Audit and Risk Committee Annual Report to the Board of Directors
2022-2023

1.0 Introduction

1.1 The Annual Report covers the period from June 2022 to May 2023 and presents the activities of the Audit and Risk Committee (ARC or the Committee) of the Asian Infrastructure Investment Bank (AIIB). The ARC has played a critical role in overseeing AIIB's financial activities, risk management practices, internal controls, and governance processes. Through regular meetings, consultations, and comprehensive briefings aligned with the Committee's Terms of Reference (ToRs), the Committee ensured effective oversight and provided informed recommendations to AIIB's Board of Directors. The Committee Chair consistently updated the Board of Directors on the Committee's activities, fostering transparency and accountability. By maintaining a robust control environment, effectively managing risk, and adhering to best practices and international standards, the Committee has played a vital role in safeguarding AIIB's operations and upholding its commitment to high standards.

2.0 Terms of Reference

2.1 The responsibilities of the Audit and Risk Committee (ARC or the Committee) are as follows:

(a) Review AIIB’s financial statements and accounting, auditing and financial reporting practices, procedures and issues.

(b) Review the selection procedures for and the qualification and performance of the external auditors; review the reports from the external auditors and ensure appropriate action be taken in respect of major improvement areas identified.

(c) Review the scope of work, the internal audit work plan and the effectiveness of the internal audit function.

(d) Review the adequacy and the effectiveness of the internal control system.

(e) Review AIIB’s financial policies, including the Bank's borrowing and investment authorities, and the asset and liability management policy.

(f) Review AIIB’s risk-related policies; annually review the Bank’s risk management framework and its risk appetite statement.

(g) Receive reports on violations of the Prohibited Practices Policy (PPP) from the Managing Director of the Complaints-resolution, Evaluation and Integrity Unit (CEIU).

2.2 The review of the Committee’s Terms of Reference (ToR) has been an important process in ensuring compliance with the Bank’s policies and aligning with the Committee’s current practices. On December 21, 2020, the Board of
Directors approved revisions to the ToR. Subsequently, a review of the ToR was conducted in September 2021 to assess its effectiveness. Looking ahead, the next scheduled review of the ToR is set for September 2023. These reviews serve as valuable opportunities to maintain the relevance and alignment of the Committee’s operating framework with the evolving needs of the Bank.

3.0 Composition of the Committee

3.1 As of the date of this report, the membership of the Committee is as follows:
- Fabrizio COSTA (Chair)
- R.M.P. RATHNAYAKE (Vice Chair)
- Zhijun CHENG
- Ahmed KOUCHOUK
- Teresa LIN (External Member)
- Elisabeth STHEEMAN (External Member)

Committee members’ biographies are available here.

3.2 At the beginning of the reporting period, the Committee was comprised of Directors Mehmet Alper Batur, Zhijun Cheng, Khuong Thanh Ha, and Ahmed Kouchouk, along with External Members Ai Phing Cheng and Elisabeth Stheeman. Director Ha assumed the role of Committee Chair, while Director Batur held the position of Vice Chair. Following the election of the Board of Directors in July 2022, Directors Fabrizio Costa, Ahmed Kouchouk, Zhijun Cheng, and R.M.P. Rathnayake were appointed to the Committee. During the Committee’s meeting on September 14, 2022, Director Costa assumed the position of Chair, and Director Rathnayake became the Vice Chair. Furthermore, in May 2023, Teresa Lin joined the Committee as an External Member, succeeding Ai Phing Cheng.

4.0 Areas of Focus

4.1 One of the key areas of focus for the Committee was the thorough review of the 2022 Financial Statements for the Bank, the Special Fund, and the Special Fund Window. During this process, Management highlighted both financial and non-financial risks that AIIB currently faces, including the challenges posed by interest rate increases and market volatility amidst global uncertainties. Following a careful evaluation, the Committee expressed its support for the 2022 Financial Statements and recommended that the Board of Directors submit them, along with a recommendation for approval, to the Board of Governors. Additionally, the Committee suggested that the Board of Directors advise the Board of Governors to allocate the Bank’s net income for fiscal year 2022 to retained earnings.

4.2 Throughout the reporting period, Management consulted with the Committee on the quarterly financial statements for Q2 2022, Q3 2022, and Q1 2023. These statements were prepared by Management and presented to the Committee for review and approval. The Committee assessed the financial statements, examining key financial indicators, performance metrics, and risk exposures.
4.3 In addition to the quarterly consultations on the financial statements, Management provided comprehensive updates to the Committee on the broader scope of AIIB's financial activities. These updates encompassed various aspects, including the Bank's liquidity management, the development of its liquidity portfolio, the growth and expansion of its Treasury functions and the impact of interest rate hikes on funding costs.

4.4 In both September 2022 and March 2023, the Committee held meetings with the Bank's external auditor, PricewaterhouseCoopers (PwC), to discuss matters pertaining to the Audit Plan and Findings. These engagements provided valuable insights into the Bank's 2022 Audit Plan. PwC highlighted significant areas of risk analysis during the discussions, including model resilience, geopolitical risks, and the evolution of the Bank's strategy. The session on the 2022 Audit Findings focused on Key Audit Matters, such as the expected credit loss (ECL), with specific attention to data validation and key assumptions, as well as the fair value measurement of financial instruments categorized as Level 2 or Level 3 under International Financial Reporting Standards (IFRS) 13. The Committee received a detailed briefing on PwC's audit of the Bank's 2022 Financial Statements, which concluded with unqualified opinions. As per the Committee's Terms of Reference (ToR), a closed session was held with PwC in March 2023, providing the Committee with an opportunity to discuss confidential matters related to the audit and seek further clarification. The engagement with PwC strengthened the Committee's understanding of the Bank's audit processes and findings, contributing to its oversight role in ensuring robust financial controls and accountability within the organization.

4.5 Quarterly briefings with the Chief Internal Audit Officer and later the Acting Chief Internal Audit Officer provided the Committee with updates on the internal audit plan, key findings, and corresponding corrective measures. These briefings covered areas such as cybersecurity, the real estate bond investment portfolio, and the Lean Team Audit of Nonsovereign-Backed Financing (LTA NSBF). The Committee engaged in constructive discussions with Management on these topics, ensuring effective oversight and risk mitigation. In addition to the quarterly briefings, a closed-door session was held with the Chief Internal Audit Officer in December 2022, in line with the Committee's Terms of Reference (ToR). This session enabled the Committee to gain comprehensive insights into the internal audit findings, assessments, and recommendations. It further facilitated informed oversight and contributed to the continual improvement of internal audit processes and practices.

4.6 The Committee received regular updates on the implementation of the Internal Control over Financial Reporting (ICFR) framework, which aligns with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) principles. Given the evolving environment and the impact of the COVID-19 pandemic, the Committee closely monitored the effectiveness of controls, including non-tested controls, and addressed challenges related to maintaining quality assurance. IT controls, cybersecurity, and data security incidents received special attention. Management assured the Committee that the ICFR workplan
was agile and well-suited to the Bank's institutional and business development, considering the changing landscape. Additionally, during their report to the Committee in March 2023, PwC provided an attestation report on Management's assertion regarding the effectiveness of the Bank's internal controls over financial reporting, further reinforcing the Committee's confidence in the Bank's control environment.

4.7 In December 2022, the Committee engaged in discussions concerning the Global Borrowing Authority (GBA) for the upcoming year. Management provided a thorough explanation of how the GBA would enhance the Bank's presence in capital markets by increasing flexibility, bolstering market credibility, enabling efficient funding, diversifying funding sources, and enhancing the Bank's capacity for larger-scale operations through proactive access to diverse funding sources and optimized funding strategies. The Committee expressed its support for the proposed 2022 GBA and recommended its approval by the Board of Directors.

4.8 Over the course of the reporting period, risk management remained a key area of focus for the Committee, with regular updates and evaluations of Level 1 Key Risk Indicators (KRIIs) provided on a quarterly basis. One key element the Committee reviewed, were the proposed changes to the Financial and Risk Management Policy, which were subsequently approved by the Board in November 2022. These changes related to concentration Level 1 KRIIs, measuring exposure at the economy level as a share of the balance sheet. More broadly, relating to the quarterly risk reporting, the Committee's inquiries throughout the year encompassed assessing the impact of the Risk Management Framework on the Bank's portfolio rating, computing various KRIIs, interpreting measures of concentration risk, and updating KRIIs accordingly. Management provided regular updates on the credit quality of investment operations, trends in the investment pipeline's credit quality, market and liquidity risks, operational risks, and compliance risk. To enhance their understanding, Committee members actively participated in technical briefings and teach-ins. Briefings on expected credit loss (ECL) staging criteria, Weighted-average Credit Rating (WACR), Risk-adjusted Return on Capital (RAROC) and Financial Sustainability, as well as the G20 Capital Adequacy Framework (CAF) working group recommendations were presented. Based on extensive deliberations, the Committee recommended placing a stronger emphasis on balancing the credit quality of the portfolio for future growth and reevaluating certain KRI limits to enhance risk management practices.

4.9 The Committee reviewed the updated 2023 Risk Appetite Statement (RAS) for AIIB, taking into account the Bank's governance frameworks and risk management practices. Management provided updates on routine stress testing exercises, and discussions within the Committee focused on scenario design and underlying assumptions. Management assured the Committee that AIIB would maintain robust capital adequacy levels and adhere to the Bank's RAS throughout its planning horizon, demonstrating prudent risk management practices. The Committee agreed to recommend to the Board of Directors that it support the updated RAS.
5.0 **Committee Priorities for the Coming Year**

5.1 The Committee's mandate for the upcoming reporting period, June 2023 through May 2024, involves actively assisting the Board of Directors in accordance with its Terms of Reference. To address prevailing financial market conditions and the Bank's continued transition into its growth phase, the Committee has identified several key areas of focus for its review and oversight:

(a) **Financial Health Review:** The Committee will diligently review the Bank's financial health, assessing capital adequacy, liquidity management, and overall financial stability. This includes monitoring the implications of debt issuance and ensuring the effective management of financial resources, amending where necessary RAROC related metrics to best fit the growth of the Bank.

(b) **Enhancing Treasury, Internal Controls, and IT Functions:** The Committee will prioritize the continuous development of the Bank's Treasury function, internal controls, and IT functions. Through its reviews, the Committee will assess the adoption of advanced technologies, cybersecurity measures, and operational efficiency improvements to align with the Bank's evolving operations.

(c) **LIBOR Transition Review:** The Committee will stay updated on the Bank's transition from LIBOR to alternative reference rates. It will review the Bank's adherence to replacement rate requirements in new lending and facilitate a seamless transition of existing loans, considering the best interests of the Bank's clients and borrowers.

(d) **Loan Portfolio Quality Assessment:** The Committee will closely monitor the impact of the pandemic-induced deterioration in the credit status of Bank Members on the loan portfolio quality. As per the G20 CAF working group recommendations, it will review the implementation of key risk indicators (KRIs) and expected credit loss (ECL) methodologies to accurately assess and manage credit risk within the portfolio, and ensure best practice is followed.

(e) **Strategic Loan Portfolio Growth:** The Committee will support the Bank's objective of strategically growing the loan portfolio to mitigate income fluctuations caused by financial market volatility. Through its reviews, the Committee will assess potential lending opportunities, evaluate risk-return profiles, and ensure effective portfolio diversification to manage risks.

(f) **Strengthening Risk Management Framework:** The Committee will actively review and enhance the Bank's risk management framework. This includes strengthening risk identification, assessment, and mitigation processes, as well as ensuring the adequacy of risk appetite and tolerance levels across the organization.

(g) **Weighted Average Credit Rating (WACR) Monitoring:** The Committee will closely monitor the Weighted Average Credit Rating (WACR) as part of its risk
management oversight. It will assess the composition and performance of the Bank's loan portfolio based on the credit ratings of its Members, whilst Management will assess where methodological changes are necessary to ensure best practice is adopted by AIIB. By reviewing the WACR regularly, the Committee will ensure that the Bank maintains a balanced and diversified loan portfolio that aligns with its risk appetite and supports sustainable lending practices.

(h) **Promoting a Strong Risk Culture**: The Committee recognizes the importance of fostering a strong risk culture within the Bank. It will actively promote a risk-aware mindset and encourage risk management practices across the organization. This includes creating awareness of risk-related responsibilities, promoting open communication on risk matters, and encouraging the integration of risk considerations into decision-making processes at all levels. By prioritizing risk culture, the Committee aims to strengthen the Bank's overall risk management framework and enhance its ability to identify, assess, and effectively mitigate risks.
Annex A: Agenda of Committee Meetings (June 2022-May 2023)

June 13-14, 2022: ARC Meeting
1. Audit and Risk Committee Draft Annual Report for 2021-2022
2. Internal Audit Office Update
3. Risk Reporting Dashboard
4. Technical Briefing on Liquidity Portfolio

August 16, 2022: Financial Consultation
1. Q2 2022 Financial Statements

September 14-15, 2022: ARC Meeting
1. Selection of Committee Chair and Vice Chair (closed session)
2. COSO/ICFR Implementation Update
3. Update on Financial Activities
4. Annual Compliance Risk Update
5. Risk Reporting Dashboard
6. PwC Audit Work Plan 2022
7. Internal Audit Office Update

November 3, 2022: ARC Briefing
1. Briefing on the Role of the External Auditor

November 15, 2022: ARC Meeting and Financial Consultation
1. Briefing on the ECL Staging Criteria
2. Q3 2022 Financial Statements
3. Revision to the Financial and Risk Management Policy
4. Briefing for Reallocation within the Current Treasury Limit

November 30-December 1, 2022: ARC Meeting
1. 2023 Global Borrowing Authority
2. Update on Financial Activities
3. Internal Audit Office Update
4. Discussion with the Chief Internal Audit Officer (closed session)
5. Risk Reporting Dashboard
7. Update on G20 Review of MDBs Capital Adequacy Framework Findings

March 13-14, 2023: ARC Meeting
1. 2022 Financial Statements
2. Update on Financial Activities
3. COSO/ICFR Implementation Update
4. PwC Independent Auditor’s Reports and ICFR Opinion
5. Discussion with External Auditors (closed session)

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1 The COSO/ICFR update was circulated in written format and subject to Q&A submitted in writing or during the meeting.
6. Internal Audit Office Update
7. 2022 Capital Adequacy Year-end Assessment
8. Risk Reporting Dashboard
9. Annual Operational Risk Update
10. Briefing on the status of AIIB’s weighted average credit rating

**May 16, 2023: Financial Consultation**
1. Q1 2023 Financial Statements (Committee Consultation)

**May 29-30, 2023: ARC Meeting**
1. Update on Financial Activities
2. Internal Audit Office Update
3. Risk Reporting Dashboard
4. Sovereign-backed Guarantee Terms
5. Briefing on Risk-adjusted Return on Capital (RAROC) and Financial Sustainability

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2 The COSO/ICFR update was circulated in written format and subject to Q&A submitted in writing or during the meeting.
### Key Observations

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<thead>
<tr>
<th>Key Observations</th>
<th>Audit and Risk Committee’s Recommendations to the Board of Directors</th>
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<tbody>
<tr>
<td>1 Financial Reporting</td>
<td>The Committee supported the 2022 Financial Statements and recommended that (i) the Board of Directors submit the audited 2022 Financial Statements of the Bank and the Special Funds to the Board of Governors with a recommendation for approval and (ii) the Board of Directors recommend to the Board of Governors to determine that the Bank’s net income for financial year 2022 be allocated to retained earnings.</td>
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<td>2 External Auditor</td>
<td>The Committee recognized that PwC had maintained high standards of professionalism in discharging their duties and reported this to the Board of Directors.</td>
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<td>3 Global Borrowing</td>
<td>The Committee recommended the 2022 Global Borrowing Authority to be approved by the Board of Directors.</td>
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<td>4 Risk Appetite Statement</td>
<td>The Committee recommended that the Board of Directors support the 2023 Risk Appetite Statement.</td>
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<td>5 Financial and Risk Management Policy</td>
<td>The Committee recommended the Board of Directors approve the proposed revision to the Financial and Risk Management Policy, which seeks to ensure that the largest share by a single economy is limited to 20% by the end of the Bank's initial Corporate Strategy implementation period. Management agreed to review the implementation plan by end-2025 to assess the feasibility of an earlier timescale.</td>
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<td>6 Reallocation of Treasury Limits</td>
<td>The Committee endorsed a recommended change to the Treasury Limits to ensure effective management of the Bank’s liquidity portfolio. The Committee also recommended visiting whether these types of technical changes require approval by the Board of Directors.</td>
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<td>7 Sovereign Guarantee Terms</td>
<td>The Committee supported recommended amendments to the Operational Policy on Financing (OPF) and the Pricing Policy for Sovereign-Backed Projects (Pricing Policy) relating to the definition of the Guarantee Fee in order to allow the Bank to charge the Guarantee Fee on the total financial exposure guaranteed by the Bank, and to allow Sovereign-backed Guarantees to be offered in United States Dollars or such other currencies as the Bank may offer from time to time in alignment with the provisions set forth in the OPF.</td>
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### Key Observations

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<tr>
<td>1 G20 CAF</td>
<td>The Committee has requested regular and ongoing updates on the advancements and progress of the G20 CAF review.</td>
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<tr>
<td>2 Risk Management</td>
<td>Throughout the reporting period, the Committee made several suggestions and recommendations for AIIB Management.</td>
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specific requests, including gaining a deeper understanding of the expected credit loss (ECL) impact resulting from various global challenges; incorporating a sector-level breakdown of the Nonsovereign-Backed Financing (NSBF) portfolio in the Risk Reporting Dashboard; conducting further analysis on the sector-level split of the NSBF portfolio within the risk report dashboard; revising the financial risk management policy and risk appetite; and incorporating climate risks within the risk appetite statement and stress testing processes.

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<th>3</th>
<th>Audit Plan</th>
<th>Over the reporting period, the Committee recommended Management to provide a follow-up report on improvements resulting from implemented audit actions; conduct follow-ups on NSBF audits/bond cases; update the internal audit plan to address risk areas and incorporate risk assessment by the three lines of defense; categorize audit findings into high, medium, and low clusters; conduct in-person reviews/procedures; assess adequacy of risk levels in the heat map; provide an acronym list; schedule a session on QAIP and peer benchmarking for reporting lines; and provide an update on Lean team audits and initiatives for managing people risk.</th>
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<td>4</td>
<td>Terms of Reference</td>
<td>The Terms of Reference of the ARC are scheduled for review in September 2023.</td>
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Annex C: Indicative Committee Workplan (2023-2024)

August 15, 2023: ARC Meeting and Financial Consultation

- Q2 2023 Financial Statements

September 4-5, 2023: ARC Meeting

- Risk Reporting Dashboard
- Internal Audit Office Update
- COSO / ICFR Implementation Update
- PwC Audit Work Plan 2023
- LIBOR Transition Update
- Review of the ARC Terms of Reference

November 15, 2023: Financial Consultation

- Q3 2023 Financial Statements

November 27-28, 2023: ARC Meeting\(^3\)

- Risk Reporting Dashboard
- Risk Appetite Statement & Report on Stress Testing
- Internal Audit Office Update
- 2024 Global Borrowing Authority
- Discussion with the Chief Internal Audit Officer (closed door session)

March 11-12, 2024: ARC Meeting

- 2023 Financial Statements
- COSO/ICFR Implementation Update
- PwC Independent Auditor’s Reports and ICFR Opinion
- Discussion with External Auditor (closed door session)
- Internal Audit Office Update
- 2023 Capital Adequacy Year-end assessment
- Risk Reporting Dashboard

May 14, 2024: ARC Consultation

- Q1 2024 Financial Statements

\(^3\) The COSO/ICFR update will be circulated in written format and subject to Q&A submitted in writing or during the meeting.