Vision to Reality

Risk Management Report 2017

CALC

China Aircraft Leasing Group Holdings Limited

(Incorporated under the laws of the Cayman Islands with limited liability)

Stock code : 01848

RISK MANAGEMENT REPORT

1 MAIN FEATURES OF RISK MANAGEMENT AND INTERNAL CONTROL

The Board has overall responsibility for the Company's system of internal control, ongoing monitoring of risk management and internal control, and reviewing their effectiveness periodically. In this connection, the Board ensures there is adequacy of resources, staff qualifications and experience, training programs and budget for the accounting, internal audit and financial reporting functions.

The system of internal control is designed to manage rather than to eliminate the risk of failure to achieve the Company's business objectives. It can only provide reasonable and not absolute assurance against material misstatement or loss.

The Board operates within clearly defined terms of reference, and has appropriate committees established, namely, Strategy Committee, Audit Committee, Nomination Committee and Remuneration Committee to oversee risk and internal control activities. These Committees also have clearly defined terms of reference.

The Board aims at achieving an appropriate balance between taking risk and generating returns for shareholders while executing its responsibility for ongoing monitoring of risk and internal controls.

Our Audit Committee is designated to oversee the risk management and internal control process, particularly, standards of financial reporting, risk management and internal controls.

On the operational level, we have a team of Risk Management function overseeing the operational and business risks of the aircraft leasing business. On the Group level, we have an Internal Audit function, which is directly reporting to the Audit Committee for independent monitoring and reporting of risks and controls.

The Company has the objectives of risk management and internal control as follows:

- Continue to optimize its business model, integrating it with its enhanced corporate governance structure to reduce the inherent risks in its business activities, such as liquidity risk and credit risk;

- Continue to utilize its business network to effectively enhance its industry knowledge so as to reduce the probability of and the impact from defaulted and discontinued lease transactions; and

- Continue to cultivate a strong risk management corporate culture through implementation of its management and staff

The Company has implemented its risk management system and policies from the business model and strategic dimension.

Business model dimension

The Group's business is organized and operated on transaction basis so as to ensure each transaction is reviewed from different perspectives to ensure stringent selection of suitable aircraft assets and stringent review of credit assessment and approval.

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Strategic dimension

Risk management initiatives are led by the Board (through its Audit Committee), and executed by CEO and his senior management team, under the supervision of Strategy Committee, through an independent Risk Management team.

The Company's risk management and internal control framework is designed to minimize the risk in the delivery of the Company's strategic objectives. The key principles of the framework are as follows:

– The Board and the Management shall promote a culture to identify, assess and report risks in an open, transparent and objective manner.

– The priority of the Company is to protect its long-term and sustainable interests.

Risk management is embedded within all businesses and operations of the Company. The Company expects all individual behavior to mirror and share the culture and core values of the Company. All employees have the responsibility of upholding the Company's risk and control culture and supporting effective risk management to deliver its strategy.

The Company operates a "three lines of defense" framework for managing and identifying risk.

The first line of defense against undesirable outcomes is undertaken by the business function and the respective line managers. Department heads of all business areas are responsible for implementing and maintaining appropriate controls.

Line management is supported and monitored by middle and back office functions like, Transaction Support, Finance and Accounting, Legal, Compliance, Company Secretarial, Human Resources, Information Technology and Risk Management, which constitute the second line of defense to ensure all risks are considered and tackled.

Risk Management team prepares the risk management reports on a quarterly basis and submits it to our Audit Committee for review. In addition, the Board reviews the effectiveness of the Group's risk management and internal control system with the assistance of Audit Committee, which covers all material controls including financial, operational and compliance control, and the risk management system.

The third line of defense is carried out by our Internal Audit function. It provides independent review on the operation of controls.

2 ANNUAL REVIEW OF THE RISK MANAGEMENT & INTERNAL CONTROL

The Risk Management team carried out the annual review of the effectiveness of the Group's risk management and internal control system and the results were reported to our Audit Committee and the Board. The Board acknowledged that the risk management and internal control system of the Group during the review period were effective and adequate.

2.1 Ongoing Monitoring of Risks and Internal Control

2.1.1 Scope and quality

During the year, the Board reviewed the business of the Company through its regular meetings in order to ensure that business risks had been considered, assessed and managed as integral part of the business. There was an ongoing process for identifying, evaluating and managing the Company's significant risks. The Company's risk assessment process included the monitoring of key strategic and financial risk matrix. In addition, the Company reviewed the impact of any changes and developments on its risk profile, strategic risk and reputation.

The impact and likelihood of each significant risk was evaluated with reference to associated measures and key performance indicators. The adequacy of the risk mitigations plans was assessed and, if necessary, extra improvement action would be added.

2.1.2 Extent and frequency of communication

Our Audit Committee held regular meetings at least quarterly for assessing control of the Company and the effectiveness of risk management.

The Risk Management team, being supported by other relevant departments, summarized the key risks and internal control matters, and identified changes in the risk and internal control profile of the Company.

Risk and risk events were captured by the business and reported to the second line of defense. Specific reports and periodic updates were submitted to the Board after the review by our Audit Committee, if necessary. Issues would be raised when there were control failings, weaknesses and inefficient processes identified or through continuous monitoring reviews by the second and third line of defense teams.

The risk and internal control review report was updated at each Audit Committee meeting where our Audit Committee members contributed their views and raised questions to ensure the risk management and internal controls were in place and effective.

2.2 Significant Control Failings or Weaknesses

The Company has underlying procedures to handle significant control failings or weaknesses, which includes material adverse event assessment, mitigation plan and follow up action. Significant control failing is required to be reported by senior management to our Audit Committee and the Board. No significant control failings or weaknesses were identified during the year.

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2.3 Effectiveness of Financial Reporting & Listing Rule Compliance

With the support and input from the External Auditors, our Audit Committee carried out its review and assessment of the Company's financial reporting, covering those key areas like whether suitable accounting policies were adopted, whether management made appropriate estimates and judgments and whether disclosures in published financial statements were fair, balanced and understandable.

With the support from the Company Secretarial Department, our Audit Committee carried out its compliance review to assess whether the Company has been complying with the relevant regulatory requirements on a quarterly basis. The compliance review summarized the compliance status, corrective actions and the enhancement recommendations.

In regard to the above, our Audit Committee considered the Company's processes for financial reporting and Listing Rules' Compliance was effective.

2.4 Changes of Key Risks

This section summarised the key risks and uncertainties that are inherent with the Company, particularly in the aircraft leasing industry.

The risks mentioned below did not purport to be exhaustive as there may be additional risks that the Company has not yet identified or has deemed to be immaterial that could have a material adverse effect on the business. In order to cope with those risks, the Company had its monitoring and mitigating measures.

Key Risk	Risk Monitoring and Mitigating Measures
1. **Procurement of aircraft** Risks related to aircraft include: – aircraft type selection – terms and conditions negotiation – aircraft delivery schedule & budgeting Risks related to procurement personnel include: – corruption – conflict of interest – counterparty risks	• The Company has several professional teams to monitor, control and review the entire procurement process. • Initial acquisition plan, budget and proposal are prepared internally and reviewed by senior management prior to submission for approval of Strategy Committee. • Due diligence is conducted to check against each counterparty and preventive clauses in transaction agreements is inserted, if necessary.

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Key Risk	Risk Monitoring and Mitigating Measures
2.1 Engineering and configuration of aircraft (technical and engineering) Related risks include: – information leakage, – conflict of interest, – engineering corruption	• The Company has a team of experienced engineers with in-depth technical knowledge and a series of procedural controls to prevent the occurrence of material problems. • Detailed scope of responsibilities and proper approval procedure are measures taken to prevent corruption. • Incentive system is in place to align individual's expectation with corporate objective for avoiding engineering corruption.
2.2 Engineering and configuration of aircraft (industry) Related risks include: – change of government policies – industry demand and changes for aircraft configuration fitting	• There are regular alerts on customers and industry-wise changes and news. • A designated team monitors regularly on changes in government policies relating to the industry.
3. Placement of aircraft and leasing Related risks include: – change in demand in global & local markets – timely placement to meet customer's need – leasable and sellable conditions of aircraft	• The Company's commercial team monitors the leasing market closely and report to senior management regularly on marketing and placement plans for business expansion. • The Company has a placing mechanism and checklist to ensure timely, appropriate and satisfactory placements of new and used aircraft to minimize the risk of idle asset. • Perform jurisdictional analysis before inception of a lease, except well-developed jurisdictions. • Annual inspection is performed for leased aircraft to monitor its sellable or leasable condition upon the expiry of aircraft lease.
4. Financing Related risks include: – mismatch of business & funding plans – concentration on one financing source – insufficient working capital	• The Company plans its project funding requirements and maintaining cohesive business network with various onshore and offshore financing banks/institutions. • The Company explores other available financing channels to diversify its financing sources.

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Key Risk	Risk Monitoring and Mitigating Measures
5. Delivery of aircraft Related risks include mismatched timing for: – manufacture of aircraft – financing – transfer of titles – delivery to airlines – approval by government	• Regular meetings of professional teams are in place to monitor: a) the manufacturing progress; b) readiness of our customer to take delivery; c) availability of aircraft financing (if required); d) completion of delivery and financing related legal documents. • Comprehensive checklists are used to ensure processes are handled properly and completed as scheduled. • Any failure to meet schedule will be reported immediately to CEO and senior management.
6. Counterparty default and concentration Related risks include: – counterparties unable to fulfill their contractual obligations under aircraft purchases contracts, aircraft lease agreements, aircraft acquisition financing agreements, other financial and relevant transaction agreements	• The Company assesses its counterparty default and concentration risk prior to entering into any agreement through a rigorous selection process and only deal with those counterparties that meet its internal selection criteria and its initial due diligence check. • The Company continues to monitor the creditworthiness of its counterparties after engaging with them through its ongoing monitoring of lease receivable collection status, market news, on-site customer visits, review of the counterparties' financial and operational data and/or other measures considered appropriate. • In case of deteriorating creditworthiness, CEO and senior management are alerted immediately by the appropriate team for taking necessary action(s).
7. Liquidity & interest rate Related risks include: – mismatch of financing terms and lease terms of aircraft deals – fluctuation of market interest rates	To minimize the uncertainty in mismatched future cash flow stream and frequency of refinancing: • The Company structures the lease terms to match that of the loan to the extent that its receipt from lease is sufficient to cover its payment on loan installments throughout the loan term or in line with the realization or refinancing plan of the lease. • The Company manages to maintain a balanced loan portfolio with fixed and floating interest rates by entering into appropriate hedging arrangement on need basis for each deal to mitigate the interest rate risk & balance the overall return. • CEO/CFO approves to execute derivative instruments (i.e. interest rate swap) to hedge against its cash flow and interest rate risk exposure.

Key Risk	Risk Monitoring and Mitigating Measures
8. **Exchange rate** Related risks include: – mismatch of currency on related receipts and payments	• To manage its exchange rate risk, aircraft and lease related contracts (including procurement, placement and disposal) are mostly denominated in USD. • The Company manages this risk by closely monitoring the outstanding foreign currencies positions and preparing regular sensitivity analysis, if significant. Any exceptions will be reported to CFO.
9. **Maintenance and residual value of aircraft** Related risks include: – poor maintenance of aircraft during the lease term	• The Company includes several asset protection clauses in aircraft lease agreement of which its customers are obliged to observe and fulfill the maintenance obligations and reserve, return compensation and re-delivery condition, etc. throughout and upon the expiry of the lease term. • Its airline customers are further required to maintain full value insurance of the leased aircraft and its installed part and restricted from subleasing the leased aircraft without its prior written consent to ensure the actual user of the leased aircraft are indeed its intended customers. • The Company is entitled to and has continuously performed periodic inspection on site of the leased aircraft and the maintenance records to ensure the performance of the maintenance obligations by its customers. • The Company also periodically engage independent professional advisor to assess the fair value of its aircraft portfolio for impairment review. • Any exceptions or non-compliance issues revealed in its monitoring process are reported to CEO and senior management.

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Key Risk	Risk Monitoring and Mitigating Measures
10. Investment value (at exit) Related risks include: – inability to re-lease or dispose the aircraft upon return from lessee.	The Company takes measures to mitigate this risk:– • Choosing popular and easily-marketable aircraft models for acquisition with subsequent regular inspection • Monitoring controls to ensure the aircraft to be returned in sellable or leasable condition. • Monitoring closely the development of aircraft leasing market and carry out early marketing campaign to dispose its finance lease receivable and/or its aircraft at early stage. • Reviewing summary of its aircraft portfolio by senior management to identify any appropriate exit strategy periodically. • Obtain opinion from external legal counsel for each new country's jurisdiction; and keep up to date on major legal developments in countries with existing leases.
11. Financial covenants and settlement obligations Related risks include: – failure to comply with covenants or obligations of signed agreements.	• The Company manages this compliance risk through closely and frequently reviews of covenants compliance status and other conditions as required by the agreement or rules and regulations by using checklist. • Early alert will be flagged to its senior management and CEO if any potential noncompliance event is anticipated.
12. Business secret and information confidentiality Related risks include: – business information leakage – breaching non- disclosure and/or information confidentiality clauses of signed agreements.	• The Company manages this risk by allowing only sufficient but not excessive information made available to the respective functions or teams. • Non-disclosure of business information and non-competitive clauses are also built in its employees' employment agreements to protect its interests upon departure of its employees.

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Key Risk	Risk Monitoring and Mitigating Measures
13. Financial management and tax Related risks include: – cash flow (liquidity) risk – counterparty default (credit) risk – interest rate risk – currency risk – tax risk	• To balance the risk and return, the Company has professional teams to monitor, on a periodic basis, the financial and tax risk exposure of the whole Company by various methods embedded in the respective process, including the interest rate derivative hedging arrangement which is the only derivative hedging allowed by the Strategy Committee. • Approval by CEO (or his delegates) is a must for derivative transaction for hedging which should be in conformity with the Interest Rate Risk Management Policy of the Group. • Monthly cash flow forecast is prepared for review by CFO to ensure sufficient liquidity of its business operations at Corporate level. • External professional advisers are engaged to advise on critical issues arising from business transactions. • Any exception or unexpected exposure is reported to CEO and Strategy Committee for proper action. • The Company manages these risks by preparing regular analysis to closely monitor these risks positions. Any exceptions will be reported to CFO.
14. Capital management & Financial Leverage Related risks include: – inability to continue as a going concern – fluctuation in returns for shareholders and long term shareholders' value	• The Company manages its capital structure and make appropriate adjustments in light of changes in economic condition and its business expansion plan by various means, including issuing new shares, raising new debts or bonds or adjusting dividend payment to shareholders. • The Company reviews its capital requirements at budgeting stage and monitor its asset-liability (gearing) ratio on a monthly basis. • Alert will be made to CFO if the asset-liability or other critical ratio exceeds the threshold set by its annual budget.

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Key Risk	Risk Monitoring and Mitigating Measures
15. Human resources Related risks include: – recruitment and retention of industry talents, key personnel and leaders – compliance of labour laws and regulations in different jurisdictions	• The Company provides training opportunities to staff to grow their talents and offers comparable remuneration and incentive package including bonus and share options. It encourages its employees to attend relevant training courses, either in house or external to keep their business and technical knowledge up-to-date. • The Company adopts standardized operating procedures and drives to have employee succession plan in place to minimize the potential adverse impact on its business operation due to departure of any key personnel. • Human resources team has procedures to satisfy and comply with all relevant labour laws and regulations in different jurisdictions.
16. Compliance Related risks include: – change of government policies affecting the Group's business or operation – disclosure or leakage of business information not accordance with rules and regulations – loss of important agreements	• The Company has designated teams to 1) monitor and follow up changes in existing government policies; 2) monitor changes in regulatory requirements and advise the relevant teams; 3) monitor the compliance of listing requirement (e.g. connected party transactions) on a regular basis; and 4) seek advice from external advisor(s) on new requirements, if necessary. • The Company has a designated corporate communication team to monitor news/media/social media and take initiatives to disclose information timely to stakeholders & the public. • The Company centralizes all key agreements and legal documents in safe custody by designated officers and in a centralized document management system; and standard document lists are maintained for this purpose.

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During the year, the Company achieved the following to mitigate its risks:

- continued to expand its global footprint and signed leases with airlines in different geographic region
- delivered and leased out 26 aircraft on time
- disposed of finance lease receivables for 21 aircraft among which the Group launches China's First Foreign Currency Asset-Backed Security ("ABS") and First Aircraft Leasing ABS (in USD) listed on Shanghai Stock Exchange
- diversified its financing channel through:
  - issuance of USD bonds for totally USD500 million
  - arrangement of USD425 million syndicated loan facility
  - arrangement of Japanese Operating Lease with Call Option (JOLCO) financing with multiple Purchase Option
  - Launch of USD3 billion medium-term note programme in Hong Kong

The diversity of funding channels increased the confidence of investors and banks in the Company and helped reducing its funding costs. In addition, the cash received through various financing channels, for example: issue of bonds and disposal of finance lease receivable, had helped strengthen the Group's cash position during the year and maintained at HK$7,023.4 million at 31 December 2017. The overall liquidity risk and financial leverage risk were considered to be maintained at an acceptable level during the year.

Following the issuance of RMB medium-term notes, the RMB position increased but not considered to be significant. The Company minimises the currency exchange risk by matching the finance lease receivables and borrowings under the same currency and considers hedging significant currency exchange exposure where necessary and appropriate.

The cost of borrowing would be expected to increase following the increase of USD interest rate. With the interest rate swap arrangement, the Company's floating interest rate borrowings were hedged as per our hedging policy. The overall interest rate risk was still considered to be at an acceptable level. In view of the upward trend of the USD interest rate, the interest rate risks would be monitored on an ongoing basis.

Apart from the above, no significant risk event occurred during the year in respect of other business, market, financial or operational risks of the Company and no significant change in the above-mentioned risks was noted during the year.

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