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
24-Dec-2019	A	A1	Stable	Maintain	-
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	-
30-Jun-2016	A	A1	Stable	Maintain	-
30-Jun-2015	A	A1	Stable	Maintain	-
30-Jun-2014	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 ~60.3% (CY18: 50.5%). The bank's funding base includes customer's deposits and borrowings; CA proportion slightly decreased 22.7% at end- Sep19 (end-Dec18: ~23.5%) while SA increased to 37.6% in 9MCY19 (CY18: ~33%). 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. During 9MCY19, lesser reliance on borrowings from financial institutes resulted in marginal improvement in cost structure; inched up spread. Other operating income witnessed decline attributable to fee and commission income and gain 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). It is expected to be cushioned with future profits. The bank needs to beef up and elaborate its investment policy. The bank's total equity stands at PKR 14,407mln (CY18: PKR 11,705mln). The bank's CAR stand at 12.6% – The legal requirement as on 31st Dec,2019 is going to be 12.5%. 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	PACRA_Methodology_FI_FY19(Jun-19),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-19),Criteria | Rating Modifier(Jun-19)
Related Research	Sector Study | Commercial Bank(Jun-19)
Rating Analysts	Sehar Fatima | sehar.fatima@pacra.com | +92-42-35869504

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 85 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.

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, has ceased to be the Chairman of the Bank w.e.f 29th October,2019. Mr Shakeel Qadir Khan was appointed as a Chairman on 23rd Dec,2019. 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. The firm is listed in category "A" by the approved panel of auditors maintained by SBP. An interim review was conducted for the six months ending June 30th, 2019.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.The firm is also listed in category "A" by the approved panel of auditors maintained by SBP.

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. Ihsan Ullah Ihsan has been appointed as the new acting CEO of bank on December 9, 2019. He is a seasoned banker with twenty six of diverse experience mainly in banking industry. He was an Executive vice president/Credit risk officer of bank since Jun, 18. 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 Despite challenging macroeconomic environment, banking sector maintained its growth trajectory during 9MCY19, backed by decent growth in deposits (9MCY19: PKR 14,945bln; 9MCY18: 13,603bln). However, lending was largely skewed towards investments and particularly towards government instruments due to favorable interest rate dynamics (9MCY19: PKR 9,641bln; 9MCY18: 6,942bln). Meanwhile, advances witnessed a slowdown owing to subdued economic activity, cautious lending approach and monetary tightening (9MCY19: PKR 9,014bln; 9MCY18: 4,422bln). Asset quality saw some deterioration – increased NPLs, particularly in sugar and energy sectors (9MCY19: PKR 758 bln; 9MCY18: 637bln). The profitability of the banking sector improved due to increase in Net Interest Income, which translated positively in other profitability indicators. The overall risk profile of the banking sector remained satisfactory.

Relative Position The Bank of Khyber - a small sized bank with sustained system share deposits in 9MCY19: 1.3% (CY18: 1.3%). During 9MCY19, the bank was able to show growth in terms of deposits by 13.8%; in terms of advances, bank showed a decline of 9%.

Revenues During 9MCY19, the Bank reported a 63% increase on the net markup income of PKR 17,304mln (9MCY18: PKR 10,618mln). Net interest showed a decrease of ~4.9% (9MCY19: PKR 3,766mln, 9MCY18: PKR 3,961mln) YoY, driven by an increase in net markup expense (9MCY19: PKR 13,539mln, 9MCY18: PKR 6,657mln). The total net income of the bank decreased by approximately 4.1 % to PKR 4,318 over the period of 9MCY19 (9MCY18: PKR 4,505).

Performance Profit before tax of the Bank decreased by 41% over last year and was reported at PKR 900mln (9MCY18: PKR 1,524mln). Provisioning expense increased over the previous year (9MCY19: PKR 161mln, 9MCY18: PKR 7mln). The bank's yield on advances was impacted positively by increasing interest rates environment and stood at 11.7% (9MCY18: 7.1%). The core spreads increased slightly to 3.4% during 9MCY19 (9MCY18: 3.0%).

Sustainability Going 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 9MCY19, gross advances grew by 25% (CY18: 14%); Total earning assets and investments also up by 37% and 52% respectively. At end 9MCY19, the Non-performing loan base of the Bank increased by ~39% of PKR 698mln (CY18: PKR 503mln). NPLs to Gross Advances ratio (9MCY19: ~4.3%; CY18: ~4.7%); mainly due to sizable addition of PKR 23bln in advances. Credit risk over advances decreased to 52.2% at end-Sep19 (end-Dec18: 58.6%).

Market Risk During 9MCY19 the bank's total fixed income investment ratio increased significantly at 46.8% (CY18: 42.1%) due to increase in government securities. BOK's net investments of PKR 132bln which constitutes ~99.7% of government securities.

Liquidity And Funding The bank's liquidity, measured in Liquid Assets / Deposits and Borrowings, decreased slightly to 42.9% in 9MCY19 (CY18: 45.1%). In 9MCY19 total Deposits were reported at PKR 187bln (CY19: PKR 171bln) – mainly led by growth in saving accounts at 25%. CA proportion slightly decreased 22.7% at end-Sep19 (end-Dec18: ~23.5%) while SA increased to 37.6% in 9MCY19 (CY18: ~33%). During 9MCY19, Liquidity coverages ratio of the Bank is 118.2% (CY18: ~109.7%).In 9MCY19 the ADR of the bank is increased by 60.3 %(CY18: ~50.5%).

Capitalization The bank's total equity stands at PKR 12,859mln (CY18: PKR 11,705mln). During 9MCY19, Equity over Total assets decreased to 4.3% (CY18: ~5.2%). The CAR of the bank stand at 12.6% - The legal requirement as on 31st Dec,2019 is going to be 12.5% . The CAR of the bank is under pressure.

PKR mln

The Bank of Khyber Listed Public Limited	Sep-19 9M	Dec-18 12M	Dec-17 12M	Dec-16 12M
A BALANCE SHEET				
1 Total Finances - net	125,004	101,467	86,947	34,202
2 Investments	132,459	87,275	136,391	138,286
3 Other Earning Assets	13,123	8,456	2,282	16,393
4 Non-Earning Assets	26,128	25,394	19,008	16,761
5 Non-Performing Finances-net	698	503	505	758
Total Assets	297,412	223,095	245,132	206,400
6 Deposits	187,256	171,168	159,247	157,020
7 Borrowings	85,565	34,842	64,190	28,701
8 Other Liabilities (Non-Interest Bearing)	11,732	5,381	6,298	4,537
Total Liabilities	284,553	211,390	229,734	190,258
Equity	12,859	11,705	15,398	16,143
B INCOME STATEMENT				
1 Mark Up Earned	17,304	14,686	14,375	12,049
2 Mark Up Expensed	(13,539)	(9,547)	(9,576)	(7,643)
3 Non Mark Up Income	553	(526)	1,651	2,673
Total Income	4,318	4,613	6,450	7,079
4 Non-Mark Up Expenses	(3,258)	(4,077)	(3,778)	(3,209)
5 Provisions/Write offs/Reversals	(161)	171	123	(631)
Pre-Tax Profit	900	707	2,795	3,240
6 Taxes	(302)	(241)	(1,005)	(1,219)
Profit After Tax	598	466	1,790	2,020
C RATIO ANALYSIS				
1 Performance				
Net Mark Up Income / Avg. Assets	1.9%	2.2%	2.1%	2.4%
Non-Mark Up Expenses / Total Income	75.4%	88.4%	58.6%	45.3%
ROE	6.5%	3.4%	11.4%	12.6%
2 Capital Adequacy				
Equity / Total Assets (D+E+F)	4.3%	5.2%	6.3%	7.8%
Capital Adequacy Ratio	12.6%	12.3%	20.0%	21.3%
3 Funding & Liquidity				
Liquid Assets / (Deposits + Borrowings Net of Repo)	42.9%	45.1%	58.8%	82.1%
(Total Finances - net + Net Non-Performing Advances + Net Non-Performing Debt Instruments) / Deposits	67.1%	59.6%	54.9%	22.3%
CA Deposits / Deposits	22.7%	23.5%	22.9%	22.5%
SA Deposits / Deposits	37.6%	33.0%	30.0%	38.3%
4 Credit Risk				
Non-Performing Advances / Gross Advances	4.3%	4.7%	5.5%	15.1%
Non-Performing Finances-net / Equity	5.4%	4.3%	3.3%	4.7%

Rating Scale | Corporate

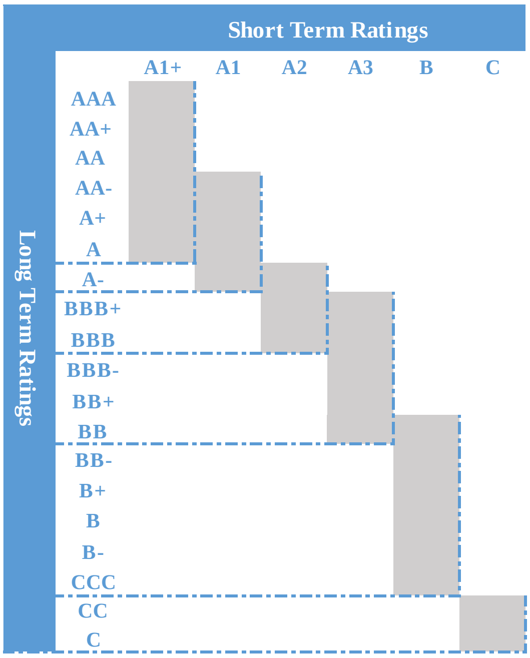
2019

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.

Regulatory and Supplementary Disclosure

(Credit Rating Companies Regulations,2016)

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