)) by Index Coop. Assets under management remain negligible, with only $100k for 21Shares and $700k for Index Coop. While the development of institutional-grade staking capabilities is promising, whether these index products will take off remains to be seen.

Regulatory Tailwind

Liquid Staking has benefited from the recent SEC crackdown on centralized exchange (CEX) staking. In February, the SEC deemed Kraken to be operating an "unlawful offer and sale of securities." Kraken's staking program was criticized for commingling staking assets with Kraken's own assets, offering stable investment returns that were unrelated to protocol-level staking returns, a lack of transparency, and marketing its services to retail investors. As a result, Kraken paid a $30m fine and announced that it would unwind its US staking operations. Although this situation currently only affects US customers, this has brought some regulatory uncertainty for other CEX staking programs, particularly Coinbase and its cbETH, which accounts for a little over 2M+ staked ETH. Since almost a quarter of the total ETH staked comes from CEXes, monitoring what Kraken's US clients will decide to do once the staking program unwinds could reveal the direction the staking market is headed. Will they move to another exchange? Will they move their assets into liquid staking?

Many see the current regulatory crackdown as a boost for liquid staking tokens, as it reduces the influence of their main competitor. Some argue that liquid staking should be protected from regulatory oversight due to its decentralized nature. The Proof of Stake Alliance, co-chaired by Lido Finance and other industry experts, commissioned two external whitepapers which suggested that:

1. The term liquid staking derivatives is misleading and that "liquid staking tokens" is more appropriate.
2. Liquid staking tokens should not be considered as investment securities.
3. The conversion of crypto assets for receipt tokens should not be considered a taxable transaction for U.S. federal income tax purposes.

Strong Price Performance YTD

Tokens related to liquid staking have all shown substantial gains year-to-date, ranging from +136% for Rocket Pool to +316% for SSV.Network. While not strictly a liquid staking protocol, SSV.Network is one of the main operators of Distributed Validator Technology (DVT) along with Obol. Liquid staking protocols hope to integrate DVT after the Shapella upgrade to become truly decentralized.

Liquid Staking Gaining Market Share YTD.

The strong price performance of the asset is supported by gains in market share and inflows into liquid staking. In the first two months of 2023, an additional 1.55 million ETH was staked, which is approximately 10% of the total amount staked at the end of 2022. Of those ETH, 60% went to liquid staking protocols, while only 4% of inflows went to CEXes. This indicates that CEXes are no longer seen as attractive by stakers.

When it comes to protocols, Lido has been the clear winner, attracting 51% of total staking in the first two months of 2023. On February 25th, 2023, it registered its largest daily stake inflow with over 150k ETH staked. Far behind, Rocket Pool only attracted 5.2% of deposits and Frax Finance, 3.1%. It is unlikely that Lido's competitors will catch up, as Lido benefits from economies of scale. Higher TVL means more resources to spend on integrations and development, which also means higher liquidity and DeFi composability.

Rocket Pool and Lido are preparing for the Post Shapella

As the Shapella upgrade approaches, liquid staking protocols have increased communication efforts in February to attract stakers and investors.

Rocket Pool

- Coinbase has made a significant investment in Rocket Pool. This investment will provide Coinbase with considerable influence over the oDAO proposals. Additionally, Coinbase will list a market on its exchange for RPL-rETH, improving liquidity.
- Rocket Pool is preparing for the Atlas Upgrade, which will reduce the requirement to run mini pools from 16 ETH to 8 ETH. This change aims to allow more people to run their own minipool. Currently, there are not enough validators to run minipools, causing rETH to trade at a premium to its fair market value.
- nodeset.io presented their new solution, "Hyperdrive", which focuses on improving the scalability of Rocket Pool. The plan is to create a secondary system on top of Rocket Pool that eliminates the bond requirement by distributing deposits to node operators in a fully non-custodial manner. The system relies on an administrator who adjusts parameters, such as commission rates and deposit pool size, based on the reputation and good behavior of each node operator. The administrators also have the power to eject underperforming node operators. Hyperdrive is expected to launch in 2023.

Lido

- Lido was the first liquid staking protocol to unveil a detailed framework onhow the withdrawals will be implemented.
- Lido is also preparing for the future decentralization of the protocol by unveilingits new Staking Router. The router makes the existing smart contract more modular by allowing various validator subsets (solo stakers, distributed validator technology, or permissionless staking).
- Lido also plans to maintain its dominance by focusing efforts on L2s (Arbitrum and Optimism). This is a smart strategic move since the number of transactions on L2 has recently surpassed that on Ethereum. Lido was awarded 1m OP tokens to incentivize wstETH adoption, which is mostly used in DeFi. These rewards will be distributed to liquidity providers on DEXes and lending protocols such as Aave.

Nethermind is preparing to publish an in-depth research paper on the future of liquid staking. The paper will examine the differences between various types of projects and how we see technology evolving in the future.

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