MOBILIZING PRIVATE CAPITAL FOR INFRASTRUCTURE
(Technical Note)

February 9, 2018

ASIAN INFRASTRUCTURE INVESTMENT BANK

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ABBREVIATIONS

ADB	Asian Development Bank
AIIB	Asian Infrastructure Investment Bank
AUM	Assets Under Management
EDHEC	EDHEC Infrastructure Institute-Singapore
EM	Emerging Markets
EPRI	Extended Political Risk Insurance
GIH	Global Infrastructure Hub
IFC	International Finance Corporation
MDB	Multilateral Development Bank
NSBF	Non-Sovereign Backed Financing
OECD	Organization for Economic Cooperation and Development
PDM	Private Direct Mobilization
PIM	Private Indirect Mobilization
PPPs	Public-Private Partnerships
PRI	Political Risk Insurance
SBF	Sovereign-Backed Financing
SPV	Special Purpose Vehicle

EXECUTIVE SUMMARY

1. The infrastructure financing gap in Asia is significant and growing. Existing sources of capital for emerging markets' infrastructure are insufficient to fill the gap. Private capital sources, in particular from institutional investors, are a key part of the solution to finance Asia's infrastructure investment needs over the coming decades. AIIB will seek to catalyze these sources.

2. The Asian Infrastructure Investment Bank (AIIB or the Bank) has therefore identified Private Capital Mobilization as a thematic priority. To execute this priority, the Bank, through a process of extensive consultation both internally and externally, developed the Strategy on Mobilizing Private Capital for Infrastructure (the Strategy) supported by this paper.

3. The purpose is to define the Bank's approach to implementing the thematic priority of Private Capital Mobilization. Allocation of the Bank's limited resources will be prioritized in order to maximize the impact of such capital.

4. AIIB's mandate is to support high-quality, sustainable infrastructure and enhanced connectivity investment in Asia. The Bank's sweet spot is where it faces less risk or can better manage risk than private financiers; can reduce risks for private financiers; or can open frontier markets to investment. The Bank has conducted a preliminary assessment of where and how, within the context of the efforts of existing Multilateral Development Banks (MDBs), the Bank may best add value in upstream, midstream and downstream financing efforts.

5. With time and experience, AIIB's activities will evolve, as it takes on increasing complex operations, in an increasingly challenging operating environment. In its initial operational phase to date, a key source of AIIB's portfolio has been co-financing partnerships with MDB partners. This will continue. However, the Bank should immediately pursue the second phase of activities, in which it will originate and lead high quality transactions. In the third phase of activities, AIIB will create markets.

6. The Bank will offer a range of products comprising debt, equity, and guarantees. It has identified a range of core partners, as well as relationships that may develop over time as sources of private capital to be mobilized for investment in Asia's infrastructure. AIIB intends to operate in a lean fashion, and as such will rely on external expert advisors for support with market assessment, legal review and other needs. The Bank intends to build an internal culture that is driven by finding solutions for its clients (rather than developing products and then finding markets for them), and that rewards innovation and excellence. The successful development of this culture will take time and will be crucial to the successful implementation of the Strategy.

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Background

1. This paper has been prepared by the Bank to support the development of the *Strategy on Mobilizing Private Capital for Infrastructure*, one of the thematic priorities of the Bank.

The paper is focused only on private capital associated with Non-Sovereign Backed Financing (NSBF).

2. Sovereign-Backed Financing (SBF) also enhances Private Capital Mobilization as it channels proceeds from private investments in AIIB bonds into infrastructure. Also, SBF-financed projects often prepare the environment in which private infrastructure investments can become viable. However, the origination, structuring, execution, credit, procurement and partnership requirements for SBF are distinct from those for NSBF.

Introduction

Purpose

3. The purpose of this paper is to define the Bank's approach to implementing the thematic priority of Private Capital Mobilization, which is instrumental to deliver on the Bank's mandate. This paper takes into account the Bank's limited resources and its operating framework, and identifies and sequences short- and medium-term priority activities. The paper also lays the groundwork for more detailed work in the coming months.

Infrastructure Financing Gap in Asia

4. To set the context for the Bank's approach to Private Capital Mobilization, it is important to dimension the gap between projected demand for new infrastructure in Asia and its current financing sources. According to the consulting firm McKinsey & Company, over 2015-2030, new infrastructure demand in Asia could amount to US$26 trillion.[1] The energy and transport sectors account for 80% of the infrastructure spending needs.[2] Based on historical information, $16 trillion of the projected new demand could be financed from identifiable sources.[3] This translates roughly into an annual supply of $1.0 trillion and an annual financing gap of $0.7 trillion. While there are differences among industry analysts on the definition of infrastructure and the geographic definition of Asia, it is clear that demand for Asian infrastructure investment far exceeds supply. The width of this infrastructure financing gap presents a key problem for the Asian region.

[1] McKinsey & Co, Bridging Global Infrastructure Gaps, 2016. The McKinsey definition of "Asia" differs slightly from the AIIB definition in that AIIB includes the Middle East and McKinsey includes Australia. The definition of infrastructure includes power, transport, telecoms, and water and waste.

[2] McKinsey & Co., Financing change: How to mobilize private sector financing for sustainable infrastructure, 2016

[3] McKinsey & Co, Bridging Global Infrastructure Gaps, 2016

Private Capital Mobilization

5. Current infrastructure financing sources in Asia comprise government (70%), private sector (20%), and multilateral development banks (10%).[4] The majority – up to 75% – of private sector financing comes from corporates, with the balance from institutional investors.[5] MDBs are very focused on infrastructure, with the sector receiving 70% of MDB lending in Asia.[6]. Continued pressure on Sovereign resources, which is projected to increase with time, means that the way forward to narrow the large infrastructure financing gap in Asia is to mobilize private capital.

6. The private sector has the capacity to play a more substantial role in narrowing the infrastructure financing gap and the AIIB is not alone in recognizing this. Multilateral Development Banks have previously come together to jointly commit to mobilizing increased investment from the private sector and institutional investors [7] and have determined a framework through which to consistently define, calculate and jointly report on Private Capital Mobilization.[8]

7. Private Capital Mobilization is defined as the sum of Private Direct Mobilization (PDM) and Private Indirect Mobilization (PIM).[9] PDM is financing from a private entity on commercial terms due to the active and direct involvement of a MDB leading to commitment. Evidence of active and direct involvement include mandate letters, fees linked to financial commitment or other validated or auditable evidence of a MDB's active and direct role leading to commitment of other private financiers. PDM does not include sponsor financing. PIM is financing from private entities provided in connection with a specific activity for which an MDB is providing financing, where no MDB is playing an active or direct role that leads to the commitment of the private entity's finance. PIM includes sponsor financing, if the sponsor qualifies as a private entity.

Institutional Investors

8. The Bank intends to continue to partner closely with other financiers like commercial banks, Export Credit Agencies, other Development Finance Institutions and Fund Managers, however the Bank believes that the greatest potential to mobilize private capital comes from institutional investors. Institutional Investors have significant assets under management. Unlike commercial banks, they are not constrained by increasingly stringent regulations and they have liabilities that could match the long term nature of infrastructure assets.

[4] Deutsche Bank Research, Asia Infrastructure Financing, January 2016. The DB definition of Asia comprises China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Sri Lanka, Taiwan, Thailand and Vietnam). The DB definition of infrastructure comprises airports, rail, road, electric power (including nuclear, gas- and hydro), water and other utilities, and oil and gas pipelines.

[5] Deutsche Bank Research, Asia Infrastructure Financing, January 2016

[6] Deutsche Bank Research, Asia Infrastructure Financing, January 2016

[7] See Development Committee Discussion Note, From Billions to Trillions: Transforming Development Finance, April 2015

[8] See International Finance Corporation, MDB Methodology for Private Investment Mobilization - Reference Guide, April 2017

[9] Ibid.

Consequently, it is important to understand what incentives or removal of barriers will induce institutional investors to invest in sustainable infrastructure in emerging markets.

9. Assets under management (*AUM*) by institutional investors are large and growing. The OECD estimates that by 2030, the funds managed by large insurance companies, pension funds and other institutional investors could reach US$106 trillion.[10] Infrastructure assets offer many characteristics that make them well-suited to institutional investors' needs: the long-term nature of infrastructure assets matches the long-dated exposure of pension payouts and insurance policies; revenues are often contracted, subject to lower volatility than other alternatives and may provide an inflation hedge; and infrastructure assets may offer attractive risk-adjusted cash yields over a long period of time. The fact that infrastructure often provides mission-critical services positions it high in the payment waterfall for both customers and public sector counterparties, providing additional revenue comfort. Over 65% of institutional investor respondents in recent surveys by the Global Infrastructure Hub (GIH) and the EDHEC Infrastructure Institute-Singapore (EDHEC) indicated that they want to increase investment in infrastructure, and over 1/3rd of respondents indicated a clear interest in emerging markets (EM).[11]

10. However, institutional investors' current allocation to EM infrastructure assets is insignificant compared with the potential. Funds are primarily directed to developed markets, despite historically low interest rates and an unprecedented search of capital for yield.
The obstacles for increasing EM infrastructure investment by the private sector, including institutional investors, range from upstream to downstream. They include:

- **Profit-driven and short-term perspective**: infrastructure assets are typically long-dated, and cash flows from greenfield (new construction) assets exhibit a significant J-curve, i.e. a period of one or more years of absorbing investment funds before commencing operation and generating cash flow. Once operational, the returns of many infrastructure assets may be limited by the contracted or regulated nature of the assets. This profile may not be attractive for investors seeking a more immediate, and higher, return.
- **Excessive perception of risk in emerging markets** (including political and currency risk and to a lesser extent social and environmental risks): 87% of global AUM today are located in developed markets,[12] and infrastructure investors tend to invest in their home region – the area where they best understand the physical environment, government policies and business climate. Increased geographic distance from the investor's primary place of business makes project management and delivery more complex. Exchange rate movements can be volatile, and emerging market currencies hard to hedge conventionally for the long periods of time that infrastructure needs to return capital. Many investors perceive that rule of law does not hold in emerging markets in the same way that it does in developed markets, and are wary of being subject to rent-seeking or transparency concerns. While individual projects and investment environments may merit such concerns, taking a broad perspective, perceived risk exceeds real risk. Historical equity

[10] OECD, Annual Survey of Large Pension Funds and Public Pension Reserve Funds, 2014
[11] EDHEC Infrastructure Institute-Singapore, Towards Better Infrastructure Financing Products?, July 2016 and GIH, Report to G20
[12] McKinsey & Co., Financing change: How to mobilize private sector financing for sustainable infrastructure, 2016

returns and default rates for private sector infrastructure loans in emerging markets are not commensurate with this risk perception. Returns are higher and default rates lower when compared with similarly rated corporate style credits.

- **Lack of standardization**: Large, complex infrastructure projects in emerging markets often require unique financing structures. Investors with limited resources, time, and expertise can find it difficult to assess projects when standards are fragmented and markets undeveloped. In addition, the need for bespoke financing solutions typically increases development and transaction costs.
- **Requirement for "bankable" projects**: Significant time and qualified human resources are required to make projects "bankable". Considerations for a project's bankability include sponsor credit quality; sovereign risk; regulatory regime and respect for contracts; cash flow predictability; counterparty (suppliers, contractors and offtakers) credit risk; development risk (greenfield vs. brownfield) and the project's investment size, among others. Challenging regulatory environments may make it more expensive to deliver infrastructure projects, and put debt repayment at risk. Projects based on inadequate preparation, inefficient procurement policy (higher than market project cost) or inappropriate risk allocation may prove difficult to structure and therefore to achieve financial close.
- **Knowledge deficit about the sector, and consensus on what constitutes "infrastructure"**: Infrastructure is a relatively new asset class, and debates continue over what characteristics distinguish it from other, similar asset classes. In its broadest definition, infrastructure may include energy (whether or not subject to commodity risk), real estate and social infrastructure (housing, hospitals, schools). The risk-return profile ranges widely from operating assets with fully contracted revenues to greenfield, merchant assets. The range of potential assets and characteristics and lack of familiarity with the sector can make it challenging for investors to assess whether infrastructure makes sense as part of their long-term asset allocation.
- **Absence of investment performance benchmarks for long-term illiquid assets**: By their nature, infrastructure assets are long-lived and illiquid, exhibiting an absence of trades of comparable assets and of publicly available cash flow. Investments tend to be somewhat unique; are distributed across a range of sponsors; and deliver cashflows over a long time horizon. These characteristics make it very difficult to benchmark performance.

The Bank's initial approach to addressing these barriers is covered in *Implementation* later in this document. Our understanding of the impact of the Bank's operational choices in addressing these barriers will evolve as the Bank develops and our approach will be refined accordingly.

11. Despite these potential barriers, well-structured EM infrastructure assets offer attractive risk-adjusted returns to long-term investors. Diversification across geographies, currencies and time improves risk management while offering access to yield in faster-growing economies. The participation of MDBs can facilitate this investment by helping to structure the risk-return profile demanded by potential private sector investors.

Multilateral Development Banks

12. Multilateral Development Banks are well-positioned to encourage private sector investment in infrastructure. MDBs are generally viewed as trusted partners, with information and market access that can help to address knowledge deficits and improve risk assessment and management. MDB operations and depth of experience across a wide range of countries and sectors enables improved project preparation and transaction structuring. MDBs' ability to leverage unique public sector relationships, and in some cases access to concessional resources and project preparation support, may reduce risks in individual transactions and increase project viability (for example, by removing barriers and/or reducing costs). Additionally, MDB preferred creditor status for sovereign lending and shareholder relationships are important in providing the private sector comfort that with an MDB as guarantor or co-lender, problems may be more likely to be worked out favorably and repayment may be more likely than in a scenario where the private sector acts alone.

13. There is room for MDBs to develop into more effective facilitators of private investment. The Bank has previously engaged MDB stakeholders (including Project Sponsors, Bankers, Lawyers and Consultants)[13] who have noted that MDBs need to be more responsive to the needs of their clients and increasingly flexible in their appoaches. Additionally, GIH consulted with the private sector to learn where they believed MDBs could improve to become better facilitators of private capital investment. Private sector respondents felt that MDBs could improve the speed of their operations (such as by decreasing the duration of approval processes) and should shift focus from being capital providers to capital facilitators, geared increasingly toward project readiness and providing contingent capital instruments and risk/insurance products. Being a new MDB, the Bank is uniquely positioned to meet the changing requirements of its clients and benefit from the experiences of the other MDBs. An analysis of what AIIB can do better will be a part of next steps.

[13] Roundtables conducted in March and June 2017.

AIIB's MANDATE

14. AIIB's mandate is to support high-quality, sustainable infrastructure investment and enhanced connectivity in Asia. The Bank is already establishing its presence by executing high profile deals in the private market. Incremental financing – economically desirable investments that otherwise would not occur – provides a positive impact. Such transactions are even more impactful when AIIB's engagement or financing facilitates additional private investment in infrastructure.

15. The private sector focus of the Bank and its public sector relationships uniquely position it to coordinate with the public sector around specific private sector transactions. A defining characteristic of the vast majority of infrastructure projects is their reliance on public authorities for a range of enabling support, including licenses, approvals and land acquisition. In many cases, government institutions serve as the counterparties for infrastructure contracts. The Bank's public sector relationships may permit increasing project viability (e.g. removing barriers, streamlining processes, shortening construction schedules, reducing costs etc.) and creating opportunities for the public sector to share in the benefits of the transaction or the project, thereby increasing its viability.

16. Like any other lender, the Bank must ensure the financial viability of its investments. In the initial years of operation, the Bank will focus on establishing itself in the market and acquiring own capacity, which is more feasible in established, rather than frontier markets. The scope and complexity of products and operating environments will expand with time and experience.

AIIB's Role

17. The Bank conducted an analysis of the reasons for the infrastructure financing gap in Asia; the current role of MDBs; and AIIB's role. Table 1 (below) provides the results of this analysis, with activities grouped by the stage of the process: *Upstream*, *Midstream* and *Downstream*.

Table 1: Infrastructure Financing Gap: MDB Role and AIIB's Role

Reasons for the gap	MDB role	AIIB's role
Upstream:		
National policy context: • Tariff and regulatory framework and implementation; • Land acquisition; • Policy uncertainty; • Transparency of contract award process.	Capacity building; concessional finance; grants; policy analysis and advisory.	Limited role. Partnership with other MDBs and bilaterals and private organizations.

Reasons for the gap	MDB role	AIIB's role
International coordination: cross-border investments and cross-border benefits require policy coordination.	Capacity building; concessional finance; grants and assistance with international coordination.	Limited role.
Midstream:		
Project design: unsatisfactory risk and economics allocation. Risks include: • Cross border/country/contract risk. • Currency risk: availability, convertibility and transferability; • Construction risk.	Project preparation funding support; government and project advisory work. Direct funding, guarantees, hedging products.	Moderate – Active role. Ability to leverage new balance sheet. Support project structuring (including selective support to governments with AIIB Special Fund).
Project preparation: Weak technical project preparation.	Project preparation funding support; government and project advisory work; technical support.	Moderate role.
Investor readiness: • Lack of familiarity with developing market infrastructure sectors; • Excessive risk sensitivity.	Investor education (conferences/meetings), risk defeasance products, direct lending.	Active role. Ability to leverage new balance sheet.
Lack of standardization of documentation and process.	Coordinate with other lenders and MDBs to standardize instruments to the extent possible.	Limited role. Activity confined to deal-related matters only where it enables market creation (see Activity 3, below).
Downstream:		
Lack of long term capital for emerging market infrastructure (debt and equity).	Direct funding, create products and structures to facilitate private sector participation.	Active role. Ability to leverage new balance sheet. Ability to provide debt and equity.
Need for credit enhancement (eg: political risk insurance (PRI); extended political risk insurance (EPRI); and	Due to their preferred creditor status, MDBs have the ability to develop	Active role. Develop instruments that other MDBs offer and where

Reasons for the gap	MDB role	AIIB's role
comprehensive guarantees) to attract commercial capital.	credit enhancing instruments.	possible refine them to make them more user friendly.
Limited appetite for emerging market infrastructure risk.	De-risk by assuming risks MDBs are better positioned to manage or mitigate.	Active role. Bridge the gap between equity sponsor and commercial bank risk tolerance.

Key for Table 1	
Limited role	Little to no effort spent pursuing – less than 10% of overall activity.
Moderate role	Medium amount of effort spent pursuing – 10-30% of overall activity.
Active role	Large amount of effort spent pursuing – 30-70% of overall activity.

18. The Bank proposes to start from the downstream by building partnerships, originating transactions and building the team, and to expand gradually towards the mid and upstream space to deliver on the long-term objective of creating markets.

AIIB ACTIVITIES IN THE SHORT AND MEDIUM-TERM

19. The Bank has identified three key activities to pursue its strategy in the medium-term. These activities are sequenced and prioritized to achieve the highest impact in terms of the Bank's mandate and their impact on Private Capital Mobilization within the constraints of the Bank's resource envelope. In the initial years, staff capacity will be the primary constraint; over time, staff constraints will ease and capital constraints will become increasingly binding. Projects and instruments will be evaluated according to their capacity to mobilize private capital, and prioritized accordingly.

Activity 1: AIIB Partners

20. The Bank is currently engaged in Activity 1, which consists of pursuing and executing transactions based on third party referrals, as well as a few readily investable non-sovereign projects. These transactions are sourced via discussions with other MDBs or project sponsor proposals submitted directly, and typically involve co-financing with other MDBs. In all cases AIIB is selective, and conducts its own internal due diligence, in addition to the due diligence of the lead institution.

21. Looking forward, the Bank will continue to cooperate with other MDBs on select project cofinancing opportunities. The fee sharing, titles, roles and participation amounts in these transactions must be commensurate with the 'AIIB brand'. AIIB will continue consideration of third-party referrals and proposals submitted directly, however over time these will be a lower priority because deal quality is not entirely in the Bank's control; there is limited impact on client relationships; and this route offers only a limited ability to mobilize private capital.

The Bank begins with Activity 1 in order to develop its operations and build up the capacity, track record and experience to ensure it is well-positioned to proceed with Activity 2.

Activity 2: AIIB Leads

22. Activity 2 consists of the Bank originating, structuring and executing stand-alone deals. These transactions provide an opportunity to innovate. They will be high quality and recognized as such by the market. The source of Activity 2 deals is project sponsors. The Bank will need to actively develop relationships with project sponsors to be in a position to win Activity 2 mandates. Sponsor coverage is discussed in "Implementation" below. Activity 2 will provide significant opportunities to mobilize private capital, as the Bank will lead the deal structuring and be in a position to invite lenders to participate in financing.

23. To create this stand-alone pipeline, the Bank will market to project sponsors on a selective and consistent basis and will partner with banks, contractors and consultants. The Bank estimates it will require one to two years to build up the pipeline. Executing this activity will require a team of experienced officers with a track record of origination, structuring and execution.

Execution of Activity 2 will establish the Bank as a market leader and ensure the Bank is a trusted partner in creating new ideas, paving the way for Activity 3.

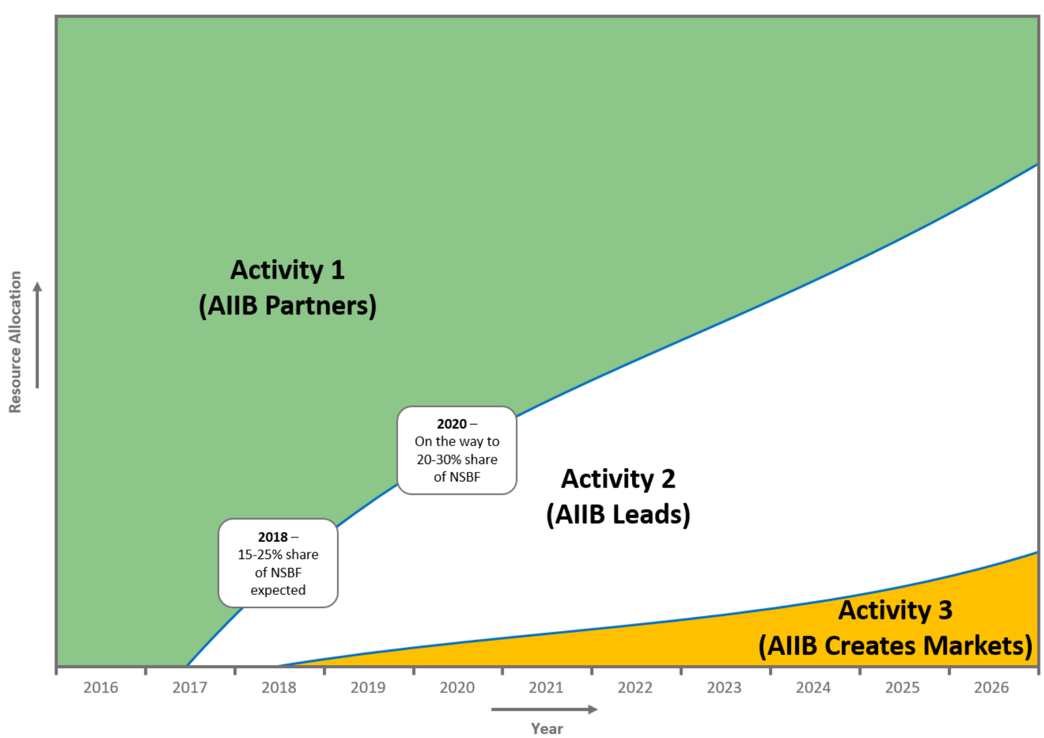
Activity 3: AIIB Creates Markets

24. Activity 3 entails opening up new markets and creating deal flow. It will therefore provide the most opportunities for Private Capital Mobilization, on a qualitative and quantitative basis. As part of Activity 3, the Bank will prioritize potential investments and sectors based on their readiness for private sector investment, regulatory regime and contractual arrangements, among other factors. The Bank will identify transactions where its public sector relationships can enable success, and success can be replicated.

25. A key to the success of this Activity is standardizing and de-risking sectors in the larger economies in the region, and may include expanding financing options for sub-sovereign borrowers. As with Activity 2, Activity 3 will require a team of experienced officers with a track record of success in origination, structuring and execution, built up through Activities 1 and 2.
The Bank intends to remain transaction-driven and to retain a focus on deals that open markets, rather than providing broad advisory services. Any financial advisory services that may be provided by the Bank in the context of a specific transaction will be charged at market rates.

26. ***The Bank should immediately launch the work streams for Activities 2 and 3 with a current focus on Activity 2. The best marketing is winning, creating and executing high quality transactions.***

Exhibit 1: Evolving Focus on Activities



IMPLEMENTATION

Instruments

27. The Bank will offer a full suite of banking products. Initially the Bank will provide debt, equity, guarantees, and other innovative mechanisms including risk sharing facilities. The most impactful initial product is the USD-denominated loan. The Bank intends to conduct an analysis of the relative mobilization impact of other product offerings and to prioritize them accordingly, as the strategic planning process continues.

28. The instruments the Bank will offer and the markets it will participate in will increase in complexity with time and experience. The Bank intends to design products around local objectives, and to identify innovations based on market needs. Following the development and finalization of the Strategy, the Bank will work to define the operational requirements and timeline for developing these products.

29. The debt and equity teams will be separate and ring-fenced if the Bank is considering debt and equity investments for the same transaction. For both debt and equity instruments, the Bank will work with commercial banks for Agency, Custody, Security and Cash Management roles.

Debt

30. The Bank's capability and product offering should be in line with what market leaders offer. Offerings will include:

- US$ loans, including Libor-based term loans and interest rate hedging;
- Foreign currency swaps;
- Local currency loans (which would require working with the Treasury team's timeline);
- Bonds;
- Mezzanine debt (very selectively);
- Loan underwriting and syndication, for balance sheet management (asset recycling) as well as transaction execution (this will require additional staffing as discussed above, as well as a separate underwriting policy);
- Acquisition financing for infrastructure assets where i) there is involvement of private capital; ii) there is reasonable potential of brown/greenfield project mandates as a consequence; iii) AIIB plays a lead role on the transaction; and iv) the financing helps AIIB build a client relationship;
- Refinancing of infrastructure assets where i) there is involvement of private capital; ii) the refinanced debt replaces temporary debt or equity financing on terms customary for the type of asset; iii) AIIB plays a lead role on the transaction; and iv) the refinancing supports the Private Capital Mobilization thematic priority of the Bank (for example, refinancing commercial bank debt after the construction period with institutional financing); and
- Bridge loans (very selectively).

31. Additional debt products to be considered over time may include:

- Credit enhancement or wraps for local currency loans or project bonds;
- Loan fronting with back to back guarantees;
- Local currency hedging;
- Financial advisory services (to be considered 2020 onwards);
- Loans to local banks for on-lending in local currency; and
- Stapled financing (for the construction and operations periods).

32. Local currency loans and hedging products are in high demand for infrastructure projects, which are likely to have revenues partially or fully denominated in local currency. Matching the currency denomination of assets and liabilities removes currency risk, which can be significant particularly in emerging markets where currency movements may be more volatile. Local currency financing can help support the development of local capital markets. In specific transactions it can also provide protection from a range of risks, including a higher debt burden or increased funding costs over time (when foreign currency debt appreciates in value compared to the local currency of earnings) and other financial distress.

33. Emerging market currencies are often difficult (if not impossible) to hedge using conventional products – even harder to do for the long tenors of most infrastructure transactions. Where the Bank's Treasury and Risk functions are positioned to manage this exposure, it will explore local currency offerings. Local currency will be sourced through transactions over time; through local currency swaps (with counterparties in commercial swap markets and potentially local central banks where commercial swap markets are not available); and by issuing local currency bonds. The Bank's local currency capacity will be developed and expanded over time.

Equity

34. The Bank will make direct equity investments with strategic sponsors at the project level and will consider minority investments.

35. The Bank will also invest in funds, including MDB and private sector managed funds. The Bank may consider setting up a platform for its own investments as well as to attract institutional investors for AIIB managed funds. Investing in funds provides a platform that supports multiple transactions and may further the goals of Activity 3 ("Creating Markets"). Working with private sector-managed funds is expected to help the Bank access deals and build up direct equity investments, and to realize AIIB's goal to mobilize private capital, where the Bank's brand name is clearly catalyzing other private investors. Working with private equity funds may help member countries, especially countries with a high public debt burden where private capital is a key source of finance. It may also help to seed capabilities in new technology.

36. Equity funds chosen for investment must meet the highest environmental and social standards, and special consideration should be given with regard to reputational risk. It is unlikely that any one fund will meet all of the objectives of the Bank, therefore the Bank is expected to invest in a number of different funds while taking into account the fund portfolio's scope, the AIIB role (active or passive), and the fund partners, so as to meet multiple objectives.

37. As for all Bank investments, all equity investments (whether direct or indirect) must be consistent with the Bank's sector strategies and in compliance with the Bank's Environmental and Social Risk Management standards. Returns should reflect the risk-adusted cost of capital, and fall within the target range of 8-20% returns for direct equity investments outlined by the Bank's financial policy. Where there are wider development benefits for member countries, the Bank may accept a lower expected return. The Bank will also consider making private equity investments in corporate entities active in the infrastructure space, and will explore: i) a take out facility[14] (which would facilitate a new structure, provide capital markets access, and can be replicated); and ii) minority equity stakes in projects.

Guarantees

38. The Bank intends to offer traditional MDB guarantees to address cross-border and/or country risk, and will explore the potential of offering products including Political Risk Insurance (PRI), Extended Political Risk Insurance (EPRI) and comprehensive cover. Guarantees will only be provided for transactions where the Bank would have otherwise been comfortable providing a loan facility from a risk and return perspective. The Bank also contemplates offering "A/B" loans. These guarantees will be developed over time, working with product and risk management experts within the Bank, as well as external consultants.

39. In order for the market to accept these products, the Bank's AAA ratings from three leading agencies will be very helpful. AIIB's guarantees will need to be accepted from a risk weighting / capital allocation perspective for regulatory purposes. The beneficiaries of these guarantee products are primarily commercial banks, though institutional investors could provide a potential future market. In addition to credit risk, guarantees pose capital allocation considerations.

40. The Bank should consider ways to make its guarantee instruments user-friendly, and to facilitate refinancing, by considering structural enhancements (such as first-loss tranches). The Bank will selectively consider enhancing sovereign guarantees in high debt burden countries, and in future may evaluate the potential to offer equity PRI, and to share demand risk for public-private partnerships (PPPs).

[14] A take out facility typically provides a commitment for long-term financing to replace short-term, often construction financing.

Partners for Financing

41. The Bank will build up relationships with core sponsors for both debt and equity transactions.

42. Core partners for debt transactions include those with MDBs and commercial banks, which may have a global, regional or domestic focus, though in many cases regulatory capital requirements are shrinking capacity. Export credit agencies will be partners in transactions where their support is tied to host country exports of goods and services.

43. Other partnerships to be developed over time include capital markets investors, private equity funds, dedicated infrastructure funds, pension funds, and insurance companies. All currently have limited, but growing, interest and capacity for emerging markets and/or infrastructure investment.

44. Core partners for equity transactions include MDBs and corporate sponsors. Private equity funds, pensions fund and dedicated infrastructure funds may also offer partnerships as their interest in and allocation for emerging markets infrastructure grows. The Bank may also explore the potential to create a platform or portfolio structure to access institutional capital.

Identifying Priority Areas

45. The Bank intends to engage with member countries and identify priority sectors and areas as it works towards the long-term objective of creating markets. Among the considerations for prioritization are: suitability of the infrastructure landscape; AIIB's competitive advantage compared with other lenders or investors; the country's investment climate and regulatory framework; and products and markets where the Bank can differentiate (for example sub-sovereigns).

46. In its initial efforts at market creation, the Bank will prioritize sectors with a focus on new financing structures and new pools of capital, as well as the potential for standardization and replicable transactions.

47. As indicated earlier, the Bank intends to prioritize its activities and products based on their relative impact on Private Capital Mobilization.

Monitoring Success

48. A first set of monitoring indicators has been established to measure progress as the Strategy begins to roll-out. These indicators will be deepened and enhanced in line with full Strategy implementation. Beginning in 2018, progress with respect to the monitoring indicators contained in Table 2 (below) as well as added qualitative indicators, when available, will be reviewed and reported in the Annual Business Plan. The Board of Directors will periodically review and, as appropriate, revise this Strategy. The timing of such reviews will be agreed with the Board of Directors in the context of the Annual Business Plans.

Table 2: Monitoring indicators

1. NSBF	
Monitoring Indicator	*Indicator Unit*
a. Share of NSBF in the portfolio	% of investment portfolio
2. Private Capital Mobilization	
Monitoring Indicator	*Indicator Unit*
a. Private Direct Mobilization achieved across the Bank's investment portfolio	$ and % of investment portfolio
b. Private Indirect Mobilization achieved across the Bank's investment portfolio	$ and % of investment portfolio
3. Status of Activities	
Monitoring Indicator	*Indicator Unit*
a. Activity 1 investments	# of projects $ and % of investment portfolio
- o/w deals carry a top tier title for the Bank in the lender group	% of Activity 1 deals
b. Activity 2 investments	# of projects $ and % of investment portfolio
c. Activity 3 investments*	# of projects $ and % of investment portfolio

**Note that Activity 3 investments are not expected to commence in the short term*

49. These preliminary monitoring indicators will be a work in progress during the Bank's early years of operation, and will be refined as the Private Capital Mobilization function develops over time. In addition, qualitative indicators will also be considered and could include the introduction of new participants and new structures to the market. The monitoring process will evolve as the Bank builds its pipeline and has a better understanding of its transaction volume over time.

50. As the Bank becomes increasingly mature and develops its capability in mobilizing private capital, by the end of 2020 it is expected that:

a. 80% or more of new Activity 1 deals will carry a top tier title for the Bank in the lender group;

b. The Bank will be engaged in three to five Activity 2 mandated transactions where the Bank is “Leading”;
c. 20-30% share of NSBF envisaged in the portfolio; and
d. The Bank will be actively originating a NSBF pipeline, involving debt financing, private equity, platform transactions, funds, etc.

Nurturing Culture and Institution Building

51. In order to achieve AIIB’s ambitious vision, the Bank will need to foster a solution-driven culture that promotes innovation and excellence. This work will comprise building a team, designing training programs, and ensuring appropriate resourcing, including relevant commercial skills. The Bank intends to set up optimal incentive structures, drawing on the good practices of peers, and to cooperate and collaborate with other MDBs, GIH, and other International Organizations.