

# Competitive Policies for Online Collateral Maintenance

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**Abstract.** Layer-two blockchain protocols emerged to address scalability issues related to fees, storage cost, and confirmation delay of on-chain transactions. They aggregate off-chain transactions into fewer on-chain ones, thus offering immediate settlement and reduced transaction fees. To preserve security of the underlying ledger, layer-two protocols often work in a collateralized model; resources are committed on-chain to backup off-chain activities. A fundamental challenge that arises in this setup is determining a policy for establishing, committing, and replenishing the collateral in a way that maximizes the value of settled transactions.

In this paper, we study this problem under two settings that model collateralized layer-two protocols. The first is a general model in which a party has an on-chain collateral  $C$  with a policy to decide on whether to settle or discard each incoming transaction. The policy also specifies when to replenish  $C$  based on the remaining collateral value. The second model considers a discrete setup in which  $C$  is divided among  $k$  wallets, each of which is of size  $C/k$ , such that when a wallet is full, and so cannot settle any incoming transactions, it will be replenished. We devise several online policies for these models, and show how competitive they are compared to optimal (offline) policies that have full knowledge of the incoming transaction stream. To the best of our knowledge, we are the first to study and formulate online competitive policies for collateral and wallet management in the blockchain setting.

## 1 Introduction

Distributed ledger technology has provided a financial and computational platform realizing an unprecedented combination of trust assumptions, transparency, and flexibility. Operationally, these platforms introduce two natural sources of “friction”: settlement delays and settlement costs. The Bitcoin protocol, for example, provides rather lackluster performance in both dimensions, with nominal settlement delays of approximately one hour and average fees of approximately 1 USD per transaction. Layer-two protocols have been the ready response to these complaints as they can provide instant settlement and, furthermore, can significantly reduce transaction costs by aggregating related off-chain transactions so that they ultimately correspond to fewer underlying ledger, or on-chain, transactions. Examples of such protocols include payment channels and networks [9, 16],

probabilistic micropayments [5, 7, 14], state channels and networks [6, 10, 13], and rollups [12, 15].

However, in order for layer-two protocols to provide these remarkable advantages without sacrificing the security guarantees of the underlying ledger, they must *collateralize* their activities. In particular, there must be resources committed on-chain that provide explicit recourse to layer-two clients in the event of a malicious or faulty layer-two peer or server. Moreover, the total value of the on-chain collateral must scale with the value of “in flight” transactions supported by the layer-two protocol.

These considerations point to a fundamental challenge faced by layer-two protocols: determining a policy for establishing, committing, and replenishing the collateral. Such a policy must ensure sufficient available collateral to settle anticipated transaction patterns while minimizing the total collateral and controlling the resulting number of on-chain transactions. Of course, any fixed collateralization policy can be frustrated by the appearance of an individual transaction—or a sudden burst of transactions—that exceeds the total current collateral. More generally, it would appear that designing a satisfactory policy must rely on detailed information about future transaction size and frequency, i.e., transaction distribution. From a practical perspective, this poses a serious obstacle because real-world transaction patterns are noteworthy for their unpredictability and mercurial failure to adhere to a steady state. Analytically, this immediately calls in to question the value of distribution-specific solutions. These considerations motivate us to elevate *distribution independence* as a principal design consideration for collateral policies.

We formulate a distribution-independent approach by adapting to our setting the classical framework of competitive analysis. In particular, we study two natural models: the *k-wallet* model in which the total collateral  $C$  is divided among  $k$  wallets of fixed size, and a general model in which  $C$  is viewed as one wallet that allows replenishment of any portion of  $C$ . After fixing only two parameters of the underlying system—the total collateral  $C$  and the size  $T$  of the largest transaction that we wish to support—we measure the performance of a given collateral policy against the performance of an *optimal, omniscient* policy. This optimal policy utilizes the same total collateral, but has full knowledge of the future sequence of transactions as it commits and replenishes collateral. Naively, this would appear to be an overly ambitious benchmark against which to measure an algorithm that must make choices on the fly based only on the past sequence of transactions. Our principal contribution is to show that the natural policies for these two models perform well, even when compared against this high bar.

## 1.1 Contributions

Our formal modeling is intended to reflect the challenges faced by standard layer-two protocols. The most immediate of the models we consider arises as follows: Consider a layer-two protocol with a total of  $C$  collateral that must serve an unknown transaction sequence  $\text{Tx} = (\text{tx}_1, \text{tx}_2, \dots)$ . As each transaction

arrives, the policy may either commit a corresponding portion of its available collateral to *settle* this transaction or simply *discard* it; in particular, in any circumstances where there isn't sufficient uncommitted collateral to cover a given transaction, the transaction must be discarded. The policy may also—whenever it chooses—replenish its currently committed collateral. This “flush” procedure returns the committed collateral to the available pool of collateral after a fixed time delay  $F$  and involves a fixed cost  $\tau$  (so transactions arriving during  $F$  will be discarded if no other sufficient collateral is available). Thus, the challenge is to schedule the flush events so as to minimize the total cost while simultaneously maximizing the total value of settled transactions.

We remark that transactions “discarded” in the model above would typically be handled by some other fallback measure in a practical setting. The flush operation, in practice, corresponds to on-chain settlement of a family of transactions that releases the associated collateral so that it can be reused as surety for additional transactions. While we assume that the flush procedure is associated with a fixed, constant cost for simplicity, in practice this cost may scale with the complexity of the aggregated transactions. We remark that a fixed cost directly models Lightning-like payment channels and networks, or escrow-based probabilistic micropayments, where the total number of participants is bounded.<sup>4</sup>

In this general setting, we study the natural family of policies determined by a parameter  $\eta \in (0, 1)$  that settle transactions as they arrive until an  $\eta$ -fraction of all collateral is consumed; at this point the committed collateral is flushed and the process is continued with the remaining collateral. Our analytic development first focuses on a simpler variation—of interest in its own right—that we call the *k-wallet* problem. As above, the policy is challenged to serve a sequence  $\text{Tx}$  of transactions with a total of  $C$  collateral; however, the collateral is now organized into  $k$  wallets, each holding  $C/k$  collateral, with the understanding that an entire wallet must be flushed at once. When a wallet is flushed it becomes entirely unavailable for settlement—regardless of how much of the wallet was actually committed to settled transactions—until the end of the flush period  $F$ , when the collateral in the wallet is again fully available for future settlement. As above, the policy may settle a transaction by committing a portion of collateral in one of the wallets corresponding to the size of the transaction. This version of the problem has the advantage that performance is captured by a single quantity: the total value of settled transactions.

## 1.2 A Survey of the Results

Continuing to discuss the  $k$ -wallet model, we consider a sequence  $\text{Tx}$  of transactions, each of value no more than  $T$ . We focus on the natural `FLUSHWHENFULL` policy, which maintains a *single active wallet* (unless all wallets are currently

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<sup>4</sup>On-chain transaction cost also varies based on network conditions; during periods of high activity or congestion, transaction issuers may resort to increasing transaction fees to incentivize miners to prioritize their transactions. As such,  $\tau$  above is viewed as the average transaction cost.

unavailable) that is used to settle all arriving transactions; if settling a transaction would leave negative residual committed collateral in the active wallet, the wallet is flushed and a new wallet is activated as soon as one becomes available. We prove that this simple, attractive policy settles at least a fraction

$$\frac{1 - kT/C}{1 + 1/k}$$

of the total value settled by an optimal, offline strategy with  $C$  collateral, even one that is not restricted to a  $k$ -wallet policy but can flush any portion of its collateral at will. We remark that this tends to optimality for large  $k$  and small  $T < C/k$ . This result also answers a related question: that of how many wallets one should choose for a given total collateral  $C$  and maximum transaction size  $T$ . We find that optimal  $k$  in this case is  $\approx \sqrt{1 + C/T} - 1$ .

As for the more flexible setting—under the general  $C$  collateral model—where the policy may flush any portion of its collateral at will by paying a transaction fee  $\tau$ , recall that this poses a bicriteria challenge: maximizing settled transactions while reducing settlement fees. We study this by establishing the natural figure of merit that arises by assuming that each settled transaction yields positive utility to the policy that scales with its value (e.g., a “profit margin”). Thus, the policy seeks to maximize  $pV - \tau f$ , where  $V$  is the total value of settled transactions,  $f$  is the total number of flushes, and  $p$  is the profit margin. Here we study the family of policies that flush when currently committed (but unflushed) collateral climbs to an  $\eta$ -fraction of  $C$  ( $\eta$  is a policy parameter). We find that this policy achieves total utility of at least  $1/\alpha$  fraction of that achieved by the optimal omniscient policy, where

$$\alpha = \frac{1}{1 - \eta - T/C} \cdot \frac{p/\tau - 1/C}{p/\tau - 1/(\eta C)}.$$

In this case, we are also able to determine the optimal constant  $\eta^*$  (as a function of  $C$ ,  $p$ , and  $\tau$ ) that maximizes the policy utility:

$$\eta^* = \sqrt{(1 - T/C) \cdot \tau/(pC)}.$$

We remark that our results in the  $k$ -wallet setting can also be applied to directly yield results with this accounting that assigns a flush cost and a profit margin.

We study some additional questions that arise naturally. For example, we show that no deterministic, single wallet policy can be competitive if the maximum transaction size can be as large as the wallet size and show that, on the other hand, a natural randomized algorithm is  $O(1)$ -competitive.

### 1.3 Applications

Online collateral management arises in various layer-two protocols, as well as in Web 3.0 and decentralized finance (DeFi) applications. For layer-two protocols,

payment networks are an emblematic example: A relay party creates payment channels with several parties, allowing her to relay payments over multi-hop routes. Each payment channel is tied to a collateral  $C$  such that the relay cannot accept a transaction to be relayed if the remaining collateral cannot cover it. This applies as well to state channels, where transactions created off-chain—while the channel is active—are accepted only if their accumulated value does not exceed the initial fund committed when the channel was created. These configurations adhere to the general collateral model discussed above.

Probabilistic micropayments follow a slightly different setting. Micropayments are usually used to permit service-payment exchange without a trusted party to reduce financial risks in case of misbehaving entities. A client creates an escrow fund containing the collateral backing all anticipated payments to a set of servers. A server provides a service to the client (e.g., file storage or content distribution) in small chunks, so that the client pays a micropayment for each chunk. For any incoming service exchange, the client cannot take it unless her collateral can pay for it. The client can decide to replenish the escrow fund to avoid service interruption, thus this also follows the general collateral model. The client may also choose to divide her collateral among several escrows, each of which has a different or similar setting with respect to, e.g., the set of servers who can be paid using an escrow and the total service payment amount. This configuration follows the  $k$ -wallet model.

Apart from layer-two scalability solutions, online collateral management captures scenarios related to Web 3.0 and DeFi applications. The framework of decentralized resource markets build systems that provide digital services, e.g., file storage, content distribution, computation outsourcing or video transcoding, in a fully decentralized way [1–3]. Due to their open-access nature, where anyone can join the system and serve others, these systems usually involve some form of collateral. In this case, a collateral represents the amount of service a party wants to pledge in the system. For example, in Filecoin [1]—a distributed file storage network—a storage server commits collateral proportional to the amount of storage she claims to own. This server cannot accept more file storage contracts, and subsequently more storage payments, than what can be covered by the pledged storage (or alternatively collateral).

In the DeFi setting, online collateral management is encountered in a variety of applications. Loan management is a potential example [11, 17]; incoming loan requests cannot be accepted unless the loan funding pool can support them. The loan DeFi application then has to decide a policy for loan request accept criteria (to favor some requests over others under the limited funding constraint) and when to replenish the loan pool balance.

Another potential application, of perhaps an extended version of our models and policies, that we believe to be of interest is the case of automated market makers (AMMs) [19]. Here, a liquidity pool trades a pair of tokens against each other, say token  $A$  and token  $B$ , such that a trade buying an amount of token  $A$  pays for that using an amount of token  $B$ , and vice versa. Incoming trades are accepted only if the liquidity pool can satisfy them, so in a sense having tokens

that can serve the requested trades is the collateral. Replenishing the pool fund, or liquidity, can be done organically based on the trades. That is, a particular trade, say to buy  $A$  tokens, reduces the backing fund of token  $A$  while increasing it for token  $B$ . Another approach for pool replenishment is via liquidity providers; particular parties provide their tokens to the pool to serve incoming trades (or token swaps) in return for some commission fees. These providers can configure when their offered liquidity can be used, i.e., at what trading price range, under what is called concentrated liquidity as in Uniswap [4]. An interesting open question is to develop competitive collateral policies that capture this setting where settling a transaction does not only depend on whether the remaining collateral  $C$  (i.e., pool liquidity) can cover it, but also on transaction-specific parameters to meet certain collateral-related conditions. Even the replenishment itself, i.e., providing liquidity, could be subject by other factors such as the resulting price slippage, so an incoming mint transaction (in the language of AMMs) that provides liquidity may not be accepted immediately. We leave these questions as part of our future work directions.

In general, our work lays down foundations for wallet management to address issues related to robustness, availability, and profitability of the wallet(s) holding the collateral. Maintaining one wallet may lead to periods of interruption; a party must wait for a while before a new wallet is created to replace an older expired one. Maintaining several wallets may help, but given the cost of locking currency in a wallet or renewing it, the number of active wallets and their individual balances must be carefully selected. Moreover, under this multi-wallet setting, it is important to consider how incoming transactions are matched to the wallets, and whether factors such as payment amount or frequency may impact this decision. A potential extension to our model is considering adaptive policy management, where the size of the collateral and the number of wallets can be adjusted after each flush decision to account for these varying factors.

## 2 The Model; Measuring Policy Quality

As discussed above, we consider the problem of designing an online collateral management policy in which a collateral fund of initial value  $C$  is used to settle transactions—each with a positive real value no more than  $T$ —chosen from a sequence  $\text{Tx} = (\text{tx}_1, \text{tx}_2, \dots)$ . Operationally, the policy is presented with the transactions one-by-one and, as each transaction arrives, it must immediately choose whether to *settle* the transaction or *discard* it. Settling a transaction requires committing a portion of the collateral equal to the value of the transaction; such committed collateral cannot be used to settle future transactions. Of course, if there isn’t sufficient uncommitted collateral remaining to settle a given transaction when it arrives, the transaction must be discarded. Committed collateral may be returned to service by an operation we call a *flush*; we focus on two different conventions for the flush operation, described below, but in either case the collateral only becomes available for use after a fixed time delay  $F$ .

We assess the performance of a particular online policy  $A$  against that of an *optimal offline policy*  $OPT$  that knows the full sequence  $\text{Tx}$  and can make decisions based on this knowledge.

Below, we describe two models for the collateral: the discrete  $k$ -wallet model and the general collateral model.

## 2.1 The Discrete $k$ -Wallet Model

The  $k$ -wallet model calls for the collateral to be divided into  $k$  wallets, each with  $C/k$  collateral value. Wallets support two operations: (i) a wallet with uncommitted collateral  $R$  may immediately settle any transaction  $\text{tx}$  of value  $v \leq R$ ; this reduces the available collateral of the wallet to  $R - v$ , and (ii) a wallet may be flushed, which takes the wallet entirely offline for a flush period  $F$  after which the available collateral  $R$  is reset to  $C/k$ . As a matter of bookkeeping, we mentally organize time into short discrete slots indexed with natural numbers: we then treat the transaction  $\text{tx}_t$  as arriving at time(slot)  $t$ , and set  $\text{tx}_t = 0$  for times  $t$  when no transactions arrive. We treat the flush period as a half-open and half-closed interval: if a wallet flushes at time  $t$ , then it is offline during the time interval  $(t, t + F]$ . In this model, the figure of merit is the *total value* of settled transactions. We let  $\text{Disc}_T^{C,k}$  denote this discrete  $k$ -wallet model with maximum transaction size  $T$ .

**Settlement algorithms, settled value, and the competitive ratio.** A  $k$ -wallet settlement algorithm  $A$  is an algorithm that determines, for any transaction sequence  $\text{Tx}$ , whether to settle each transaction, which wallet to use, and when to flush each wallet. For such an algorithm  $A$  and a sequence  $\text{Tx} = \text{tx}_1, \text{tx}_2, \dots, \text{tx}_n$  we let  $A[\text{Disc}_T^{C,k}; \text{Tx}]$  denote the total value of all transactions settled by the algorithm. In general, we use the notation  $A[\mathcal{M}; \text{Tx}]$  to denote the value achieved by algorithm  $A$  in model  $\mathcal{M}$  with input sequence  $\text{Tx}$ . When the model is clear from context, we simply write  $A[\text{Tx}]$ .

We say that an algorithm  $A$  is *online* if, for every  $N$ , any decisions made by the algorithm at time  $N$  depend only on  $\text{tx}_1, \text{tx}_2, \dots, \text{tx}_N$ , i.e., transactions seen so far. We let  $OPT$  denote the optimal (offline) policy; thus  $OPT[\text{Disc}_T^{C,k}; \text{Tx}]$  denotes the maximum possible value that can be achieved by any policy, even one with a full view of all (past and future) transactions.

**Definition 1.** We say that an algorithm  $A$  is  $\alpha$ -competitive in the  $k$ -wallet model if, for any sequence  $\text{Tx} = \text{tx}_1, \dots, \text{tx}_n$  with maximum value no more than  $T$ ,

$$OPT[\text{Disc}_T^{C,k}; \text{Tx}] \leq \alpha \cdot A[\text{Disc}_T^{C,k}; \text{Tx}] + O(1),$$

where the constant in the asymptotic notation may depend on the model parameters ( $C$ ,  $k$ , and  $T$ ), but not the sequence  $\text{Tx}$  or its length  $n$ .

*Remark 1 (Relation to the bin packing problem).* We remark on the relationship between our problem and the well-studied online bin packing problem [8, 18], where an algorithm must pack arriving objects into bins of constant size, while

*opening* a new bin any time a newly arriving object does not fit into any of the current bins. In this context, the  $k$ -wallet model calls for a bounded number of *bins* (a.k.a., wallets) that can only be reset with the flush operation. Also, we measure the total settled value rather than the number of utilized bins. In any case, we adopt the standard classical paradigm of competitive analysis to study our algorithms, as described previously.

## 2.2 The General Collateral Model

In contrast to the discrete  $k$ -wallet model, where each wallet must be flushed as a whole, the general setting permits any portion of the collateral to be flushed at any time. The basic framework is identical: the policy is presented with a sequence of transactions  $\text{tx}_1, \text{tx}_2, \dots$  and must decide whether each transaction will be settled or discarded; the total collateral  $C$  and the maximum transaction size  $T$  are parameters of the problem. Settling a transaction requires committing collateral of value equal to the transaction; however, any portion of the committed collateral can be flushed at any time. As before, each flush period is  $F$  and is defined to be a half-open and half-closed time interval. We denote this model as  $\text{Gen}_T^C$ .

Since there is no penalty for flushing collateral in this model, it is clear that any algorithm may as well immediately flush any committed collateral. Despite the simple appearance of the model, it is still useful to consider this setting as a comparison reference point for  $k$ -wallet policies, and we define  $A[\text{Gen}_T^C; \text{Tx}]$  to be the total value of transactions settled by algorithm  $A$  in this general model for a transaction sequence  $\text{Tx}$  (with total collateral  $C$  and maximum transaction size  $T$ ).

**Definition 2.** *We say that an algorithm  $A$  is  $\alpha$ -competitive in the general collateral model if, for any sequence  $\text{Tx} = \text{tx}_1, \dots, \text{tx}_n$  with maximum value  $T$ ,*

$$\text{OPT}[\text{Gen}_T^C; \text{Tx}] \leq \alpha A[\text{Gen}_T^C; \text{Tx}] + O(1).$$

where the  $O(1)$  term may depend on model parameters but not on  $\text{Tx}$  or  $n$ .

Note that for any algorithm  $A$  defined in the  $k$ -wallet model the following is always true:

$$A[\text{Disc}_T^{C,k}; \text{Tx}] \leq \text{OPT}[\text{Disc}_T^{C,k}; \text{Tx}] \leq \text{OPT}[\text{Gen}_T^C; \text{Tx}].$$

A more natural model arises by introducing a cost for flushes. In order to reflect the relative cost of flushes in the context of settled transactions, we introduce two additional parameters:

1. *Profit margin  $p$* : a profit  $p \cdot v$  is gained when a transaction with value  $v$  is settled.
2. *Flush cost  $\tau$* : each flush operation costs  $\tau$ .

Table 1: Summary of our results. Here  $r = kT/C$ ,  $\tau$  is the flush cost,  $p$  is the profit margin, and  $f$  is the number of flushes.

<b>Discrete k-wallet model</b>	
$r < 1$	Theorem 1: FLUSHALL is $(2 - r)/(1 - r)$ -competitive
	Theorem 2: FLUSHWHENFULL is $(k + 1)/(k(1 - r))$ -competitive
$r = 1$	$k = 1$ Theorem 3: No competitive deterministic settlement algorithm
	$k > 1$ Theorem 4: FLUSHALL is 3-competitive
	$k > 1$ Theorem 5: FLUSHTWOWHENFULL is $2(k + 1)/k$ -competitive
<b>General collateral model</b>	
maximize $V$	Corollary 1: FLUSHWHENFULL is $(k + 1)/(k(1 - r))$ -competitive
maximize $pV - \tau f$	Theorem 7: $A_\eta$ is $(1 - \beta)/(\sqrt{1 - T/C} - \sqrt{\beta})^2$ -competitive, where $\eta = \sqrt{\beta(1 - T/C)}$ and $\beta = \tau/pC$

We assume throughout that  $pC > \tau$ ; otherwise there is no value to settling transactions because the cost of even single flush exceeds the total profit that can be accrued from the flushed collateral.

We let  $\text{Gen}_{T;p}^{C;\tau}$  denote this model, observing that  $\text{Gen}_T^C$  and  $\text{Gen}_{T;1}^{C;0}$  coincide. In keeping with the notation above, we let  $A[\text{Gen}_{T;p}^{C;\tau}; \text{Tx}]$  denote the total profit minus flush cost by applying algorithm  $A$  in the general model with total collateral  $C$ , maximum transaction size  $T$ , profit margin  $p$ , flush cost  $\tau$ , and transaction sequence  $\text{Tx}$ . Then, we have the following.

**Definition 3.** We say that an algorithm  $A$  is  $\alpha$ -competitive in the general collateral model with flush costs if, for any sequence  $\text{Tx} = \text{tx}_1, \dots, \text{tx}_n$  with maximum value  $T$ ,

$$\text{OPT}[\text{Gen}_{T;p}^{C;\tau}; \text{Tx}] \leq \alpha \cdot A[\text{Gen}_{T;p}^{C;\tau}; \text{Tx}] + O(1),$$

where the  $O(1)$  term may depend on the model parameters but not  $\text{Tx}$  or  $n$ .

**Transaction size.** Our analysis identifies two regimes of interest regarding transaction costs (for both of the previous models): the “micro-transaction” setting, where  $T \ll C$  (arising in micropayment applications) and “arbitrary” transaction size when  $T \approx C$  (arising in more general settings).

In the next two sections, we analyze policy competitiveness under each model; the discrete  $k$ -wallet model can be found in Section 3 and the general collateral model can be found in Section 4. Table 1 summarizes our results.

### 3 The Discrete $k$ -Wallet Setting

We now formally consider the  $k$ -wallet setting. Our focal points are two natural policies described next: FLUSHALL and FLUSHWHENFULL.

### 3.1 The FlushAll Algorithm

We begin with the simple FLUSHALL algorithm, which uses  $k$  wallets placed in (arbitrary, but fixed) order  $W_1, \dots, W_k$ . The algorithm packs transactions into its wallets using the *first fit* algorithm: each transaction is settled by the first wallet (in the established order) that can fit the transaction until a transaction arrives that cannot fit into any wallet. At that time, all  $k$  wallets are simultaneously flushed (and so during the flush period  $F$  all incoming transactions will be discarded).

In the following theorems, we use  $r$  to denote  $kT/C$ , which is the ratio between the maximum transaction size and the wallet size. Note that  $r \leq 1$ .

**Theorem 1.** FLUSHALL is  $(2 - r)/(1 - r)$ -competitive in the  $\text{Disc}_T^{C,k}$  model, where  $r = kT/C$ .

*Proof.* For a sequence Tx of transactions, subdivide time into *epochs* according to the behavior of the FLUSHALL algorithm. The first epoch begins at time 0 and continues through the first flush of the  $k$  wallets; the epoch ends in the last timeslot of this flush period. Each subsequent epoch begins in the timeslot when the wallets come back online (that is, in the timeslot just after the previous epoch ends) and continues through the next flush to the end of the flush period. In general, there may be a final *partial epoch* at the end of the transaction sequence; other epochs are referred to as *full*. Any full epoch can be further broken into two phases: the *accumulation phase* when all transactions are settled by FLUSHALL, and the *flush phase*, during which no transactions can be settled (as all wallets are offline).

For any particular full epoch, let  $V$  be the total value packed by FLUSHALL into its wallets in the accumulation phase. We note that  $V \geq k(C/k - T) = C - kT$ , since every wallet will clearly be filled to at least  $C/k - T$ . As for OPT, during the accumulation phase it can settle at most  $V$  (as this is the value of all transactions appearing in that phase) and during the flush phase it can settle at most  $C$  (as a unit of collateral can settle at most one transaction unit in any  $F$  period). Therefore, the ratio between the value settled by OPT and FLUSHALL in a full epoch is no more than

$$\max_{C - kT \leq V \leq C} \frac{V + C}{V} \leq \frac{C - kT + C}{C - kT} = \frac{(2 - kT/C)}{(1 - kT/C)} = \frac{2 - r}{1 - r}.$$

Moreover, the same formula above can be said for any partial epoch, since the accumulation phase comes first.

Thus, the competitive ratio is  $\alpha = (2 - r)/(1 - r)$ . Observe that when  $r$  decreases, the competitive ratio approaches 2.

Aside from the simplicity of the analysis, FLUSHALL may have an advantage for certain sequences of transactions in practice: keeping all  $k$  wallets open during the epoch (rather than optimistically flushing some earlier so as to bring new collateral online earlier) may permit higher density packing of transactions into the wallets. Indeed, one could consider leveraging an approximation algorithm for

bin packing for the purposes of optimizing this. On the other hand, in situations where some of the wallets may become nearly full early in an epoch it seems wasteful to wait to flush these wallets until all others are full. This motivates the FLUSHWHENFULL algorithm, which attempts to more eagerly flush wallets so as to bring them online sooner.

### 3.2 The FlushWhenFull Algorithm

We now consider the FLUSHWHENFULL algorithm, which fills wallets in a round-robin order. Specifically, transactions are settled by a particular wallet until a new transaction arrives that cannot fit; at that point the wallet is immediately flushed, and the algorithm moves on to the next wallet in cyclic order. (In cases where the next wallet is offline, the algorithm waits for the wallet to finish its flush before processing further transactions, so all transactions arriving during this wait period will be discarded.)

**Theorem 2.** *For  $k > 1$ , FLUSHWHENFULL is  $(k + 1)/(k(1 - r))$ -competitive in the  $\text{Disc}_T^{C,k}$  model, where  $r = kT/C$ .*

*Proof.* Assume, for the purpose of contradiction, that there is a time  $t$  for which the interval  $I = (0, t]$  satisfies

$$V_{\text{OPT}}(I) > (k + 1)/(k(1 - r)) \cdot V_{\text{FWF}}(I),$$

where  $V_{\text{OPT}}(I)$  and  $V_{\text{FWF}}(I)$  are the total values of transactions OPT and FLUSHWHENFULL settle during  $I$ , respectively; let  $t_e$  be the earliest such  $t$ .

Since  $t_e$  is the earliest such time, there must be a transaction  $\text{tx}$  at  $t_e$  that is not settled by FLUSHWHENFULL. As FLUSHWHENFULL does not take  $\text{tx}$ , it must be the case that either all wallets are offline at  $t_e$  or  $k - 1$  wallets are already offline at  $t_e$  and the remaining wallet goes offline at  $t_e$  after failing to fit  $\text{tx}$ . Therefore, every wallet flushes during  $I_f = (t_e - F, t_e]$ . Suppose, without loss of generality, that they do so in order  $W_1, W_2, \dots, W_k$ .

If  $t_e \leq F$ , then OPT settles transaction value at most  $C$  in the interval  $(0, t_e]$  since each wallet settles at most  $C/k$ . In the same interval, FLUSHWHENFULL settles at least  $k(C/k - T)$  since each wallet settles at least  $C/k - T$ . Therefore,

$$\frac{V_{\text{OPT}}(I)}{V_{\text{FWF}}(I)} \leq \frac{C}{k(C/k - T)} = \frac{C}{C - kT} < \frac{kC}{kC - k^2T} + \frac{C}{kC - k^2T} = \frac{k + 1}{k(1 - r)},$$

which would contradict our assumption.

Otherwise  $t_e - F > t_0$ . Observe that of the  $k$  wallets, at least  $W_2, W_3, \dots, W_k$  began taking transactions during  $I_f$  since, if a wallet  $W_i$ 's transaction activity before its last flush starts at a time before  $I_f$  for any  $i = 2, \dots, n$ , then  $W_{i-1}$ 's last flush time must also be before  $I_f$  which contradicts the earlier conclusion that all the  $k$  wallets' last flush times are during  $I_f$ . Therefore, those  $k - 1$  wallets together contribute  $(k - 1)(C/k - T)$  to  $V_{\text{FWF}}(I_f)$ . The only wallet that may have started taking transactions before  $I_f$  is  $W_1$ . Let  $t_s$  denote the last time

before  $t_e$  that  $W_1$  came back online and  $t_{s'}$  denote the time  $W_1$  flushes. Note that  $t_{s'} \in I_f$ , while  $t_s$  may or may not be in the interval. Let  $I_s = (t_s, t_{s'}]$  and  $I_{s'} = (t_{s'}, t_e]$ ; then we have  $V_{\text{FWF}}(I_s \cup I_{s'}) \geq k(C/k - T)$  since each wallet starts to take transactions and then flushes within the interval  $I_s \cup I_{s'}$ . We also have  $V_{\text{OPT}}(I_s) \leq V_{\text{FWF}}(I_s) < C/k$  since wallet  $W_1$  is active during  $I_s$ .

Additionally, we have  $V_{\text{OPT}}(I_{s'}) \leq C$  since the length of  $I_{s'}$  is no more than  $F$ , leading to  $V_{\text{OPT}}(I_s \cup I_{s'}) \leq C/k + C$ . Therefore,

$$\frac{V_{\text{OPT}}(I_s \cup I_{s'})}{V_{\text{FWF}}(I_s \cup I_{s'})} \leq \frac{C/k + C}{k(C/k - T)} = \frac{k+1}{k} \cdot \frac{C}{C - kT} = \frac{k+1}{k(1-r)}.$$

But this contradicts our initial assumption; we conclude that there is no such  $t$ .

### 3.3 Optimal Wallet Number

When  $k$  is large and  $r$  is small, `FLUSHWHENFULL` approaches optimality. For a given total collateral  $C$  and maximum transaction size  $T$ , it is natural to ask how many wallets one should choose so as to optimize the competitive ratio of `FLUSHWHENFULL`. This amounts to determining a  $k$  that minimizes  $(k+1)/(k(1-kT/C))$ . By computing

$$\frac{\partial}{\partial k} \left( \frac{k+1}{k(1-kT/C)} \right) = 0,$$

we find that the optimal value  $k^*$  for  $k$  is  $\sqrt{1 + C/T} - 1$ . Of course, the actual number of wallets must be an integer. We remark that if  $k \approx \sqrt{C/T}$ , then each wallet has size  $\approx \sqrt{CT}$  and the competitive ratio is approximately

$$\frac{\sqrt{C} + \sqrt{T}}{\sqrt{C} - \sqrt{T}}.$$

### 3.4 Remarks on the profit margin–transaction cost setting

We remark that the competitive analyses above focusing on total settled value immediately give rise to a bound for the setting that introduces a profit margin  $p$  and a flush cost  $\tau$ . Observe that, for any algorithm constrained to the  $k$ -wallet framework that settles total value  $V$ , the maximum profit is  $V(p - \tau k/C)$ , as only  $C/k$  value can be settled in any single flush. Thus the profit of `OPT` is no more than  $V_{\text{OPT}}(p - \tau k/C)$ . On the other hand, the profit of `FLUSHWHENFULL` is at least  $V_{\text{FWF}}(p - \tau k/(C - kT)) - O(1)$ , as each wallet is flushed with at least  $C/k - T$  value (except for the last wallet, which may introduce a  $O(1)$  additional penalty). It follows that the competitive ratio in the profit model is inflated by a factor

$$\frac{p/\tau - k/C}{p/\tau - k/(C - kT)}$$

over that of the “value-only”  $k$ -wallet setting.

Note that the same argument can be applied to FLUSHALL because each wallet is likewise flushed with at least  $C/k - T$  value (except perhaps for the last flush event).

### 3.5 Remarks on the Case $r = 1$

If the maximum transaction size can be as large as the wallet size, we make a few additional observations:

1. No deterministic algorithm can be competitive if there is only one wallet.
2. FLUSHALL is 3-competitive.
3. FLUSHWHENFULL is not competitive, but a variation on the scheme that groups wallets into pairs can solve the problem.

We prove these in the following.

**Theorem 3.** *There is no competitive, deterministic 1-wallet settlement algorithm if  $r = 1$ .*

*Proof.* For the sake of simplicity, we assume the wallet size and maximum transaction size are both 1. Fixing an online algorithm A, consider the following schedule of transactions:

- Begin with a rapid succession of one or more *microtransactions* each having size  $\epsilon$ , terminating with the first microtransaction that the algorithm chooses to settle.
  1. If the algorithm does not choose to settle any of the microtransactions, end the succession after  $1/\epsilon$  transactions.
  2. If the algorithm *does* choose to settle one, follow it immediately with a transaction of size 1.
- Allow an interval of length  $F$  to pass without any transactions.
- Repeat indefinitely.

In any iteration of the above, either case 1 or case 2 applies. In case 1, the online algorithm settles no transactions, while the optimal offline algorithm settles a total value of 1. In case 2, the online algorithm settles a single transaction worth  $\epsilon$  while the optimal offline algorithm settles a single transaction of size 1. Therefore, the competitive ratio is no better than  $1/\epsilon$ . As  $\epsilon$  can be chosen arbitrarily, it follows that the algorithm cannot achieve any fixed ratio.

*Remark 2.* A simple randomized algorithm can achieve constant competitive ratio when both  $k$  and  $r$  are 1. We first show that FLUSHALL with 2 wallets is 2-competitive against OPT with one wallet. During each epoch, which extends from the time the two wallets come back online after the previous flush until the end of the next flush period, FLUSHALL settles total value  $V \geq 1$ . On the other hand, OPT can settle at most  $V + 1$ , that is, during the time FLUSHALL settles transactions, OPT settles  $V$ , and during the flush time period of FLUSHALL,

OPT packs 1. Therefore, the competitive ratio is  $(V + 1)/V \leq 2$ . Now we will let our randomized algorithm that uses one wallet to simulate one of the wallets in the FLUSHALL algorithm with 2 wallets. At each time when the wallet comes back online, we flip a coin, if it is heads, it simulates the first wallet in FLUSHALL, and if it is tails, it simulates the second wallet in FLUSHALL. That is, the wallet in the randomized algorithm only settles the transactions that are taken by the chosen wallet and ignores the other transactions. The expected value the randomized algorithm can pack in each epoch is half of what FLUSHALL can pack. Hence the competitive ratio against one-wallet OPT is 4.

**Theorem 4.** *For any number  $k > 1$  of wallets FLUSHALL is 3-competitive if  $r = 1$ .*

*Proof.* We use a similar analysis as the proof in Theorem 1. Time is divided into *epochs*, each of which contains the *accumulation phase* and the *flush phase*. For any particular full epoch, let  $V$  be the total value packed by FLUSHALL into its wallets in the accumulation phase. We note that  $V \geq C/2$ . To see this, observe that for any pair of wallets  $W_i$  and  $W_j$  with  $i < j$  the final transaction values  $v_i$  and  $v_j$  of the wallets must satisfy  $v_i + v_j > C/k$ —otherwise the transactions in the later wallet  $j$  would have been placed in the earlier wallet  $i$  by first fit. Summing these constraints

$$\sum_{i < j} (v_i + v_j) \geq \sum_{i < j} \frac{C}{k} \Rightarrow (k-1) \sum_i v_i \geq \frac{k(k-1)}{2} \frac{C}{k} \Rightarrow \sum_i v_i \geq \frac{C}{2}.$$

OPT can settle at most  $V + C$  in this epoch. Considering that  $V \geq C/2$ , the quantity  $V + C \leq 3V$ , as desired. It follows that the competitive ratio is  $\alpha \leq 3$  as desired.

Unfortunately, when  $r = 1$ , the competitive ratio for FLUSHWHENFULL is unbounded. To see that, again, assume the maximum transaction size and wallet size are both 1. The adversary can produce a series of suitably spaced transactions alternating in value between  $\epsilon$  and 1. FLUSHWHENFULL will be forced to take all the  $\epsilon$ -valued transactions and forgo the high-value transactions, while OPT can decline to process the low-value transactions in order to process all the high-value ones. Therefore, the competitive ratio would be  $1/\epsilon$ . This problem can be solved if we pair consecutive wallets and flush each pair when a transaction can not be settled by either of the two wallets. Within each pair, the second wallet takes a transaction when it is too large for the first wallet. We denote this algorithm as FLUSHTWOWHENFULL, for which we have the following result.

**Theorem 5.** *When  $k > 1$ , FLUSHTWOWHENFULL is  $2(k + 1)/k$ -competitive if  $r = 1$ .*

*Proof.* The proof is similar to the proof of Theorem 2. We use the same notations as before. Between time interval  $(t_0, t]$ , FLUSHTWOWHENFULL can settle transaction value at least  $C/2$  since each pair settles at least  $C/k$  before they flush, while OPT settles at most  $C + C/k$ . Therefore, the competitive ratio is  $2(k + 1)/k$ .

## 4 The General Collateral Setting

In this section, we study the general model where the entire collateral  $C$  is held in a single pool. A collateral maintenance policy can replenish any portion of committed collateral (used to settle a transaction) at any time. Even with this additional flexibility, a unit of collateral can only be used for settlement once in a time period of length  $F$ ; it follows that the total settled value of transactions in any time period of length  $F$  is no more than  $C$ . Thus, using the same proof as in Theorem 2, we conclude the following, which shows that FLUSHWHENFULL is competitive even when compared against an adversary who may use the full power of the general model (while FLUSHWHENFULL continues to be constrained operate in the  $k$ -wallet discrete model).

**Corollary 1.** *Setting  $r = kT/C$ ,*

$$\text{OPT}[\text{Gen}_T^C; \text{Tx}] \leq \frac{k+1}{k(1-r)} \cdot \text{FLUSHWHENFULL}[\text{Disc}_T^{C,k}; \text{Tx}].$$

The above result concerns the total transaction value  $V$  settled by an algorithm. As mentioned in the introduction, without further constraints on the adversary it's clear that the optimal approach (in the general model) is to immediately flush any collateral used to settle a transaction. In practice, this is unattractive as there is, in fact, a cost associated with the (typically on-chain) transaction used to refresh collateral. To study this, we introduce two new parameters: (i.)  $p$ , the profit margin: the algorithm is provided a reward of  $p \cdot v$  for settling a transaction of value  $v$ , (ii.)  $\tau$ , the cost of any flush (regardless of the amount of collateral involved in the flush operation).

We seek to maximize the total profit with flush cost deducted. Formally, we would like to find an algorithm that selects transactions to settle so that  $p \cdot V - \tau f$  is maximized, where  $V$  is the total value of settled transactions and  $f$  is the total number of flushes. (Note that by scaling the figure of merit by  $1/\tau$ , this is equivalent to maximizing  $(p/\tau)V - f$  and it follows that the single parameter  $p/\tau$  suffices; we separate these merely for the purpose of intuition.) Recall that we use  $A[\text{Gen}_{T;p}^C; \text{Tx}]$  to denote  $pV - \tau f$  for an algorithm  $A$ .

Inspired by the algorithm FLUSHWHENFULL, we consider a family of policies that flush when the currently committed collateral has reached a specified fraction of  $C$ .

### 4.1 The Threshold Algorithm $A_\eta$

This algorithm is parameterized by a threshold  $\eta$  for which  $T/C \leq \eta \leq 1$ . The behavior of the algorithm is determined by the running quantity  $R$ , the current total collateral that has been committed to settle transactions, but not (yet) flushed. The algorithm proceeds as follows: When a new transaction  $\text{tx}$  arrives, it is settled if and only if there is sufficient remaining collateral. Immediately after settling a transaction, if  $R \geq \eta C$  (so that there is at least  $\eta C$  committed but unflushed collateral), then it flushes exactly  $\eta C$  collateral.

The following analysis derives the competitive ratio of  $A_\eta$  and then computes the optimal value of  $\eta$ , denoted by  $\eta^*$ , that minimizes this competitive ratio.

**Lemma 1.**  $\text{OPT}[\text{Gen}_T^C; \text{Tx}] \leq \frac{C}{C - \eta C - T} A_\eta[\text{Gen}_T^C; \text{Tx}]$ .

*Proof.* The proof is similar to the proof of Theorem 2, so we are somewhat more brief. For contradiction, assume there is a (first) time  $t_e$  for which the interval  $I = (0, t_e]$  satisfies

$$V_{\text{OPT}}(I) > C/(C - \eta C - T) \cdot V_{A_\eta}(I),$$

where  $V_{\text{OPT}}(I)$  and  $V_{A_\eta}(I)$  are the total values of transactions OPT and  $A_\eta$  settle during  $I$ , respectively.

Since  $t_e$  is the earliest such time, there must be a transaction  $\text{tx}$  at  $t_e$  that is not settled by  $A_\eta$ . As  $A_\eta$  does not take  $\text{tx}$ , there are two possibilities: 1) all collateral is offline at  $t_e$ ; 2) the remaining uncommitted collateral is insufficient to settle  $\text{tx}$ . Let  $I_f = (t_e - F, t_e]$ . Recall that collateral is flushed sequentially in portions of size  $\eta C$ , and that any such portion will only start to take transactions after (or at the same time that) the previous portion has been flushed. Let  $W_k$ , refer to the remaining portion of unflushed collateral at time  $t_e$ , if any, and to the last-flushed portion of collateral otherwise. Let  $W_1, W_2, \dots, W_{k-1}$  refer to the portions of collateral flushed during all prior flush events throughout  $I_f$ . We have  $\sum_{i=1}^k W_i = C$ .

If  $t_e \leq F$ , then OPT settles transaction value at most  $C$  in the interval  $(0, t_e]$ . In the same interval,  $A_\eta$  settles at least  $C - T$  since the uncommitted collateral is no more than  $T$ . Therefore,

$$\frac{V_{\text{OPT}}(I)}{V_{A_\eta}(I)} \leq \frac{C}{C - T} < \frac{C}{C - \eta C - T},$$

which would contradict our assumption.

Otherwise  $t_e - F > t_0$ . Observe that of the  $k$  portions,  $W_2, W_3, \dots$ , and  $W_k$  began settling transactions during  $I_f$  since if a portion  $W_i$ 's transaction activity before its last flush starts at a time before  $I_f$  for any  $i = 2, \dots, n$ , then  $W_{i-1}$ 's last flush time must also be before  $I_f$ .

The only portion that may have started settling transactions before  $I_f$  is  $W_1$ . Since  $W_1$  has size equal  $\eta C$  and the uncommitted collateral in  $W_k$  is at most  $T$ ,  $V_{A_\eta}(I_f) \geq C - \eta C - T$ .

Again, we have  $V_{\text{OPT}}(I_f) \leq C$  since the length of  $I_f$  is  $F$ . Therefore,

$$\frac{V_{\text{OPT}}(I_f)}{V_{A_\eta}(I_f)} \leq \frac{C}{C - \eta C - T}.$$

This contradicts our initial assumption so we conclude that there is no such  $t_e$ .

**Theorem 6.** Let  $p \in (0, 1)$  and  $\tau > 0$  be a profit margin and flush cost. For a threshold  $\eta \in (0, 1]$  the algorithm  $A_\eta$  is  $\alpha$ -competitive in the  $\text{Gen}_{T;p}^{C;\tau}$  model for

$$\alpha = \frac{1}{1 - \eta - T/C} \cdot \frac{p/\tau - 1/C}{p/\tau - 1/(\eta C)}.$$

*Proof.* For simplicity, assume that at the end of the sequence Tx any committed but unflushed collateral is flushed in both algorithms. Note then that the algorithm  $A_\eta$  flushed total collateral equal to the total settled value and, furthermore, that each flush processes exactly  $\eta C$  collateral with the exception of the last which may be smaller. It follows that the total number of flushes is exactly  $\lceil A_\eta[\text{Gen}_T^C; \text{Tx}] / (\eta C) \rceil$ . We conclude that

$$\begin{aligned} A_\eta[\text{Gen}_{T;p}^{C;\tau}; \text{Tx}] &= p \cdot A_\eta[\text{Gen}_T^C; \text{Tx}] - \tau \cdot \left\lceil \frac{A_\eta[\text{Gen}_T^C; \text{Tx}]}{\eta C} \right\rceil \\ &\geq p \cdot A_\eta[\text{Gen}_T^C; \text{Tx}] - \tau \cdot \left( \frac{A_\eta[\text{Gen}_T^C; \text{Tx}]}{\eta C} + 1 \right) \\ &= A_\eta[\text{Gen}_T^C; \text{Tx}] \left( p - \frac{\tau}{\eta C} \right) - O(1). \end{aligned} \quad (1)$$

OPT flushes at least once when it commits  $C$  collateral, therefore

$$\text{OPT}[\text{Gen}_{T;p}^{C;\tau}; \text{Tx}] \leq p \cdot \text{OPT}[\text{Gen}_T^C; \text{Tx}] - \tau \cdot \frac{\text{OPT}[\text{Gen}_T^C; \text{Tx}]}{C} = \text{OPT}[\text{Gen}_T^C; \text{Tx}] (p - \tau/C). \quad (2)$$

We combine these to conclude that

$$\begin{aligned} \text{OPT}[\text{Gen}_{T;p}^{C;\tau}; \text{Tx}] &\leq \text{OPT}[\text{Gen}_T^C; \text{Tx}] (p - \tau/C) \leq A_\eta[\text{Gen}_T^C; \text{Tx}] \frac{C}{C - \eta C - T} (p - \tau/C) \\ &\leq A_\eta[\text{Gen}_{T;p}^{C;\tau}; \text{Tx}] \frac{C}{C - \eta C - T} \cdot \frac{p - \tau/C}{p - \tau/(\eta C)} + O(1), \end{aligned}$$

as desired. The second inequality holds because of the inequality in Lemma 1.

**Optimal value of  $\eta$ .** The optimal value of  $\eta$  (which we denote  $\eta^*$ ) satisfies:

$$\frac{\partial}{\partial \eta} \left( \frac{1}{1 - \eta - T/C} \cdot \frac{p/\tau - 1/C}{p/\tau - 1/(\eta C)} \right) = 0,$$

which leads to the optimal value  $\eta^*$ , where  $\beta = \tau/(pC)$ :

$$\eta^* = \sqrt{(1 - T/C) \cdot \beta}.$$

Intuitively, as  $\beta$  approaches 0, the flush fee becomes negligible, and the algorithm should flush as often as possible. Using this optimal  $\eta^*$ , the competitive ratio is  $(1 - \beta) / (\sqrt{1 - T/C} - \sqrt{\beta})^2$ , which approaches 1 as  $\beta$  approaches 0. As a final result, we have the following theorem.

**Theorem 7.** *Choosing  $\eta = \sqrt{\beta(1 - T/C)}$ , the competitive ratio for  $A_\eta$  is*

$$\frac{1 - \beta}{(\sqrt{1 - T/C} - \sqrt{\beta})^2}.$$

## 5 Conclusion

We constructed a modeling framework for collateral management policies of layer-two protocols in the blockchain setting. This framework targets two natural models encountered in practice: the  $k$ -wallet model in which the collateral  $C$  is divided among  $k$  wallets, and the general model in which  $C$  is viewed as one wallet (or collateral pool). We adopt the standard classical paradigm of competitive analysis in which an online algorithm  $A$ , that only knows the transactions encountered so far, is compared against an optimal algorithm  $OPT$  that has full knowledge of the transaction stream including future transactions. Our analysis is agnostic to transaction distribution and only requires knowing the maximum transaction size (i.e., value). Given the dynamic nature of blockchain applications and the unpredictable behavior of their transactions and workload, developing transaction distribution-independent techniques is highly desirable.

Using our framework, we study natural collateral management policies for the  $k$ -wallet and the general models, and we show how competitive they are compared to  $OPT$ . This is measured in terms of the total transaction value that can be settled and when to replenish the collateral to allow settling future transactions. The general model also studies the replenishment cost and how this affects the utility of the policy. We also derive the optimal configuration for the policy parameters, in terms of the number of wallets and the fraction of the committed collateral to be replenished.

To the best of our knowledge, this work is the first to study the collateral management problem for layer-two protocols. Our future work include extending this model to account for more factors, e.g., transaction specific conditions rather than just a transaction value, and develop dynamic policies in which the number of wallets, and even the collateral value itself, can change over time based on the experienced transaction stream.

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