The Pakistan Credit Rating Agency Limited

Rating Report

The Bank of Khyber

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
25-Jun-2019	A	A1	Stable	Maintain	-
24-Dec-2018	A	A1	Stable	Maintain	-
25-Jun-2018	A	A1	Stable	Maintain	-
29-Dec-2017	A	A1	Stable	Maintain	-
21-Jun-2017	A	A1	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

The lending portfolio of BoK continued ascending trajectory when NPLs largely remain stagnant; asset quality improved marginally. BoK's ADR increased to ~56% (CY17: 52%). Another reason for the rise in ADR was the less then market growth in the deposit mobilization. The bank's funding base includes customer's deposits and borrowings; there was slight uptick in CASA as compared to last year. Deposit base grew with contribution by savings deposit. The bank has dependence on large ticket deposits from Government of Khyber Pakhtunkhwa (GoKP) and its related institutions. Stability is observed in such deposits, over the years, composing 62% of the public deposits. Treasury Single Account may pose a challenge. During CY18, lesser reliance on borrowings from financial institutes resulted in marginal improvement in cost structure; inched up spread. Other operating income witnessed sharp decline attributable to loss on investments. The slimming total net revenue coupled with maintained cost structure resulted in declined profitability. In the current economic scenario, recovery of NPLs seems a challenge. The ratings incorporate association of the bank with the Government of Khyber Pakhtunkhwa (GoKP). The bank suffered sizable loss on its investment book, though the future losses are not anticipated. It is expected to be cushioned with future profits. The bank needs to beef up and elaborate its investment policy. The bank's CAR stand at 12.3% as at end-Dec18 (Tier-I: 12.2%) – it will need to be increased to 12.5% by end of this year. Profitability in operations is a crucial.

The ratings are dependent on bank's ability to hold its risk profile, while maintaining its relative market position. Improvement in the technology platform is critical to foster the control environment including reporting framework. Meanwhile, any significant infection in asset quality, in the wake of significant expansion in the loan book, and/or any intervention compromising the governance standards would impact negatively.

Disclosure

Name of Rated Entity	The Bank of Khyber
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	Sehar Fatima | sehar.fatima@pacra.com | +92-42-35869504

Commercial Bank

Profile

Structure The Bank of Khyber (BoK) was established in 1991 under the BoK Act, passed by the Provincial Legislative Assembly of the province of Khyber Pakhtunkhwa (KP). It was awarded status of a scheduled bank in September 1994 and is listed on Pakistan Stock Exchange (PSX).

Background BoK was established with a vision to gradually promote Islamic banking. At present, 84 of its branches function as dedicated Islamic banking branches, whereas 82 cater conventional banking. The bank has a separate Islamic banking group under its structure looking after operations of Islamic branches and devising new shariah compliant products.

Operations The Bank of Khyber is operating as a scheduled bank. The bank registered office is located at The Mall – Peshawar Cantt. The bank is operating with 169 branches (including 84 Islamic branches). It operates with ~1,388 employees. The branch network is mainly concentrated in the province of KP and also increasing in Punjab, while having limited presence in all other provinces of Pakistan.

Ownership

Ownership Structure The Government of Khyber Pakhtunkhwa (GoKP) has majority stake in BoK (70%), whereas, Ismail Industries has 24.2%. The remaining shareholding is widely dispersed.

Stability As the Government of Khyber Pakhtunkhwa shareholding remained 70% for many years and Ismail Industries shareholding increased in 2015; its evident of the confidence of sponsor on the bank. The bank's shareholding will remain stable for the longer term.

Business Acumen The Khyber Pakhtunkhwa is one of the biggest province of Pakistan. Ismail Industries Limited was incorporated as a public limited company in 1989, and Ismail Industries is one of the largest food companies in Pakistan, manufacturing a wide range of confectionery, biscuits, snacks and packaging films under the brand names of CandyLand, Bisconni, SnackCity and Astro Films respectively. The company is rated as A/ A1 by The Pakistan Credit Rating Agency (PACRA). During 1QFY19, the company reported assets PKR 23bln, revenue PKR 7bln and net income of PKR 392mln. The financial strength of the sponsors considered strong.

Financial Strength As the bank is backed by Government of Khyber Pakhtunkhwa; financial strength of sponsor is considered good.

Governance

Board Structure The board comprises eight members including CEO, out of which three are non-executive directors and two are independent directors. Board composition is in line with the parameters set in the BoK Act.

Members' Profile The profile of the members is considered adequate; government dominated board. Dr. Shahzad Khan Bangash, MBBS doctor by profession, is the Chairman of the board. He has been associated with Government of KPK from many years. All other members are adequate experienced professionals.

Board Effectiveness The board monitors the key functional and risk areas through its four committees as per SBP instruction. During the year, board had total 6 meetings and the attendance of members is considered strong.

Financial Transparency The auditors of the bank, M/S Grant Thornton Anjam Rahman, Chartered Accountants has expressed an unqualified opinion on the bank's financial statements for the year ended December 31, 2018 and also highlighted the important matters as per the new instruction of the regulators. As Grant Thornton Anjam Rahman have completed their term of five years. The board has proposed the name M/S EY Ford Rhodes for the year December 31, 2019.

Management

Organizational Structure The bank's overall functions are currently segregated into twelve divisions. Out of these functions, the internal audit function reports to Board Audit Committee in line with the code of corporate governance. The remaining functions report to the MD.

Management Team Mr. Saif ul Islam has been appointed as the new CEO of bank on December 4, 2018. He is a seasoned banker with forty years of diverse experience mainly in banking industry. Other senior management consists of seasoned professionals.

Effectiveness The bank has 10 committees in place at the management level with well-defined terms of reference to oversee its day-to-day operational matters and to take decisions to implement the strategy outlined by the board. But the effectiveness of the committees during the year considered weak.

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

Risk Management Framework BoK has established separate risk management, credit management and compliance and internal control divisions. The IRMC and ALCO of management operate within the established framework in order to monitor the bank's activities and maintain the risk level within predefined limits. The operational risk management of the bank is also considered adequate

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 The Bank of Khyber - a small sized bank with sustained system share YoY (Deposits: CY18: 1.3%; CY17: 1.3%).

Revenues The bank of Khyber has both core income and other operating income; majorly dominated by core income.

Performance During CY18, NIMR showed an increase of ~7% (CY17: 9%) attributable to increase in asset yield due to interest rate rise. Cost of funds inched down due to lesser rely on borrowings as funding source. Hence, spread inched up to 2.5% (CY17: 2.3%). Other operating income reported at negative PKR 631mln (CY17: PKR 1,545mln) mainly due to losses on Government securities. Non-markup expenses were kept in check slight increase of 8% (CY17: 18%). Net provision of PKR 171mln (CY17: PKR 123mln) was book. Hence, bottom-line booked at PKR 466mln (CY17: PKR 1,790mln). During the year, Bank's return on asset (ROA) and return of equity (ROE) impacted to 0.2% (CY17: 0.8%) and 3.2% (CY17: 12.1%).

Sustainability PGoing forward, BoK, is trying to stabilize its performance in current stretched economic environment of the country. Furthermore, sustained profitability remains essential for the bank as the bank was not able to achieve targeted PBT during the year.

Financial Risk

Credit Risk During the year, gross advances grew by 13% (CY17: 143%) whereas earning assets were down by 13%; attributable to Investments down by 36%. The client concentration remained high with top 20 customers demonstrating ~63% of overall advances (CY17: 69%); considered high. The bank's portfolio comprises ~50% both government and private segment. The bank has off balance sheet exposure of PKR 29bln (CY17: PKR 20bln). NPLs decreased by ~3% due to some settlements. Asset quality marginally improved as reflected by NPLs to Gross Advances ratio (CY18: ~5%; CY17: ~6%); mainly due to sizable addition of PKR 12bln in advances.

Market Risk The bank of Khyber's total trading book reported at PKR 115bln in CY18 (CY17: PKR 152bln), which implies decrease. The bank's investment to deposit ratio decreased significantly at 51% (CY17: 86%) due to decrease in government securities; previously banks invested in PIBs most of which are maturing this year and due to interest rate scenario the banks have to bear losses on yield. Government securities continued to dominate the bank's investments which comprised 99% of total investments in CY18 same as previous year (CY17: 99%).

Liquidity And Funding Bank's liquidity position, emanating from investment in government securities, weakened on YoY basis as reflected in liquid assets as percentage of total deposits and borrowing (CY18: 49%; CY17: 59%). The bank was able to grow its deposit base by 7% as compared to previous year (CY17: 1%); mainly Government (Federal/ Provincial). CASA proportion slightly inched up 56% in CY18 (CY17: ~53%). Top-20 depositors' concentration decreased to 46% (CY17: 50%) but still on the higher side as the most of the deposits are government owned funds. During the year, bank has decreased its borrowing to PKR 34,842mln (CY17: PKR 64,190mln).

Capitalization The bank's total equity stands at PKR 14bln (CY17: PKR 15bln). The bank's CAR has reached an edge 12.3% as CAR is reaching maximum limit by CY19 at 12.5%. Currently, the bank has no instrument to support CAR. Going forward, bank's CAR is expected to come under pressure.

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Financial Summary

The Bank of Khyber

BALANCE SHEET	31-Dec-18	31-Dec-17	31-Dec-16
Earning Assets			
Advances (Net of NPL)	94,509	82,864	30,598
Debt Instruments	6,958	4,082	3,604
Total Finances	101,467	86,947	34,202
Investments	87,275	136,391	138,286
Others	8,456	2,282	16,393
	197,198	**225,620**	**188,881**
Non Earning Assets			
Non-Earning Cash	15,296	11,421	11,052
Deferred Tax	1,757	380	-
Net Non-Performing Finances	503	505	758
Fixed Assets & Others	8,340	7,207	5,709
	25,897	**19,513**	**17,519**
TOTAL ASSETS	**223,095**	**245,132**	**206,400**
Interest Bearning Liabilities			
Deposits	171,168	159,247	157,020
Borrowings	34,842	64,190	28,701
	206,010	223,437	185,721
Non Interest Bearing Liabilities	5,381	6,298	4,537
TOTAL LIABILITIES	**211,390**	**229,734**	**190,258**
EQUITY (including revaluation surplus)	**11,705**	**15,398**	**16,143**
Total Liabilities & Equity	**223,095**	**245,132**	**206,400**

INCOME STATEMENT	31-Dec-18 Annual	31-Dec-17 Annual	31-Dec-16 Annual
Interest / Mark up Earned	14,686	14,375	12,049
Interest / Mark up Expensed	(9,547)	(9,576)	(7,643)
Net Interest / Markup revenue	**5,139**	**4,799**	**4,406**
Other Income	(631)	1,545	2,584
Total Revenue	**4,509**	**6,344**	**6,990**
Non-Interest / Non-Mark up Expensed	(4,077)	(3,778)	(3,209)
Pre-provision operating profit	536	2,672	3,871
Provisions	(171)	(123)	631
Pre-tax profit	707	2,795	3,240
Taxes	(241)	(1,005)	(1,219)
Net Income	**466**	**1,790**	**2,020**

Ratio Analysis	31-Dec-18 Annual	31-Dec-17 Annual	31-Dec-16 Annual
Performance			
ROE	3% *	12%	14%
Cost-to-Total Net Revenue	90%	60%	46%
Other operating income/ Total net revenue	-14%	24%	37%
Capital Adequacy			
Equity/Total Assets	6%	6%	7%
Capital Adequacy Ratio as per SBP	12%	20%	21%
Funding & Liquidity			
Liquid Assets / Deposits and Borrowings	49%	59%	83%
Advances / Deposits	56%	52%	20%
CASA deposits / Total Customer Deposits	56%	53%	61%
Intermediation Efficiency			
Asset Yield	7% *	7%	7%
Cost of Funds	-4% *	-5%	-5%
Spread	3% *	2%	3%
Outreach			
Branches	169	166	150

** 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.

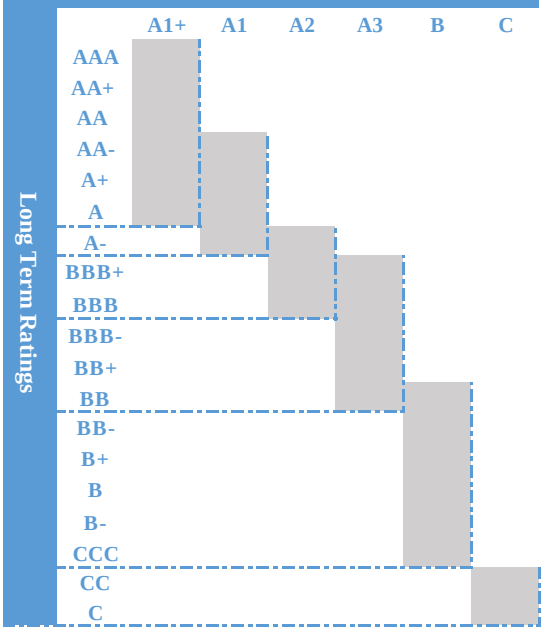
Long Term Ratings

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.

Short Term Ratings



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