ASIAN INFRASTRUCTURE
INVESTMENT BANK

Risk Management Framework

April 2019

Contents

A. Background

1. This document provides background and context to the Asian Infrastructure Investment Bank's (AIIB or the Bank) Risk Management Framework.

B. General Principles and Objectives

2. The Bank's principles of risk management are designed to accomplish the following objectives:

   a) Provide a coherent foundation for effective management of key risks, including credit risk related to loans, guarantees and equity investments, market risk, liquidity risk, counterparty credit risk, model risk, operational risk and compliance risk.

   b) Identify emerging risks to AIIB's capital, mitigate these risks timely and maintain satisfactory capital levels to ensure that the Bank's triple-A ratings on a stand-alone basis are not affected.

   c) Implement sound credit risk practice into the Bank's accounting and financial reporting process.

C. Risk Management Framework

C.1. Risk Management Governance

3. Risk management governance is the Bank's approach to risk management. Risk management governance (1) applies the principles of sound governance to the identification, measurement, monitoring, and controlling of risks, (2) ensures that risk-taking activities are in line with AIIB's strategy and risk appetite and (3) covers all material risk categories applicable to the Bank.

4. To manage the Bank's risk effectively, the Board of Directors (BoD) and Management:
   a) Build and reinforce the Bank's risk culture.
   b) Articulate and monitor adherence to the risk appetite.
   c) Establish the Bank's risk management architecture with three lines of defense to identify, measure, monitor and control risks.

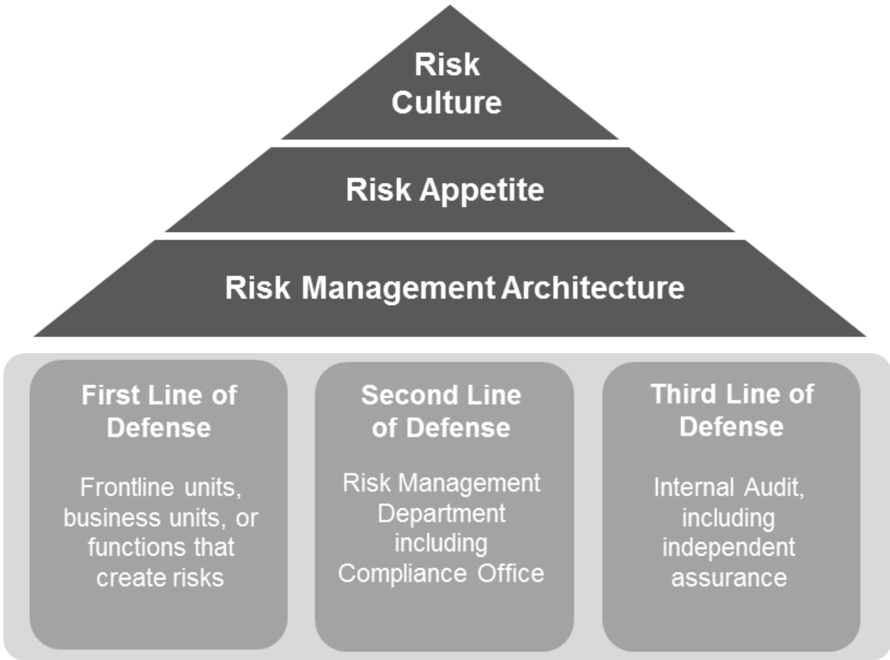
5. The BoD oversees the design and implementation of the Bank's risk management governance.

6. The Risk Committee (RC)[1] develops and maintains the framework, which enables Management to effectively identify, measure, monitor and control risk exposures consistent with the BoD-supported risk appetite. Risk Management Department (RMD)

[1] The Risk Committee is a committee established by, and accountable to, the President.

reports to the BoD on the Bank's overall risk profile, including aggregate and emerging risks.

Figure 1: Risk Management Governance Structure



C.2. Risk Culture

7. Risk culture is the shared values, attitudes, competencies, and behaviors throughout the Bank that shape and influence governance practices and risk decisions. Risk culture pertains to the Bank's risk approach and is critical to a sound risk management governance.

8. To promote a sound risk culture:

   a) The BoD establishes the tone at the top by promoting risk awareness within a sound risk culture. The expectations of the BoD are conveyed to all staff that the BoD does not support excessive risk taking and that all staff is responsible for ensuring the Bank operates within the established risk appetite and limits.

   b) The RC ensures material risks and risk-taking activities exceeding the risk appetite and limits are recognized, escalated and addressed in a timely manner.

9. Risk philosophy is the foundational pillar of the Bank's risk culture and the guiding basis for the entire risk management governance. Since each of the building blocks of the governance structure is built upon this, it is imperative to develop a clear articulation of the Bank's risk philosophy.

10. The Mission Statement (reproduced below) provides the overarching philosophy of AIIB's Risk Management:

"The AIIB Risk Management aims to

a. *Enable the Bank to fulfill its mandate to promote infrastructure and other productive sectors;*
b. *Ensure the stability and financial continuity of the Bank through efficient capital allocation and utilization, and comprehensively manage risks and reputational consequences;*
c. *And foster strong risk culture by embedding risk accountability in the Bank."*

C.3. Risk Appetite

11. Risk appetite is the aggregate level and types of risk that the Bank is willing to assume, or to avoid, in pursuit of its goals, objectives, and operating plan, consistent with applicable capital, liquidity and other requirements and reinforces the risk culture.

12. The development of a risk appetite is driven by both top-down BoD leadership and bottom-up RC involvement. Successful implementation depends on effective interaction among the BoD, RC, RMD, and frontline units such as the Investment Operations Department and the Office of the Treasurer.

13. The BoD's role is to review and support the Bank's risk appetite and to approve top down risk allocation and limits. The risk appetite is communicated throughout the Bank. The BoD evaluates and supports the risk appetite at least annually.

14. The RC, in consultation with the BoD, develops the risk appetite. The RC executes the strategic, capital and operating plans within the risk appetite and established limits.

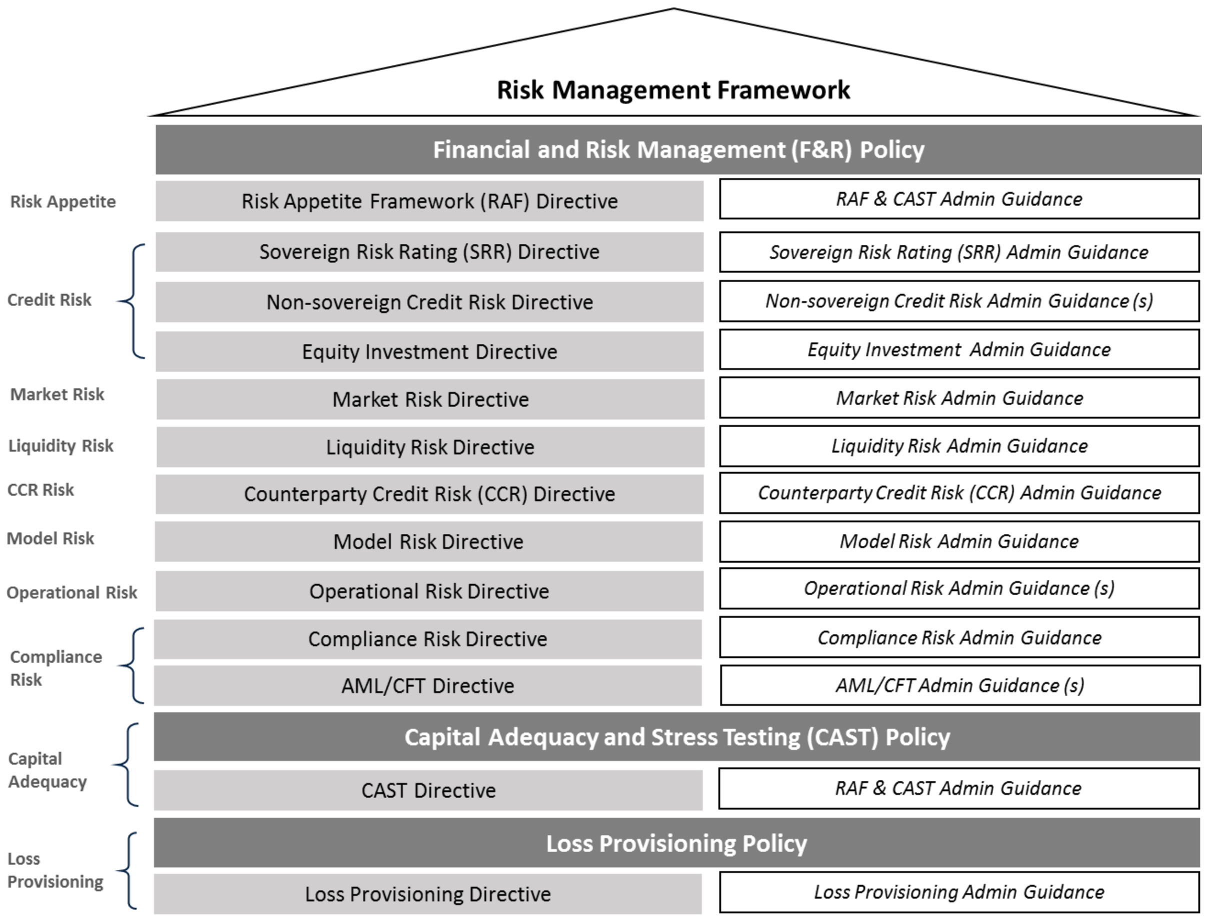
C.4. Risk Management Architecture

C.4.1. Policies

15. The risk management architecture comprises the Bank's policies, processes, organizational structure and control and assurance system which identifies, measures, monitors, reports and controls risks.

16. The specific set of risk policies, directives and administrative guidance is depicted in Figure 2.

Figure 2: Risk Management Policies, Directives and Administrative Guidance(s)



17. **Financial and Risk Management Policy** establishes prudent risk management processes to identify, measure, monitor, and control all material risks (credit and other investment risk, market risk, liquidity risk, counterparty credit risk, model risk, operational risk and compliance risk) arising from business activities and ensures the Bank takes risks within the risk appetite and limits.

17.1. ***Directive on Risk Appetite Framework (RAF)*** sets out guidelines for the controls and processes to monitor and report all material risks of the Bank. The RAF provides a detailed articulation of the responsibilities of the RMD as they pertain to the Bank's Risk Appetite.

17.2. ***Directives on Credit Risk***[2] will set out guidelines around the assessment, structuring, approval and monitoring of credit risk on loan and guarantee exposure (including nonperforming assets) arising from the default or change in the creditworthiness of a borrower or any relevant third-party entity. Credit risk is managed on individual and portfolio levels.

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[2] Not yet approved.

17.3. ***Directive on Equity Investment***[3] will set out guidelines for assessment, monitoring and control of equity investment risk which is due to deteriorating performance as measured by relative or absolute performance metrics.

17.4. ***Directive on Market Risk*** sets out guidelines for the assessment, monitoring and control of market risk, which is the risk of the Bank losing money due to the overall performance of the financial markets for all marketable instruments.

17.5. ***Directive on Liquidity Risk*** sets out guidelines for the assessment, monitoring and control of liquidity risk, arising from two general sources: (i) market liquidity risk, stemming from mismatches in asset and liabilities, and (ii) funding liquidity risk, which is the inability to access capital markets.

17.6. ***Directive on Counterparty Credit Risk*** sets out guidelines for the assessment, monitoring and control of the risk stemming from the default of a counterparty to a transaction before the final settlement of the transaction's cash flows.

17.7. ***Directive on Model Risk***[4] will set out guidelines for the assessment, monitoring and control of model risk due to the occurrence of fundamental errors in model outputs and the incorrect use of models.

17.8. ***Directive on Operational Risk*** sets out guidelines for the assessment, monitoring and control of operational risk, which is the risk of loss resulting from inadequate or failed processes or systems, through human error or the occurrence of external events.

17.9. ***Directive on Compliance Risk***[5] will establish the roles and responsibilities of compliance function of the Bank and set out guidelines for the assessment, monitoring and control of the risk of legal or regulatory sanctions, material financial loss, or loss to reputation the Bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organization standards and codes of conduct applicable to its banking activities.

17.10. ***Directive on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)*** establishes the Bank's AML/CFT framework and ensures its effective implementation by establishing principles and guidance to safeguard the Bank, including its personnel, from money laundering, the financing of terrorism or other illicit activities.

18. Capital Adequacy and Stress Testing (CAST) Policy

18.1. The Bank's capital supports its operations, acts as a cushion to absorb unanticipated losses and declines in asset values that could otherwise cause the Bank to become insolvent and provides protection to debt holders. Therefore, it is important for the Bank to establish a sound process commensurate with its overall risk and complexity to

[3] Not yet approved.
[4] Not yet approved.
[5] Not yet approved.

determine whether its overall capital is adequate and to maintain a capital level to cover risks it faces even after being subjected to a prolonged and severe crisis.

18.2. The CAST Policy establishes a framework for the efficient use of available capital of the Bank and sets forth the principles and practices required: (i) to ensure that the Bank operates within its risk appetite; (ii) to align the Bank's capital adequacy practices with industry best practice; and (iii) to clarify the capital adequacy limits.

18.3. Capital adequacy management helps the Bank to:

a) Identify risks, improve its understanding of the Bank's overall risks, set risk appetite and assess strategic choices in business planning.
b) Identify vulnerabilities such as concentrations and assess the impact on capital.
c) Integrate business strategy, risk management, and capital management decisions.

18.4. To manage our capital effectively, AIIB establishes forward-looking capital adequacy management processes coordinated with the Bank's overall strategy and business planning cycle and risk appetite. The Bank factors in potential events that could occur outside of the normal capital adequacy management cycle; for example, an economic downturn could have a major impact on capital needs. An effective capital adequacy management process includes:

a) Identifying and evaluating all material risks.
b) Setting and assessing a capital adequacy appetite that relate to these risks.
c) Maintaining a business strategy to ensure capital adequacy.
d) Ensuring integrity in the capital management process and capital adequacy assessments.

18.5. Stress testing is an important tool that is used by the Bank as part of its risk management that alerts the BoD and the RC to adverse unexpected outcomes related to a broad variety of risks and provides an indication to the Bank of how much capital might be needed to absorb losses should large shocks occur.

18.6. In capital adequacy management, stress testing is used to obtain a forward view on the sufficiency of the Bank's capital base. Stress testing is a prudent way for the Bank to identify its key vulnerabilities to market forces and assess how to effectively manage those risks should they emerge. If the results of a stress test indicate that capital adequacy could fall below the Bank's overall risk appetite, the BoD and the RC shall take appropriate steps to protect the Bank from such an occurrence.

18.7. Economic Capital methodologies are employed to quantify the amount of risk inherent in all its operations as a common currency. The risk adjusted return on capital (RAROC) is used to determine the profitability of transactional business, and that of the existing portfolios, with minimum hurdle rates set as part of deal acceptance criteria.

19. **Loss Provisioning Policy**

19.1. The Bank adopted International Financial Reporting Standard 9–Financial Instruments (IFRS 9) which is a forward-looking approach and results in timely recognition of credit losses in impairment accounting. Under IFRS 9, banks are required to recognize Expected Credit Loss (ECL) at all times, to take into account past events, current conditions and forecast information, and to update the amount of ECL recognized at each reporting date to reflect changes in an asset's credit risk. Expected losses are considered on either a 12-month or lifetime basis, depending on the level of credit risk associated with the asset, and should be reassessed at each reporting date. The projected value is then recognized in the profit and loss statement.

19.2. The Loss Provisioning Policy sets forth the accounting standards adopted by the Bank for determining loss provisioning for loans and guarantees and provides the guidelines for calculating those provisions.

19.3. Adequate credit risk management structure leads to timely recognition and measurement of increases in credit risk, which affects the capital adequacy of AIIB and the proper assessment and control of the Bank's credit risk exposure. RMD's involvement in the assessment and measurement of accounting ECL is essential to ensuring adequate allowances in accordance with the applicable accounting framework.

C.4.2. Processes

20. Processes are the procedures, programs, and practices that impose order on the Bank's pursuit of its objectives. A well-designed risk assessment process helps the RC address emerging risks at an early stage and allows it to develop and implement appropriate strategies to mitigate the risks before they have an adverse effect on the Bank's soundness or financial condition. The completed risk assessment is integrated into the Bank's strategic planning process and risk management activities.

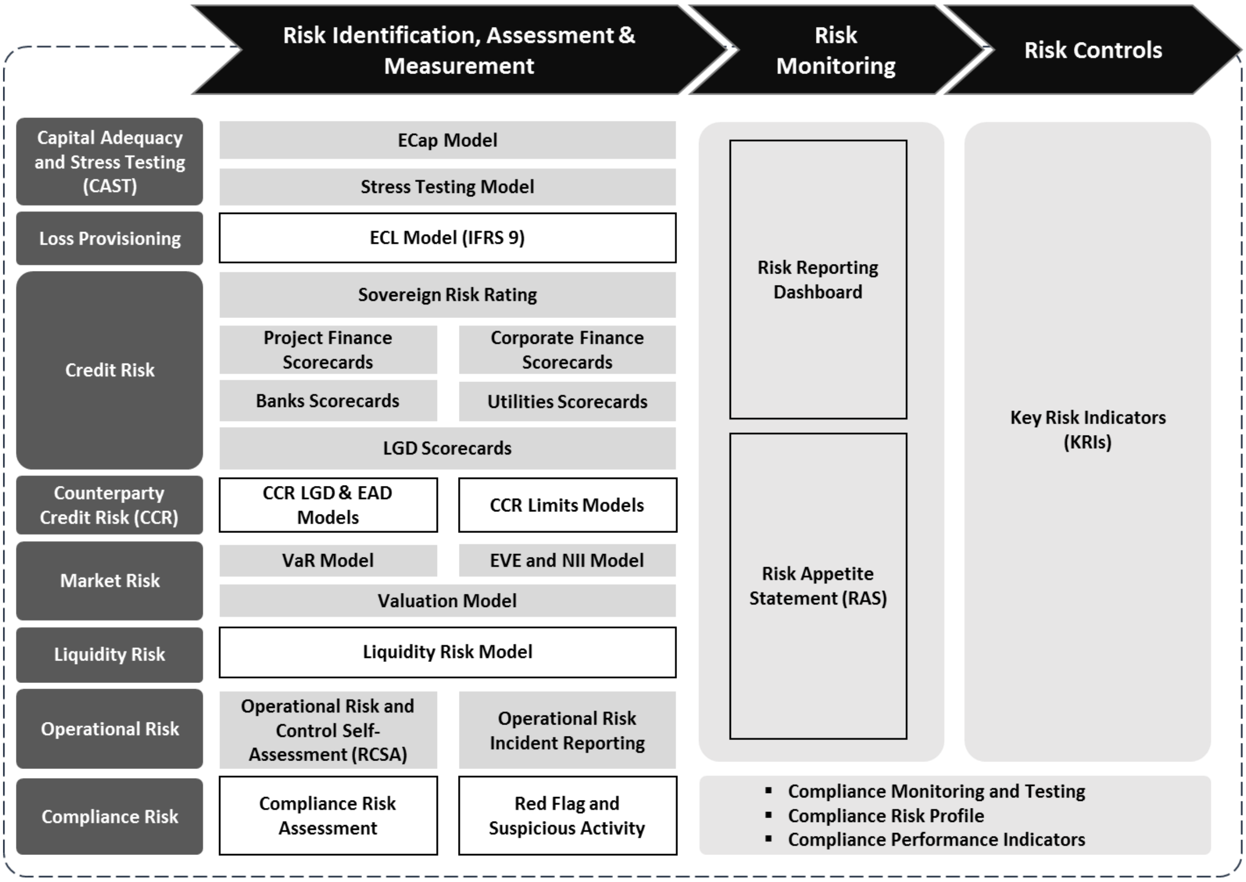
20.1. **Identify Risk:** The Bank recognizes and understands existing risks and risks that may arise from new business initiatives, and those that arise from external market conditions. Risk identification is a continual process and occurs at the transaction, portfolio and enterprise levels. The Bank shall identify interdependencies and correlations across portfolios and lines of business that may amplify risk exposures.

20.2. **Assess and Measure Risk:** Accurate and timely measurement of risks is essential to effective risk management. The Bank needs sophisticated measurement systems as the complexity of the risk increases. Sound risk measurement systems assess the risks at the individual transaction, portfolio and enterprise levels.

20.3. **Monitor Risk:** The Bank monitors risk levels to ensure timely review of risk positions and exceptions. Ongoing communication about risk issues, including AIIB's risk strategy, throughout the Bank is a key tenet of a strong risk culture. Monitoring reports shall be timely and accurate and shall be distributed to appropriate individuals including the BoD to ensure action, when needed. Well-designed monitoring systems allow the BoD to hold the RC accountable for operating within established risk appetites.

20.4. **Control Risk:** The BoD and the RC establishes and communicates risk limits through policies, directives and administrative guidance that define responsibility and authority. These limits serve as means to control exposures to the various risks associated with the Bank's activities. The limits should be tools that the RC can adjust when conditions or risk appetites change.

Figure 3: Risk Management Processes



C.4.3. Organizational Structure

21. Capable Management and staff are essential to effective risk management. Personnel shall understand the Bank's mission, risk appetite, core values, policies and processes.

22. Management creates and maintains an organizational structure that ensures clear lines of responsibility, accountability and oversight. Management ensures that personnel in risk management and audit have sufficient independence and stature.

23. **Three Lines of Defense.** To implement effective risk management governance and address the full spectrum of possible risks, the responsibilities among different units of

the Banks are defined in such a way that there are three lines of defense which are independent from each other.

23.1. ***First Line of Defense*** is provided by the business units where risks are taken. In the course of conducting business activities, staff in the business units hold frontline positions in the proper identification, assessment, management and reporting of risk exposures on an ongoing basis, having regard to the Bank's risk appetite, policies, procedures and controls.

23.2. ***Second Line of Defense*** is provided by independent risk management and compliance functions. The risk management function is primarily responsible for overseeing the Bank's risk-taking activities, undertaking risk assessments and reporting independently from the business units, while the compliance function monitors compliance with laws, corporate governance rules and internal policies.

23.3. ***Third Line of Defense*** is provided by an independent internal audit function, which is responsible for providing assurance on the effectiveness of the Bank's risk management framework including the risk management governance arrangements (including the first and second lines of defense described above).

24. **Risk Management Responsibilities.** The following seven key areas are the main responsibilities of the RMD:

a) ***Risk Management and Oversight.*** Overall development and oversight of the Bank's risk framework and policy, and direct governance of the RC.

b) ***Guardian of Risk Appetite.*** Facilitating the articulation of the overall Risk Appetite and appropriate risk limits, and the embedding of the Risk Appetite into the Bank's processes and culture.

c) ***Risk Identification and Assessment.*** Identification of all material risks, definition of key risk metrics/indicators, and development of methodologies, indicators, and models to measure these risks.

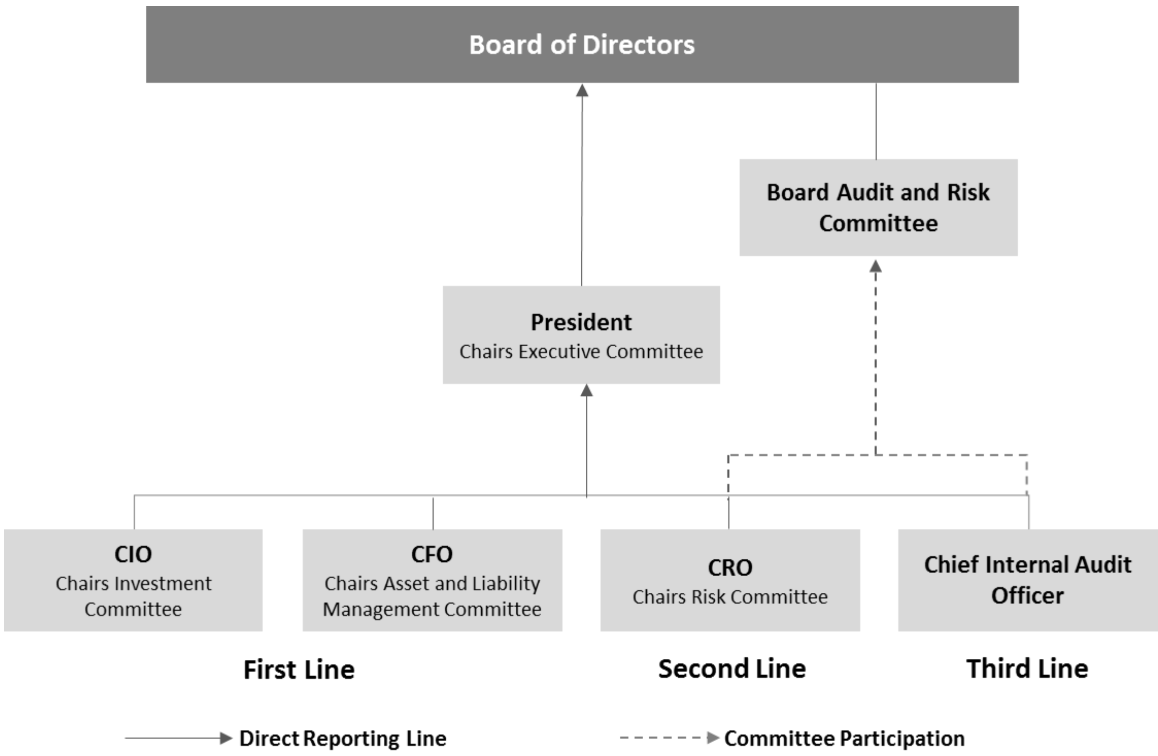
d) ***Risk Monitoring and Reporting.*** Regular monitoring of the Bank's risks and the development and maintenance of a concise Board and senior management level risk reporting.

e) ***Strategic Decision Making.*** Align overall business and operational plans with appropriate risk management and ensure that strategic planning reflects the Risk Appetite.

f) ***Risk Optimization.*** Risk optimization and active risk management by shaping the risk profile within Risk Appetite limits, strategic capital allocation through risk adjusted capital and development of risk-adjusted performance management.

g) ***External Communication.*** Collaborate with the relevant parties in the Bank on consistent and proportionate disclosure of all risks to external parties, interaction with rating agencies and participation in external conferences.

Figure 4: AIIB Organizational Structure



C.4.4. Control and Assurance Systems

25. A critical element to support an effective risk management architecture is the existence of a sound internal control system and internal audit.

26. The Bank's internal control system is designed to minimize the operating risk of loss from irregularities, fraud and errors, to ensure effective risk management systems and to ensure compliance with relevant laws and internal policies.

27. Internal audit office performs independent periodic checking on proper implementation of the risk management framework and compliance with risk management policies and control procedures.