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DIGITAL FINANCIAL ASSETS | RUSSIA

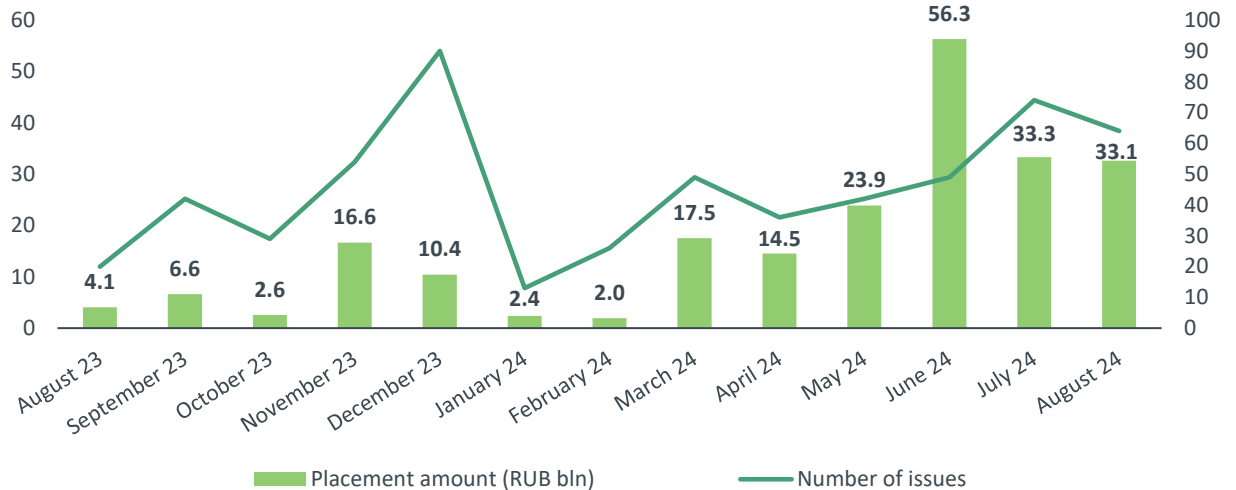
DFAs IN 2024 — CONFIDENT GROWTH IN TURBULENT TIMES

In 2024, the digital financial asset (DFA) market continued to develop. Despite the high key rate, which puts pressure on the entire financial sector, the DFA segment has demonstrated better-than-anticipated growth and considerably exceeded its performance in 2023. Taking into account recent legislative developments that could give digital instruments a new impetus in the short term, the market outlook appears very interesting.

Market dynamics — growth and consolidation

As of the end of August this year, the cumulative number of DFA issues (starting from June 2022) is estimated to be between 650 and 700, which is twice as much as the indicator for the whole of 2023. A conservative estimate of the market volume based on public information, which is defined as the total nominal value of DFAs in circulation, also shows an almost fourfold increase — from RUB 60 bln to 217 bln over eight months. The total volume of new DFA issues, calculated based on data on the amounts of individual issue placements, excluding amortization and redemptions, since the beginning of 2024 amounted to around RUB 182 bln. However, publicly available information on the volume of DFA placements does not always reflect complete information, which complicates the task of accurately determining the integral market indicators. Additional processing of available data allows us to make an alternative estimate of the volume of new issues in the range from RUB 220 bln to 240 bln for the analyzed period.

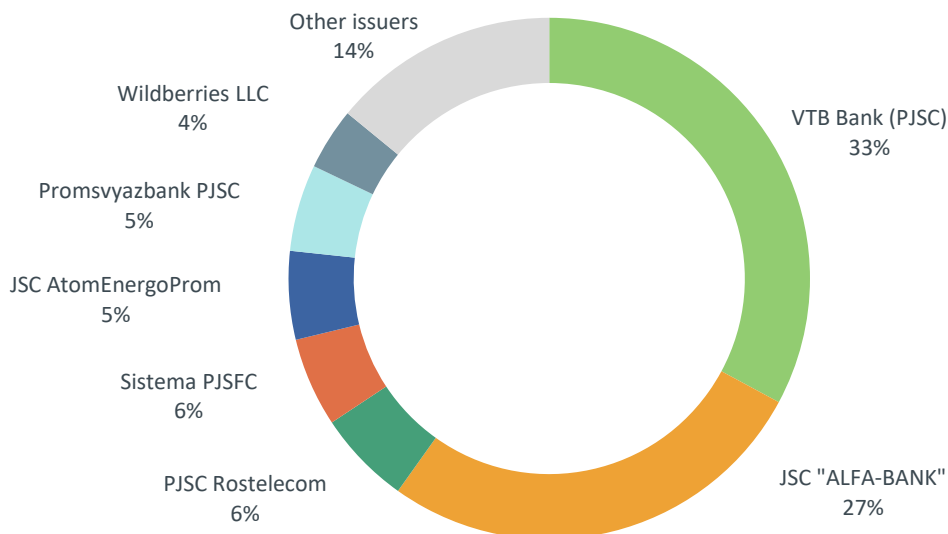
Figure 1. New DFA issues in 2024, monthly



Sources: Cbonds, ACRA

In 2024, DFA issuers are both financial institutions and non-financial companies, including SMEs. Since the beginning of this year, there were around 110 issuers, with about 35% of them placing two or more DFA issues. The market is highly concentrated — the seven largest issuers account for over 86% of the total volume of placements. Such a high concentration amid a relatively small number of issuers, on the one hand, is explained by the unfavorable conditions for entering the market and, above all, high rates, which only large issuers who have significant financial resources and are purposefully engaged in the development of DFAs are able to withstand. On the other hand, this indicates the immaturity of the market, since so far only a small number of issuers have been able to find practical application for this new instrument. The two largest issuers are JSC “ALFA-BANK” and VTB Bank (PJSC), who together account for more than 60% of the market. It is noteworthy that these issuers have selected different strategies for working with digital financial assets: while VTB Bank (PJSC) prefers one-time large issues (three issues worth RUB 20 bln each), JSC “ALFA-BANK” has already issued more than 130 issues of various sizes.

Figure 2. Main DFA issuers since the start of 2024



Sources: Cbonds, ACRA

In most cases, DFAs have fixed rates and a coupon that is paid throughout the life of the financial instrument or on the redemption date. Conditions for payment of the nominal value also vary, including regular amortization and one-time payment on the maturity date.

As in 2023, the market is dominated by the simplest DFA issues (more than 95%), which certify direct payment claims to issuers, and are thereby close to bonds in economic essence. However, individual issues have a more complex structure.

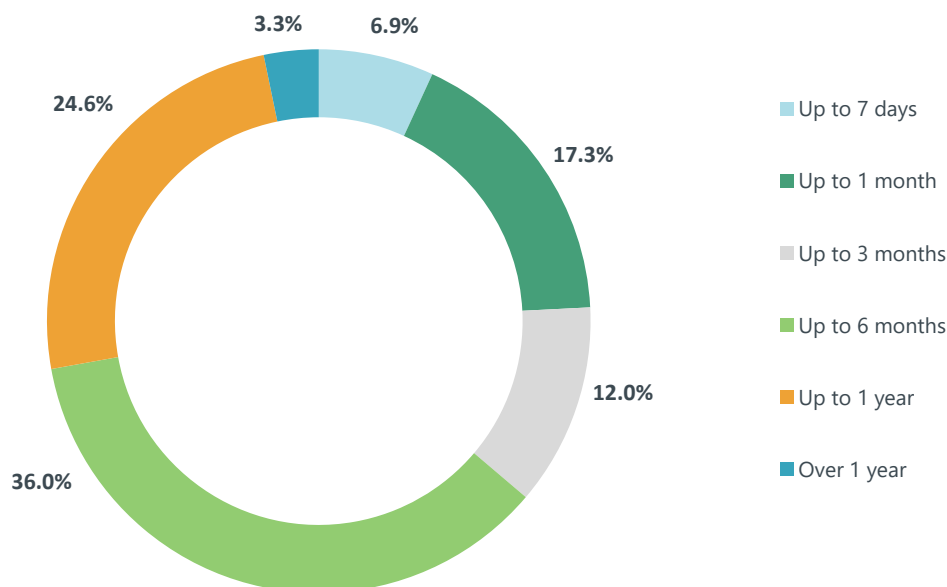
Hybrid rights and digital partnership finance

Hybrid digital rights have become rather popular in 2024 — more than 10 issues included these rights tied to the cost of gold, silver, or other precious metals. Issue conditions may include the investor's right to receive a reward upon redemption of the DFA that is equivalent to the market price of a certain quantity of precious metal as of the same date, or its physical delivery. These instruments are often referred to as 'tokenized metals', however, the potential practical application of these mechanisms is a lot wider and may be relevant for any exchange-traded commodity. The possibility of physical delivery of goods paves the way for hybrid digital rights as part of trading of minerals, and therefore in international trade. Some issues were tied to the value of non-exchange traded goods, but the application of these instruments is limited due to the absence of mechanisms for determining their objective market value.

One of the innovations for the market in 2024 is the issue of DFAs that are an analogue of the Islamic financing instrument — sukuk. A distinctive feature of this type of financial instrument is the prohibition on charging interest payments. In this case, the return on investment and the income from investments are determined based on the principle of dividing income and losses between the investor and the borrower. In particular, the level of income from the indicated issue is fully determined by the profitability of the issuer's commercial activities, which were financed through the DFA issue. Certain elements of Islamic finance, which are known as 'partnership finance' are being implemented in Russia, however, at the moment this only concerns banking services for retail clients and SMEs, and only in a limited number of regions. As for the possibilities and economic feasibility of issuing a full-fledged sukuk in the Russian financial market in traditional paper form, the possibilities of this happening are not entirely clear, and it is likely that additional regulatory and legislative work is required. Consequently, the aforementioned pilot DFA issue in this area is something completely new for Russia. However, the Agency assumes that further development of sukuk in one form or another has moderately high potential — first, the international Islamic finance market (mainly sukuk) amounts to more than a trillion USD, second, the current vector of economic development points toward, among other things, countries with well-established Islamic finance sectors.

Returning of the characteristics of the market, it is important to note that DFAs are generally viewed as an instrument for obtaining short-term liquidity. Less than 28% of the total volume of issues in 2024 were financial instruments due in more than six months. The lion's share — 36% — were DFAs with maturities of three to six months. It is likely that this is because the main issuers are major banks who can offer DFAs to a wide client base via mobile applications as a more profitable alternative to bank deposits that are opened for similar periods. The share of long-term DFAs is likely to increase as the key rate decreases and regulation develops.

Figure 3. DFA maturities by issue volume



Sources: Cbonds, ACRA

In general, it can be stated that the formation period of the DFA market was quite successful. Despite external circumstances, the market shows moderate positive dynamics — in addition to the growing volume and number of issues, the number of active issuers is also growing, and the variety of instruments is expanding. It is also important that DFAs are more recognizable among both professional participants in the financial market and private investors. ACRA believes that the high key rate remains a significant constraint on the segment's development. Accordingly, any key rate declines will be equivalent to lowering the market entry barriers for new issuers, which will not only accelerate the growth of the segment, but reduce the concentration of issuers as well.

DFA market infrastructure development

The DFA market infrastructure has been established and is unlikely to change significantly. Over the past year, only one data system operator (DSO) was included in the DSO Register, thus bringing the total number of DSOs to 11. The incentives for new participants to enter the market in the current conditions are not clear, however, even if the number of participants increases, this will not significantly change the DFA market landscape. On the other hand, new DSOs may emerge if DFA technology is implemented in international settlements. At the same time, in ACRA's view, market consolidation around the largest DSOs may continue for two to three years, which may result in a reduction in the number of active operators.

A mechanism for transferring the registry from one DSO to another when the first one is excluded from the register is still to be created, but work in this area is underway.

Legislative changes — international recognition of DFAs

The regulatory environment does not stand still either. The Agency considers the most significant milestones in legislative development to be new draft laws authorizing the use of DFAs and utilitarian digital rights in foreign economic activity, as well as permitting to apply foreign digital rights in Russian jurisdiction and Russian DFAs in foreign jurisdictions.

The law¹ adopted in March this year allows Russian DFAs to be used in cross-border settlements under various contracts. The obvious limitation was the specifics of Russian DFAs, which could not be used outside Russian data systems. In practice, this meant that both Russian companies and their foreign counterparties had to have access to a Russian data system through an electronic wallet or personal account (and in the case of utilitarian digital rights, to the Russian investment platform), as well as to Russian payment systems, which limited the application scope of this initiative.

In August 2024, the so-called crypto mining law² was adopted, which strongly complemented the abovementioned innovations. In particular, in addition to creating a legal environment for mining digital currencies and the possibility of regulating digital currencies by the Government of the Russian Federation together with the Bank of Russia, the law also makes it possible to register and use foreign digital rights as DFAs and hybrid digital rights on Russian platforms, as well as to use Russian DFAs abroad. The law also defined a foreign nominal DFA holder.

Practice will show the viability of the international settlements system, and whether the created regulatory framework is sufficient for its full-fledged deployment. A foreign holder of DFAs issued in the Russian jurisdiction for use in settlements for, for example, imports of any products to or any work done in the Russian Federation would use such DFAs to buy products in Russia, pay in DFAs to other foreign counterparties, or use counterclaim mechanisms with a Russian counterparty. However, this approach seems to be very limited and unsuitable for some foreign companies. Given the technological difficulties of integrating DFAs on different platforms even within the same jurisdiction, the Agency believes that the most effective way would be to use an international equivalent of an exchange operator or technological integration of a Russian exchange operator with foreign peers. Nevertheless, the potential exclusion of cross-border interbank settlements, which are the most vulnerable to sanctions, from such an arrangement requires a detailed study.

Despite all the design and technical challenges that the foreign economic actors will have to overcome together with the government, ACRA believes that the cross-border use of DFAs has great potential and can have a significant positive impact on the Russian DFA market and contribute to deepening international economic cooperation with friendly countries. The forthcoming creation of the BRICS PAY international payment system, which purposes largely coincide with those of the Russian DFAs, gives special relevance to this area.

¹ Federal Law dated March 11, 2024 No. 45-FZ "Amending certain legislative acts of the Russian Federation".

² Federal Law dated August 8, 2024 No. 221-FZ "Amending certain legislative acts of the Russian Federation".

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