Board's Risk Governance and Oversight

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I shall speak on **'Board's Risk Oversight – Appetite and Tolerance of Strategic and Financial Risks'**.

The topic focuses on establishing best practice Risk Governance and Oversight, which has been crucial for Asian Infrastructure Investment Bank (AIIB) from the beginning. Risk Governance has gone through significant changes since the global financial crisis in 2008. The consequences of failing to implement effective oversight mechanisms have been demonstrated not only in severity of losses experienced during the global financial crisis but continue to be demonstrated by many Banks in recent years still being involved in scandals of compliance failures, mis-selling, market collusion and fraud cases. These have resulted in substantial losses, eroded trust with clients, punitive fines from regulators and in cases the Bank's collapse requiring external rescue.

AIIB was established in 2016 with the ambition to be the next generation multilateral lending institution, learning lessons on what had worked well from other peer institutions, but also to incorporate best practice from commercial banks in particular in the light of lessons learned from the global financial crisis. As the Bank's core values "lean, clean and green" were established.

Historically, many multilateral lending institutions have stressed the development role of their operations without necessarily focusing on financial sustainability. Consequently, despite maintaining the strongest credit ratings, many have needed repeated capital injections from their shareholders to maintain balance sheet growth and remain relevant. AIIB's articles, on the other hand, explicitly require the Bank to adhere to *sound banking principles.*

Also consistent with our *lean* values, AIIB has been structured to be not only operational efficient but also to embed a risk management framework which can ensure long-term financial sustainability.

Our risk management framework instituted a governance framework for oversight, monitoring, managing and escalation of risks and introduced Economic Capital and Risk Adjusted Return on Capital (RAROC) as the key drivers for decision making guiding our business activities. In addition to financial risk, we integrated non-financial risks as well i.e. operational risk and compliance risk.

It is vital that a strong risk culture is promoted from the very beginning, with risk awareness embedded in operating model. Culture encompasses shared values and behaviors that guide interactions, decisions and outcomes at all levels of an organization. **As the legendary management consultant Peter Drucker once stated, "Culture eats strategy for Breakfast!**" To effectively achieve this, it is imperative that the tone is set from the very top, with the Board of Directors conveying that they do not support excessive risk taking and that all staff is responsible for ensuring that the Bank operates within its risk appetite and limits. It is imperative that all senior management actively exemplifies risk management principles, and not merely talk the talk.

To implement and enforce a strong risk culture, AIIB deploys a three line of defense model:

- The client facing operations playing the 'first line' role in taking full ownership of risks they take.
- The 'second line' role to be performed by the risk management department, ensuring independence in overseeing the risk and compliance activities.
- The 'third line' role to be performed by the internal audit to provide assurance on the effectiveness of the processes.

The centerpiece of the risk management framework is the annual issuance of a comprehensive Risk Appetite Statement approved by the Board, which is the formal articulation of the aggregate level of risk AIIB is willing to accept in pursuit of its mandate. This is a top-down approach and identifies the material sources of risk. We have differentiated between core risks, which are central to the Bank's business model, and non-core risks, which are acquired through supporting activities. A low, medium and high appetite is thereafter assigned to each risk type, with limits structured accordingly.

The identified risk types cover not just the financial risks, such as credit, market and liquidity risks, but also cover non-financial risks, such as operational, reputational risks and compliance risks. In addition, risk types like Environmental and Social Risk, and Business and Strategy risks which are not typically the responsibility of the CRO are also included.

Non-financial risks have manifested themselves as being particularly destructive for the reputation of Banks, even within countries with a very low level of perceived risk as demonstrated by the repeated scandals at multiple Nordic Banks. These instances were attributed to failures of management oversight and weak systems to perform risk-monitoring.

Operational losses in many institutions now exceed those of credit losses, such as impact of punitive regulatory fines, internal and external fraud events. These were globally estimated at $17 billion in 2019 and $57 billion in 2016.

Within the Risk Appetite Statement, a distinction is made between risk capacity, which is the maximum level of risk the Bank can assume given its level of capital resources, and that of risk appetite which must be below that of our capacity, particularly due to the possibility of unquantifiable risks. The Bank's capacity is ultimately formed from its stock of available capital, comprising of our paid-up capital, as well as retained earnings, which act as a buffer against unexpected losses.

To measure the adherence to the risk appetite statement, AIIB has introduced key risk indicators (KRIs) to enable our Board members to be informed of the Bank's performance. These cover the full spectrum of the different risk factor types. These are supported by cascaded down lower level KRIs reported to the President. Triggers as well as limits are used as an early warning system. Any realized or forecasted breach in a KRIs limit requires a remediation plan to be presented. KRI limits are structured to have both an upper and lower bound, ensuring that that the Bank's appetite is not deployed inappropriately.

In parallel, AIIB has chosen from its creation to use the latest forward looking risk concepts, being an early adopter of IFRS-9 accounting standards. IFRS-9 looks at forward looking credit scenarios to determine the size of expected credit loss provisions specific to each investment. While originally an accounting responsibility, given the complex credit modelling required, the Risk Department has become responsible for determining expected credit losses under IFRS-9. This replaced the backward looking incurred loss framework which was purely driven by the respective credit rating. By directly impacting the Bank's P&L, the adoption of IFRS-9 has facilitated a much greater understanding of the drivers of credit losses.

As said earlier, Capital Adequacy is measured through the concept of Economic Capital, which also forms the common currency of risk to measure the utilization of our appetite and capacity. Economic Capital is a risk-based view of the requirements needed to support Bank operations to ensure solvency at a desired level of creditworthiness. It is particularly sensitive to levels of concentrations (be they single-name, geographic and sector) and can incorporate maturity effects. Given AIIB's mandate to deliver long-term financing needs within the Asian region, Economic Capital provides the ability to fully capture the resultant portfolio characteristics. Economic Capital is not only allocated to each transaction of the banking book and Treasury's liquidity – but also against non-financial risk i.e. operational risks.

As Investment Committee member, I hold a veto on investment decisions. The investment proposal's RAROC is a core consideration. This measures how pricing compensates for the level of risk within the investment proposal, and is subject to a minimum hurdle rates, thus ensuring the Bank's scarce capital resources are deployed consistent with our Risk Appetite Statement.

The adoption of both Economic Capital and IFRS-9 thus further embeds AIIB's risk culture, requiring the Risk Function to take up a larger role in the institution, rather than Finance, who have historically been the guardians of loan provisioning and capital adequacy. This shift of responsibilities is in line with trends among commercial banks.

Together with the evolution in complexity of Risk methodologies system requirements have increased substantially.

Operationalizing Economic Capital, IFRS-9, and relevant metrics and KRIs requires large investment in systems and platforms, to enable data to flow not only from the actual portfolio, but from that of the planned and forecast activities as well. Our Risk data-mart has defined over 5600 data fields. However, AIIB has had the advantage of having no legacy systems, enabling the platforms to be implemented quickly. AIIB's system investments reflects wider trends, with worldwide IT spending in the Banking industry was forecast to exceed $387 billion in 2019, addressing increased regulatory requirements, but also to ensure competitiveness and customer service offered by disruptive fintech companies. Also in line with industry trends, we have chosen to buy and customize system solutions rather than develop in-house.

AIIB's risk appetite statement is also presented alongside the Bank's business plan, which is approved by the Board. To ensure consistency with the Risk Appetite Statement, AIIB conducts stress testing analysis of the major drivers to determine the consequences of the business plan against our Risk Appetite. Given the longer tenors of our investment portfolios, a longer term trajectory over 10 years is also assessed. Stress scenarios applied are to ensure AIIB remains well capitalized and protected from extreme and extensive shocks affecting our ability to operate. The multitude of different scenarios includes both historically observed events, such as the Asian Financial Crisis or the Global Financial Crisis, but also potential future events. While we hold sufficient capital consistent with a AAA default probability of 0.01%, we hold an additional buffer of capital to assure that we not only continue to service our bond holders but maintain the ability to act as countercyclical lender.

This annual stress testing analysis is designed to enable the Board to provide effective challenge to management and is discussed at the Bank's audit and risk committee, as well as the full Board meeting.

I would like to mention the specific stress test scenarios we ran for 2019 and close with the upcoming task to define the major stress test scenarios for 2020.

Trade Tensions and Balkanization

Trade tensions have dissipated in recent weeks, yet there remain risks of these escalating once again. While there are some relative winners, the impact on well-integrated supply chains and reduced global demand is a systematic risk for all countries, and consequently the creditworthiness across the Asia region, particularly for directly affected corporates.

Credit Driven Scenarios

Increases in global debt observed in recent years are also a concern within the Asia-Pacific region. Post the Global Financial Crisis as while Banks have deleveraged, this has been counterbalanced with large rises in Government, corporate and consumer debt. While I don't believe we are currently facing a heightened broader system risk, however some countries have heightened debt concerns on the sovereign level, while on the corporate side bankruptcies have begun to rise with some large credit roll-overs posing potential volatility.

We currently do not expect rising interest rates, but I wish to remind you that this time a year ago most forecasts predicted increased financial stress due to rising rates.

Operational Risk

Operational risk scenarios such as a cyber risk, may not only take the form of a targeted attack against a particular institution, but potentially more damaging be against the critical infrastructure of the financial industry. This would result in widespread reduction in liquidity and significantly impair the ability to access custodian accounts, and in extremes impact the ability to meet the scheduled interest and principal payments. While it is extremely difficult to estimate potential losses associated with Cyber Risk, some data sets are emerging from the Insurance industry.

Climate Change

As per the Bank's values and longer term lending horizon - climate change also has the potential to impact our borrowers, and the viability of projects, which may be left as stranded assets. Leading regulators have started to take steps to require lenders and insurers to become aware of the consequences of the forecasted changes in climate as well as the impact of an unexpected shock. Hence, we have started in 2019 to include Climate Change into our stress testing scenarios.

Regarding the 2020 outlook, I expect existing risks to remain relevant with additional uncertainty introduced by:

- Increased geopolitical tensions and US election uncertainty
- New level of Cyber warfare
- Lesser ability of a global coordinated policy response to potential economic shock
- Political leaders who focus more on tactical decisions rather than longer term strategies
- Increased pressures from Social control, activism forcing companies to be accountable beyond the current standards of compliance. ■

Excerpts from the Special Address delivered by
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