Simple Summary

On Aave V3, isolation mode requires multiple considerations, including mitigating tail risks to protocols, optimizing user experience, and allowing on-chain liquidity to remain robust. Here we describe the main factors we consider in calculating isolation mode recommendations.

We may deviate from these methodologies in certain edge cases and in the event of very idiosyncratic or compelling developments.

Methodology

We aim to isolate assets that are susceptible to infinite mint attacks, possess non-standard token functionality, or may otherwise have inherent and unpredictable risks. The debt ceiling is designed to restrict protocol exposure to price swings and potential resulting insolvencies.

To mitigate insolvencies, we prioritize having adequate on-chain liquidity to ensure an effective liquidation process. Thus, we recommend setting the initial debt ceiling for an asset at a maximum of 15% of its existing circulating market cap for a conservative approach and 25% for an aggressive approach. Furthermore, to avoid overexposure to isolated assets, we cap the debt ceiling at 20% of the available liquidity of assets that can be borrowed in isolation mode on the protocol.

If the community believes that the primary purpose of debt ceilings is to protect against unpredictable asset behavior and market risk, a natural progression would be to remove an asset from isolation mode when it has demonstrated “safety” rather than increase the debt ceiling over time. On the other hand, if an asset is demonstrated as being risky, we should aim to delist it from the protocol rather than reduce the debt ceiling. However, since the debt ceiling is denominated in USD, we may consider revisiting the debt ceiling if:

- Available liquidity on protocol drops and the existing debt ceilings represent a substantial percentage of the remaining liquidity

Moreover, we may consider removing an asset from isolation mode if:

- Users express a preference to borrow from a more diverse set of assets
- The increase in revenue generated for the protocol would be significant
- The asset has demonstrated some level of safety (e.g., gone through security audits, is not experiencing market fear and doubt, etc.)

It is important to note that this methodology aims to help safeguard against unpredictable attacks but does not protect against a specific type of attack.

Application of Methodology to Aave V3 Avalanche, Polygon, and Arbitrum

We recommend the following changes to the isolated debt ceiling across the Aave v3 deployments:

Chain

Asset

Current Borrowed Against Asset

Current Debt Ceiling

Conservative Recommendation

Aggressive Recommendation

Avalanche

FRAX

$0

$2M

$600K

$1M

Polygon

EURS

$1.43M

$5M

$405K

$675K

Arbitrum

USDT

$773.21K

$5M

$2.5M

$2.5M

Arbitrum

EURS

$0

$5M

$15K

$25K

Notice that these recs would cease borrowing against EURS on Polygon but would not affect current user positions. 85% ($2.31M) of EURS on Polygon is currently supplied on Aave v3 Polygon, with one whale account 0x8da35b920fe236a757a0fad93d3a3ab8ea0a24cc

supplying 62% ($1.7M). While this user is currently at a relatively safe health factor on Aave v3 Polygon, there would not be enough liquidity on Polygon to liquidate the user in a worst-case scenario.

Next Steps:

- Welcome feedback from the community.