Audit and Risk Committee Annual Report to the Board

2021-2022

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 (ToR) on December 21, 2020, to ensure consistency with the Bank’s policies and alignment with the Committee’s up-to-date practice. The Terms of Reference were reviewed in September 2021.

Composition

3. This Annual Report covers the work of the Committee between June 2021 and May 2022.

4. As of the date of this report, the membership of the Committee is as follows:
   - Mehmet Alper Batur (Vice Chair)
   - Ai Phing Cheng (External Member)
   - Zhijun Cheng
   - Khuong Thanh Ha (Chair)
   - Ahmed Kouchouk
   - 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 Elisabeth Stheeman, Directors Muhammad Aslam Chaudhary, Zhijun Cheng, Khuong Thanh Ha and Katharine Rechico. Following the resignation of Director Katharine Rechico, Director Ahmed Kouchouk was appointed to the Committee on July 22, 2021. Director Khuong Thanh Ha was selected as Vice Chair at the Committee’s Meeting on September 13, 2021. Following the resignation of Director Muhammad Aslam Chaudhary, Director Mehmet Alper Batur was appointed to the Committee on February 7, 2022. Director Khuong Thanh Ha and Director Mehmet Alper
Batur were, respectively, selected as Chair and Vice Chair of the Committee at the Committee’s Meeting on March 14, 2022.

Areas of focus during 2021/2022:


7. The Committee reviewed the 2021 Financial Statements for the Bank, the Project Preparation Special Fund and the Special Fund Window (“2021 Financial Statements”). The Committee noted the continued impact of the COVID-19 crisis, and the Bank’s response was reflected through different aspects of the 2021 Financial Statements, including impairment provisioning, liquidity management, fair value changes of instruments, income and expenditures as well as disbursements through the Special Fund Window. The reduced net interest income of the Bank was attributed to an overall low interest environment in 2021, coupled with the diversification of investment away from bank deposits. Further to this, the rising market interest rates starting from Q4 2021 have resulted in fair value losses for investment securities, however these are mostly unrealized as the underlying investments are of high credit quality. The ARC supported the 2021 Financial Statements and recommended that (i) the Board of Directors submit the audited 2021 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 2021 be allocated to retained earnings. Management consulted the Committee on the Q2 2021, Q3 2021 and Q1 2022 quarterly financial statements as prepared for approval by the President.

8. The Bank’s external auditor PricewaterhouseCoopers (PwC) briefed the Committee on the 2021 Audit Plan, which reflected changes to the AIIB’s business operations as well as the continued impact of the Covid-19 pandemic. PwC also elaborated on their assessment of the Key Audit Matters (KAMs), including the impairment provision of loans and valuation of financial instruments. The Committee was briefed by PwC on the audit of the 2021 Financial Statements. PwC’s audits of the 2021 Financial Statements were completed with unqualified opinions. In March 2022, the Committee met with PwC in a closed session.

9. The Chief Internal Audit Officer provided quarterly briefings on the internal audit plan, the key audit findings, and follow-up on agreed corrective measures. The Committee was briefed on changes to the audit plan and the rationale for the changes, including evolving business requirements as well as mitigating actions. Committee Members recommended a presentation of a risk heat map to highlight the various audit areas, with specific regard to those considered a high priority, including IT, Investment Operations, Treasury and Procurement. There was a particular focus on the IT universe with regards to managing the associated risks, including cybersecurity, and the Committee advised Management to continue focusing on this area. Building upon the recommendation from 2020, the Internal Audit Office (IAO) provided assurance on the agreed areas with a focus on improving the organization, actively seeking innovation in adopting the Agile Audit Methodology and the Lean Team Audit.

10. Over the reporting period, the Committee received quarterly updates on the ICFR/COSO implementation.
11. The Committee focused on the effectiveness of controls, rectification of control issues and the challenges on internal controls. The Committee suggestion to ensure special attention on IT controls were being addressed, with proper controls being put in place. The Committee recognized the advancements made by the team and recommended that focus continue to be placed on the cybersecurity and outsourcing control for FY2022. The ICFR workplan was kept agile, to correspond to the rapid growth of the Bank, its business development and surrounding environment, including cyber and data security concerns. PwC once again, reconfirmed and issued an attestation report on Management’s assertion in respect of the effectiveness of the Bank’s internal control over financial reporting, along with the issuance of 2021 Financial Statements.

12. The Committee received regular updates on the Bank's financial activities. Topics of frequent discussion included understanding the impacts of the Covid-19 pandemic and the conflict in Ukraine on the Bank’s operating income and liquidity management, the build-up of the Bank’s liquidity portfolio, and the growth in capacity of the Bank’s Treasury functions.

13. In December 2021, the Committee discussed the Global Borrowing Authority (GBA) for 2022 and Management elaborated on how this would continue to support the Bank’s presence in capital markets. The Committee supported the 2022 GBA for approval by the Board of Directors.

14. The Committee received quarterly Risk Management updates, including the level-one Key Risk Indicators (KRIIs). Frequent lines of inquiry included an assessment of the impact of the CRF on the Bank’s portfolio rating, the two KRIIs in breach namely RAROC and cost-to-income ratio, calculation of different KRIIs, the interpretation of different measures of concentration risk and updating KRIIs. The Committee also discussed with Management the calculation of ECLs and provisions and received technical briefings and further detailed elaborations outside of the Committee meetings. In addition, Management briefed the Committee regularly on the credit quality of investment operations, the trend of credit quality of the investment pipeline, market and liquidity risk, as well as a standalone annual operational risks and compliance risk updates. The Committee recommended a greater focus in balancing the portfolio credit quality for future portfolio growth and reviewing some of the KRI limits, particularly on concentration risk. Following feedback from the Committee, Management in 2021 refined the Economic Capital attribution methodology to provide improved signaling of long-term capital efficiency of lending.

15. The Committee was briefed on the 2022 Risk Appetite Statement (RAS) for AIIB, which was updated to reflect the latest governance development of the Bank. Levels for two KRIIs were established. The ARC agreed to recommend that the Board support the Risk Appetite Statement 2022 Update. The Committee received updates on the regular stress testing exercise, in particular the inflationary scenario 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 reviewed the adequacy of the Bank’s capital to cover all risk assets including under stressed conditions, as stipulated by the Bank’s CAST policy. Though current levels of capital remain high, it is expected that by 2032 the Bank would approach full capital utilization. Further to this, the importance of ensuring a well-diversified portfolio was highlighted as a priority, denoting the positive effects on ECap requirements.
17. The period also included an induction series for Board Members joining the Committee mid-term. The induction included introductory meetings with Management, as well as briefings and teach-ins on relevant topics.

Committee priorities for the coming year (2022-2023)

18. The Committee will continue fulfilling its mandate over the course of 2022-2023 by assisting the Board, as per its Terms of Reference. Several areas of focus for the Committee include:

a. Revision of the Bank’s Risk Management Framework

b. Review of the Bank’s Key Risk Indicators (KRIs), including indicators on concentration risk

c. Enhancing climate-scenario analysis and stress testing

d. Further embedding of active portfolio risk management capabilities

e. Assessment of ECL and changes of the creditworthiness of borrowers

f. The impact on operations of having more debt issued than paid-in capital

g. Financial health of the Bank in 2022-2023, given market volatility and geopolitical tensions

h. Impact on operations related to the recruitment and retention of staff

i. Cybersecurity and outsourcing controls
Annex A: Committee Agendas June 2021 to May 2022

June 14-15 & 21, 2021
1. Internal Audit Office Update
2. Risk Reporting Dashboard Update
3. Review of Pricing Levels for Sovereign-Backed Products
4. Alternative Reference Rate and LIBOR Transition Update
5. COSO/ICFR Implementation Update

August 17, 2021
1. ARC Consultation Q2 2021 Financial Statements

September 13-14, 2021
1. Selection of Vice Chair (closed session)
2. Internal Audit Office Update
3. COSO/ICFR Implementation Update
4. PwC Audit Work Plan for 2021
5. Annual Compliance Risk Update
6. Risk Reporting Dashboard
7. Operational Risk Heat Map

November 16, 2021
1. ARC Consultation Q3 2021 Financial Statements

December 6-7, 2021
1. Risk Reporting Dashboard
2. Risk Appetite Statement and Report on Stress Testing
3. Annual Operational Risk Update
4. Revision of the Pricing Policy
5. Internal Audit Office Update
6. PwC Audit Update
7. 2022 Global Borrowing Authority

March 14-15, 2022
1. Selection of the Chair and Vice Chair (closed session)
2. 2021 Financial Statements
3. COSO/ICFR Implementation Update
4. PwC Independent Auditor’s Report and ICFR Opinion
5. Discussion with External Auditor (closed session)
6. 2021 Capital Adequacy Year-end assessment
7. Risk Reporting Dashboard
8. Internal Audit Office Update

May 16, 2022
1. ARC Consultation Q1 2022 Financial Statements
## Annex B: Summary Table of Committee Recommendations June 2021 to May 2022

<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 Committee supported the 2021 Financial Statements and recommended that (i) the Board of Directors submit the 2021 Financial Statements 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 2021 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 supported 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 2022 Risk Appetite Statement.</td>
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<tr>
<td>5 Pricing Policy</td>
<td>The Committee recommended that the Board of Directors approve changes to the Pricing Policy for Sovereign-Backed Products, including removing the annual reporting obligation on pricing adequacy and updating the language to reflect the pricing terms and the Board-approved elements applicable to SBGs and SBLs.</td>
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<th>Key Observations:</th>
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<tr>
<td>1 Financial Reporting</td>
<td>The Committee recommended continuous improvement and transparency in financial statement presentation and disclosure, in line with the increased complexity in the Bank’s business. Following feedback from the Committee, additional disclosures were made, and “Frequently Asked Questions” were developed to provide additional information to the Committee.</td>
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<td>2 Risk Management</td>
<td>The Committee recommended a greater focus in balancing the portfolio credit quality for future portfolio growth and reviewing some of the KRI limits, particularly on concentration risk. Following feedback from the Committee, Management in 2021 reformed the Economic Capital attribution methodology to provide improved signaling of long-term capital efficiency of lending.</td>
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<td>3 Internal Control</td>
<td>The Committee recommended a continued focus on cybersecurity and outsourcing controls for FY 2022.</td>
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<td>4 Internal Audit &amp; Risk Management</td>
<td>The Committee recommended a continuation of the practice of developing a Risk Heatmap.</td>
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Annex C: Indicative Committee Work-Plan: 2022-2023

June 13-14, 2022, ARC Meeting
- Audit and Risk Committee Draft Annual Report for 2021-2022
- Internal Audit Office Updates
- Risk Reporting Dashboard
- Technical Briefing on Liquidity Portfolio

August 16, 2022, ARC Consultation
- Q2 2022 Financial Statements (Consultation with ARC members on Quarterly Financial Statements)

September 14-15, 2022, ARC Meeting
- Annual Operational Risk Update
- Annual Compliance Risk Update
- COSO/ICFR update
- Revision of Financial and Risk Management Policy and Risk Appetite
- Internal Audit Office update
- Risk Reporting Dashboard
- PwC Audit Work Plan 2022

November 15, 2022, ARC Consultation
- Q3 2022 Financial Statements (Consultation with ARC members on Quarterly Financial Statements)

November 30 - December 1, 2022, ARC Meeting
- 2023 Global Borrowing Authority
- PwC Audit Updates
- Risk Appetite Statement & Report on Stress Testing
- Risk Reporting Dashboard
- Internal Audit Office Update

March 13-14, 2023, ARC Meeting

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1 COSO/ICFR update will be circulated in written format and subject to Q&A in writing and/or during the meeting.