



**ASIAN INFRASTRUCTURE
INVESTMENT BANK**

ASSET LIABILITY MANAGEMENT POLICY

DECEMBER 2017

1. Introduction

This Asset Liability Management (ALM) Policy establishes a framework for the sound management of ALM and sets forth the principles and practices related to the first line of defense responsibilities for interest rate risk and currency risk management.

2. Asset Liability Management

The Asian Infrastructure Investment Bank's (the Bank) ALM approach shall be to limit potential losses by keeping consumption of economic capital under limits allocated to ALM risks, to be applied as Value at Risk (VaR) limits.

2.1 Management of Debt-Funded Assets

Loan Assets

Loan terms that create market exposures, such as fix/float convertibility, inflation-adjusted cash flows or optionality will be funded on a back-to-back basis, or hedged back individually to the desired basis. Otherwise, such features will be offered in a way that transfers the cost of the market risk to the borrower.

Debt funded loans may be offered on a floating rate basis, a fixed rate basis or with a fixing option.

Repricing Risk

Sovereign-backed loans will have pass-through pricing such that borrowing costs are passed through to borrowers as the loans are refinanced over the life of the asset. A static pass-through cost will be established to serve as the basis for pricing sovereign-backed loans. The pass-through cost may be based on historical cost of funds, comparables from peer banks, secondary fixed income market activity or other relevant factors and will be re-evaluated at least annually. This pass-through cost will be the basis for the projected funding spread to LIBOR that is a component of the Pricing Policy¹. Non-sovereign-backed loans will be priced with a premium designed to absorb periods when funding costs rise at the time of refinancing.

Liquidity Portfolio Assets

The Bank's Liquidity Portfolio assets will be debt-funded with an objective of capital preservation (as measured against an appropriate benchmark or cost of funding). On an exceptional basis, equity may be used to fund the liquidity portfolio whenever loan assets do not fully consume available equity.

A short-term investment program may be created to serve the purpose of maintaining active contingent funding sources, such as commercial paper, repurchase agreements and callable notes with short first call tenors. The size of the short-term investment program will be no larger than the short-term borrowings, which will be set annually by the Board of Directors (BoD) as part of the Global Borrowing Authorization. Short-term funding may only be used to invest in short-term assets and a duration gap of no more than 0.5 years will be the limit on

¹ *Financial Policies (AIIB-0004) Annex A(v)(b).*

this portfolio. Liabilities in such a program may be excluded from the calculation of the Debt Redemption Limit established in section 2.6 below. The program is excluded from the calculation of prudential liquidity for purposes of measuring compliance with the liquidity limits referenced in paragraph 2.5 below.

2.2 Management of Equity-Funded Assets

The Bank previously had an equity duration range of two to five years. While duration remains an important ALM tool, it will now be a matter addressed by Directive, and the Risk Limits Policy establishes VaR as the limit metric reported to BoD.

2.3 Management of Non-US Dollar-Funded Assets

The Bank may offer loans denominated in currencies other than US Dollars whenever it has the means to adequately operate in other currencies and manage risks unique to the products, including operational risks and transfer and convertibility risk.

2.4 Currency Risk

Debt-funded assets shall be funded in the same currency (on an after-hedging basis). Equity is US Dollar denominated, but non-USD assets may be funded with US Dollar equity.

2.5 Liquidity Risk

The Bank will ensure its ability to meet cash flow obligations by managing liquidity risk with a perspective informed by the following core themes:

- a) Maintain sufficient liquid assets to cover maturing liabilities.
- b) Funding sources, counterparties and term of funding should be diversified.
- c) Funding needs during business-as-usual and stress scenarios should be anticipated and available through contingency funding plans.

The Liquidity Portfolio assets will be selected with key criteria being a) relatively low volatility of market value during times of stress and b) expected ability to sell the assets in times of stress.

In managing the amount of prudent liquidity reserves to hold, this ALM Policy defines liquidity as the sum of the market value of marketable securities, deposits and collateral available for rehypothecation, less restricted cash and securities, and excluding securities funded by short-term funding. The minimum level of prudential liquidity is reset each quarter and applies to a rolling 12-month period. Any expectation of a breach of the minimum over the 12-month horizon must be reported to BoD.

2.6 Refinancing Risk

Debt-funded assets may be funded with liabilities of a shorter maturity or with mismatched timing of cash flows. To prevent debt redemption concentrations, the Bank will maintain a

limit on how much of its liabilities may mature during any period. The Debt Redemption Limit sets the maximum amount of debt redemptions as a percentage of current outstanding debt principal that may occur over a rolling twelve-month period. Initially, this limit is set to be a range between 20% and 30%.

2.7 Use of Financial Derivatives

It is a sound business and financial practice for the Bank to use financial derivatives as outlined in *General Investment, Borrowing and Asset Liability Management Authority Policy (AIIB-0006)* to hedge the balance sheet and manage interest rate risk, where the level of exposure outweighs the derivative transaction costs.

The following procedures must be maintained:

- Any proposed hedging strategy shall be accompanied by detail about responsibility of reporting, limit monitoring and rate scenario analysis and how and when the hedge will be tested for effectiveness.
- Hedge effectiveness will be measured at the portfolio level in terms of residual exposure.

Monitoring Derivatives

Monitoring of Financial Derivatives includes:

- Measuring the value of the instrument on periodic basis (at least quarterly).
- Assessing the instruments' appropriateness as hedges given the current economic environment (at least annually).
- Disclosing the market value of derivative instruments annually in the notes to the financial statements.
- Annual model validation on models used for the valuation of hedges and hedging instruments and on models used to support hedging decisions.
- Establishing limits on each product that will be used for hedging.
- Segregation of execution and monitoring of derivatives use across business units.

3. Policies, Limits and Controls

The Bank's ALM appetite provides for ALM risk to be incurred provided that the Bank maintains prudent boundaries around the potential impact of market changes on both near-term and longer-term earnings and capital. These boundaries are expressed as the following Key Risk Indicators (KRI) to be reported to BoD:

Market Risk

- Stressed Economic Value of Equity (EVE); change in EVE
- Net Interest Income (NII) change;
- Value at Risk (VaR).

Liquidity Risk

- Liquid Assets, % coverage of next three years' net cash flow requirements

- Liquid Assets, % coverage of next twelve months' net cash flow requirements under extreme stress conditions

Controls

This ALM Policy requires an effective system of internal control for market and liquidity risk. Such controls shall ensure the following:

- Implementation of: (a) appropriate limits and enforcement on risk taking; (b) adequate systems and standards for identifying, measuring, monitoring and evaluating risk; (c) standards for valuing positions and measuring performance; (d) a comprehensive ALM risk reporting and ALM review process; and (e) effective internal controls.
- Clear lines of authority and responsibility for the management and control of ALM risk.

4. Revocation of Existing Policies

This ALM Policy hereby revokes and replaces (i) the Liquidity Policy, (ii) the Borrowing, Liability Management and Derivatives Policy, and (iii) the sections "Currency Risk" and "Interest Rate Risk" in the Risk Management Policy, all of which are included in *Financial Policies (AIIB-0004)*, which were approved by BoD in January 2016.

5. Implementation

The President shall ensure the implementation and observance of this Policy through issuing Directives, which shall:

- Determine how duration is managed and specify duration limits.
- Establish a prudently governed short-term investment program.
- Specify methodologies for allocating equity as a funding source.
- Govern equity funded portfolios for deployment of excess liquidity.
- Determine the circumstances under which the Bank may open investment operations in non-US Dollar currencies and the associated allocation of economic capital available for non-US Dollar investment operations.
- Authorize the creation of non-US Dollar currency liquidity portfolios in support of non-US Dollar currency loan products, and govern ALM for such portfolios.
- Define usage of economic capital for foreign exchange exposure of non-US Dollar assets funded with US Dollar-equity.
- Govern composition of the liquidity portfolio and associated investment strategies.
- Establish the appropriate level of prudential and tactical liquidity, as informed by stress analysis.
- Govern hedging activities and instruments.
- Define how financial products that introduce non ALM risk must be approved.
- Define responsibilities and structure of hierarchy mindful of the need to avoid potential conflicts of interest.