Risk Management of Asian Infrastructure Investment Bank

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Abstract. The Asian Infrastructure Investment Bank (referred to as the AIIB) is an intergovernmental multilateral development bank led by developing countries. Its establishment has had an indispensable impact on China, Asia and the world. The business purpose of the AIIB is to promote the development of the Asian economy through the construction of infrastructure. In the process of conducting business, the AIIB will face general risks and special risks, so the risk management of the AIIB is particularly important. This paper studies the risk management of AIIB through qualitative analysis and helps AIIBs control their own risks, achieve normal business operations, and ensure the liquidity of AIIBs.

Background of the Establishment of the AIIB

The successive financial crises have had a certain impact on the world economic structure and the international financial order. The 2008 financial crisis has not only brought major disasters to the United States but also to the world. In the following years, the world economy has been sluggish and global trade has shown a trend of slow growth. According to the Table 1, in 2009-2017, the growth rate of global GDP was around 3%, and the growth rate of import and export volume and FDI (inward) showed a negative growth trend. In the past few years, developing countries and some emerging markets have grown stronger in the thorns. However, there are many problems facing the development path. The biggest problem is the shortage of funds. The World Bank and ADB loans are far from meeting the current funding gap, and the source of funds is a major problem that needs to be solved urgently.

In this economic context, on December 25, 2015, a China-led multilateral development agency was established, namely the Asian Infrastructure Investment Bank (AIIB). The establishment of the AIIB is in line with the trend of economic development and is intended to help developing countries realize the interconnection of infrastructure. However, it faces many risks in the development process and needs to adopt scientific and efficient risk management measures.

Table 1. 2006-2017 Global GDP, Import and Export Volume and FDI Growth Rate Unit [%].

<table>
<thead>
<tr>
<th>Years/ Indicators</th>
<th>GDP growth rate</th>
<th>Import growth rate</th>
<th>Export growth rate</th>
<th>FDI (inward) growth rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>4.3</td>
<td>14.5</td>
<td>15.4</td>
<td>47.9</td>
</tr>
<tr>
<td>2007</td>
<td>4.2</td>
<td>14.6</td>
<td>15.4</td>
<td>34.9</td>
</tr>
<tr>
<td>2008</td>
<td>1.8</td>
<td>15.4</td>
<td>15.2</td>
<td>-21.6</td>
</tr>
<tr>
<td>2009</td>
<td>-1.7</td>
<td>-22.8</td>
<td>-22.2</td>
<td>-20.6</td>
</tr>
<tr>
<td>2010</td>
<td>4.3</td>
<td>21.5</td>
<td>22.1</td>
<td>16.4</td>
</tr>
<tr>
<td>2011</td>
<td>3.2</td>
<td>19.1</td>
<td>19.7</td>
<td>14.3</td>
</tr>
<tr>
<td>2012</td>
<td>2.5</td>
<td>1.4</td>
<td>1.0</td>
<td>0.4</td>
</tr>
<tr>
<td>2013</td>
<td>2.6</td>
<td>1.6</td>
<td>2.4</td>
<td>-9.5</td>
</tr>
<tr>
<td>2014</td>
<td>2.9</td>
<td>0.7</td>
<td>0.1</td>
<td>-6.1</td>
</tr>
<tr>
<td>2015</td>
<td>2.9</td>
<td>-11.9</td>
<td>-12.8</td>
<td>43.5</td>
</tr>
<tr>
<td>2016</td>
<td>2.5</td>
<td>-2.9</td>
<td>-3.0</td>
<td>-2.8</td>
</tr>
<tr>
<td>2017</td>
<td>3.2</td>
<td>10.6</td>
<td>10.6</td>
<td>-23.4</td>
</tr>
</tbody>
</table>

Source of data: GDP source World Bank database; import and export volume from WTO database; FDI from UNCTAD database
AIIB’s Risk Types and Causes

General Risks Faced By the AIIB

Credit Risk. Credit risk is a potential loss caused by default or credit rating deterioration in the borrowing country. With the development of risk measurement technology and the development and application of new tools for bank asset flows, AIIB not only pays attention to the default of credit assets, but also pays attention to the continuous changes in the quality of credit assets. When the asset rating declines and the market value of credit assets declines, the AIIB will inevitably face the risk of loss.

Market Risk. The AIIB is facing losses due to the deterioration of financial market performance. This risk is called market risk. It is generally due to changes in some variables in the market, such as interest rates, exchange rates, and asset prices. Generally speaking, market risk mainly refers to changes in market value, and market parameters are the main driving force for risk formation.

Liquidity Risk. Liquidity risk generally refers to the risk that a bank cannot immediately provide debt repayment to a fund supplier or creditor. Liquidity risk has a very close relationship with AIIB’s asset and liability management. The AIIB is of a commercial nature and is a highly indebted business, that is, it uses some of its own funds to incite the participation of social capital. This way of doing business determines that the AIIB is facing liquidity risks at any time.

Operational Risk. There are many risk factors involved in operational risk. If the AIIB’s business management or internal management is in error, compensation or compensation must be made; legal documents are loopholes, and people are being exploited; internal personnel are self-stealing, and external personnel are deceived. The operation will bring losses to the AIIB. This type of risk is collectively referred to as operational risk.

The Specific Risks Faced By the AIIB

AIIB is a multilateral international financial institution initiated by China. In addition to the risks faced by ordinary commercial banks, it also manages a series of special risks.

Financial Risk. Financial risk refers to the loss of profits arising from the failure of the AIIB to invest in projects that fail to function as expected and fail to return funds. The investment in infrastructure has a high risk, which is caused by many factors such as the huge amount of capital required for infrastructure construction, long construction period and unstable income.

Country Risk. The AIIB has a large number of participating countries. There will always be frictions between the state and the country. Once a country runs counter to one another, it will bring certain risks to the AIIB. National risks can be divided into two categories according to their nature: one is political risk and the other is economic risk.

Reputation Risk. As an international multilateral development agency, the AIIB maintains its reputation as a vital task. Reputational risk is generally a risk arising from the negative perceptions of bank customers, and counterparties, shareholders or investors can have an adverse impact on the organization's capabilities. Once reputational risk occurs, it is difficult to re-establish market confidence.

Environmental Risks. Maintaining environmental security is a "long-term" goal. In the course of operations, the AIIB cannot give up long-term benefits just for the immediate benefit. In the process of infrastructure projects in various countries, we must not destroy the local ecological environment. Man and nature should be coordinated development. The more you ask for from nature, the more you will lose in the future. AIIBs must pay close attention to environmental issues.

The Risk Management Strategy of the AIIB

General Risk Management Strategy

Management of Credit Risk. The credit risk of AIIB is mainly generated from the loan business of AIIB, so it is necessary to reduce credit risk from the loan business. First, the AIIB should establish a strict credit rating system and loan approval procedures. Loans are not granted to
customers with very low credit ratings, and strict loan approval procedures should be applied to customers who pass credit ratings when issuing loans. Many credit risks arise from less stringent, unscientific loan operations. The AIIB should subdivide sovereign and non-sovereign borrowers and limit the concentration of loans and the limits of borrower default or payment failures within the controllable range of bank risk exposures. Finally, it is necessary to establish a credit risk transfer mechanism. In the event of credit risk, the AIIB needs a scientific risk transfer mechanism. A sound credit risk transfer mechanism can reduce the systemic risk of the AIIB.

**Management of Market Risk.** The market risk is due to the loss of interest of the AIIB due to changes in interest rates or exchange rates. The AIIB is an international multilateral development agency that is more vulnerable to market risks. Firstly, the AIIB should establish an independent market risk management department and be responsible to the risk management committee. The role of the market risk management department is to monitor daily interest rate or exchange rate fluctuations and make timely predictions. Secondly, the AIIB should improve its own information database. As financial markets continue to mature and grow, financial institutions must build large systems of systems to ensure that the right decisions are made. The AIIB collects financial data from customers and processes them accurately and in a timely manner. This will help the AIIB to make a correct judgment on the financial market. The AIIB should also innovate the measurement method of market risk, combine the new method with the traditional market risk measurement method, and jointly serve the risk management of the AIIB.

**Management of Liquidity Risk.** The AIIB is a newly established financial institution. Its source of funds is relatively simple, and it does not form a stable financing mechanism, which can easily cause liquidity risks. In order to ensure that banks have sufficient liquid assets to meet the short-term financial needs of other businesses, AIIB should adopt a proactive response strategy. Firstly, the AIIB should draw on the setting of the capital adequacy ratio in Basel III. The AIIB has the attributes of a commercial bank and must control its asset-liability scale to ensure sufficient capital reserves to reduce potential risks and unexpected incidents. The capital adequacy ratio of the AIIB is a monitoring indicator for risk management. Secondly, the AIIB should establish a liquidity risk warning system. Set up a series of indicators to monitor the liquidity of AIIB, including: source of funds, profitability, amount of debt due, amount of cash reserves and maturity structure of assets and liabilities. Once these indicators are abnormal, AIIB should immediately take corresponding measures to avoid the occurrence of liquidity risk. Finally, the AIIB should also establish a liquidity risk emergency response mechanism. Once the risk occurs, the AIIB can timely obtain low-cost, high-efficiency emergency liquidity supplements.

**Management of Operational Risk.** There are many predisposing factors for AIIB’s operational risk, which may arise from any part of the business process, and the management of operational risk is more complicated than other risk management. The AIIB should conduct operational risk management of the AIIB from various aspects. Firstly, the AIIB should improve its internal governance structure. Staff at all levels are responsible for complying with the rules and regulations of the AIIB. The AIIB may additionally establish an operational risk management department, directly responsible to the risk management committee or the board of directors, and maintain the independence of the operational risk management department. Secondly, the AIIB should also establish an advanced information system. The system can scientifically and accurately identify and measure operational risks, and on this basis, develops scientific and reasonable response strategies. In addition, the AIIB should form a good corporate culture. Cultivate high-quality employees and regularly hold employee training of operating systems to ensure that the technical level of the staff can ensure the normal operation of the organization.

**Specific Risk Management Strategies**

**Management of Financial Risks.** The construction of infrastructure has a large investment and a long construction period, which results in a low turnover rate of funds and is prone to financial risks. In order to deal with financial risks, the AIIB should firstly conduct a rigorous review and evaluation of infrastructure projects. Predict the project’s enforceability and future cash flow. The
NPV, IRR, and cash payback periods of the project can be analyzed. Ensure that the AIIB maintains a healthy financial position during its operations. Secondly, the AIIB should also establish scientific and reasonable accounting standards and adopt conservative accounting methods to avoid overestimating the benefits and underestimating the costs.

Management of National Risks. The AIIB is a multilateral international financial institution led by developing countries, most of which are located in Asia. In some developing countries, there are frequent incidents such as turmoil, geopolitical conflicts, and religious frictions, which have caused the national risk of the AIIB. In response to national risks, the AIIB should build national risk measurement indicators for member countries. Indicators can be divided into first-level indicators and second-level indicators. For example, the economic development indicators are the first-level indicators, and the GDP growth rate, inflation rate, and corporate asset-liability ratio are secondary indicators. After the establishment of a mature indicator system, the AIIB can conduct a national risk assessment for the loan country. The evaluation results can be divided into four risk levels, A, B, C, and D. A indicates the lowest risk and increases in turn. Each risk level has a corresponding loan strategy.

Management of Reputation Risk. The management of the reputation risk of AIIB needs to start from the operation of the banking business to ensure that the bank does not have unexpected situations, thereby reducing the negative feelings of bank customers and revitalizing the market. The AIIB should establish an open mechanism for the operation of rights. All departments of the AIIB should strictly abide by the company's institutional charter and use its rights correctly. All departments coordinate operations to build the AIIB into an open and transparent operating organization. Second, the AIIB should develop a reputational risk management program. In the daily business process, it is necessary to develop a reputation risk early warning mechanism for real-time monitoring and tracking. In the event of a reputational risk, the AIIB should conduct public relations with social media for the first time to maximize the reputation of the AIIB.

Management of Environmental Risks. In the process of infrastructure construction, the AIIB must protect the environment and resources. The AIIB must develop a scientific and comprehensive feasibility assessment report before implementing the project. The report should truly reflect the strengths and weaknesses of the project implementation. Due to the large amount of infrastructure construction, it is easy to cause damage to the local ecological environment when constructing roads, railways and other facilities. In addition, the migration of the population should also be considered. Therefore, the AIIB should fully consider the possible situation when formulating the feasibility report. Do your best to protect the environment and ecology and avoid environmental risks. Finally, the AIIB should improve its engineering and technology to reduce the damage to the ecological environment.

Conclusion

The establishment of the AIIB is a landmark event. Its future development space is huge and its development prospects are also very optimistic. However, the establishment time of the AIIB is relatively short and it’s risks will be more. AIIB's risk management is an important measure to deal with various risks and challenges. The AIIB must manage all kinds of risks from internal and external sources in order to develop healthily and in the long run.

References


