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Risk Management and Internal Control

Smart risk-taking

Timely identification and management of risks is essential to maintaining sustainable growth and achieving the Company's strategic and operational objectives.

MegaFon's approach to risk management is based on international and national best practice and standards.

The Company is focused on continuously improving its RMICS to ensure that it successfully delivers on MegaFon's corporate strategy while providing a robust platform for stable and continuous business operations.

MegaFon also continuously fosters a risk-based culture at all levels of management, providing regular training to employees in risk management theory and practice.

The risks faced by MegaFon in its operations are driven by macroeconomic, market, technological and industry-specific factors, including rapidly changing regulation.

MegaFon makes a constant effort to identify, assess and mitigate risks, and aims to minimise the negative impacts of risks beyond its control.

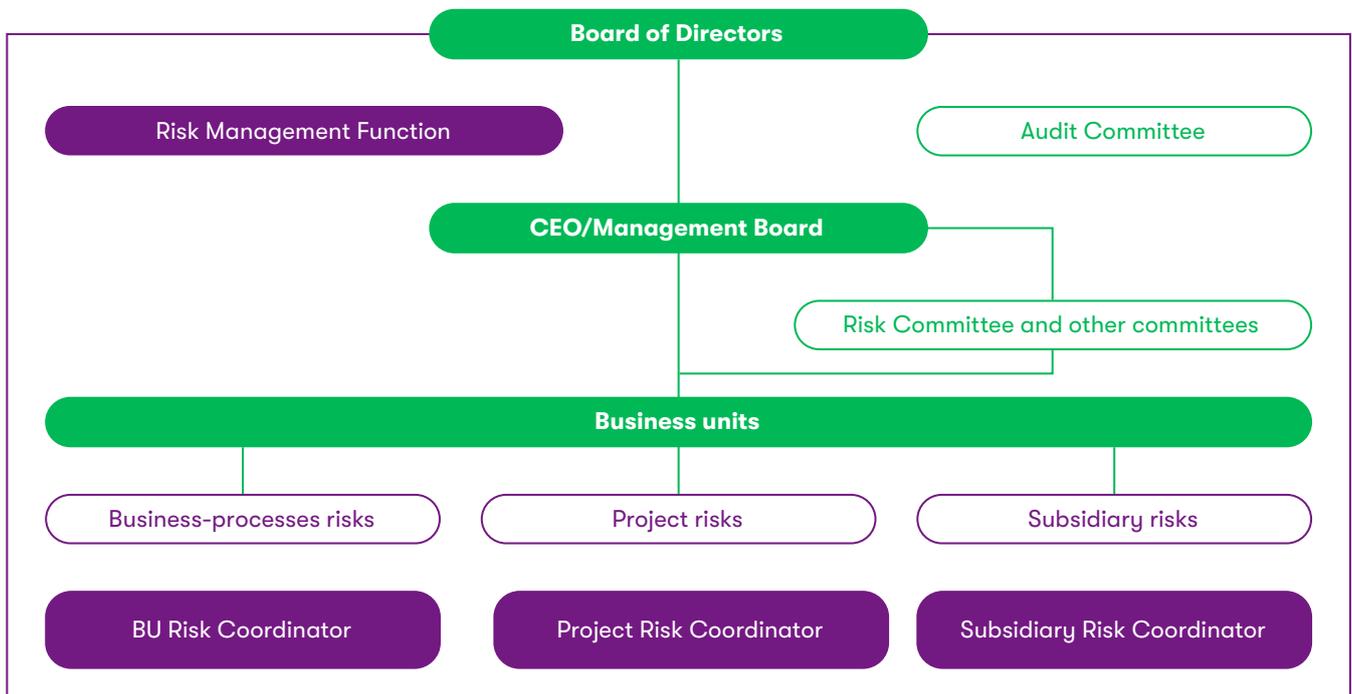
The risk management strategy involves:

- 1 continuously aligning risk management and internal controls to business changes,
- 2 developing risk assessment models to improve the accuracy of data available to drive decision-making,
- 3 improving risk identification,
- 4 formalising and updating risk appetite metrics and aligning risk appetite with the Company's development strategy,
- 5 continuously seeking out business opportunities and options for transforming threats into opportunities, as well as finding the best ways to respond to risks,
- 6 improving risk management and internal control communications and
- 7 regular employee training

The corporate Risk Management and Internal Control System (RMICS) Policy is the key document governing MegaFon’s risk management activities. The policy, developed in line with applicable Russian laws and international risk management standards, establishes general approaches to risk management and internal control.

 [The RMICS Policy](#)

Risk management structure



— Management — Coordination, development

Risk management and internal controls are embedded across all operations and at all levels throughout the organisation.

The Board of Directors through the Audit Committee determines the RMICS principles and approaches and evaluates the system’s effectiveness.

The CEO and the Management Board ensure the: setting up and maintenance of a robust RMICS, allocation the roles, responsibilities and accountability for specific risk management and internal control procedures among business unit (BU) heads, including through the Risk Committee and other committees, approval of reporting format requirements, review and agreement on principal risks and promotion of a risk management and internal control culture.

The BU heads ensure that the RMICS is incorporated into business processes and projects, including risk identification and assessment, and also ensure the development and implementation of risk management measures, including operation of control procedures.

MegaFon’s Risk Committee is a permanent collegial advisory and consultative body, which includes various top managers and is chaired by the Chief Executive Officer. The Committee reviews the status of and changes to MegaFon’s principal risks, and is responsible for decision making on principal risks, approving risk management measures and reviewing their implementation status and promoting a unified approach to compliance risk management.

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The risk management function drives the development of risk management across the Company, implementing the RMICS Policy, ensuring risk updates, overseeing the implementation of risk management measures, coordinating the efforts of business units to identify and assess risks, and developing appropriate risk management measures. The risk management team ensures the preparation of risk management materials for the Management Board, Risk Committee, and Audit Committee, and implements measures to foster a risk-based culture, including training and support for employees.

Risk coordinators have been designated with respect to the Company’s key functions, driving collaboration on risk management.

MegaFon uses the Oracle Hyperion RiskCom automated solution to maintain its risk inventory and conduct risk analysis, ensuring that risk data are collated in a user-friendly way.

MegaFon is focused on building a risk-based culture, the key aspects of which include:



Tone at the Top

MegaFon’s senior managers act as role models in the discussion, identification, and assessment of risks, and are actively involved in risk management.



Corporate governance

Risk ownership and responsibilities are included in employees’ job descriptions and targets. Timely communication about risks is encouraged and all risks are regarded as opportunities to improve the Company’s performance.



Skills and capabilities

The Company’s key employees are continuously trained in risk management with support from management.

Risk management training for employees is a top priority for MegaFon. The Company’s managers take a mandatory online risk management course based on ISO 31000, which reflects the Company’s specific business profile. This course is also made available to all MegaFon employees.

Principal risks and mitigation

MegaFon’s analysis considers various types of risks, while setting out the measures that the Company takes to minimise them. This analysis covers strategic, geopolitical, technological, regulatory, operational (including compliance) and financial risks.

#	Risks	Risk Description
Strategic/external risks		
1	Geopolitical	<p>As a company registered in the Russian Federation, MegaFon is exposed to economic and geopolitical risks specific to Russia in general, including those related to the current sanctions regime imposed by the United States, European Union (EU) and other countries against certain Russian companies. There is a risk that new sanctions may be imposed or the list of entities subject to existing sanctions may be expanded. Additional sanctions may also be imposed on supplies of equipment, software and services from the EU and the United States.</p> <p>MegaFon relies on multiple international suppliers to conduct its business and develop its complex infrastructure. If the Company is unable to deliver its development plans due to supply disruption, MegaFon may face delays in infrastructure development and/or increased costs.</p>
2	Risk of an economic slowdown	<p>Falling oil prices and a weaker rouble may negatively impact the Russian economy.</p> <p>The coronavirus pandemic in 2020 may also lead to an economic downturn and a slowdown in business activity, which could potentially result in lower revenues for the Company, delays in equipment deliveries, and adjustments to MegaFon's CAPEX programme.</p>
3	<p>Technological and digital transformation</p> <p>New business models, new entrants</p>	<p>The telecommunications and digital industries are rapidly changing amid an accelerating pace of innovation, while new players are entering non-core markets, such as banks establishing telecoms operators and telecoms operators creating banking products. At the same time, customers are becoming more demanding and expecting superior digital customer service and a seamless online and offline experience. Failure to provide such high-level service and experience can reduce customer loyalty, and lead to increased churn and possible loss of market share. To meet the high customer expectations, MegaFon needs to be fast and agile, and have strong digital capabilities.</p>
4	Market disruption	<p>The mobile market is one of the most developed segments of the Russian telecommunications industry. It is characterised by high penetration rates, which has led to increased competition as operators strive to retain existing and attract new customers. This competitive landscape is one of the most influential factors continuing to impact the mobile market. MegaFon's key direct competitors include MTS, VEON, and Tele2. Further, evolving business models in the market may lead to changes in the structure and dynamics of the current market, the impact of which may not currently be foreseeable.</p>

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Risk Management

MegaFon’s business is conducted outside the EU and the United States and is focused on telecommunications, which are usually excluded from sanctions regimes. Besides, although trade sanctions do not directly apply to the Company, MegaFon cannot guarantee that actions aimed to mitigate negative changes will lead to a significant change in the situation, since the vast majority of the above risks are beyond MegaFon’s control.

MegaFon closely monitors on an ongoing basis the economic and political situation affecting key suppliers. MegaFon works with experts and suppliers to keep up-to-date on current affairs so as to be able to prepare an appropriate action plan as necessary. The Company also works closely with its key suppliers to ensure continuity of key equipment supply.

The wireless market is quite resilient during an economic downturn, as customers are unwilling to reduce their minutes and mobile data usage and therefore spending on these services is less exposed to the risk of an economic downturn.

The long-term contracts MegaFon holds with major global vendors should ensure the continued construction and modernisation of its network.

MegaFon continues to implement its strategy aimed at the digital transformation of its business.

The Company continues to transform its internal processes, accelerating the review process for technology innovations, and enhancing ‘Agile’ development practices. MegaFon is focused on developing artificial intelligence solutions which will drive the evolution of autonomous and intelligent networks while improving the customer experience through more advanced behaviour analytics.

To speed up the implementation of business initiatives, MegaFon has launched a microservice factory and continues to develop API management.

MegaFon continues to develop and improve its technology sandbox, a tool that, by using simplified procedures, enables a faster review process for new technology to be piloted within the Company.

The Company continues to build its digital capabilities in agile development practices, cloud technology and data virtualisation, as well as in building high-performance IT teams, Big Data and machine learning.

MegaFon has undertaken a wide range of initiatives to bolster its competitive advantage, including deploying cutting-edge technology, developing new and innovative products and services, creating new partnerships with other companies and building innovative infrastructure.

#	Risks	Risk Description
Operational risks		
5	Risk of new business acquisitions/mergers or strategic alliances having an adverse impact on MegaFon's business	MegaFon will likely continue to grow its business through acquisitions and participation in strategic alliances and partnerships. Should the Company be unsuccessful in integrating or managing any acquired company or taking full advantage of a strategic alliance, this may result in remediation efforts which divert management's attention away from other business concerns. In addition, any potential acquisition could negatively impact MegaFon's financial position or credit ratings, dilute share capital value subject to the acquisition deal structure, possible deferred payments, FX exposure in the transaction price, and the successful delivery of targeted synergies and integration processes.
6	Transfer pricing	The practice of enforcing transfer pricing legislation is still in its early stages, and the approaches used to establish arm's length prices under controlled transactions may be challenged by tax authorities, which could lead to additional tax liabilities being imposed.
7	Controlled foreign companies	In accordance with the Tax Code of the Russian Federation, undistributed profits of foreign companies controlled by Russian tax residents may be subject to taxation in Russia. The law makes Russian tax residents in control of foreign companies liable for tax payments and submission of relevant CFC notifications. At the same time, there are risks associated with the lack of court practice relating to the CFC Rules and of guidance by competent authorities on their application.
8	Risk of revocation, suspension, or non-renewal of licences	Changes in licensing legislation requirements applying to the Company's core business (provision of communications services) could adversely affect MegaFon's operations if such changes affect the process of obtaining or renewing the Company's existing licences for the provision of communications services required for the Company to continue its business.
Technology risks		
9	Technology resilience	Although MegaFon ensures that its technological infrastructure has a high level of reliability and resilience, an accident may affect the speed and quality of provided services.
10	Telecommunications fraud risks	MegaFon may incur losses resulting from wilful misconduct by unscrupulous counterparties or subscribers. The Company is also exposed to the risk of losing subscribers who become victims of fraud, as well as reputational damage.
11	Cyber risks	Certain vulnerabilities may lead to a failure to maintain appropriate security levels for software, equipment, network and subscribers' personal data, potentially leaving them compromised and subject to unauthorised access and use, such as the use of subscriber data or confidential information in fraudulent transactions or the spread of malware.

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Any asset acquisition is always preceded by extensive due diligence on the target business, an evaluation of the transaction's viability, and legal due diligence to verify ownership of the asset and validity of the proposed transaction.

MegaFon has a good track record of successful acquisitions and post-transaction integration and its Management Board and the Board of Directors consists of experienced professionals who have the necessary expertise and qualifications for effective decision-making regarding acquisitions. When entering into transactions, MegaFon also endeavours to include provisions in the relevant agreements, whereby payment of the consideration is tied to the target meeting set objectives and KPIs, and MegaFon's exposure to tax, legal and commercial risks is minimised.

To minimise tax risks related to transfer pricing, MegaFon has introduced and continues to improve internal procedures ensuring compliance with the transfer pricing legislation, while monitoring prices used in related party transactions to ensure they are in line with the market and identifying controlled transactions as defined by the Russian Tax Code.

MegaFon also formed a consolidated group of taxpayers among the members of the MegaFon Group so that transactions among members are not subject to transfer pricing control.

MegaFon has developed internal procedures to identify entities that may be treated as controlled foreign companies, and to ensure the timely filing of required reports with the tax authorities. The Company also participates in discussions of legislative initiatives, make timely assessments of the impact of potential changes, monitor guidance on relevant topics by competent authorities, take timely measures to mitigate the negative impact of changes in tax laws or their interpretation, and continues to improve its internal procedures in accordance with the official directives and instructions provided by competent authorities.

MegaFon holds GSM, 3G and 4G/LTE licences with varying expiry dates. The Company pays close attention to tracking licence expiry dates and keeping licence data up to date, taking all necessary steps to ensure timely renewal of licences with the Federal Service for Supervision of Communications, Information Technology, and Mass Media of the Russian Federation (Roskomnadzor). To date, MegaFon has not experienced any refusals to renew, or even delays in renewal.

MegaFon takes all necessary measures to ensure the high quality of its services. In particular, to improve the overall resilience and performance of the Company's technological infrastructure, MegaFon has put in place business continuity regulations and is focused on building its technological architecture in line with the highest global standards, ensuring redundancy of the most critical elements of its infrastructure. MegaFon also implements a number of relevant initiatives to enhance business continuity.

MegaFon has a dedicated unit responsible for preventing fraud and associated financial or reputational losses while safeguarding customers against fraud. MegaFon uses a number of dedicated automated anti-fraud solutions to support fraud prevention. Monitoring for the more critical fraud threats is carried out 24/7.

MegaFon takes all necessary measures in line with its information security strategy to ensure an appropriate level of security for its IT systems, software, technology, and equipment. This includes continuous monitoring for potential threats and the use of security intelligence platforms across its IT and telecommunications infrastructures.

In addition, MegaFon has in place a strong information security policy supplementing internal regulations governing personal data protection, and has developed a robust monitoring system for cyber threats.

#	Risks	Risk Description
Regulatory risks		
12	Data exchange	A large number of draft regulations on data exchange are currently in development. Of particular note are some controversial draft laws regulating information exchange between telecoms operators and banks (customer data), Big Data (user-generated Big Data), and public data exchange (available online to the public).
13	Changes in regulations on restricting access to blocked webpages; cross-border traffic routing	Federal Law No. 90-FZ on Amendments to the Federal Law on Communications and the Federal Law on Information, Information Technology and Information Protection, dated 1 May 2019, provides for the implementation of a range of organisational, administrative and technical measures to improve the information security, integrity and resilience of the internet information and communication network within the Russian Federation. MegaFon will need to ensure it remains compliant with all amendments.
14	Risk of the introduction of minimum communications service quality parameters	<p>Legislation in the Russian Federation currently does not contain provisions specifically requiring compliance by communications service providers with minimum quality parameters.</p> <p>The regulator's philosophy to date has been that the quality of communications services will be assured as long as subscribers have the right to select their communications operator, based on the requirement that operators provide information about service quality to subscribers.</p> <p>At the same time, government authorities have recently reconsidered their position in considering the introduction of minimum communications service quality parameters.</p>
15	Risks related to 5G	<p>The Government and industry participants are developing various 5G development scenarios. The commercial 5G launch will require a wide range of regulations to be introduced.</p> <p>However, there remains considerable uncertainty as to the development scenario which will be chosen, as well as the nature and scope of the implementing regulations.</p>
Financial risks		
16	Interest rate risk	Rising interest rates could increase MegaFon's cost of raising funds to finance its operations and CAPEX programmes. In addition, where MegaFon's existing debt carries a floating rate, the Company is exposed to the risk of higher costs of servicing such debt.
17	Risk of adverse changes in FX rates	<p>The Company's exposure to FX risks is mostly linked to its financial and investing activities.</p> <p>A significant portion of MegaFon's capital expenditure, expenses and liabilities are denominated in foreign currencies, mostly in US dollars or euros. The rouble's depreciation against the US dollar and/or euro may make it difficult for the Company to repay or refinance its foreign currency denominated debt and maintain an adequate level of capital investment. Therefore, a weaker rouble may increase MegaFon's investment and financial costs in roubles, leading to lower net profit.</p>

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MegaFon believes that these draft laws and regulations require thorough elaboration and discussion with the industry players, as flawed regulation would put pressure on revenue growth from technology products. The Company participates actively in the discussions relating to all legislative initiatives on data exchange.

MegaFon closely monitors draft legislative enactments under this law.

MegaFon believes it is unlikely that minimum parameters for service quality will be required in the medium term. However, even if the regulators change their current approach, the Company believes it will be able to ensure its services comply with any such minimum parameters.

MegaFon is closely monitoring all initiatives related to the development of communications technologies, above all 5G, and actively participates in discussions relating to such initiatives.

Currently, MegaFon enjoys a high credit rating, which makes it well-positioned to raise funds at the most attractive terms available in the market.

A major portion of the Company's debt portfolio is long-term and carries attractive interest rates. Over 85% of the Company's debt portfolio has fixed rates. Furthermore, MegaFon has headroom to manage its floating rate debt.

To mitigate FX risks, MegaFon uses cross-currency interest rate swaps and other derivative financial instruments to hedge the euro-denominated portion of its debt portfolio, and seeks to increase the share of rouble-denominated operating expenses and capital expenditures to cover such expenses using rouble revenues.

#	Risks	Risk Description
18	Credit risk	Credit risk refers to the risk of financial loss resulting from a counterparty's failure to meet its contractual obligations. Financial instruments that may potentially lead to a higher credit risk include short-term investments, receivables, and long-term deposits.
19	Risk of credit rating downgrade	The Company's credit rating has an impact on the availability and cost of raising funds, therefore a rating downgrade can lead to higher costs of funding and debt servicing.
20	Liquidity risk	<p>The availability of funding in capital markets and the key rate level have an impact on MegaFon's liquidity and borrowing costs.</p> <p>Further sanctions in the banking sector could lead to restrictions on certain transactions.</p>

Compliance

Compliance framework

MegaFon defines compliance as employees' acting in accordance with the Company's principles and standards of business ethics and integrity to protect the interests of the Company and all parties affected by its activities or decisions. Compliance requires observance of applicable Russian and foreign laws, as well as the Code of Ethics and Corporate Conduct, and other internal regulations.

MegaFon is focused on building an effective compliance framework in line with ISO 19600:2014 – Compliance management systems, while incorporating best practice, standards, and regulators' guidelines.

The Company's Compliance Policy sets out the guidelines for building a compliance framework, describes its mandatory elements, and defines its scope. Management of key compliance risk areas and identification of compliance requirements is an ongoing process at MegaFon, along with efforts to ensure these requirements are met.

MegaFon's compliance function management and Compliance Policy implementation are driven at several levels of the organisation, including the Board of Directors, Audit Committee, Chief Executive Officer, Management Board, and Risk Committee. The Risk Committee defines the strategy and provides senior level support for the development of MegaFon's compliance framework. Compliance is also addressed at the BU level, with dedicated employees assigned responsibilities for the implementation of specific compliance programmes.

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To mitigate credit risk, MegaFon invests its surplus funds on a diversified basis both with Russian branches of international banks and a limited number of selected Russian banks. The majority of Russian banks engaged with MegaFon are either owned or controlled by the state.

Preventive measures to mitigate credit risk with respect to other counterparties include the use of prepayments, bank guarantees and other collateral, and building relations with counterparties whose solvency is continuously monitored based on their credit history and assigned credit ratings.

MegaFon also annually monitors possible impairment with respect to loans and other financial investments made.

As at the date of this Annual Report, MegaFon had a high credit rating level:

- A Ba1 long-term credit rating with a stable outlook from Moody's
- BB+ foreign and local currency ratings with a stable outlook from S&P Global Ratings
- AA(RU) credit rating with a stable outlook from ACRA – the highest rating for companies with no government shareholding.

Thus, MegaFon remains one of Russia's highest-rated companies, which combined with consistent financial performance allows the Company to raise funds on the best terms available in the market and serves as a guarantee of its creditworthiness. MegaFon has the necessary resources to ensure uninterrupted access to finance to support its economic activities.

MegaFon has access to adequate funding through its existing credit facilities, thereby reducing liquidity risk in the short and medium term.

The Company carefully monitors MegaFon's exposure to Russian financial institutions, which could become subject to new or increased sanctions, to ensure that the Company always has access to adequate funding even if dealing with, and accessing funds held by, such institutions become more difficult.

MegaFon also holds funds in different currencies and is endeavouring to provide where possible for payment of obligations in different currencies to mitigate any possibility of restrictions being imposed on the currencies in which it normally deals.

2019 Highlights

In 2019, the Board of Directors decided to transfer the Compliance Committee's authority and responsibilities to the Risk Committee, including ensuring observance of applicable Russian and foreign laws, the Code of Ethics and Corporate Conduct, and other internal regulations.

During the year, the Committee considered and approved several key areas relating to compliance, as well as a number of cross-functional initiatives aimed at improving the existing compliance framework: enhancing technical and regulatory compliance, further automation of procedures under the AML/CFT programme and protecting the confidentiality of insider information.

In 2019, an updated ethics and compliance training course and test for employees was rolled out, and efforts continued to refine the compliance framework across MegaFon subsidiaries. MegaFon also refreshed its Gifts and Hospitality Policy in 2019.

In 2020, MegaFon intends to continue enhancing its compliance framework, including improvements to existing processes and rollout of new compliance programmes, as well as promoting employee awareness and overall compliance with ISO 19600:2014.