Liquidity Risk Is a Side Effect of Ethereum Crypto Upgrade

- Staked Ether owners can’t offload until an upgrade months away
- About 11% of all Ether supply has already been staked

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As the buzz around the revision of the Ethereum blockchain reaches a crescendo, few observers appear to be talking about the potentially risky trade-off that cryptocurrency holders face.

More investors in Ether, the native token of the most commercially important crypto network, are expected to lock up their tokens in special digital wallets that earn their owners a return once the network transition takes place as soon as later today. But they won’t be able to take them out, at least not for a while.

Locked Ether will play a vital role on the upgraded network. Wallets with what’s being referred to as staked Ether will be used to help order network transactions via the new system that is dubbed proof of stake. Currently, about 11% of Ether is already locked up -- either directly or via providers such as Lido, Coinbase Global Inc. and Kraken -- in staking wallets on the Beacon Chain of Ethereum that is being used to test the process, according to blockchain analytics firm Nansen.
The only problem is that Ethereum will have to undergo yet another software change dubbed Shanghai, which is at least six months away, to enable withdrawals of the staked Ether. Even then, the withdrawals will be capped.

“This is another type of risk called illiquidity risk, because it’s not a liquid asset,” said Campbell Harvey, a professor of finance at Duke University. “This is the reason the yield is higher.”

In exchange for staking their tokens, Ether owners are paid rewards in the form of more tokens at a rate of about 4%. The yield could jump to 5.2% right after the upgrade is completed, before declining over time, according to data tracker Staking Rewards. The software upgrade is called the Merge because Ethereum’s main blockchain will be merged with the Beacon Chain.

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To make staked Ether holdings more liquid, some investors have been buying derivatives such as Lido’s stEth, which represents staked Ether but can be traded, lent or borrowed. Coinbase, the biggest US crypto exchange, recently announced a similar derivative. The risk is that the proxies can be illiquid as well. Lido’s product has recently traded at a discount to Ether. Liquidity issues with stEth contributed to problems at crypto lender Celsius Network, which filed for bankruptcy this summer.

Even so, the products have increased in popularity. About 80,000 unique depositors have poured 13.6 million Ether into staking to date, according to Nansen. Eventually, about 80% of all Ether supply will be staked, according to ConsenSys, an Ethereum blockchain technology provider.
Ether Drops Before the Merge

![Graph showing the decrease in Ether prices leading up to the Merge.](https://www.bloomberg.com/news/articles/2022-09-14/liquidity-risk-is-a-side-effect-of-ethereum-crypto-upgrade?refId=H1RVk7ry)

Source: Bloomberg

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Ethereum developers, for their part, haven’t yet provided a definitive timeline for the Shanghai software update.

“There's no agreed timeline for withdrawals yet, just a commitment to do it ‘soon’ after the Merge,” said Ben Edgington, lead product manager at ConsenSys. “This is likely to be a minimum of six months, but may be longer depending on what other work we decide to bundle in with it. Deciding on this will be high priority once the Merge is behind us.”

Ethereum has a history of software upgrades happening later than expected, as developers complete extensive testing and work to implement other priority features. Ethereum is home to about 3,500 active distributed apps, and its ecosystem handles billions of dollars in transactions.
After the Shanghai upgrade, staking withdrawals will be limited to about 43,200 Ether per day out of every 10 million Ether staked. The limit has been put in place to prevent a mass exodus of funds. A stampede out is probably unlikely since most stakers are underwater in the wake of this year’s more than 50% drop in the value of Ether.

“Unlocking of the Merge assets is unlikely to be a top priority for the Ethereum Foundation,” said Toby Lewis, chief executive officer of analytics provider Novum Insights. Staked holders may have to “hold their breath for a while.”