AIIB Directive on
Liquidity Risk Management
February 26, 2019

1. Overriding Objective

1.1. This Directive on Liquidity Risk Management (Directive) establishes rules, processes and parameters to ensure that the assessment, monitoring and control of liquidity risk arising from the Bank's Treasury and Investment Operations is undertaken in accordance with the *Risk Limits Policy (Sec2016-091)* and the *Asset Liability Management Policy (Sec2017-122)*. To manage these risks, the Bank has developed a set of directives that ensures compliance with its risk requirements and overall *Risk Appetite Statement*.

1.2. The exercise and interpretation of this Directive shall be consistent with the Bank's *Risk Management Framework (Sec2016-093)* and seeks to give effect to this overriding objective and to ensure the creation of a robust liquidity risk management framework that ensures the Bank maintains sufficient liquidity; holding a cushion of unencumbered, high quality liquid assets protects the Bank to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources.

2. Definitions

2.1. **Early Warning Indicators (EWIs)** are early warning indicators of potential stress-monitoring market conditions and counterparty behaviors.

2.2. **Liquidity Contingency Plan (LCP)** is the Bank's strategy for handling liquidity crises. It describes procedures for managing cash flow shortfalls in stress situations.

2.3. **Liquidity Coverage Ratio (LCR)** is a ratio representing the amount of high-quality liquid assets (HQLA) over stressed cash outflows covering a prospective 30 calendar-day period.

2.4. **Operational Liquidity** is the amount of liquidity Management has chosen to hold at any point in time for the purpose of remaining above prudential levels and also meeting tactical liquidity needs.

2.5. **Tactical Liquidity** is the amount of liquidity the Bank holds above the prudential level in order to meet cash needs over some period of time.

2.6. **Prudential Liquidity** is the minimum amount of liquid assets the Bank will hold to meet its obligations even in times of stress, without the need to access funding sources, for a defined period of time.

2.7. **Excess Liquidity** means assets that are funded by paid-in capital levels, that exceed the need to fund Operational Liquidity and loan assets.

3. Governance

3.1. Roles and Responsibilities

3.1.1. Chief Risk Officer (CRO)

(a) Sets the Bank's liquidity risk tolerance in light of business objectives and overall risk appetite;

(b) Approves the Bank's stress testing methodologies and assumptions; reviews liquidity stress testing results.

3.1.2. Chief Financial Officer (CFO)

(a) Approves strategies to manage liquidity levels in accordance with the risk tolerance and to ensure that the Bank maintains sufficient liquidity;

(b) Approves LCP and EWIs.

3.1.3. **Risk Committee (RC) and Asset and Liability Management Committee (ALCO)** shall exercise their duties in accordance with their respective responsibilities.

3.1.4. Risk Management Department (RMD)

(a) Implements liquidity risk management framework including updating the Directive and Guidance to manage liquidity risk in accordance with the risk tolerance and with an aim to ensure that the Bank maintains sufficient liquidity;

(b) Oversees compliance with the liquidity risk limits set by the Bank's policies and the CRO;

(c) Responsible for calculating the size of the Bank's liquidity reserves including the prudential and maximum liquidity the Bank shall hold.

3.1.5. Office of the Treasurer (TRE)

(a) Identifies, monitors and manages liquidity risk associated with the Bank's business and maintains sufficient liquidity;

(b) Establishes, calibrates, maintains and monitors the EWIs;

(c) Proposes and executes the LCP.

3.2. Matters arising under this Directive that cannot be resolved between respective functions shall be brought to the Risk Committee (RC).

4. Risk Identification

4.1. The Bank identifies liquidity risk positions for the following:

- Future cash flows of assets and liabilities;
- Sources of contingent liquidity demand and related triggers associated with on- and off-balance sheet positions;

- Currencies in which the Bank is active;
- Correspondent, custody and settlement activities.

4.2. RMD is to ascertain the overall liquidity risk management framework to be implemented.

4.3. TRE establishes a robust framework for comprehensively projecting cash flows arising from assets, liabilities, and derivatives over an appropriate set of time horizons under both normal conditions and stressed scenarios.

5. Risk Assessment

5.1. The Bank ensures that its liquidity risk assessment considers a variety of factors. These include vulnerabilities to changes in liquidity needs and funding capacity over short- and medium-term horizons.

5.2. **Liquidity Coverage Ratio (LCR)**

5.2.1. The Bank maintains an adequate stock of unencumbered HQLA that consists of cash or assets that can be converted into cash at little or no loss of value in markets, to meet its liquidity needs for a 30 calendar-day liquidity stress scenario.

5.2.2. RMD defines HQLA and assesses LCR monthly and reports to the RC.

5.3. **Net Cash Requirement**

5.3.1. Liquidity must be sufficient at any time such that, without recourse to accessing funding markets ensuring that at least 40% of the next three years' net cash requirements can be met.

5.3.2. Net cash requirements are an aggregate of projected cash flows generated by but not limited to:
(a) Disbursements of loans and equity investments;
(b) Loan repayments and prepayments and equity divestments;
(c) Repayment of the Bank's borrowings;
(d) Operating cash flows related to administrative expenses and earnings, including fees, interest, equity gains and dividends from investments.

5.3.3. TRE monthly assesses the next three years' net cash requirements and establishes a borrowing program based on this assessment.

5.3.4. RMD monthly reports Liquid Assets-to-Net Cash Requirement ratio[1] to the RC.

[1] Liquid Assets / 40% of next three years' cash flow requirements

5.4. **Stress Testing**

5.4.1. The minimum prudential requirement is derived such that AIIB could survive an extremely stressed scenario without market access for 12 months and without withdrawing any principal resources from members.

5.4.2. RMD conducts stress testing based on AIIB's stress test methodology to identify potential liquidity strain and to ensure that current exposures remain in accordance with the Bank's established liquidity risk tolerance.

5.4.3. The Bank uses stress test outcomes to adjust its liquidity management strategies, policies, and positions and to develop effective contingency plans.

5.4.4. RMD reports stress testing assumptions and results to the RC quarterly.

5.5. **Other Liquidity Risk Parameters.** RMD and TRE produce and analyze supplementary risk parameters to assess the liquidity risk incurred by the Bank, although no formal limits have been adopted in relation to these numbers.

5.6. RMD uses risk assessment models approved by the CRO. RMD validates each risk assessment model, reviewing the assumptions and reporting to the CRO.

5.7. TRE uses risk assessment models approved by the CFO. RMD validates the risk assessment models and reviews the assumptions used by TRE and informs the CFO.

5.8. RMD reviews model validation results in case RMD or TRE uses risk assessment models maintained by outside providers.

6. **Risk Monitoring and Reporting**

6.1. **Contractual Maturity Mismatch**. TRE monitors contractual cash and security inflows and outflows from all on- and off-balance sheet items, mapped to defined time bands based on their respective maturities.

6.2. **Concentration of Funding**

6.2.1. TRE establishes a funding strategy that provides effective diversification in the sources and tenor of funding. TRE maintains an ongoing presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources.

6.2.2. The Bank regularly gauges its capacity to raise funds quickly from each source. TRE identifies the main factors that affect the Bank's ability to raise funds and monitors those factors closely to ensure that estimates of fund raising capacity remain valid.

6.3. **Concentration of Investment**

6.3.1. RMD monitors market liquidity risk and exposure concentration on both a regular and ad hoc basis to avoid price distortions and impeding economic performance. RMD monitors size and tenor of individual exposures and portfolio concentration in individual asset classes.

6.3.2. The Bank must not purchase any securities if, after giving effect to that purchase, the aggregate holding by the Bank in such security would exceed 15% of the entire tranche or issue. This limit does not apply to deals pre-approved by the CRO.

6.4. **Early Warning Indicators (EWIs)**

6.4.1. TRE monitors a set of indicators to identify the emergence of increased risk or vulnerabilities in its liquidity risk position or potential funding needs.

6.4.2. EWIs can be qualitative or quantitative and include but are not limited to the followings:

(a) Rapid asset growth, especially when funded with potentially volatile liabilities;
(b) Growing concentrations in assets or liabilities;
(c) Occurrences of/changes to (particularly increases in) currency mismatches;
(d) A decrease of weighted average maturity of liabilities;
(e) Signs of financial turmoil (e.g. volatility in FX markets, changes in yield curves);
(f) Increases to CDS implied default rates when available;
(g) Significant geopolitical events impacting AIIB's operating environment.

6.5. TRE shall monitor its intraday liquidity positions, cash accounts and risks to meet payment and settlement obligations on a timely basis and thus contribute to the smooth functioning of payment and settlement systems.

6.6. TRE shall actively monitor its collateral positions, differentiating between encumbered and unencumbered assets.

6.7. RMD monitors limit utilization for the limits set by any Policies, Directives or the CRO. RMD promptly informs TRE and the CFO of any limit breach.

6.8. TRE monitors, on daily basis, limit utilization for the limits set by the CFO. TRE promptly informs RMD and the CFO of any limit breach.

6.9. If a limit breach occurs, the CRO shall determine in consultation with the CFO and TRE whether, by when, and how to reduce the risk. Exceptions to limits set pursuant to this Directive can only be approved by the CRO. The CRO is responsible for reporting limit breaches and approved exceptions to the RC and/or, as the case may be, to the Board of Directors (BoD).

6.10. RMD and TRE are responsible for liquidity risk reporting. RMD reports to the RC and TRE reports to the ALCO.

6.11. Liquidity risk reporting includes but is not limited to:
- Risk parameters listed in this Directive or the Risk Appetite Statement;
- Limit utilization status as well as excess limits.

6.12. Should TRE determine that there exists new or emerging liquidity concerns, TRE will inform the CFO and the CRO immediately. Such liquidity concerns include increasing funding costs or concentrations, the growing size of a funding gap, the drying up of alternative sources of liquidity, material and/or persistent breaches of limits, a significant decline in the cushion of unencumbered, highly liquid assets, or changes in external market conditions which could signal future difficulties.

7. Liquid Assets

7.1. RMD is responsible for recommending the Bank's appropriate level of liquidity in accordance with the Bank's liquidity risk appetite and business needs.

7.2. The CRO annually sets the level of maximum amount of total and tactical liquidity for the following fiscal year.

7.2.1. This level ensures that (a) in management of its liquid assets the Bank is not exposed to higher credit risk than otherwise necessary, (b) the relatively low yielding treasury assets do not unduly reduce capital available to support the Bank's operational activity, and (c) the Bank's overall balance sheet leverage does not weaken the Bank's profile.

7.2.2. This level is a planning constraint for the borrowing program.

7.3. The CRO resets level of minimum amount of liquidity every quarter (Prudential Liquidity).

7.3.1. RMD is responsible for recommending the bank's minimum liquidity level in accordance with the Bank's risk tolerance and business needs.

7.3.2. The CRO sets forth the procedure and assumptions regarding an extreme stress situation, the result of which defines the minimum liquidity level.

7.3.3. TRE sets a year-end target liquidity level within the set maximum and minimum limits and the target serves an input into determining each year's borrowing program. TRE maintains the daily level of operational liquidity to be within limits.

8. Liquidity Contingency Plan (LCP)

8.1. LCP sets out the strategies for addressing liquidity shortfalls both firm-specific and market-wide situations of stress.

8.2. LCP outlines procedures to manage a range of stress environments, establishes clear lines of responsibility, including clear invocation and escalation process.

8.3. LCP's design, plans and procedures should be closely integrated with the Bank's ongoing analysis of liquidity risk and with the results of the scenarios and assumptions used in stress tests.

9. Implementations

9.1. The CRO monitors the implementation of this Directive. The CRO shall prepare and issue the Administrative Guidance: (1) establishing the detailed methodology for liquidity risk assessment and (2) providing additional content where required to ensure the efficient implementation of this Directive.

9.2. The CFO shall prepare and issue the Administrative Guidance on Liquidity Contingency Plan outlining the procedures and action plans for responding to a severe disruption of the Bank's ability to fund some or all its activities in a timely manner and at a reasonable cost.

9.3. This Directive revokes and replaces the Directive on Liquidity Risk Management of March 2018.