Audit and Risk Committee Annual Report to the Board 2020-2021

Terms of Reference

1. The responsibilities of the Audit and Risk Committee are as follows:
   i. Review AIIB’s financial statements and accounting, auditing and financial reporting practices, procedures and issues.
   ii. 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.
   iii. Review the scope of work, the internal audit work plan and the effectiveness of the internal audit function.
   iv. Review the adequacy and the effectiveness of the internal control system.
   v. Review AIIB’s financial policies, including the Bank’s borrowing and investment authorities, and the asset and liability management policy.
   vi. Review AIIB’s risk-related policies; annually review the Bank’s risk management framework and its risk appetite statement.
   vii. Receive reports on violations of the Prohibited Practices Policy (PPP) from the Managing Director of the Complaints-resolution, Evaluation and Integrity Unit (CEIU).

2. The Board approved updates to the Audit and Risk Committee’s Terms of Reference on December 21 2020, to ensure consistency with the Bank’s policies and alignment with the Committee’s up-to-date practice.

Composition

3. This Annual Report covers the work of the Committee between July 2020 and May 2021.

4. As of the date of this report, the membership of the Committee is as follows:
   - Muhammad Aslam Chaudhary (Chair)
   - Ai Phing Cheng (External Member)
   - Zhijun Cheng
   - Khuong Thanh Ha
   - Katharine Rechico (Vice Chair)
   - Elisabeth Stheeman (External Member)

   Committee Members’ biographies are available here.

5. At the start of the period covered by this report, the Committee’s membership comprised External Members Ai Phing Cheng and Jan Engström, Directors Suminto, Wencai Zhang, Emil Levendoğlu and Sameer Kumar Khare. Director Levendoğlu and Director Khare were, respectively, Chair and Vice Chair of the Committee. Following the election of the Board of Directors in July 2020, Directors Muhammad Aslam Chaudhary, Khuong Thanh Ha, Katharine Rechico and Wencai Zhang were appointed to the Committee. Director Chaudhary and Director Rechico were, respectively, selected as Chair and Vice Chair at the Committee’s Meeting on August 18, 2020. Following the resignation of Director Wencai Zhang, Director Zhijun Cheng was appointed to the Committee on March 15, 2021. Elisabeth Stheeman joined the Committee as External Member in April 2021 following the
Areas of focus during 2020/2021:


7. The Committee reviewed the 2020 Financial Statements for the Bank, the Special Fund and the Special Fund Window (“2020 Financial Statements”). The Committee noted the impact of the COVID-19 crisis and the Bank’s response was reflected through different aspects of the 2020 Financial Statements, including loss provisioning, liquidity management, fair value changes of investments, incomes and expenditure as well as disbursements through the new Special Fund Window. The ARC supported the 2020 Financial Statements and recommended that (i) the Board of Directors submit the audited 2020 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 2020 be allocated to retained earnings. Management consulted the Committee on the Q2 2020, Q3 2020 and Q1 2021 quarterly financial statements as prepared for approval by the President.

8. The Bank’s external auditor PricewaterhouseCoopers (PwC) briefed the Committee on the 2020 Audit Plan, which reflected changes to AIIB’s business operations as well as the impact of the Covid-19 pandemic. PwC also elaborated on their assessment of the Key Audit Matters (KAMs) and explained the Bank’s expected credit losses continued to be the most significant area of audit effort given the judgement and complexity involved. The Committee was briefed by PwC on the audit of the 2020 Financial Statements. PwC’s audits of the financial statements of the Bank and of the Special Funds were completed with unqualified opinions. In March 2021, the Committee met with PwC in closed session.

9. The Chief Internal Audit Officer provided quarterly briefings on the internal audit plan, the key audit findings and the follow up on the corrective measures. The Committee was briefed on changes to the audit plan and the reasons for them, including evolving business requirements as well as the mitigating actions. Committee Members were particularly concerned about robust audit and scrutiny of the IT universe in order to manage the associated risks, including cybersecurity, and advised Management to focus on this area. The Internal Audit Office was able to provide assurance on this and started an audit of IT functions in late 2020.

10. Over the reporting period Committee Members received quarterly updates on the ICFR/COSO implementation. The Committee followed this issue closely and gave particular attention to the effectiveness of controls, non-tested controls, the challenges posed by the COVID-19 pandemic on internal controls and issues of quality assurance. The Committee suggested special attention should be placed on IT controls. Management indicated that the ICFR workplan was agile and fit for purpose given the progress of the Bank’s institutional and business development and the changing environment, including cyber and data security incidents. PwC issued an attestation report on Management’s assertion in respect of the effectiveness of the Bank’s internal controls over financial reporting.

11. Over the reporting period the Committee received regular updates on the Bank’s financial
activities. Topics of frequent discussion included understanding the implications on the Bank’s liquidity management from the COVID-19 crisis, the build-up of the Bank’s liquidity portfolio, and the growth in capacity of the Bank’s Treasury functions.

12. Since November 2020, Committee meetings included a regular briefing on the Bank’s preparations for the LIBOR Transition. Management updated the Committee on the Transition progress in peer institutions. The Committee enquired about the emergence of a market-preferred replacement rate (SOFR) and the adjustment spread announcement by the International Swaps & Derivatives Association (ISDA). Management also kept the Committee closely informed about their communication and engagement with borrowers about the Transition.

13. At the August 2020 meeting the Committee discussed a USD 3 billion increase in the Global Borrowing Authority (GBA) for 2020. At the December 2020 meeting the Committee discussed the GBA for 2021 and Management explained how this would support the Bank’s presence in capital markets. The Committee were also briefed on the development of the Sustainable Development Bond Framework which aligns with a broader market trend of sustainable investment. The Committee supported the 2021 GBA for approval by the Board of Directors.

14. The Committee received a quarterly Risk Management update, including on the level-one Key Risk Indicators (KRIs). Frequent lines of enquiry have included an assessment of the impact of the CRF on the Bank’s portfolio rating, calculation of different KRIs, the interpretation of different measures of concentration risk and updating KRIs. Committee Members have also discussed with Management the calculation of ECLs and provisions and received technical briefings and teach-ins outside of the Committee meetings. In addition, Management briefed the Committee at various times on the credit quality of investment operations, the trend of credit quality of the investment pipeline, market and liquidity risk, operational risks as well as compliance risk. The Committee recommended a greater focus in balancing the portfolio credit quality for future portfolio growth and reviewing some of the KRI limits.

15. Committee Members were briefed on the 2021 Risk Appetite Statement (RAS) for AIIB, which was updated to reflect the latest governance development of the Bank. Levels for two KRIs were established. The ARC agreed to recommend that the Board support the Risk Appetite Statement 2021 Update. The Committee received updates on the regular stress testing exercise, and discussions usually focused on the scenario design and the underpinning assumptions. Management confirmed that AIIB would maintain strong levels of capital adequacy and good adherence to the Bank’s RAS over the projection period.

16. The Committee was briefed by the Managing Director of the CEIU on the Bank’s first batch of cases in violation of the Policy on Prohibited Practices. Staff members elaborated how the Bank investigated the fraud in the bidding of IT equipment supply and what evidence strongly supported the investigation in the specific incident.

17. The period also included an induction series for the new External Members, Ai Phing and Elisabeth Stheeman, and for new ARC Board members. The induction included introductory meetings with Management, as well as briefings and teach-ins on relevant topics.

Committee priorities for the coming year
18. The Committee will continue to fulfill their mandate in 2020-2021 by assisting the Board according to its Terms of Reference. The Committee resolves that near-term financial market conditions and challenges as the Bank moves into its next phase of growth provide several areas of focus, including:

a. The Bank’s Treasury function and operations, internal controls and IT functions will increase in sophistication and complexity.

b. The Libor Transition will require all new lending to move to a replacement rate. The Bank will continue to maintain close engagement with borrowers enabling a smooth transition of existing loans, keeping client interests at the fore.

c. The Bank will have more debt issued than paid-in capital. The Board, and the Committee will need to consider how this could impact the Bank’s operations.

d. The quality of the loan portfolio has been impacted by the deterioration in Bank Members’ credit status brought on by the pandemic. The Committee will need to thoughtfully consider implementation of key risk indicators and ECLs.

e. Growing the Bank’s loan portfolio will help avoid large fluctuations in income from financial market volatility.
Annex A: Committee Agendas July 2020 to June 2021

August 18, 2020:
1. Selection of Chair and Vice Chair
2. Chief Financial Officer (CFO) Update
3. Risk Reporting Dashboard

September 14-15, 2020:
1. COSO/ICFR Implementation Update
2. PwC Audit Work Plan for 2020
3. Internal Audit Office Updates
4. Covid-19 Stress Test Q3 2020 Update
5. Review of the ToRs for the ARC (closed session)

November 17-18, 2020:
1. CFO Update
2. Briefing on Violation of Policy on Prohibited Practices
3. Annual Compliance Risk Update

November 30-December 1, 2020:
1. COSO/ICFR Implementation Update
2. PwC Audit Updates
3. 2021 Global Borrowing Authority
4. Libor Transition Update
5. Risk Reporting Dashboard
7. Internal Audit Office Updates
March 15-16, 2021:
1. 2020 Financial Statements
2. COSO/ICFR Implementation Update
3. PwC Independent Auditor's Reports and ICFR Opinion
4. Internal Audit Office Update
5. Discussion with External Auditors (closed session)
6. Risk Reporting Dashboard
7. 2020 Capital Adequacy Year-end Assessment
8. LIBOR Transition Update
9. Discussion with Internal Auditor (closed session)
10. Discussion on the Performance of the External Auditor (closed session)

May 18, 2021, ARC Consultation
1. Q1 2021 Financial Statements (Consultation with ARC members on Quarterly Financial Statements)

June 14-15, 2021:
1. Internal Audit Office Update
2. Risk Reporting Dashboard Update
3. Review of Pricing Levels for Sovereign-Backed Products¹
4. Alternative Reference Rate and LIBOR Transition Update
5. COSO/ICFR Implementation Update
6. Audit & Risk Committee Draft Annual Report for 2020-2021 (for circulation & comment)

¹ The Review of Pricing Levels for Sovereign-Backed Products discussion was extended to June 21, 2021.
### Annex B: Summary Table of Committee Recommendations July 2020 to April 2021

<table>
<thead>
<tr>
<th>Key Observations:</th>
<th>Audit and Risk Committee’s Recommendations to the Board of Directors:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Financial Reporting</td>
<td>The ARC supported the 2020 Financial Statements and recommended that (i) the Board of Directors submit the audited 2020 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 2020 be allocated to retained earnings.</td>
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<td>2 External Auditor</td>
<td>Committee Members 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 ARC supported the 2021 Global Borrowing Authority to be approved by the Board of Directors.</td>
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<tr>
<td>4 Risk Appetite Statement</td>
<td>The ARC recommended that the Board support the 2021 Risk Appetite Statement.</td>
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<tr>
<th>Key Observations:</th>
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<tr>
<td>1 Financial Reporting</td>
<td>The Committee requested additional insights in respect of the probability of default to be applied in the ECL calculations in the financial statement for 2020.</td>
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<td>2 Risk Management</td>
<td>Committee members emphasized that indicators like ‘single sovereign-backed exposure’ and ‘Top 3 sovereign-backed exposures’ are limits rather than targets. The Committee recommended reviewing the KRI1 limits, specifically those relating to single country exposure and concentration. A recommendation was also made to review the overall risk structure to strike a balance between development impact and financial sustainability.</td>
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<td>3 Internal Control</td>
<td>The Committee welcomed Management’s presentations summarizing the internal control activities but suggested the forward-looking actions should be enhanced and greater standardization to reduce the occurrence of certain types of ineffective controls. Throughout the year the Committee recommended paying close attention to several areas of work related to internal controls, including LIBOR transition and IT controls.</td>
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<td>4 Audit Plan</td>
<td>Committee Members requested the External Auditors, PwC, to update the audit plan to reflect the application of materiality.</td>
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<td>5 Terms of References</td>
<td>The Committee made several suggestions for addition to the Terms of Reference, including adding the review of the internal audit work plan and the adequacy of the internal control system. Committee members also hope the flexibility to allow observers to attend ARC meetings could be kept even when conditions return to normal.</td>
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Annex C: Indicative Committee Work Plan 2021-2022

**August 17, 2021, Tue. ARC Consultation**
- Q2 2021 Financial Statements (Consultation with ARC members on Quarterly Financial Statements)

**September 13-14, 2021, Mon.-Tue. ARC Meeting**
- Annual Compliance Risk Update
- COSO/ICFR Update
- Risk Reporting Dashboard
- Internal Audit Office Updates
- PwC Audit Work Plan for 2021
- Operational Risk Heat Map

**November 16, 2021, Tue. ARC Consultation**
- Q3 2021 Financial Statements (Consultation with ARC members on Quarterly Financial Statements)

**December 6-7, 2021, Mon.-Tue. ARC Meeting**
- Annual Operational Risk Update
- COSO/ICFR Update
- Risk Reporting Dashboard
- Internal Audit Office Updates
- 2022 Global Borrowing Authority
- Risk Appetite Statement and Report on Stress Testing
- PwC Audit Updates

**March 15, 2022, Tue. ARC Meeting**
- 2021 Financial Statements
- 2021 ICFR Attestation
- PwC Independent Auditor's Reports and ICFR Opinion
- Internal Audit Office Update
- Discussion with External Auditors (closed session)
- Risk Reporting Dashboard
- 2021 Capital Adequacy Year-end Assessment

**June 14, 2022, Tue. ARC Meeting**

**September 14-15, 2022, Wed.-Thur. ARC Meeting**

**November 30 – December 1, 2022, Wed.-Thur. ARC Meeting**

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2 Dates of committee meetings will depend on the recomposition of all committees after the election of the Board of Directors in June 2022.
3 Same as above.