World House Student Fellows 2016-2017

The AIIB and the Future of Multilateral Infrastructure Financing

By Mathilde Beniflah, I Vivek Kai-Wen, Alex Kaplan, and Akanksha Santdasani
Abstract

The Asian Infrastructure Investment Bank is one of the most recent additions to a long list of multilateral development institutions. Observers have speculated as to what the ultimate purpose of the AIIB is, and how it might fit into the existing ecosystem. Western critics are especially worried about ulterior motives and the AIIB’s potential proclivity to ignore best practices and act as a competitor. This paper presents a comprehensive analysis of the AIIB by drawing on historical evidence, comparative cases, official documents and reports, press releases, and interviews with experts and both current and former AIIB staffers. Our analysis of the evidence demonstrates that there is a clear demand for infrastructure financing, especially in the Asia-Pacific region. The paper finds that elements of the AIIB’s structure make it an appropriate candidate to fill the infrastructure financing gap. However, the Bank’s financing, along with anticipated future market conditions, could both become problematic as the Bank struggles with balancing competitiveness with accountability. While the AIIB appears to be committed to best practices, it may face constraints on promoting sustainable development in the long-run, exacerbated by tensions among shareholders and management. Incentives to maintain institutional “leaness” may jeopardize the Bank’s ability to properly conduct oversight. Finally, the paper offers recommendations for how the Bank might overcome potential challenges in the future.

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1 We would like to extend a warm thank you to the many experts that helped to inform our analysis, challenge preconceived notions, and point us in the right direction when we seemed stuck. We are particularly grateful to Michael Dee, Michael Hirson, Przemyslaw Macholak, Richard Perry, Scott Mulhaiser, Michael Horowitz, and Stephanie Herrmann for their invaluable guidance.
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<td>Asian Development Bank</td>
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<td>AIIB</td>
<td>Asian Infrastructure Investment Bank</td>
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<td>AoA</td>
<td>Articles of Agreement</td>
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<td>BREB</td>
<td>Bangladesh Rural Electrification Board</td>
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<td>DESCO</td>
<td>Dhaka Electric Supply Company Limited</td>
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<td>DOISP</td>
<td>Dam Operational Improvement and Safety Project</td>
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<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>ESF</td>
<td>Environmental and Social Framework</td>
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<td>ESP</td>
<td>Environmental and Social Policy</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GNP</td>
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<td>IBRD</td>
<td>International Bank for Reconstruction and Development</td>
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<td>IDA</td>
<td>International Development Association</td>
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<td>IFC</td>
<td>International Finance Corporation</td>
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<td>IFI</td>
<td>International Financial Institutions</td>
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<td>LIBOR</td>
<td>London Inter-Bank Offered Rate</td>
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<td>MDB</td>
<td>Multilateral Development Bank</td>
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<td>NATO</td>
<td>North Atlantic Treaty Organization</td>
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<td>NGO</td>
<td>Non-governmental Organization</td>
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<tr>
<td>SDG</td>
<td>Sustainable Development Goal</td>
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<tr>
<td>USD</td>
<td>United States Dollars ($)</td>
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<td>WBG</td>
<td>World Bank Group</td>
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Introduction

The success or failure of the Asian Infrastructure Investment Bank is by no means a preordained conclusion. Since the Bank’s inception in early 2016, pundits have been eager to categorize the AIIB in broad terms: “on the road to success” or “on the road to failure.” The reality is a much more complicated framework of expectations, leading indicators, and historical parallels. Parsing through the lopsided punditry requires a comprehensive analysis not only of the AIIB as an institution, but also of the entire ecosystem of multilateral development banks (MDBs) in which the AIIB is situated. Through data-driven analysis and historical comparisons to existing MDBs, this paper aims to provide a level of depth and breadth required to place judgements of the AIIB in their appropriate context.

China is central to the AIIB’s establishment and future trajectory, but it is hardly the only player involved. The AIIB has become a truly multilateral development bank: 70 nations have already joined the bank as founding or prospective members, and its shareholders represent a wide array of interests and voting blocs. As such, the bank will likely face many of the same challenges that existing MDBs have needed to overcome (and struggle with to this day). Understanding the history and critiques of these existing MDBs is therefore crucial to understanding how the AIIB will grow and develop.

At the same time, it is impossible to fully divorce the bank from its geopolitical context. Many critics have cast the bank as a tool of Chinese economic diplomacy, likening its creation to the Chinese “One Belt One Road” grand strategy to engage with Central and Southeast Asia. Critics have questioned the intent behind the AIIB’s creation in an attempt to undermine it. According to this particular critique, if China’s intention in creating the bank was self-motivated, then the bank’s existence must be called into question. However, intentions do not always translate directly into
outcomes – though they are certainly vital in considering how they might affect outcomes. The intentions behind the bank’s creation—both implicitly and explicitly stated—shall be considered to the extent that intentions of stakeholders can hinder the credibility and functionality of the bank.

This purpose of this policy paper is to provide an outcomes-based approach to analyze whether the AIIB fills a market gap in providing capital to support sustainable development in the Asia-Pacific region. By looking at the current state of multilateral development financing in the region, the mission and structure of the AIIB, and the international context in which the Bank is situated, this paper provides a nuanced approach to understanding one of the most complicated and interesting new additions to the multilateral development landscape. This paper identifies the proper steps that the AIIB has taken to promote sustainable development in the short-run, while remaining skeptical of the Bank’s long-run commitment to upholding best practices. While it would be naïve to presume what the future holds for the AIIB, it is nonetheless critically important to examine the many challenges that the Bank will face if it hopes to become a model institution for the 21st century.
The MDB Ecosystem: Perspectives on Existing Development Institutions

To understand the context in which the AIIB has developed, it is critical to explore the global environment of MDBs. The earliest MDB, known as the World Bank, grew out of the Bretton Woods Conference in 1944, with the aim of providing low-interest financing and professional governance advice for national development projects. Initially, the mission of this institution was to facilitate European reconstruction after the Second World War. The World Bank shifted its focus to developing countries after the implementation of the Marshall Plan. As the bank’s scope rapidly expanded, new institutions were created that collectively became the World Bank Group (WBG). In the WBG, each subsidiary organization serves an independent purpose. By contrast, the AIIB offers a variety of services, including sovereign and non-sovereign lending, through a singular organization.

Setting the Precedent: The World Bank Group

The projects financed by the WBG are developed for sectors that include infrastructure, education, public administration, and agriculture. In addition, the WBG routinely engages in partnerships in the pursuit of goals like food security and climate change. Social motivations, such as poverty reduction and healthcare expansion, drive certain project criteria. The WBG consists of several subsidiary organizations that each serve a specific purpose. The three primary organizations that are analyzed below are the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA) and the International Finance Corporation (IFC).
At 189 member states, the IBRD is easily the largest Multilateral Development Bank in the world. It provides loans, guarantees, risk management products, and advisory services to creditworthy middle- and low-income countries. Regional and global crisis management is another field in their portfolio of services. The IBRD borrows at favorable market terms and is thereby able to offer low-rate loans to its borrowing members. In essence, this is the principal operational purpose for MDBs; they provide competitively-priced loans that would not otherwise be offered through the market. Examples of IBRD projects include the Center West Regional Development Corridor project in Kazakhstan, whose purpose is to strengthen transportation infrastructure, and the Philippines Social Welfare Development and Reform Project, which aims to improve education and health services for low-income children.

By contrast, the IDA is the world’s largest multilateral source of concessional financing for the poorest countries. It provides concessional development credits, grants, and guarantees in support

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**Figure 1: comparative annual financial commitments in two of the WBG’s most important subsidiaries: the IBRD and IDA.**

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of efforts to increase economic growth, reduce poverty, and improve the living conditions of the poor. The financing is provided by contributions from creditor countries (generally high- and middle-income members), as well as transfers or grants from the IBRD and IFC. For instance, the Livelihood Enhancement and Association of the Poor Project in Cambodia aims to improve access to financial services, employment opportunities, and small-scale infrastructure.

Finally, the IFC is the largest global development institution focused on supporting the private sector in developing countries. It provides investment, advisory, and asset management services, along with short- and long-term financing. One project supported by the IFC involves advisory support to the Bank of Lao People’s Democratic Republic to establish a new credit reporting system based on international best practices.

Figure 2 shows the regional breakdown of loans provided by the IBRD and the IDA. The East Asia and Pacific regions, which would be a primary focus for the AIIB, receive a large amount of funding from the IBRD. However, many countries in the Asia-Pacific region fall under the purview of the IDA, and so they may not be receiving adequate loans from the existing WBG institutions.

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Internal Structure of the World Bank Group: Decision-Making and Accountability

The Board of Directors is responsible for the day-to-day running of the WBG and its policies, including the approval of loans and guarantees for the respective organizations. The Board of Directors is a resident board that meets twice a week, and is often perceived to be the internal watchdog of the WBG, given its close supervision of all operations. The five largest shareholders – the United States, Japan, Germany, France and the United Kingdom – are each represented by an Executive Director, while the rest of the countries are grouped into constituencies. Furthermore, the United States holds 20.99% of the voting power in the IFA and 16.39% in the IBRD. The ten largest shareholders in the IBRD control more than 48% of the voting power. These ten countries are the United States, Japan, China, Germany, the United Kingdom, France, India, Russia, Saudi Arabia and

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Italy. This has been a point of dissatisfaction for several lower-income member countries, which find that the voting structure gives little weight to those most heavily affected by the WBG’s policies.

Accountability is further reinforced by the WBG’s internal standards. The Inspection Panel monitors adherence to these standards by investigating situations in which WBG projects have adversely affected people. Such unfortunate results could be the consequence of environmental, cultural, or social neglect. Although the Inspection Panel addresses certain concerns that lack other forms of recourse, it nevertheless entertains limited independence; the Board of Directors’ approval is a prerequisite to conducting investigations.

The WBG maintains a minimum ratio between its paid-in capital and callable capital. Paid-in capital refers to the money that is readily available for investment, while callable capital refers to the contingency funds that can be called-on as a last resort if bad investments are made. Historically, callable capital has rarely been used by MDBs. The amount of loans extended to borrowers cannot exceed the callable capital. This model guarantees the reliability of the WBG.

Branching out: The Establishment of Regional MDBs

Led largely by the United States and its allies, regional MDBs were subsequently set up to facilitate lending on a smaller scale. The Asian Development Bank (ADB), led by the United States and Japan, was founded in 1963. The ADB now has 67 member countries, and invested $31.5 billion in its operations in 2016. The ADB’s focus areas include infrastructure, regional integration and

education. It aims to increase development and reduce poverty in Asia by providing loans, guarantees and grants. Advisory services and the facilitation of international cooperation are also included.  

The decision-making mechanisms function in similar ways to those of the WBG. The ADB’s Board of Directors distributes voting power based on the contributions of its shareholders. In this case, Japan, China, and the United States hold more than 30% of the voting power, and are each represented by a single board member, while other countries are represented in constituencies. Committees, such as the Ethics Committee, constantly review the projects taken up by the ADB and ensure that internal standards are met. Like the WBG, the total amount of lending cannot exceed the callable capital, so as not to compromise the reliability of the MDB.

More recently, the European Bank for Reconstruction and Development (EBRD) was established in 1991. The EBRD was set up with a specific mandate: to integrate and rebuild the economies of the former Soviet bloc back into the market-oriented world economy. It serves as a useful point of comparison as it was chartered after most existing MDBs had been in operation for several decades. The EBRD provides support for financial reforms, along with the liberalization and privatization of various sectors of the economy. Additionally, the bank has a political mandate to assist only countries that are committed to the principles of multi-party democracy and pluralism. The EBRD has since expanded its operations into countries in the Middle East and Central Asia, like Jordan and Mongolia. There are currently 67 shareholders, with investments totaling about $10 billion in 2016. At present, the AIIB has a specific mandate of investing in infrastructure in Asia. Nonetheless, it is useful to keep the expansion of the EBRD in mind when analyzing the AIIB’S possible development paths.

Criticisms of the World Bank Group and other Existing MDBs

Major sources of criticisms pertaining to existing multilateral developmental institutions such as the World Bank stem from the human rights and environmental consequences of the projects they finance. The International Consortium of Investigative Journalists estimates that dams, power plants, conservation programs and other projects financed by the World Bank in the past decade have displaced an estimated 3.4 million people.\(^{15}\) The Kenya Forest Service’s National Resources Management Project, financed by the World Bank Group in 2007, is a notorious example. Critics argued that the $68 million conservation project redrew the Cherangani Hill’s protected Forest Reserve in a way that endangered thousands of Sengwer, an indigenous minority group in the country’s western forest, located within the reserve’s boundaries.\(^{16}\) The Kenyan government was known to believe that the Sengwer were illegally occupying public land. WBG funding was linked to efforts through which Nairobi acquired the equipment necessary for a “mass eviction.”\(^{17}\) Other instances of WBG projects leading to humanitarian disasters include the controversial 1978 Indian dam construction project that led the forced resettlement of Narmada River Valley natives, and the Western Poverty Reduction Project that displaced more than 37,000 ethnic Chinese within Tibet.\(^{18}\) Clearly, the World Bank Group has received much criticism pertaining to the humanitarian consequences of its projects.

Similarly, many concerns have been raised regarding the environmental impact of the Bank’s projects. Figure 3, below, illustrates the WBG’s lending patterns for fossil fuel industries. The WBG’s


\(^{17}\) Ibid.

lending to coal, oil and gas sectors increased by 94% between 2007 and 2008, reaching over $3.4 billion during the 2013-2014 financial year, according to Oil Change International.¹⁹ Allowing for discrepancies in project classification, the WBG continues to support – even subsidize, critics claim – significant investment in fossil fuel energy. The IFC’s investments in financial institutions that provide loans to energy companies constitute the primary mechanism for fossil fuel lending. According to Inclusive Development International, the IFC indirectly supports at least 91 projects that can be deemed environmentally harmful, 41 of which involve the coal industry.²⁰ An example of such an investment is the 1320-megawatt Rampal power station project in Bangladesh, which the WBG declined to fund directly. Built in the Sundarbans Forest, the project destroyed the habitats of many endangered species. By some estimates, the IFC has invested $40 billion in such entities between 2011 and 2015.²¹ As a result, the Bank’s role as a central proponent of climate change mitigation efforts come into direct conflict with its carbon-intensive lending portfolio and continued financial support for heavily polluting industries.

²¹ Ibid.
The equity of the WBG’s governance structures and policies has also been called into question. Since voting power is based on ownership shares, some argue that developing nations have insufficient influence over the bank’s decisions. This is reflected by the fact that presently, non-borrowing high-income members control 62% of the votes at the World Bank.\textsuperscript{23} To preserve the influence of smaller shareholders and protect the “collective voting power of developing countries,” the WBG issued an equal number of 250 basic membership shares during the 1979 General Capital Increase.\textsuperscript{24} However, for subsequent capital increases, the amount of other shares held increased while these basic membership shares remained constant, diluting the importance of the original basic membership shares and weakening the voice of smaller members. Developing countries are under-represented if their shares of WBG votes are compared with their share of world GDP, especially when considered on a Purchasing Power Parity (PPP) basis. Figure 4 compares the ownership shares and executive

\textsuperscript{22} Stephany Griffith-Jones, ”Governance of the World Bank .” Department for International Development , United Kingdom Government, 2002.
\textsuperscript{23} Ibid.
\textsuperscript{24} Ibid.
board distributions of major international financial institutions. The World Bank is noticeably inequitable with respect to the underrepresentation of borrowers and the overrepresentation of developed countries.\textsuperscript{25}

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 & \textbf{Voting Share} & & & \textbf{Chairs} & & \\
 & \textbf{US} & \textbf{Other} & \textbf{Total} & \textbf{Total} & \textbf{US} & \textbf{Other non-} \\
 & & \textbf{developed} & \textbf{developed} & \textbf{borrowers} & & \textbf{non-} \\
 & & & & & \textbf{developed}\textsuperscript{*} & \textbf{Total} & \textbf{Total} \\
\hline
World Bank & 17.0 & 44.6 & 61.8 & 38.2 & 1 & 13 \\
Inter-American Development Bank (IDB) & 30.5 & 19.1 & 49.6 & 50.4 & 1 & 4 \\
Asian Development Bank (ADB) & 13.1 & 35.3 & 48.4 & 51.6 & 1 & 5 \\
African Development Bank (AfDB) & 6.1 & 43.9 & 50.0 & 50.0 & 1 & 5 \\
\hline
\end{tabular}
\caption{Comparative voting shares and executive board distributions of developed and developing members across four major MDBs}
\end{figure}

Moreover, from a procedural perspective, the World Bank has been criticized for its safeguard policies, which many advocacy groups regard as insufficient to ensure appropriate accountability for its financed projects. Designed to “identify, avoid, and minimize harms to people and the environment,” safeguards include provisions for the adoption of an Environmental and Social Framework (ESF) that includes impact assessments, labor and working condition protections, community health and safety measures, emergency response procedures, and grievance redress mechanisms amongst others.\textsuperscript{26} The WBG updated its ESF in 2015 to expand the scope of its current policies, particularly as they pertained to issues of labor standards and land ownership. Despite these efforts, environmental and human rights groups argue that the changes might actually “dilute” existing


rules and diminish the ability of the Bank’s inspection panel to oversee projects. Many regard the Bank’s practice of transferring accountability and oversight away from itself and to borrowers and local governments, who bear the responsibility of ensuring that projects are implemented without harm to local communities and the environment, as an inadequate means of assuring its standards are met.

Finally, the WBG’s has been criticized for attaching political “strings” to many of its projects. This process of “conditionality” has received backlash from borrowing nations who oppose WBG’s political nature. Although there has been a decline in the number of conditions per operation (from 35 in the 1980s to 12 in 2005), the content of conditionality has evolved from short-term economic adjustments to complex medium-term institutional changes, such as public sector governance and social sector reforms. The most adamant critics have also blamed the WBG for the role it may have played in worsening the third world debt crisis and perpetuating, rather than alleviating poverty. For instance, Niger received $637 million in WBG loans between 1965-1995, yet its Gross National Product per capital fell by more than 50% during that time.

27 Tom Murphy, 2017.
The AIIB and New Development Institutions

A New Development Framework in Asia

In August 2009, the ADB released a report estimating that, from 2010 to 2020, the Asia region would need to invest approximately $8 trillion in infrastructure spending to meet projected demand. Over 68% of this $8 trillion would need to finance new projects, many of which would be needed in developing and underdeveloped nations. 30 The construction of new roads, ports, and telecommunication networks would dominate regional demand, necessitating a massive influx in foreign capital from MDBs and other international financial institutions (IFIs). This multi-trillion dollar “infrastructure gap” has been widely cited in the years since the report’s publication, catalyzing concern that existing development institutions have failed to meet the needs of a rapidly-developing region.

While the 2009 ADB report spoke to the relative inability of existing institutions to meet regional demand for infrastructure investment, it also identified MDBs as crucial actors in the effective procurement and implementation of such projects. Unlike other development projects, infrastructure projects often need to consider the cross-border consequences of their implementation. In an oft-cited example, placing hydroelectric dams on the Upper Mekong River may have supplied clean energy to millions in southern China, but the same dams have also exacerbated water contamination and drought downstream, affecting millions of people in the Southeast Asian countries that rely on the Mekong as a life source. 31 The cross-border environmental and social nature of these infrastructure

projects requires the presence of a “neutral and respected multilateral agency” to provide “dispassionate and professional assessment of projects’ merits” (183).32

Additionally, many projects financed by existing MDBs in Asia (and elsewhere) are too risky for the private sector to consider financing. Especially for projects in developing Asian countries whose creditworthiness is questionable, a non-private institution is required to finance sovereign and private lending projects at reasonable rates. In this regard, the ADB and the World Bank have been invaluable suppliers of dispassionate assessment and financial capital in Asia, but the 2009 ADB report predicted that far more would be necessary to meet projected demand.

![Figure 5: the ADB's 2009 projections for Asian infrastructure financing demand.]

### Origins of the AIIB

During visits to Southeast Asia in late 2013, Chinese President Xi Jinping announced China’s intention to create a new multilateral development bank in response to the infrastructure gap and the

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33 Ibid, 167.
critiques of existing MDBs. In subsequent rounds of talks, President Xi and Premier Li Keqiang referred to the “financial bottleneck” that limits the channeling of capital supply through existing institutions as the main justification behind the bank’s creation. In 2014, the Chinese Finance Ministry appointed Jin Liquan as head of the Multilateral Interim Secretariat tasked with the formal establishment of the institution. Prior to his appointment, Secretary-General Jin (now AIIB President Jin) spent his career at the World Bank Group and the ADB. His interim Secretariat drew largely from his contacts at these institutions. As the Secretariat began drafting the bank’s formal Articles of Agreement, 21 prospective founding members signed a “Memorandum of Understanding on Establishing AIIB” on October 24th, 2014, and a new multilateral development institution was formed.

![Image](https://example.com/n.png)

*Figure 6: Leaders of 21 Asian countries sign a memorandum of understanding on the AIIB’s establishment.*

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Over the next 16 months, the interim Secretariat worked to ratify the bank’s Articles of Agreement (AoA) and to expand its prospective founding membership. Notable alumni of the World Bank Group served as the principal drafters of the AIIB’s AoA and other important institutional documents, which has helped the AIIB gain international credibility. By the time of its official commencement in early 2016, 57 countries had joined as founding members. This group included 20 non-regional members, including notable NATO countries such as Germany, the United Kingdom, and France. The United States, Japan, and Canada chose not to join the bank as founding members. In justifying its opposition, the United States cited concerns about the bank’s commitment to international environmental and social standards. While Canada recently joined as a prospective member, the U.S. and Japan remain opposed to joining the bank.

**Mission and Structure of the AIIB**

The stated mission of the AIIB is two-fold: (i) to foster sustainable economic development and connectivity in Asia, and (ii) to promote collaboration with other nations and institutions within Asia. While the Articles of Agreement of the AIIB are quite similar to those of existing MDBs such as the IBRD and the ADB, the AIIB was established to fill a more specific need for the financing of infrastructure projects in the Asia region. The bank allows projects to be financed outside of Asia, but they must be “in the interest of the Bank’s membership,” and projects outside of Asia are subject to stricter requirements for project approval. The AIIB is nimble in its ability to finance development through multiple means: direct loans, investment in equity capital, guaranteeing loans, and the deployment of loosely-defined “Special Funds” as determined by the Board of Governors and Board

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38 “Articles of Agreement,” 8.
of Directors. This contrasts with the WBG institutions, which each tend to serve a specific lending purpose. At the same time, the AIIB is constrained both by geography and the focus of its projects on infrastructure.

The AIIB was established with an initial authorized capital stock of $100 billion USD. Like existing MDBs, the bank’s available capital is determined by its authorized capital stock, plus any net income on investment from existing projects. 20% of this capital stock ($20B) is capital that has already been paid-in by the bank’s shareholders, whereas 80% of the stock ($80B) is guaranteed as callable shares in the event of an emergency. Shares are mainly allocated based on the economic size of each country (measured by GDP), membership status (founding member vs. non-founding member), and the nation’s geographic location (regional vs. non-regional).

A country’s shareholding power determines the amount of subscribed capital it must contribute. Currently, the Bank’s most powerful players by shareholding power are China (29.7% of all shares), India (8.4%), Russia (6.5%), and Germany (4.4%).\n
Regional members—defined as states within Asia or Oceania—are guaranteed 75% of the total shareholding power of the bank, ensuring that Asia-Pacific nations will maintain a supermajority of the bank’s voting power, regardless of the number of non-regional countries that choose to invest in the bank. Theoretically, if the United States (a non-regional state) were to join, the relative shareholding position of other non-regional members like Germany and France would thereby lessen, whereas regional members would maintain 75% of the bank’s shares regardless.

Each member state’s shareholding position directly correlates with its voting power in the bank’s chief governing body: the Board of Governors. The Board of Governors holds all absolute power in the bank, but it delegates most operational and strategic responsibilities to a Board of Directors. This 12-member Board of Directors is fully accountable to the shareholders, and no two

\[39\] Ibid., 29-31.
members of the Board may be of the same nationality. Accordingly, there is only one Chinese national serving on the current AIIB Board of Directors. Finally, the Board of Governors is also responsible for electing the President of the Bank, who serves as the non-voting Chairman of the Board of Directors and helps oversee all of the bank’s daily operations. The President may appoint Vice Presidents at the approval of the Board, tasked with carrying out specific operational responsibilities separate from the Board of Directors. Supermajorities representing three-fourths of the bank’s total voting power are required for the passage of most major decisions at the bank. In this way, a single bloc of powerful nations is unable to steamroll contested projects or policies.

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<td><strong>Board of Directors</strong></td>
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<td><strong>President</strong></td>
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<td><strong>Vice Presidents</strong></td>
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*by Majority **by Supermajority

Figure 7: Table depicting major responsibilities of the AIIB’s main tiers of governance.

**Strategy of the AIIB**

In the words of President Jin, the AIIB is determined to be a “Lean, Clean, and Green” institution. The AIIB’s goal to be a “Lean” institution refers to its criticism of some existing MDBs as being bloated and unfocused. The AIIB is still a new institution of under 100 full-time staff, with significant gaps in its anticipated number of personnel. These gaps notwithstanding, the AIIB also intends to remain a much smaller institution than the World Bank and the ADB (as measured by the number of full-time staff). The desire to be a “lean” institution has both strategic and financial
implications. By slimming down its administrative staff, the AIIB hopes to reduce large administrative costs, allowing the bank to offer loans with competitive interest rates on a lower net interest margin than other existing MDBs. Its AoA and Environmental and Social Framework (ESF) have major similarities to those of existing institutions, but the differences in size and organization between the AIIB and established MDBs will necessarily result in differences in how these policies are implemented. Analysis of how the AIIB plans to finance its loans provides insight into how these institutional policies are reflected in the finances of the AIIB.

**Project Financing**

The intended goal of the AIIB and any other MDB is to ensure that the bank is profitable and financially viable. Ensuring the financial viability of the AIIB’s project portfolio requires a consideration of both the revenue and the cost of loans. For cost, the bank must consider the paid-in capital it has available and, when more capital is required, the cost of borrowing more money. For revenue, the bank must use careful risk management analysis to determine the variable interest rate that it will charge on its loans. The degree of profitability of a particular project—known as the net interest margin—is given by subtracting cost from revenue. Total profitability of the institution is then given by subtracting administrative costs (ex. personnel, rent, overhead) from the total net profit on the bank’s portfolio.

Figure 8: Simple equation showing the general breakdown of revenue and cost for an MDB.
Revenue: The “Revenue” side of the equation is determined by the interest rates at which the AIIB offers its loans. The AIIB’s first loans for its projects in Bangladesh, Indonesia, Pakistan, and Tajikistan have interest rates based off a benchmark floating interest rate—the London Interbank Offered Rate (LIBOR)—plus 1.15% in interest. This LIBOR benchmark is used by all MDBs (and other lending institutions) to trade floating-interest loans. The AIIB uses the LIBOR benchmark to determine how to price its loans given their cost. In this way, the LIBOR plus 1.15% return on the loan (revenue) can be compared to the LIBOR-based cost of the loan (cost) to determine the loan’s net interest margin. The determination of how to price loans relative to LIBOR requires lengthy analysis into how risky the loans may be. All sovereign loans are offered at the same rate due to their low risk. Private loans, which the AIIB plans to provide, however, are offered at different rates depending on the riskiness of the project. The AIIB will utilize its Risk Analysis Framework in order to price these loans.

Borrowing Cost: Currently, the “Cost” side of the equation is of less concern to the AIIB because it has total paid-in capital of $20 billion USD available to finance loans in the short-term. So far, the AIIB has only used around $3 billion of its paid-in capital. Therefore, the AIIB can finance a project portfolio upwards of $20 billion USD before needing to borrow.

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41 Note on LIBOR: The financial methods used to understand the impact of LIBOR and interest rate swaps on the financing of loans is important, but incredibly technical. The most important take-away is that both the borrowing cost and selling price of the AIIB’s loans are based off of the LIBOR. It is worth noting that LIBOR increased substantially after August 2015 due to market forces. This hike is sure to affect the AIIB more than other MDBs in the future, because the debt portfolios of other MDBs mostly contain loans approved before summer 2015.
43 Note on paid-in capital available to the AIIB: The AIIB’s Articles of Agreement state that all $20 billion USD of paid-in capital shall be paid in five equal installments of $4 billion USD per year from 2016-2020. Since the bank is currently financing projects at a rate far below $4 billion USD per year, it is currently overcapitalized and will remain overcapitalized in the short-term.
funds to increase its available capital. The AIIB has several years before the demand to borrow money becomes apparent. After this point, however, the bank must consider the costs associated with borrowing additional funds in the calculations of its net profit margin. Like revenue, the borrowing cost of loans is calculated in relation to LIBOR. For example, if a bank faces a borrowing cost of LIBOR + 0.2% and sells loans at LIBOR + 1.5%, the loan’s net interest margin would be 1.3%.

➢ **Administrative Cost:** In order to run at a net operating profit, the AIIB must be able to offset its administrative costs with the profit it makes off of its loans (determined by the net interest margin). Currently, the AIIB employs less than 100 employees and pays no taxes, so its administrative costs are relatively low. Additionally, as the “Lean” institution scales over the next decade, it intends to continue to operate with lower administrative costs than its peer lending institutions. Finding a balance between the net interest margin (which is often quite slim) and the size of administrative costs will be a core focus of the AIIB.

There is nothing fundamentally new about the AIIB’s project financing. However, the market environment it was born into may lead to discrepancies between the AIIB’s financing efforts versus other MDBs in the future. Project development and implementation are also similar across the board. Like other MDBs, the AIIB’s project approval, implementation, and evaluation processes are governed by familiar frameworks and policies.

**Project Development Process: Frameworks and Policies at the AIIB**

Since the establishment of the Multilateral Interim Secretariat in 2014, experts from existing development institutions (notably the ADB and the World Bank Group) have worked with the AIIB
to draft its AoA and other operational policies. Most notably, in February 2016 the bank approved an ESF that established policies and procedures aimed at ensuring the environmental and social sustainability of the bank and its financed projects. The ESF draws on language from the 2015 UN Sustainable Development Goals (SDGs) and the 2015 Paris Climate Agreement, noting AIIB’s commitment to being a “Lean, Clean, and Green” institution. The ESF and Procurement Policy are highly influential in deciding which projects to take on.

The Environmental and Social Policy (ESP) dictates the majority of preliminary criteria necessary for a project to be considered by an Executive Committee. ESPs are stringent, and can only be changed with a supermajority in the Board of Governors. Issues like gender equality, climate change, and biodiversity are governed by the ESP. If a project is accepted, the borrowing country must provide environmental and social assessments at the AIIB’s behest. Additionally, if the borrowing country happens to have more stringent regulations than those outlined in the ESF, the AIIB mandates that its financed projects abide by the domestic laws. Otherwise, adherence to AIIB standards is an essential component for accepted projects.

The bank’s Procurement Policy operationalizes how it will engage with contractors, workers, consultants, and specialists. Both the AIIB itself and its approved projects must abide by fair practices, open recruiting, and fair labor standards. Anyone hired to work on a project financed by the AIIB must adhere to the practices outlined in the document. Interestingly, the Procurement Policy mandates a principle of “open procurement”; that is, the AIIB allows any company in the world to compete for project contracts. Theoretically, open procurement means that the Bank will not extend preferential access to contractors from shareholding nations.

45 Ibid.
**Project Acquisition**

The AIIB can finance projects in any regional member state (the caveat is that China has made it clear that projects falling within Chinese borders will not be considered unless the project is regional and would affect surrounding members). They can even finance projects in non-member states, so long as the proposed project would clearly benefit a member state. For example, the AIIB could conceivably finance the construction of a port in Chile—a non-member—if the port would have a demonstrable impact on the economy of a shareholding member.

Projects can be proposed by shareholders, governments, private companies, regional blocs, and other entities. Preliminary criteria are determined mostly by the ESP; if they are satisfied, projects are then passed along to an Executive Committee. These criteria include:

- Commercial viability
- Environmental and social viability
- Eminent domain
- No slave or prison labor
- No corruption
- Attention to the Procurement Policy for all hiring practices

Central to these criteria is a commitment to international norms. Notably, eminent domain is enumerated in part for countries like China, who operate under communist principles wherein the government could use land for public purposes without giving proper compensation to displaced persons. This criterion is vital given the poignant critiques of WBG projects that neglected the principle of eminent domain.

Before a project proposal is passed to the Board of Directors, it must undergo a thorough vetting process by AIIB staff and contracted consultants. Documents regarding each project’s viability
and adherence to AIIB standards are scrutinized. In particular, a project must prove that it is a “bankable project” – that is, it is financially viable. Accordingly, project proposals must demonstrate how the project will generate economic activity and pay for itself. A proposal to build a highway might involve plans to include a toll booth, for example. However, current staffing issues at the AIIB limit its potential to conduct extensive research. At current capacity, certain projects can only have several staffers assigned to them. Partially in order to keep the AIIB a “lean institution,” senior management has sought to keep the functions of the AIIB deliberately specific. Thus, the AIIB does not conduct field research, publish books, or engage in fields other than infrastructure compared to most MDBs.

Directors from the non-resident Board must approve all projects before they can be implemented. The Board of Directors meets only four times a year, and by virtue of being non-resident, has no staff to guide Directors in their decisions. Challenges arise because the non-resident board necessitates that the bulk of the analysis be conducted before proposals are submitted to the Board of Directors. To serve this purpose, the Investment Committee offers formal project recommendations.\footnote{47 “Project Process,” \textit{Asian Infrastructure Investment Bank} (2017), accessed on April 10, 2017, \url{https://www.aiib.org/en/projects/process/index.html}.} A proposed procedural change may delegate projects below a designated financial threshold directly to management.

\textit{Project Implementation}

At the AIIB, there is a heavy focus on project readiness. Most of the AIIB’s attention is spent on conducting preliminary analyses to minimize complications once project construction has actually started. Most oversight is subcontracted to consultants and other external staff. In compliance with MDB traditions, field visits for projects are generally conducted twice a year. In addition, the borrowing country must prepare a monthly progress report, which includes environmental and social
reports. Just as the ESF and the Procurement Policy dominate the project development stage, additional frameworks govern project implementation.

Risk Management at the AIIB essentially contains three “lines of defense.” First is Investment Operations, an office that oversees basic implementation progress. Relationships with clients, and between creditors and borrowers are managed at this stage. The other two defenses are the Risk Management function and the Internal Audit. Included in these are various rules governing finance risks, market risks, and currency risks. Each project must undergo a risk evaluation that is broken down by sector. For collaborative projects, the AIIB’s risk rating may be different from that of the partner institution. The AIIB reserves the right to conduct field visits without warning.48

The AIIB also has a list of Prohibited Practices: a comprehensive list of assurances that guarantees the bank will not finance activities involving, corruption, bribery, misallocation of funds, and more.49 As with other central documents, Prohibited Practices contains very similar language to documents at the WBG and the ADB. Much like other MDBs, the document contains protections for whistleblowers, and detailed proceedings for how to tackle any challenges relating to the behaviors enumerated. Similarly, the AIIB agreed to adopt the World Bank Group’s blacklist of sanctioned contractors.50

Collaborations and Relationships with other MDBs

Thus far, the AIIB has approved 11 projects, totaling around $2 billion USD in loans. 10 additional projects have been proposed but are still in the approval process. The projects that have been accepted are occurring in seven different countries. Interestingly, the AIIB is the sole financier on only one approved project: the Bangladesh Distribution System Project. A list of approved projects with the corresponding leading financiers is presented in Figure 9 below.

<table>
<thead>
<tr>
<th>Project Country</th>
<th>Title</th>
<th>Main Financier</th>
<th>Est. Cost</th>
<th>Date Approved</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bangladesh</td>
<td>Natural Gas Infrastructure and Efficiency Improvement</td>
<td>ADB</td>
<td>$453 million</td>
<td>03/22/17</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Dam Operational Improvement and Safety Phase II</td>
<td>World Bank</td>
<td>$300 million</td>
<td>03/22/17</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>Trans-Anatolian Natural Gas Pipeline</td>
<td>World Bank, AIIB, EBRD, EIB</td>
<td>$8.6 billion</td>
<td>12/21/16</td>
</tr>
<tr>
<td>Oman</td>
<td>Duqm Port Commercial Terminal and Operational Zone Development</td>
<td>AIIB</td>
<td>$353.33 million</td>
<td>12/08/16</td>
</tr>
<tr>
<td>Oman</td>
<td>Railway System Preparation</td>
<td>AIIB</td>
<td>$60 million</td>
<td>12/08/16</td>
</tr>
<tr>
<td>Myanmar</td>
<td>Myingyan Power Plant</td>
<td>AIIB, IFC, ADB</td>
<td></td>
<td>09/27/16</td>
</tr>
<tr>
<td>Pakistan</td>
<td>Tarbela 5 Hydropower Extension</td>
<td>World Bank</td>
<td>$823.5 million</td>
<td>09/27/16</td>
</tr>
<tr>
<td>Indonesia</td>
<td>National Slum Upgrading</td>
<td>AIIB, World Bank</td>
<td>$1.743 billion</td>
<td>06/24/16</td>
</tr>
<tr>
<td>Pakistan</td>
<td>National Motorway M-4</td>
<td>ADB</td>
<td>$273 million</td>
<td>06/24/16</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>Distribution System Upgrade and Expansion</td>
<td>AIIB</td>
<td>$262.29 million</td>
<td>06/24/16</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>Dushanbe-Uzbekistan Border Road Improvement</td>
<td>EBRD</td>
<td>$105.9 million</td>
<td>06/24/16</td>
</tr>
</tbody>
</table>

Figure 9: List of AIIB’s approved projects and collaborations.51

Collaborations between MDBs are relatively common in the international community, especially between newly established MDBs and older ones. Following custom, the AIIB has signed memoranda of understanding with most MDBs. The purpose of these documents is to reinforce a

51 Information in this table comes from official AIIB and corresponding MDB report for each project.
credible commitment to cooperation and mutual respect. They create a framework through which project collaborations can occur. Furthermore, the ESF includes several provisions that lay out a process of “harmonization,” ensuring that regulations are consistent across multiparty collaborations.\footnote{52 “Environmental and Social Framework,” Asian Infrastructure Investment Bank (2016), accessed on April 9, 2016, https://www.aiib.org/en/policies-strategies/_download/environment-framework/20160226043633542.pdf.} Thus far, the AIIB’s main partners have been the WBG and the ADB.

The AIIB is a new institution that provides narrowly focused services. Accordingly, many of its co-financiers have taken on much of the heavy lifting in the project development process. When the AIIB does not have a majority share of the financing, the project implementation, progress, and procurement processes are overseen completely by the partner bank. Collaborative projects explicitly state that another MDB is the lead co-financier and “will administer the Bank’s loan on behalf of the Bank.”\footnote{53 “Project Document of the Asian Infrastructure Investment Bank: Republic of Indonesia, Dam Operational Improvement and Safety Project Phase II,” Asian Infrastructure Investment Bank, February 28, 2017.} Field visits, oversight, and additional documentation are almost always conducted by the other MDB. Indeed, many of the AIIB’s reports on projects are written in conjunction with other MDBs.

Why Collaborate?

As a new institution, collaborations with existing MDBs are an excellent opportunity for the AIIB to take on projects that carry the reputation and low risk of the main financier. This is especially important given President Jin set ambitious goals for the AIIB’s first few years. To meet the goal of approving $2.5 billion USD in new loans by the end of its second year, the AIIB will need assistance in the acquisition bankable projects.\footnote{54 “Jin Liqun: China’s Internationalist,” Global Capital, April 5, 2017, accessed on April 12, 2017, http://www.globalcapital.com/article/b12dq63p9n71je/jin-liqun-chinas-internationalist.}
The AIIB is currently understaffed; thus, collaborations allow hundreds of work-hours of research and evaluation to be passed on to the partner MDBs. Projects can be distributed among more staff, which can increase the rigor of project analysis. Greater staffing capacity, along with the introduction of new capital flows, increase the bandwidth of the AIIB’s projects and portfolio. Additionally, by providing additional funding, underfunded or very expensive projects that would otherwise require additional years of consideration can be completed in less time. Finally, by accepting a share of debt, the AIIB is effectively accepting part of the risk that accompanies each project. In doing so, the AIIB may inadvertently increase the likelihood that other MDBs assume riskier projects, since project risk can be more evenly shared.

**On the Ground: Case Studies of the AIIB’s Financed Projects**

The AIIB’s first approved projects entered the implementation stage several months ago. Little observable progress has been made that could inform a thorough analysis of whether the projects are adhering to the AIIB’s established frameworks and policies. Understanding the types of investments that the bank has made, however, sheds light on potential future risks. Below is a representative sample of three of the bank’s approved projects:
Indonesia and the World Bank: Dam Operational Improvement and Safety Project (DOISP) Phase II

Figure 10: Dams constitute a large portion of Indonesia’s clean energy production. Unfortunately, many of them are in dire need of technological assistance.\textsuperscript{55}

Indonesia suffers from frequent natural disasters and crumbling infrastructure. Over 1.5 million people live under risky circumstances due to inconsistent flooding. Additionally, water shortages plague many zones within the country. The DOISP project aims to restore existing dams and ensure their functioning at the highest levels of safety. It functions as the second phase of an existing dam project financed by the IBRD in 2009.\textsuperscript{56} The scope of the first DOISP was limited, since construction was limited to 63 top-priority dams.\textsuperscript{57} The World Bank approved a second phase in February 2017, when authorities recognized that there were at least another 100 dams that were


\textsuperscript{56} “Project Appraisal Document on a Proposed Loan in the Amount of US$ 50 Million to the Republic of Indonesia for a Dam Operational Improvement and Safety Project (DOISP),” World Bank, February 20, 2009.

desperately in need of technical support. The World Bank estimated that approximately 11 million people would benefit from the completion of this project.58

The World Bank is steering the project, and in its capacity as leading financier, is administering, implementing, and overseeing the AIIB’s loan. The total cost of the project is estimated at $300 million, and should be completed by 2023. The AIIB approved a sovereign loan for $125 million with a maturity of 15.5 years, which does not include an 8-year grace period.

As is the case for most of the AIIB’s collaborations, regulations are “harmonized” with the partner MDB’s policies. For the Indonesia project, the AIIB promptly adopted the World Bank’s policies on corruption, environmental standards, and procurement. Since the World Bank is formally monitoring the use of the AIIB’s loan, the burden of accountability and implementation falls largely on the World Bank.

The implementation of the first stage of DOISP did contain certain errors. For example, there were flaws in the risk calculations, and overestimations of the number of experts available on the ground. Thus, plans for a decentralized implementation encountered complications. Such challenges were rectified for the Phase II aspect. It is worth noting that the World Bank anticipated that additional funding would likely be necessary at the time of its approval for the first stage.59 Since the project was approved on March 22nd, the project has moved ahead without delay. All targets were reached in the first phase of the DOISP, so it is likely that the project fill its objectives in this second phase.60

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60 World Bank, Implementation Completion and Results Report (IBRD-76690) on a Loan in the Amount of US$50 Million to the Republic of Indonesia for a Dam Operational Improvement and Safety Project (DOISP) P096532.
Pakistan and the ADB: National Motorway M-4 Project

The purpose of the National Motorway M-4 Project is to construct a 64km-long four-lane highway connecting the northern and southern parts of Pakistan. This length represents the last section of an existing road to be completed before the entire highway becomes operational.

The Asian Development Bank is the lead financier for the project, and will be administering the AIIB’s loan on the Bank’s behalf. The total cost of the project is $273 million. The estimated completion date is June 2020. The AIIB approved a loan for $100 million to the government of Pakistan, with a maturity of 20 years and a grace period of 5. As in the case of Indonesia and the WBG, the AIIB decided to adopt the ADB’s standards of procurement, environment, corruption, and social policies.

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Initial challenges to the implementation of the project include issues of eminent domain and resettlement. The ADB used a process of public consultation and independent land valuation to compensate the displaced persons – around 23,000 – accordingly. The AIIB itself did not play a very important role in this process. Other complications became evident shortly after the loan was approved; certain materials and commodities needed for construction rose more rapidly than the initial budget proposal had anticipated, thus increasing the projected cost of the project. The budget was adjusted accordingly. Nonetheless, some sources claim that this project is significantly overpriced and expensive.

**Bangladesh and the AIIB: Distribution System Upgrade and Expansion Project**

![Image of an electric substation](image)

*Figure 12: In the AIIB’s first independently financed project, support is extended to expand access to electricity in Bangladesh.*

The government of Bangladesh believes that the lack of universal access to cheap electricity is a major impediment to economic growth and prosperity. This project would expand coverage by creating over 2.5 million new connections in rural areas, as well as providing support for established links that run through major cities. Approximately 12.5 million people would benefit from the rural

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section of the project alone. This project is unique in that it is not the product of a collaboration between the MDBs. Thus, its success could inform the effectiveness of the AIIB’s established frameworks and policies.

The cost of the project is $262.29 million, with projected completion due in June 2019. The AIIB is extending a loan of $165 million with a term of 25 years – and an additional 5 years for grace period – to the government of Bangladesh. Taking into account the contributions by other parties, the AIIB has provided 63% of the funding for the projects. The implementation of the project is to be undertaken by the Bangladesh Rural Electrification Board (BREB) and Dhaka Electric Supply Company Limited (DESCO). BREB and DESCO have been involved with other MDB projects in the past, and are considered vetted.

Since the project is not a collaboration, the AIIB’s responsibility for the implementation process is more significant than in other situations. The effective implementation of the project is in part a function of domestic laws and regulations. Two government agencies could act as watchdogs: the Ministry of Power, Energy and Mineral Resources and the independent Bangladesh Energy Regulatory Commission. Per formal AIIB documentation, AIIB staff will be rigorously monitoring the project’s strict adherence to the AIIB’s anti-corruption policies. Logistically, however, the AIIB has only a handful of full-time staff who would theoretically monitor project implementation. An additional complication is Bangladesh’s poor record on corruption. In their annual report, Transparency International ranked Bangladesh 145th out of 176 countries in terms of “cleanliness.”66 Bangladesh’s high corruption levels have been very consistent, showing no indication of improvement in the foreseeable future. Thus far, there is no evidence of the misuse of funds provided by the AIIB, but this project must definitely be scrutinized.

Research Question

This paper aims to analyze the AIIB that exists today in order to predict what the AIIB might look like in the future. It is understandably difficult and risky to predict future behavior off current events. As such, this analysis will not attempt to predict the future. Instead, it presents the challenges that the AIIB currently faces and will need to overcome if the Bank aims to become a reputable development institution for the 21st century. The most basic question concerning the AIIB focuses upon its purpose and credibility in the multilateral development ecosystem:

- **Does the AIIB fill a market gap in providing capital to support sustainable development in the Asia-Pacific region?**

  The bank has a primary responsibility to its shareholders to uphold its mission of providing necessary financing for sustainable development projects in the Asia-Pacific region. This purpose, however, is predicated on the assumption that the need for additional financing actually exists. If the AIIB is attempting to fill a gap that other MDBs and IFIs have already filled, then the AIIB may be accomplishing a task that could be more efficiently accomplished by existing institutions. Therefore, a proper analysis of this research question must also consider:

  - Does a market gap exist?
  - Does the AIIB properly fill this market gap?

  Providing capital to support “sustainable development” has been the mission of MDBs since their inception. While the definition of sustainable development has changed over time, its main purpose is to promote economic development that does not compromise the needs or abilities of future generations to do the same. As outlined in the Sustainable Development Goals (SDGs) platform, this definition now includes environmental and social considerations like climate change,
which Bretton Woods institutions originally did not consider. The ESF and open procurement framework of the AIIB aim to promote sustainable development. But proper procedure on paper does not always translate to proper procedure in practice:

- Is the AIIB committed to sustainable development?

Next, this section of the analysis will begin by addressing the known conditions on the ground at the AIIB to determine the current success of the institution. Looking towards the future, it will analyze whether the short-term successes on the ground can be expected to continue as the AIIB scales into a fully functional development institution. This section will also look at future challenges that the AIIB will face, including financial viability, internal accountability, and the development of “bankable projects,” to inform its analysis. In anticipating future challenges, the paper also hopes to continue the analysis of the research question into the near future:

- Will the AIIB continue to fill a market gap in providing capital to support sustainable development in the Asia-Pacific region?

Finally, this paper offers simple, normative recommendations that could address some of the AIIB’s potential future challenges.

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67 SDG platform
Analysis and Evaluation of the AIIB

In this section, analysis is presented in two parts. First, the AIIB’s ability to fill a market gap is evaluated by determining whether a market gap exists, whether the AIIB is indeed filling it, and whether the AIIB supports sustainable development in general. Next, the paper looks to the AIIB’s prospects, by analyzing whether the AIIB will continue to fill a market gap. We find that the AIIB is indeed filling a gap and promoting sustainable development, but that it will likely have to overcome certain challenges if it wishes remain credible and financially viable.

Current Analysis

Does a market gap exist in for sustainable development in the Asia-Pacific? Does the AIIB properly fill this gap?

There is a consensus among experts in international development that a gap exists for providing capital to support sustainable development in the Asia-Pacific. While pundits argue about the extent to which this gap exists, there are several explanations for why the presence of a new institution makes sense in the region:

- **Capital bottleneck:** While the 2009 ADB report estimated that over $8 trillion USD in additional infrastructure spending would be needed to meet the demands of Asian nations, there is currently a severe gap between capital demand and capital supply. The ADB’s own supply of sovereign debt financing has increased over 20% from 2014 to 2015, but the ADB continues to fill a large portion of its portfolio with projects in China, in which the AIIB initially does not plan to invest. While a latent supply of additional capital existed prior to the establishment of the AIIB, there lacked a
necessary additional channel through which to invest in infrastructure projects in developing nations throughout Asia.

**Infrastructure lending**

Developments around the Asian Infrastructure Investment Bank (AIIB) come at a time when infrastructure lending within the region by multilateral institutions, such as the ADB, have slowed. The AIIB could fill in a crucial infrastructure gap in Asia.

<table>
<thead>
<tr>
<th>TOP ADB LENDING RECIPIENTS 2013</th>
<th>TOTAL ADB DISBURSEMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>$12 billion</td>
</tr>
<tr>
<td>China</td>
<td>$8.5 bln</td>
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<tr>
<td>Pakistan</td>
<td></td>
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<tr>
<td>Indonesia</td>
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<td>Philippines</td>
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<td>Bangladesh</td>
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<td>Myanmar</td>
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<tr>
<td>Afghanistan</td>
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<tr>
<td>Regional</td>
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</tr>
</tbody>
</table>

Source: ADB annual reports

Figure 13: Graph showing the recipients of ADB funding, and the total disbursements.68

➢ **Power of shareholders:** One of the leading reasons behind the AIIB’s creation and criticisms of WBG institutions is that they do not adequately represent the economic size of developing nations in Asia. In the AIIB, China holds almost 30% of the voting share, giving it veto authority over any Board decisions that require a supermajority. Some have argued that the lack of adequate voting power of developing nations like China and Russia has created a market gap in the provision of funds to Asian nations; the AIIB’s structure might address this. However, there is little evidence to support this hypothesis. A more likely explanation for how the AIIB’s division of shareholding

power might fill a market gap is through the provision of excess capital supply in China, Russia, and India. The AIIB provides the “channel” through which nations that have been historically underrepresented in the WBG can now provide additional capital to an MDB.

➢ **“Streamlining”:** Another major criticism of the WBG institutions and the ADB is that the process by which projects are approved is bureaucratic, inefficient and comes with many political caveats. Since the AIIB does not intend to mandate prescriptions of national governance for its loans, the AIIB’s “streamlined” model may reasonably provide capital more efficiently than existing institutions.

➢ **Riskier Portfolio:** While the AIIB does not aim to explicitly take on “riskier” projects than the ADB and other existing MDBs, it is likely that the AIIB’s project portfolio will contain relatively risky projects. Whereas the ADB invests heavily in China—a country with a AA credit rating—thus far the AIIB has invested exclusively in countries with sovereign credit ratings of BBB- and below. The AIIB’s willingness to assume more risk in sovereign lending portfolio could conceivably lead to the bank to take on projects that other MDBs have determined to be too risky.

It is difficult to determine whether the AIIB’s current projects would have been approved by other lending institutions had the AIIB not existed. In one explanation, the AIIB is attempting to fill a gap that is due to a lack of “bankable projects”—high-quality, sustainable projects that are ready for financing—rather than a lack of available capital. This is a concern that will be addressed when evaluating the long-term challenges that the AIIB will face. Regardless, a gap in the financing of sustainable development projects in the Asia-Pacific clearly does exist, and the AIIB’s most recent

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69 As measured by Standard & Poor’s (S&P) sovereign credit ratings
project commitments seem to show that a supply of bankable projects does exist. Even within a co-financed project like the DOISP, Phase II might not have been undertaken without the presence of a co-financier like the AIIB.

**Is the AIIB committed to sustainable development?**

At face validity, there are no glaring discrepancies between the AIIB’s charter compared to those of existing MDBs. While there are dramatic differences in structure and institutional size, many of the frameworks and documents that govern how the AIIB operates are very similar across MDBs. Thus, from a legal standpoint, there are no smoking guns that would indicate any departure from international norms and adherence to best practices. Indeed, the AIIB’s ESF is meticulously articulated, and is considered to be quite innovative. Before officially approving the current ESF, the AIIB held consultations on successive drafts. Key civil society organizations, like Greenpeace and Oxfam, were invited to comment on the draft and provide recommendations for improvement.70 The AIIB’s ESF and Procurement Policy generally garnered widespread approval from civil society.

Additionally, the internal attitudes of AIIB staff members are worth considering. As discussed earlier, many current employees of the AIIB, especially at high levels, were hired after working at other MDBs. President Jin himself worked at the World Bank before becoming Vice President of the Asian Development Bank. The AIIB’s open procurement policy means that former MDB staffers can be hired from any country, regardless of whether their country of origin is a member of the AIIB. Hypothetically, every post beneath the Vice Presidential level could be occupied by individuals who come from non-members states, like the United States. Internally, the AIIB’s staff seem to be quite

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optimistic about the Bank. Externally, many experts have referenced the high levels of former WBG and ADB employees as grounds for trusting that the AIIB will adhere to best practices.

Proper adherence to best practices requires an internal accountability mechanism that limits the ability to cut corners. As discussed, WBG institutions have hundreds of employees devoted to compliance and oversight, and yet they still often fail to prevent egregious violations of human rights and internal ESFs. This leads some critics to ask: How will the AIIB, an institution whose final staff count will only be several hundred, be able to prevent the same sorts of violations? Currently, the AIIB Board of Directors has authorized the creation of a Compliance, Effectiveness, and Integrity Unit (CEIU), which will report directly to the Board of Directors and has been tasked with guaranteeing compliance and best practices at the bank. The CEIU will be led by Mr. Hamid Sharif, who was appointed by President Jin and served as China’s Country Director at the ADB. While this is an important first step, ensuring long-term compliance for the entire organization will be an important challenge that the AIIB will be sure to face.

Judging the AIIB’s current commitment to best practices and sustainable organizational growth is a difficult task, because the bank is still in its infancy. As such, it is necessary to not assume the presence of faults unless evidence suggests otherwise. The current air-tight legal frameworks that the AIIB has adopted, as well as their creation of the CEIU, are all important first steps that suggest the bank is moving in the right direction. Several warning signs, however, suggest that future market conditions might jeopardize the bank’s initial feats.

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Future Analysis

Market conditions will affect the future of the AIIB

The AIIB is currently overcapitalized and does not need to worry about borrowing money in the short-term. However, within the next decade, the bank will face a shortage of capital and will need to purchase loans in order to continue to finance projects. While other MDBs have borrowed funds in the same capacity for years, a confluence of market conditions in the interest rate swap market has led to a substantial increase in the cost of borrowing funds at floating interest rates since mid-2015.\(^{73}\)

For example, as measured against 6-month LIBOR, the IBRD’s cost of borrowing funds at floating rates has increased by over 35 base points (0.35%).\(^{74}\) For MDBs that generally rely on small net interest margins to turn profits, this increase can greatly affect the price of interest rates offered on loans. Interest rate swaps have been historically quite stable, so this recent change in market conditions could prove to be problematic for the AIIB.

For existing MDBs like the IBRD and the ADB, this change in borrowing cost is not as dramatic. This is because these institutions already have billions of dollars in project loans that were borrowed at stable, pre-2015 rates. The current market forces that are causing concern in interest rate swap markets can be offset by historically positive spreads. However, for a new institution like the AIIB, this new phenomenon could prove disastrous. Unlike the older institutions that can leverage profits from their existing project portfolio to offset smaller margins, the AIIB will need to price its entire loan portfolio based on suboptimal interest swap rates. Since MDBs engage in price competition with each other, the AIIB may be faced with two scenarios: (1) reduce interest rates offered on loans

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\(^{74}\) HSBC, publicly available data
to price competitively with other MDBs, or (2) take on riskier loans that other MDBs would not take. Both scenarios could cause serious problems for the financial viability of the AIIB.

If these market trends continue, the AIIB will be forced to rely on slimmer net interest margins than those of its peer institutions. Additionally, in efforts to stir investment demand and shareholder confidence, the bank has already planned on offering lower rates compared to its peers. For example, the LIBOR + 1.15% rates offered on loans to the bank’s Indonesia, Pakistan, and Bangladesh projects are significantly lower than its co-financiers’ rates.\(^\text{75}\) Since the bank aims to be “leaner” than its peers, lower administrative costs would traditionally justify these lower net interest margins. However, if market trends continue, the already-slim margins will tighten even further.

The combination of the AIIB’s perceived competitive advantage (its “leaness”) and market realities will pose serious challenges to the bank’s ability to promote sustainable development in the Asia-Pacific. The AIIB may be pushed to (1) take on riskier projects; (2) further reduce administrative costs, which could reduce staff required for proper institutional compliance; and (3) focus less on compliance (“cut corners”). The risk of non-compliance exists whether or not the interest rate swap market stabilizes, but the current negative spread of swaps exacerbates the risk and might promote a “race to the bottom,” as shown in Figure 14 below:

Finally, there is a chance that the AIIB will not receive a AAA credit rating once it begins borrowing money. If this occurs, the AIIB’s cost of borrowing money will likely increase by over 10 base points (0.1%), which would further tighten the bank’s net interest margin. Since the bank has chosen not to loan to China, which has a very good AA credit rating, there is a slight likelihood that its portfolio will be considered to have a greater credit risk than its peer institutions. This would be further disadvantageous to the bank and might encourage more corner-cutting to reduce cost.

**The supply of viable projects may not increase**

While there is no doubt that the demand for infrastructure financing is increasing, it is unclear whether the supply of bankable projects that fall within the purview of the AIIB is sufficient. In other words, the AIIB may not be able to fill the previously identified infrastructure financing gap due to a lack of viable projects. The tension between supply and demand of project development is exacerbated...
by two factors: the tension between crediting and borrowing member states, and the AIIB’s ambitious goals.

Creditors and borrowers face completely different sets of incentives in any banking context. Borrowing member states want access to funds as swiftly as possible, and generally want the project to be completed quickly. The borrowing member states of the AIIB generally have poor credit and high corruption levels. Moreover, they tend to either have poor environmental and social standards, or they do not implement domestic laws stringently. Borrowers theoretically have an incentive to cut corners, in order to expedite funding and project completion. On the other hand, crediting countries often care more about the reputational risk of abandoning standards. Creditors (Western countries and wealthier regional members) have a vested interest in making sure that projects adhere to the ESF and other policies agreed to in the AIIB’s AoA. However, if these incentives were to change, then there may not be a driving force behind acquiring projects of the highest environmental and social standard.

Additionally, the AIIB’s lofty goals may push the Bank to approve riskier, low-caliber projects in an effort to meet targets. The AIIB does not have the capacity to unilaterally develop projects. Thus, it is reliant on the market supply of projects. Collaborations with other MDBs are a good temporary solution, but the AIIB will need to finance its own projects if it wishes to establish itself as a truly independent, powerful institution. It is reasonable to infer that, sensing the AIIB’s eagerness to take on new projects as quickly as possible, other MDBs may have offered collaborative opportunities on the more risky, unsavory projects. According to this view, the AIIB would be paying the partner MDB to reduce their debt liability. This claim is difficult to prove, but tempting in its logic.
The AIIB’s institutional “leaness” may reduce standards and accountability

At the moment, being ‘lean’ is one of the goals set out by President Jin, but conventional wisdom suggests that a growth in the scale of the bank could eclipse this objective. The growth of the EBRD, one of more recently established MDBs, can provide a useful comparison. The EBRD expanded its area of coverage well beyond the initial boundaries of Eastern Europe to countries as far as Mongolia; this expansion was accompanied by a rise in staff to more than 2,000, in contrast to the AIIB’s target of around 300 staff. Nonetheless, the EBRD has not encountered serious criticism of its size or bureaucratic procedures. On the contrary, most recommendations for the EBRD call for an increase in size. A report on the transition of the EBRD suggests that the Bank should develop criteria for disengagement from recipient countries, strengthen its measurement and monitoring of environmental and social impact, and emphasize projects in energy efficiency and environmental rehabilitation.

In view of this, the challenge for the AIIB would lie in ensuring that there are sufficient mechanisms to monitor operations beyond the approval stage. Otherwise, the Bank may lend out funds efficiently but lose sight of its standards. Personnel shortages have already been cited by the AIIB as a justification for the short consultation timeframe on ESF and other policies.76 There is a careful balance to be struck between the desire to maintain institutional leanness and a lack of accountability due to staff shortages.

The AIIB has strived to incorporate best practices of existing IFIs within its governance framework and procurement strategies. This may have lent the AIIB the initial credibility required to attract the 57 regional and non-regional member states it currently boasts. Still, the evolution of its growth strategy as it aims to expand the scale of its lending operations remains to be seen. At this

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stage, it is too early to assess how the AIIB’s future growth trajectory will impact its credibility. Distinctive features such as the Bank’s non-resident board establish a system of checks and balances to prevent the same inequitable accumulation of power among member nations for which many existing MDBs have been criticized. However, if not appropriately implemented, they could also act as a form of deferring accountability that could give rise to agency conflicts.
Moving Forward: Recommendations for the AIIB

Given the challenges the bank may face in the coming decades, the AIIB must make deliberate, strategic choices to maintain its credibility and withstand criticism. The AIIB’s voracious demand for bankable projects may not be satisfied by the current supply. Overcoming this obstacle will require the AIIB to increase its capacity to develop new projects, which it might do in a variety of ways. In this section, the paper offers normative solutions to some of the AIIB’s aforementioned potential challenges. The three broad areas of focus are (1) the capacity for new project development, (2) internal structural strategy, and (3) accountability and civil society engagement.

1. Increase the AIIB’s capacity to develop new projects

Collaboration is Key

In terms of establishing long-lasting credibility and attracting bankable projects, the AIIB stands to benefit a great deal from working closely with existing institutions. Previously, this paper discussed the AIIB’s gains from engaging in collaborations with other MDBs; these included expediency, risk diffusion, and reputation building. Until the AIIB is fully staffed, most of its portfolio should be co-financed projects. Independently financed projects simply do not have enough staff assigned to them that could conduct effective oversight. Moreover, the reputational costs the AIIB would suffer if one of its independently financed projects were to encounter any issues would be monumental.
New venues for collaborative opportunities are constantly emerging in the MDB ecosystem. Driven by the incredible demand for infrastructure in developing countries, particularly in Asia, countries are increasingly willing to contribute to a variety of platforms. The Global Infrastructure Hub (GI Hub), for instance, was established by G-20 countries in 2014 with, according to their website, a mission to supplement the “flow and quality of private and public infrastructure investment opportunities.” President Jin of the AIIB recently met with the GI Hub’s CEO, to share information and possibly to discuss a future memorandum of understanding between the two organizations. The AIIB and GI Hub have some overlapping goals and members (China is a contributing member of both development institutions; the United States is noticeably missing from both). More importantly, they complement each other. The GI Hub’s principal goal is to increase the supply of financially viable

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infrastructure projects across the globe, while the AIIB is eager to finance such projects - with a regional focus - as soon as possible.

Cooperation between MDBs is a growing trend in the international context. The Global Infrastructure Forum, launched in April 2016, convenes leaders from all major MDBs and development institutions to discuss the improvement of infrastructure project acquisition and implementation. The AIIB should direct resources to engaging in strategic partnerships with infrastructure project researchers, like the Sustainable Infrastructure Foundation and the PPP Knowledge Lab. Creating such relationships would appease any critics who believe the AIIB is a competitor in the international system, rather than a collaborator.

2. Enforce quality hiring and staffing practices

Maintaining institutional “leaness” without cutting corners on standards and accountability is a daunting task. Given future market conditions, the AIIB will almost certainly need to keep its administrative costs artificially low to remain competitive. Moreover, the lack of bureaucracy is considered very attractive; projects take years to pass through the approval process in most MDBs. Bearing this in mind, the AIIB should be extremely deliberate in its procurement practices. An open procurement practice is an important step in fulfilling this goal, as it allows the AIIB to recruit the best from all over the world. An advisable next step is to keep the goals of each AIIB sub-committee narrow and precise. The WBG has hundreds of committees with seemingly overlapping jurisdiction. In conclusion, the AIIB should not rush past its initial hiring phase, to accommodate a rapidly expanding portfolio. Rather than sacrificing accountability, it would be better to reach the target of 300 staff slowly, and take on fewer projects during this stage until a balance is struck.
3. Ensure accountability through engagement with civil society

The need for an independent watchdog for the AIIB’s projects could be filled by engaging with non-governmental organizations (NGOs). In its first annual meeting, the AIIB demonstrated a surprising level of goodwill by inviting NGOs to participate and ask questions. NGOs have also been scrutinizing the bank’s actions and publications, demonstrating their intention to hold the AIIB accountable to established standards. Greenpeace has been particularly active on this front and has evaluated the bank on its policies several potential projects.

Increasing civil society involvement can only yield positive results for the AIIB’s credibility and effectiveness. Leaders of NGOs could be invited to serve on a semi-independent commission to ensure compliance, effectiveness and integrity. Another option is to simply give NGOs increased access and information on the AIIB’s projects. The AIIB would send a strong message about its commitment to transparency and standards if it were to incorporate NGOs in its processes. Of course, the AIIB should be wary of the agendas of certain organizations that may seek not only to impose standards but also to change them. Ultimately, civil society engagement would serve an additional purpose: to increase Western trust in an institution that is headquartered in a country that demonstrates less respect for civil society.
Conclusion

This paper sought to determine what the AIIB’s place is – and indeed, will be – in the sustainable infrastructure development context. The AIIB is a nascent institution that is still maneuvering the MDB ecosystem. As such, the information that is available is limited and does not offer much predictive value. This paper began by considering the players in the MDB context that are very influential in the field, and who could serve as valuable points of comparison for analyzing the potential future trajectory of the AIIB. Each MDB has sustained a great deal of criticism on a variety of fronts: environmental and social costs, bureaucratic complications, inequitable representation, and a general lack of financing.

The AIIB’s structure and mission were designed in part to tackle some of the criticisms of existing MDBs. President Jin’s desire to keep the Bank a “Lean, Clean, and Green” institution is encouraging. The AIIB’s internal structure ensures a 75% share for regional members, allowing borrowing countries a significant vote in the Bank’s decisions. The Bank’s Articles of Agreement, along with other key documents like the ESF, the Procurement Policy, and Prohibited Practices bear significant resemblance to other MDB frameworks and support the view that the AIIB is committed to international norms and IFI best practices. In an effort to appease Western critics, the AIIB has gone to great lengths to demonstrate that it plans to be a collaborator, and not a competitor. The Bank signed memoranda of understanding with major MDBs, and has engaged in collaborative co-financing for the vast majority of its initial project portfolio.

Nonetheless, challenges remain ahead. While this paper determined that the AIIB could fill the gap in capital financing for infrastructure projects, it may face adverse market conditions that will constrain its ability to remain competitive. An incentive to cut corners on key issues, like adherence to environmental and corruption standards, is undeniably present. Moreover, there may not be a
large enough supply of bankable projects for the AIIB to finance. Given the Bank’s lofty goals and international scrutiny, such a shortage is sure to cause tensions.

On the path to establishing itself, the AIIB has had to assure skeptical observers of its credibility and long-term viability. Western observers have been quick to ask whether or not the AIIB is simply an instrument of Chinese economic policy. Although China currently has veto power, the AIIB’s openness to adding new members means that China’s share may rapidly decrease as new regional members are added. China’s decision to not to submit projects to the AIIB diminishes its ability to use the AIIB for its own development. Moreover, Chinese intentions may not matter; thus far, the AIIB’s output has been fairly successful in promoting sustainable development throughout Asia. The AIIB’s ESF and AoA are exemplary, and were drafted by many Western consultants and lawyers from existing MDBs.

The United States has expressed concern with the AIIB’s establishment. Initially urging allies not to join, the U.S. has receded to a position of neutrality. If the U.S. is concerned about Chinese overreach, or the failure to comply with environmental and social practices, the U.S. could theoretically become a member. Some experts have argued that the best watchdogs for the AIIB are the Western countries that have a stake in its success, but maintain a critical and analytic stance. They are committed to best practices and financial viability. While it seems unlikely that the U.S. will join the AIIB in the next few years, it seems likely that the AIIB is here to stay. The U.S. government will need to devise a strategy that accepts the existence of the Bank, which has been accepted by most MDBs so far.

In conclusion, this paper urges interested parties to pay particularly close attention to how the AIIB acts over the course of the next decade. Will it remain committed to sustainable development? How will it overcome the apparent tension between the supply and demand of bankable infrastructure projects? Will accountability measures be properly enforced? The signs are encouraging thus far, but only time will tell how the AIIB plans to resolve impending challenges.