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Economic growth will be weak and will depend on government support	1
The situation in the banking system and insurance sector.....	2
Shocks will have an uneven impact on non-financial industries.....	4
Reduced tax revenues will have a negative impact on the financial indicators of some Russian regions.....	7
Negative tendencies in the economy will not impact ratings assigned to structured finance transactions.....	8

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The spread of COVID-19 and the fall in oil prices are worsening the economic situation and the creditworthiness of Russian issuers

An overview of the situation in various segments of the economy

The sharp increase in negative trends in the global economy that occurred in early March 2020 will negatively affect both the economic situation in Russia and the creditworthiness of Russian issuers. However, the scale and duration of these consequences will largely depend on the specifics of a given issuer.

This study examines the macroeconomic prerequisites for possible developments, analyzes the situation in the banking system and insurance sector, and assesses the potential impact of deteriorating economic conditions for various sectors of the economy and regions of the Russian Federation, as well as in the context of ratings assigned to structured finance transactions.

Economic growth will be weak and will depend on government support

The number of reported cases of the COVID-19 coronavirus is currently minimal in Russia. However, the relative openness of Russia's economy makes it impossible to avoid the negative impact of reduced economic activity in key trading partners (e.g., China, Korea, Italy, other European countries), where the spread of COVID-19 has had a serious impact on the economy. Russia has taken a hit as a mineral resource exporter as well, as this market is sensitive to imbalances in supply and demand. The imbalance does not only result in a decrease in export prices, but can potentially lead to a short-term decline in physical export volumes.

ACRA believes that a capital outflow is possible, but it is difficult to predict its volume at the moment. Measures taken in Russia to counter the spread of COVID-19 may have a negative impact on the dynamics of the service sector, as is the case in other countries.

Previously, ACRA's base case scenario assumed a real GDP growth rate of 0.8% in 2020. However, taking into account new challenges, this figure does not seem attainable. ACRA estimates that Russia's economy will grow from -0.2% to 0.6% in 2020 if the Bank of Russia takes timely actions to prevent liquidity crises in the banking system. Another important condition for this scenario is timely budget support for the economy. Therefore, the challenges facing Russia's economy must be considered in the context of the opportunities available to the government and the Bank of Russia.

For some time oil prices should remain below the level at which the federal budget is balanced. However, ACRA does not expect that steps will be taken in 2020–2021 to consolidate the budget, which could lead to an additional decrease in domestic demand and negatively affect GDP dynamics. ACRA estimates the federal budget's liquid assets, including funds from the National Wealth Fund, to be about 14% of GDP as of January 1, 2020. This makes it possible to finance expenditures without recourse to debt during an adverse period for the economy.

ACRA believes the elasticity of the ruble exchange rate for oil prices will be lower than before 2017 due to currency interventions under the budget rule. This reduces the likelihood of a sharp increase in inflation, comparable to the levels of 2015.

Based on the information currently available, ACRA believes that inflation will not exceed 7% over the course of 2020 (it will most likely be significantly lower).

The Bank of Russia may resort to raising the key rate to maintain financial stability, reduce incentives for short-term savings in foreign currency, and prevent deposit valuation. This measure may be necessary to reduce the probability of the exchange rate exceeding fundamental levels.

The situation in the banking system and insurance sector

The banking system is more prepared for worsening economic conditions than in 2014, but a number of credit institutions are at significant risk

The short-term negative effect of the sharp fall in the ruble exchange rate and oil prices will be moderate for the banking system, which is largely due to the limited open currency position of most Russian banks and strong liquidity positions. Support also comes from the readiness of financial regulatory authorities to provide banks with additional funds to refinance short-term liabilities.

Money market rates are generally stable, which limits the risks of negative revaluation of the securities portfolios of high-quality issuers. While the decline in the ruble is putting pressure on banks' capital adequacy indicators by revaluing risk-weighted assets (RWA), ACRA estimates that industry-wide risks of regulatory violations remain low. In addition, the Bank of Russia can use a number of additional measures that would soften regulation and reduce the impact of recent events on the financial stability of credit institutions.

A possible increase in the key interest rate by the Bank of Russia would increase the risks for banks that actively attract market funding (repo operations, interbank loans, etc.). During a period of high volatility in the securities market, the use of such a business model reduces the financial stability of credit institutions.

The long-term effect of changes in the economy depends on a number of factors. Among these factors, ACRA highlights the impact of lower oil prices on Russia's GDP, the Bank of Russia's stance on the key rate, as well as the share of assets and liabilities of banks denominated in foreign currency.

The fall in oil prices has had a negative impact on the Russian economy in general and in particular on the interest of non-financial companies in attracting debt financing. According to ACRA, the growth rate of the corporate loan portfolio will be close to zero in 2020, while the quality of the portfolio will depend largely on the borrower's industry specialization and the currency of the loan.

In recent years, Russian banks have tended to reduce investments in foreign currency assets. Over the past six years, the total amount of foreign currency assets on banks' balance sheets has decreased by USD 76 bln. As of February 1, 2020, foreign currency loans (including interbank loans) accounted for less than 20% of the total, while this figure exceeded 36% as of January 1, 2014, when the exchange rate was comparable. However, corporate loans in foreign currency have a lower level of delinquency compared to ruble loans, which may be explained by foreign currency revenue from export operations for large corporate borrowers. Borrowers who have debt in foreign currency but receive revenue in rubles will remain more vulnerable. However, the impact of the devaluation on the quality of foreign currency loans and the financial stability of banks will be less severe than in 2014–2015.

According to ACRA, loans provided to the construction industry (despite changes in financing rules), as well as to the real estate sector, are at the highest risk of impairment. Some deterioration in the quality of loans is also possible for companies from other industries that are highly sensitive to fluctuations in the business cycle.

The solvency of construction companies will largely depend on the impact of lower oil prices on household incomes. The weakening of the ruble will support increased demand for real estate in the short term, but this could be followed by a slowdown in demand growth or even its decline. The overall effect will depend on how well the Bank of Russia can manage the situation in the domestic financial market without raising the key rate.

ACRA does not expect a significant deterioration in the quality of the mortgage portfolio, which traditionally remains high even during periods of economic slowdown. However, ACRA notes the risks to unsecured retail lending posed by the weakening of the ruble. Rising consumer prices, which limit the ability of borrowers to service debt obligations, could put pressure on the quality of the unsecured portfolio and potentially affect living standards. ACRA notes that in recent years in Russia, the share of household income set aside for savings has decreased. This may be a sign that Russians are becoming less resilient to possible economic stresses, as well as evidence of a significant decline in the quality of unsecured loan portfolios.

The insurance sector has enough capital reserves to withstand negative trends in the economy

ACRA believes that the current turbulence in financial markets will have a moderate impact on insurance companies in the short term. Most Russian insurers adhere to a conservative investment policy, placing funds mainly in government securities, bonds of companies with high credit ratings, and deposits in large banks. The size of insurance companies' investments in stocks is small, with their share in total assets amounting to just over 3% and in total capital to 13%. The open currency position is also limited, with most companies in the industry either fully hedging currency risk or having a long position in foreign currency. Therefore, for most insurers, the weakening of the ruble should not lead to losses.

In the longer term, the impact of the coronavirus pandemic and the fall in oil prices will depend on the extent and duration of the downturn. A significant drop in insurance premiums for those traveling abroad is expected due to a sharp decline in tourist flows. Demand for other types of insurance will depend on several factors and could either decrease or increase. For example, recognizing the threat of epidemics can help increase client interest in life insurance, private health insurance, extended coverage for breaks in production, insurance for event cancellations, and other risks. The demand for insurance services among bank borrowers will also decrease amid reduced business activity and reduced lending volumes.

From the point of view of losses on existing policies, ACRA expects an increase in insurance payments for those traveling abroad, as well as some increase in the amount of payments for private health insurance and life insurance. According to ACRA, there is practically no insurance coverage in the Russian market against interruptions in production caused by pandemics, and relatively few policies have been issued to insure losses from event cancellations.

Given these factors, the increase in insurance payments should be insignificant. As of the beginning of the year, insurance companies had significant own funds, and their solvency indicators exceeded standards by 185% on average for the industry.

Shocks will have an uneven impact on non-financial industries

According to ACRA, the collapse of the OPEC+ agreement could lead to a sharp change in the global oil market in the long term. It is possible, although unlikely, that the deal is restored (the next OPEC+ meeting is scheduled for June 10). However, in the current conditions, ACRA's base case scenario for the long-term development of the oil market assumes the lack of coordination in production between OPEC and non-OPEC countries and the transition to a strategy focused on maximizing production levels.

By the end of the year, the increase in the average daily oil production in OPEC+ countries by 4–5 million barrels compared to March 2020 would lead to a market excess of an unprecedented 5 million barrels per day. Under the new market conditions, ACRA's base case scenario estimates the average annual price of Brent crude oil for 2020–2021 at USD 35 per barrel.

Sectors of the economy mostly affected by lower oil prices and measures to contain COVID-19

Oil and gas sector. ACRA expects that the total EBITDA figures for Russia's largest vertically integrated oil companies¹ will decrease by about 18% in 2020 (in ruble terms), while the debt to EBITDA ratio will grow to 1.8x compared to 1.3x in H1 2019. As in previous periods of low oil prices, the negative impact on the financial performance of oil and gas companies will be significantly mitigated by the tax system, which will allow them to maintain financial stability.

Air and rail transportation. According to ACRA, the spread of COVID-19 in Europe will have a negative impact on tourist flows in the spring and summer, which will directly affect both Russian and foreign airlines. This is made worse by the fact that airlines generate almost all of their revenues from May to September. The market conditions are worsened by ruble depreciation, and similar situations in the past have significantly restricted international transportation. If Russia is able to maintain a low infection rate, ACRA expects passenger traffic from the international transport segment to shift partially to the domestic segment. However, this will not occur if Russia sees an increase in cases and additional measures are taken to contain the pandemic, in which case the Russian air travel market could experience one of its largest declines.

In addition to the negative impact on the volume of traffic, the growth of the dollar exchange rate will negatively affect the financial performance of companies in the industry, given the significant share of foreign exchange expenses for aircraft leasing. The decline in the cost of kerosene amid falling oil prices may partially compensate for this negative effect. ACRA notes that in the current conditions, airlines may again begin to reduce the price of tickets to support demand. This, with the current low level of operating profitability and rising costs, could lead to defaults and bankruptcies for air carriers as soon as late summer and autumn. As a support measure, the government has decided to defer tax collection for the air

¹ (PJSC "GAZPROM" ([AAA\(RU\), outlook Stable](#)), PJSC Rosneft, PJSC LUKOIL, PJSC TATNEFT, PJSC «Surgutneftegas», PAO NOVATEK, PJSC "RussNeft")

travel and tourism industries, which could then be applied to other sectors. According to ACRA, this measure can support the creditworthiness of market participants in the short term, but it may not be enough to prevent a wave of defaults.

Allowing banks to work with borrowers from the air travel and tourism industries without worsening their financial assessments, as well as providing state guarantees on loans to such borrowers, may be more effective. At the same time, it is necessary to keep in mind that most airline debt is owed to leasing companies, including foreign ones.

The cost of rail transportation is ruble based. Therefore, in the short term, the volatility of the exchange rate should not affect the activities of JSC "Russian Railways" ([AAA\(RU\), outlook Stable](#)). However, taking into account the cyclical nature of the railway transport industry and its dependence on commodity demand, ACRA believes a decrease in freight turnover is possible in the event of a slowdown in economic activity.

Machinery and equipment production. The machinery and equipment production sector (especially automotive producers) is the most vulnerable to the risks of devaluation of the national currency and its consequences for the operational and financial activities of industry companies. In 2019, the volume of the new vehicle market in Russia shrank by 2.3% year-on-year and amounted to 1.76 mln units. The fall in consumer purchasing power due to ruble depreciation will negatively affect demand for vehicles in 2020. This, in turn, may lead to the market declining further, by as much as 10% in ACRA's opinion. The spread of the coronavirus is also having a negative impact on the operations of a number of Russian carmakers amid interruptions to the supply of components from China. The inability to pass to consumers increases in costs caused by the ruble depreciation combined with the risks of market decline will have a negative impact on the operating margin, which in 2018 was only just over 6%.

Retail sector. The non-food segment of the retail sector will be most affected by the coronavirus pandemic and depreciation of the ruble. In particular, electronics importers are already experiencing problems with supplies from China. As this is coupled with abnormal demand due to expectations of delays in new supplies and higher prices due to the devaluation of the ruble, ACRA does not rule out possible deficits of some items in the near future. The unavoidable growth of prices in the event of continued ruble weakness over a one to one-and-a-half-month horizon and the anticipated fall in real wages will lead to deferred demand for home appliances. This may put pressure on the revenue and profitability of the non-food retail segment (for example, in 2015, PJSC M.Video's revenue fell by 6% y-o-y and EBITDAR declined by 3%). Although there isn't any panic on the lending market, ACRA assumes that banks will factor growing risks into the cost of credit, and as a result, issue new loans at higher rates (+50 bps), even if the Bank of Russia's key rate is left unchanged.

In ACRA's opinion, retailers of clothing and footwear not produced in Russia will also face difficulties. As for food retail, the segment may be supported to a certain extent by the removal of restrictions on freight transport that supplies retail chains, as well as the creation of a "green corridor" at customs for essential goods. In addition, the government has announced that if necessary, measures will be taken to provide additional concessional lending to replenish retailers' working capital and thereby ensure that stocks of socially important products are sufficient.

Sectors of the economy moderately affected by the devaluation of the ruble

Metals and mining. In ACRA's opinion, Russian steel companies are the most resilient to forex market volatility caused by the fall in oil prices. The weakening of the national currency will most likely have a positive impact on the profitability of metal producers, as about 80% of their costs are ruble denominated, while most of the revenue is denominated in dollars or linked to world export prices. The sector's indebtedness then, judging by the indicators of Russia's four largest steel producers, has not yet been seriously affected by the coronavirus pandemic. Nevertheless, as the virus is spreading at a rapid rate there is a risk of steel consumption falling in the global market, and consequently, that global steel prices will continue to decline.

ACRA believes that the weakening of the national currency may have a positive impact on companies in the mining sector, as most of them are export oriented. At the same time, ACRA notes that there are risks for coke and iron ore exporters related to possible falls in global prices for these commodities due to a fall in steel consumption.

Utilities, power generation, and network. The fact that power generation, network (distribution) and public utilities are operated entirely in rubles should allow them to get through this adverse period with minimum losses. Most major players have already completed the periods of high capital expenditure. Nevertheless, ACRA assumes there may be a slight increase in the non-payment of utilities payments, especially by residential customers, and this may have a negative effect on the operations of the sector's small companies.

Real estate development. The growth of the dollar exchange rate and expectations of higher mortgage rates may lead to a short-term surge in demand on the primary real estate market in Q2 2020. In turn, this should give developers a certain margin of safety, allowing them to withstand the inevitable fall in demand (from H2 2020 to H1 2021) caused by the decline in real wages and higher mortgage rates. However, ACRA believes that the sector's transition to the escrow account system significantly reduces the risks of project suspension even in the face of weak sales, as funding is provided by banks under project finance agreements. In ACRA's opinion, during the period of reduced demand housing prices will be supported by the reduction of supply caused by the fall in current construction volumes (by around 20% in six months) which started halfway through 2019.

Telecommunications. The telecommunications sector has ruble revenue and expenses, which means that the negative impact of ruble depreciation will be minimal for companies in this sector. In addition, the low elasticity of demand for communications services will support the sector. The telecommunications sector has an extremely low share of foreign currency borrowings, which adds to its stability. However, the sector is characterized by its high level of capital expenses, a significant share of which are denominated in foreign currency. In ACRA's view, the sharp fall in the exchange rate may lead to growth in capital expenses, have an adverse effect on the debt level of telecommunications companies, and postpone the start of the active phase for investment in 5G infrastructure.

Reduced tax revenues will have a negative impact on the financial indicators of some Russian regions

The influence of falling oil prices. For extractive regions, the situation may be complicated by the fact that the reduced oil prices (and subsequently, prices of other minerals and products of their processing, especially in the event of an expansion of anti-coronavirus measures) will not be accompanied by a weakening of the ruble to the level that previously allowed regions to balance their budgets. As a result, tax revenues from the oil sector may fall by up to 30% in 2020. The biggest extractive regions have accumulated significant liquidity cushions, which will help them get through one or two years of reduced tax revenues. At the same time, regions that produce one to three percent of Russian oil have not accumulated reserves and are therefore more vulnerable to the fall in commodities prices.

In 2018–2019, Russia's regions received additional transfers from the federal budget. This allowed some of them to reduce their debt loads, while others boosted capital expenses.

ACRA expects that the size of transfers may fall during the period of reduced oil prices, and as a result, some regions may be deprived of sources for reducing their debt loads.

The regions that have to refinance their debts in the near future will find themselves in a difficult situation. Should expectations of a key rate hike grow, there may be no one willing to lend to regional governments under "key rate + 1%" terms, and regions do not benefit from holding on to open but unused credit lines. In ACRA's opinion, some regions will be forced to violate the aforementioned terms in order to avoid default.

ACRA expects that in some cases, regions may return to the practice of increasing accounts payable in order to avoid the growth of debt. At the same time, the majority of Russian regions finished last year with surpluses and maintained account balances, which will help them survive a fall in income in 2020.

Influence of the coronavirus. In the stress scenario, if business activity declines in connection with the mass isolation of potentially infected citizens, then reduced personal income tax contributions to budgets can be expected as well as reduced corporate income tax revenues. As it is not possible for employees from all sectors of the economy work from their homes, in the best case we can expect forced vacations and downtime, and in the worst case — unpaid leave and layoffs. As a result, the most stable and often most significant type of income of regional and municipal budgets may fall, which would impact the regions whose budgets do not directly depend on commodity price fluctuations. Should this scenario materialize, ACRA cannot rule out that regions will attempt to maintain existing levels of tax and non-tax revenues by revising the conditions according to which they are allocated between regional and municipal authorities, and compensating the latter's lost income through an increase in transfers.

However, as previously noted, this is the stress scenario and there is currently a low likelihood of it unfolding.

Negative tendencies in the economy will not impact ratings assigned to structured finance transactions

ACRA does not currently expect any negative rating actions for Russian, rated structured finance transactions as a result of the drop in oil prices, the subsequent fall of the Russian ruble against major currencies, and the global economic slowdown due to the spread of the coronavirus.

The current negative changes to macroeconomic conditions remain within the stress scenarios used during the rating analysis.

Russian structured finance transactions rated by ACRA have both ruble denominated assets and liabilities. The liabilities as well as the underlying assets have fixed coupon payments. In light of this, current macroeconomic shocks will have a muted effect on the credit quality of structured finance transactions.

Transactions include two asset types:

Residential mortgage-backed securities (RMBS): The ruble-denominated pools would only be significantly affected if the Russian economy is considerably negatively impacted and economic shocks are transferred to the majority of the general public that are able to obtain a mortgage.

Given the static nature of the transactions, the fixed rate nature and the fixed installment/equal annuity repayment profiles of the loans, despite a potential increase in delinquencies, ACRA expects ratings to remain stable in the near future.

Small and medium-sized enterprises (SME): While exporting companies may temporarily benefit from the ruble's depreciation, a prolonged change in current economic conditions (i.e., an interest rate change, inflation, etc.) could lead to an increase of delinquencies in the SME pools of ACRA's rated transactions. According to ACRA's calculations, the share of indebtedness of the companies operating in the sectors that are most likely to hit by a recession (oil and gas, tourism, air transportation) accounts for less than 3% of the loan portfolio that secures SME securitization transactions. Therefore, macroeconomic tendencies will have a limited negative impact on the level of defaults in SME portfolios.

Counterparty risk is present in structured finance transactions. Transactions are exposed to the credit risk/default of key counterparties because they rely on third parties (management companies, accountants, account banks, servicers, etc.), to ensure the proper fulfilment of all contractual obligations. As such, if any of these counterparties were to be negatively impacted and/or downgraded, this could have a negative effect on the credit quality of structured finance deals. Nevertheless, the presence of back-up counterparties, reserves and liquidity facilities in SME transactions partially mitigates this risk.

ACRA will continue to monitor economic developments and perform corresponding rating actions if necessary.

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