The Pakistan Credit Rating Agency Limited

Rating Report

MCB Islamic Bank Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
27-Jun-2019	A	A1	Stable	Maintain	-
26-Dec-2018	A	A1	Positive	Maintain	-
29-Jun-2018	A	A1	Positive	Maintain	-
16-Oct-2017	A	A1	Stable	Maintain	-
01-Feb-2017	A	A1	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

MIB is a wholly owned subsidiary of MCB Bank Limited (MCB). MCB has long term rating of "AAA" reflecting its robust profile duly supplemented by its strong market position in local banking landscape, established brand equity, and sound financial profile. MIB’s standalone risk profile is improving. The management’s strategy is to focus primarily on high-rated, blue chip corporate clients. Meanwhile, undertaking new business lines including Micro, SME and Consumer financing are also on the horizon. MIB has set relatively high targets for deposit growth and plans to focus on maintaining its financing book quality. Technological implementation and setting governance structure were mile stones achieved by bank in the last year. The thrust of the business plan is to achieve break-even. The bank added branches from parent company resulting in bank's expanded outreach. Increase in advances book added from parent company; asset quality remained intact. Dilution in bank's ADR may provide room for future growth. CASA remained largely same but cost structure of the bank is considered to be under stress. Going forward, monitoring of CAR while expanding lending portfolio and achieving sustainable profitability is essential.

The ratings are dependent on bank's ability to hold its risk profile, while maintaining its relative market position in the banking industry.

Disclosure	
Name of Rated Entity	MCB Islamic Bank Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Financial Institution(Jun-18),Methodology | Criteria | Rating Modifier(Jun-18),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-18)
Related Research	Sector Study | Commercial Bank(Jun-19)
Rating Analysts	Saliha Sajid | saliha.sajid@pacra.com | +92-42-35869504

Profile

Structure MCB Islamic Bank Limited (MIB) was incorporated in Pakistan as an unlisted Public Limited Company in May 2014 with its head office in Lahore. After issuance of Certificate of Commencement of Banking Business by the State Bank of Pakistan (SBP) in September 2015, it started its commercial operations as an Islamic Bank in November 2015.

Background In March 2016, Lahore High Court approved demerger of Islamic Banking Group (IBG) of MCB Bank Limited from MCB and its merger with and into MIB. Resultantly, all domestic Islamic banking operations of MCB-IBG were incorporated into MIB w.e.f September 30, 2015 for PKR 7.9bln.

Operations The Bank is operating as an Islamic Bank in Pakistan with its head office in Lahore. During CY18, the demerger of 90 branches of MCB into MIB took place. The Bank provides financing through shariah compliant financing products including, Ijarah, Murabaha, Diminishing Musharaka, Istisna, Running Musharaka and Export Refinance through Export Refinance Scheme to different segments of its customers.

Ownership

Ownership Structure MIB is a wholly owned subsidiary of MCB Bank Limited. MCB is the country's fourth largest bank in terms of deposit and operates a branch network of 1,376 spread across Pakistan.

Stability Lately, bank has raised PKR 1.2bln (120mln shares @ 10/ share) through right issue which was fully subscribed which shows the sponsor support. So, the stability of the bank will stay intact.

Business Acumen The business acumen of the bank's sponsor is considered strong. Nishat Group has vested interests in various sectors; all companies are successful business models.

Financial Strength The sponsor's financial muscle is considered strong. Apart from MCB Islamic Bank Limited, MCB Bank Limited has five more subsidiaries. The bank rated "AAA/A1+" by PACRA, had an annual net income of PKR 21,359mln for the year ending December, 2018 (end-Dec17: PKR 22,458mln). Nishat Group – the major shareholder in MCB – is a renowned business groups in Pakistan with ventures in cement, real estate, financial sector, insurance, power, food and textile Nishat's total assets are about PKR 2 trillion (USD 16 billion), net worth is about PKR 440 billion (USD 4 billion) and revenue generation is about PKR 275 billion (USD 2.5 billion) in 2017.

Governance

Board Structure The overall control of the bank vests with eight members of the Board of Directors (BoD) including the CEO. Board consist of one independent director and five non-executive members.

Members' Profile Mr. Raza Mansha is the Chairman of the Board. He is accompanied with ~2 decades of diversified experience in various business sectors. Majority of the Board members possess extensive national and international banking and financial services industry experience. So, the overall board profile considered good.

Board Effectiveness The Board exercises close monitoring of the management's policies and the Bank's operations through its Committees. While participating in all Board and Committee meetings, active decision making was ensured.

Financial Transparency M/s KPMG Taseer Hadi & Co, Chartered Accountants (listed as A category of SBP) was appointed as external auditor and has given an unqualified view on the financials of the bank for the year December 31, 2018.

Management

Organizational Structure MIB follows functional structure, where bank's operations are grouped under forteen departments.

Management Team Mr. Muhtashim Ahmad Ashai joined MCB Islamic Bank Limited as CEO, has over twenty-five years of professional experience in the banking sector. He holds a master's degree in Business Administration from LUMS followed by the International Management Program at McGill University, Montreal. He is supported by experienced team members.

Effectiveness The bank has various committees in place at the management level to oversee its day-to-day operational matters and take decisions to implement the strategy outlined by the board.

MIS The frequency of reports generated are daily, weekly, and monthly. The quality of the reports is considered good.

Risk Management Framework The bank established its risk strategy and undertakes controlled risk-taking activities within its risk management framework. The bank has Risk Management & Portfolio Review (RM & PRC), Asset Liability Committee (ALCO). MCB Islamic Bank Limited using Basic Indicator Approach (BIA) for operational risk.

Business Risk

Industry Dynamics The year 2018 was a marked year as the industry saw an expansion of ~22% in advances, although the deposit growth rate stayed in single digit. As a result the industry saw a rise in the ADR ratio from 50% to 55%. In terms of advances expansion, a predominant portion went in to energy sector followed by textile, individuals and agriculture. Corporate sector claimed the major portion of the borrowings with small amounts going into commodity, consumer and SME sectors. Profitability of the banks has taken a hit due to incremental costs and provisioning on account of NPLs. After a lapse of few years the industry NPLs have seen a accretion which is a concern going forward.

Relative Position MIB is a small bank in term of deposits system share which stand at (Deposits: CY18: 0.5%; CY17: 0.25%; Advances: CY17: 1.7%).

Revenues The bank's core markup revenue consists of PKR 4,209mln and other operating income consist of PKR 386mln in CY18.

Performance During CY18, NIMR witnessed an increase of 80% owing to the significant rise in lending book and yield; mark up expenses also doubled. Bank's spread increased to 3.1% (CY17: 2.7%). Non-markup income declined by ~10% (due to lower dividend and income from realized gain on sale of investments) while non-markup expense raised (CY18: PKR 3.0bln; CY17: PKR 1.8bln) due to branches addition. The cost to total net revenue increased to 135% (CY17: 124%). Bank's pre-provision operating profit stood at PKR 785mln. Provisioning expense of PKR 896mln was booked. Resultant loss for the year booked at PKR 1.0bln (CY17: PKR 263mln (Loss). During 1QCY19, NIMR stood at PKR 840mln. Other operating income marginally declined (1QCY19: PKR 65mln, 1QCY18: PKR 66mln). Consequently, with increased non-markup expenses and provisioning the bank booked a loss at PKR 197mln (1QCY18: profit of PKR 45mln).

Sustainability Going forward, MIB plans to improve its performance trend, with primary focus on Murahaba and Musharkah financing. MIB has set relatively high targets for deposit growth. The management's strategy is to focus primarily on high-rated, blue chip corporate clients.

Financial Risk

Credit Risk During CY18, advances book grew by double (CY18: PKR 63bln; CY17: PKR 31bln). ADR declined (CY18: 85.5%; CY17: 95.8%) but still considered high. The off balance sheet exposure is of PKR 20bln (CY17: PKR 8bln). The bank's NPL increased to PKR 11mln (CY17: PKR 1mln) mainly due to almost doubling advances book.

Market Risk The MCB Islamic Banking total trading book only consist of PKR 11bln. MCB Islamic's Investments to Deposits ratio decreased 14.3% in CY18 (CY17: 21.7%) mainly due to increased deposits. MIB invested majorly in Government of Pakistan (GoP) Sukuks (91%), rest of the book (9%) is invested in non strategic equity investments.

Liquidity And Funding During CY18, MIB's customer deposits increased to PKR 62bln (CY17: PKR 27bln). CA proportion in total customer deposits inched up to 41% at CY18 (CY17: ~32%). SA proportion remained same at 50%. CASA ratio increased to 91%; which is a positive. During 1QCY19, customer deposits further increased to PKR 65.1bln (CY18: PKR 62.2bln). Major growth was witnessed in demand deposits of (191%), followed by saving deposits (128%).

Capitalization The bank remained complaint with SBP requirements stated in BPRD Circular No. 10 of 2014. During CY18, the bank received capital injection worth PKR 1.2bln from its parent (MCB). The bank may need more support from its parent. However, as bank is growing in terms of financing MIB's CAR is decreasing to 19.5% at end Mar18 (end-Dec17: 23.8%). The bank's CAR in 1QCY19 stands at 13.4% (1QCY18: 19.5%).

The Pakistan Credit Rating Agency Limited

MCB Islamic Bank Limited

BALANCE SHEET	31-Mar-19	31-Dec-18	31-Dec-17	31-Dec-16
	3MCY19	CY18	CY17	CY16
Earning Assets				
Financing	62,338	62,911	31,314	16,174
Private Sukuks	2,121	2,237	2,087	2,035
Total Financing	64,459	65,148	33,401	18,209
Investments	17,076	10,477	7,100	3,734
Others	6,626	5,654	3,561	2,751
	88,161	**81,280**	**44,061**	**24,695**
Non Earning Assets				
Non-Earning Cash	9,587	7,434	3,933	1,510
Deferred Tax	835	751	289	-
Provision for Loan Losses - Prudential General	(77)	(4)	(0)	(1)
Fixed Assets & Others	6,039	5,434	3,463	2,365
	16,384	**13,615**	**7,685**	**3,874**
TOTAL ASSETS	**104,545**	**94,894**	**51,746**	**28,569**
Remunerative Liabilities				
Deposits	77,987	73,307	32,691	14,279
Borrowings	12,715	7,801	7,927	2,786
	90,701	81,108	40,618	17,065
Non-remunerative Liabilities	3,948	3,717	1,498	1,238
TOTAL LIABILITIES	**94,649**	**84,825**	**42,115**	**18,303**
EQUITY (including revaluation surplus)	**9,896**	**10,070**	**9,631**	**10,266**
Total Liabilities & Equity	**104,545**	**94,894**	**51,746**	**28,569**

INCOME STATEMENT	31-Mar-19	31-Dec-18	31-Dec-17	31-Dec-16
	3MCY19	CY18	CY17	CY16
Profit / Return Earned	1,995	4,209	2,061	1,527
Return Expensed	(1,155)	(2,305)	(1,006)	(577)
Net Revenue	**840**	**1,904**	**1,055**	**950**
Other Income	70	399	439	259
Total Revenue	**910**	**2,303**	**1,494**	**1,209**
Admin and Other Expenses	(1,140)	(3,088)	(1,845)	(1,190)
Pre-provision operating profit	(230)	(785)	(351)	20
Provisions	(37)	(896)	0	94
Pre-tax profit	(268)	(1,680)	(351)	114
Taxes	71	584	88	(34)
Net Income	**(197)**	**(1,096)**	**(263)**	**80**

Ratio Analysis				
Performance				
ROE	-8.0% *	-11.1%	-2.6%	0.8%
Cost-to-Total Net Revenue	126.0%	134.8%	124.4%	99.3%
Provision Expense / Pre Provision Profit	-16.3%	-114.2%	0.0%	-474.6%
Capital Adequacy				
Equity/Total Assets	9.3%	10.5%	19.0%	35.3%
Capital Adequacy Ratio as per SBP	13.4%	13.3%	23.8%	39.7%
Funding & Liquidity				
Liquid Assets / Deposits and Borrowings	31.5%	25.8%	35.3%	58.7%
Advances / Deposits	79.8%	85.8%	95.8%	113.3%
CASA deposits / Total Customer Deposits	85.1%	91.7%	83.0%	67.3%
Intermediation Efficiency				
Asset Yield	9.5% *	6.8%	6.2%	6.4%
Cost of Funds	5.4% *	3.8%	3.5%	4.2%
Spread	4.2% *	3.1%	2.7%	2.1%
Outreach				
Branches	176	176	76	66

Annualized*

Rating Scale

Credit Rating Scale & Definitions

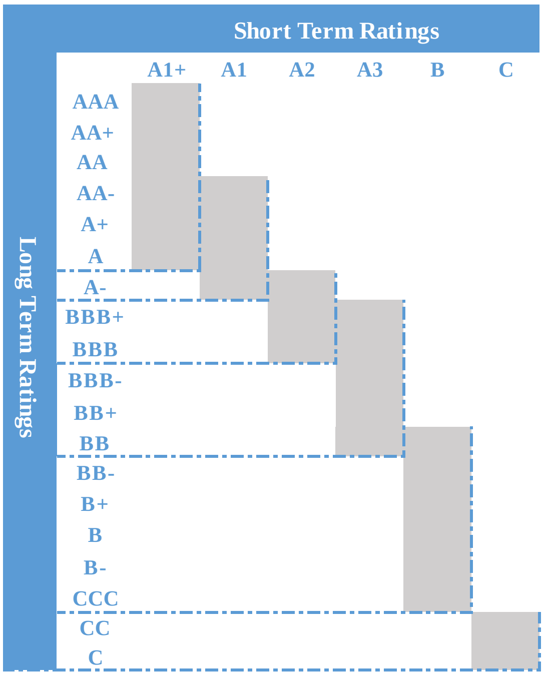
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings

AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default.
D	Obligations are currently in default.

Short Term Ratings

A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
C	An inadequate capacity to ensure timely repayment.



Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Rating Team Statements
(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**
i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)
iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term "family members" shall include only those family members who are dependent on the analyst and members of the rating committee

Restrictions
(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)
(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)
(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

Conduct of Business
(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)
(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.
(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)
(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)
(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest
(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity
(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)
(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)
(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)
(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst's area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)
(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

Monitoring and review
(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)
(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)
(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)
(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)
Probability of Default
(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)
Proprietary Information