RATING REPORT

Silk Bank Limited

REPORT DATE:
October 16, 2020

RATING ANALYSTS:

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RATING DETAILS				
Rating Category	**Latest Rating**		**Previous Rating**	
	Long-term	**Short-term**	**Long-term**	**Short-term**
Entity Rating	A-	A-2	A-	A-2
TFC	BBB+		BBB+	
Outlook	Rating Watch-Negative		Rating Watch-Developing	
Date	*October 12, 2020*		*March 1, 2020*	

COMPANY INFORMATION	
Incorporated in 1994	**External auditors:** Grant Thornton Anjum Rahman Co. Chartered Accountants
Public Limited Company	**Chairman of the Board:** Khalid Aziz Mirza
Key Shareholders (with stake 5% or more):	**Chief Executive Officer:** Azmat Tarin (at end-June'2020)
Arif Habib Corporation Limited – 28.23% Shaukat Tarin – 11.55% International Finance Corporation – 7.74% Zulqarnain Nawaz Chattha – 7.47%	

APPLICABLE METHODOLOGY	
VIS Commercial Banks Rating	*https://s3-us-west-2.amazonaws.com/backupsqlvis/docs/Meth-CommercialBanks201803.pdf*

Silk Bank Limited

OVERVIEW OF THE INSTITUTION

Silk Bank Limited (Silk) was incorporated as a public listed company in 1994. Ownership of the bank is shared by Arif Habib Corporation, Mr. Shaukat Tarin, Gourmet Group and International Finance Corporation.

Profile of Chairman

Khalid Aziz Mirza served for 14 years in various positions in Investment Corporation of Pakistan (ICP), and Credit & Finance Corporation London, Subsequently, for about two decades, he remained on the professional investment staff of the International Finance Corporation (IFC) (Member, World Bank Group).

Profile of CEO (at end-June'2020)

Mr. Azmat Tarin is the President & CEO of Silkbank since October 2008. Prior to which, he was the Executive Director in Silkbank. He was re-appointed as Executive Director on the Board of the Bank on March 22, 2019.

RATING RATIONALE

Silk Bank Limited (Silk) is a small sized listed commercial bank with a market share of 1.02% (2018: 0.99%) in domestic deposits as at end-2019. The bank operates through 123 branches (2018: 123) including 30 (2018: 30) Islamic branches located across the country.

<u>Key Rating Drivers:</u>

Given sizeable accretion of fresh NPLs in the Islamic banking portfolio as has been previously highlighted, overall asset quality indicators deteriorated while provisioning coverage is low due to FSV coverage. Credit risk assessment and monitoring needs to be strengthened.

Gross financing portfolio increased by 8.4% in 2019 with growth manifested in corporate (including Islamic financing) and consumer advances. Gross advances declined by 2% to Rs. 110.2b (2019: Rs. 112.2b, 2018: Rs. 103.6b) at end-Mar'20. Corporate portfolio features concentration is real estate based counterparties. Asset quality indicators of the bank witnessed significant weakening during 2019 and 1Q20 on account of sizeable increase in NPL portfolio of the Bank. Most of the fresh increase in NPLs pertained to Islamic portfolio with clients engaged in the businesses of real-estate/construction sector. This is mainly due to slow down in the business activities of these sectors, tax issues relating to these businesses and the ban on construction of high rise buildings in Karachi. Resultantly, gross infection in the portfolio weakened to 30.94% (2018: 6.4%; 2017: 6.45%) while total provisioning coverage plunged to 20% (2018: 78%) at end-2019. The management has a recovery plan in place with the same targeted to be materialized in 4Q20. Asset quality pressures may emanate from concentration of large-ticket exposure against closely-linked groups/companies. Accordingly, close monitoring of exposures of existing clientele and speedy recovery from NPLs is warranted from a ratings perspective.

Consumer financing continued to depict double digit growth across all three products (personal installment loan, ready line and credit cards) with overall portfolio growth recorded at 13% in 2019. In contrast to other peer banks, lending in the consumer portfolio is entirely in the unsecured segment where the Bank is amongst the leading players. Gross infection in the consumer portfolio increased to 3.74% (2018: 2.80%) at end-Dec'2019 but remains below industry norms. Maintaining sound asset quality indicators in the consumer portfolio is important given the sizeable contribution of the segment to Bank's overall profitability. Going forward, management plans to pursue a conservative lending strategy with decline targeted in corporate exposure (both conventional and Islamic) with growth planned to continue in consumer segment. Moreover, Bank also plans to venture in mortgage financing. However, fresh liquidity is planned to be primarily deployed in real estate based counterparties.

Sizeable exposure undertaken in PIBs while duration has been maintained on the higher side

Silk's investment portfolio witnessed substantial increase in 2019 and during the ongoing year. Exposure has been built in PIBs to earn capital gains in anticipation of decline in interest rates. Credit Risk emanating from investment portfolio is considered minimal, as around 99% of the investment portfolio was deployed in GoP securities at end-June'20. However, duration has been maintained on the higher side at around 4 years in anticipation of further decline in interest rates.

Deposit base witnessed growth in 2019. However, deposit mix and concentration has room for improvement. Liquidity buffer on balance sheet has increased on a timeline basis while the Bank has achieved compliance with liquidity coverage ratio at end-June 2020.

Deposit base increased by 12.2% and 7% to Rs. 148.8b and Rs. 159b at end-2019 and 1Q20, respectively. Increase in deposit base was manifested in growth in high cost saving and fixed deposits.

Consequently, proportion of non-remunerative current accounts in deposit mix declined. Going forward, Silk plans to reduce its cost of deposits by shedding high cost deposits and replacing them with low cost deposits. Depositor concentration is sizeable (top 50 depositors represent 47.1% of aggregate deposits at end-Mar'20) although proportion of hot deposits as per Bank's internal criteria (deposits above Rs. 450m) have declined have decline from 47% in January 2019 to 42% in July 2020. Improving deposit concentration and mix remains a key focus area for the management.

With growth in deposits being higher than advances during 2019 and 1Q20, advances to deposits ratio (ADR) (adjusted for export refinance scheme) improved to 68.2% (2019: 74.3%; 2018: 76.8%) at end-1Q20. As at end-Mar'20, Silk's Average Liquidity Coverage Ratio (LCR) for 2Q2020 increased and stood at 107.52% (three months numbers are 94.24%, 94.27% and 106.06%) which was higher than the regulatory requirement of 100%. Reduction in corporate portfolio and deploying the same in liquid avenues as planned by management will result in increase in liquidity buffer carried on the balance sheet. The monthly trend is as follows:

Average LCR -2020								
Months	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Average LCR
LCR	94.24%	94.27%	106.06%	112.79%	115.26%	116.88%	118.33%	107.52%

Profitability profile of the bank weakened during 2019 on account of decline in spreads (sizeable suspended markup income from non-performing portfolio), higher provisioning charges and increase in expense base. For 2020, sizeable capital gains and targeted provision reversal are expected to support profitability indicators.

The Bank incurred a sizeable net loss in 2019 due to decline in net spreads (sizeable suspended markup income from non-performing portfolio), sizeable provisions against NPLs and higher administrative expenses. In absolute terms, the Bank posted an operating loss during 2019 amounting Rs. 3.7b. Given the decline in operating profitability, efficiency ratio depicted deterioration to 184% (2018: 80%). Overall profitability of the Bank was supported by capital gains recognized on the investment portfolio during 2019 amounting to Rs. 538m. During 1H20, the Bank has recognized Rs. 5.6b capital gains on its government securities portfolio due to timely exposure in fixed rate PIBs prior to commencement of discount rate cuts while provisioning reversals (due to additional collateral obtained and restructuring of non-performing exposures) are also targeted to support profitability. The latter will also facilitate in reversal of suspended markup income. Expiry of earning OREOs over the rating horizon and low likelihood of these being repaid may result in an increase in already sizeable non-earning asset base.

Capitalization indicators are weak given significant losses incurred

Capital Adequacy Ratio (CAR) of the bank was reported at 5.81% as at December 31, 2019, against minimum requirement of 11.5%. Non-compliance was on account of sizeable losses incurred during 2019 on account of regulatory provisioning against delinquent loans which depleted equity of the Bank. However, as of June 30, 2020, CAR improved to 8.36% mainly due to realization of significant capital gains on Government Securities. While declining on a timeline basis, Non-Earning Assets (NEAs) remain sizeable in relation to total assets and bank's own equity.

The Bank has the following plan to meet its MCR and CAR requirements:

- Capital Injection through a right issue to the tune of Rs 7 to 10 billion.
- Restructuring of NPL exposure from a single group.

Timely achievement of planned reduction in RWAs, disposals of non-banking assets, quantum of future profits and quality of exposures will be important determinants for achieving regulatory compliance capitalization requirements.

Mr. Tarin is a career banker with an experience of over 30 years. He started his career in Branch Operations in Lincoln Savings, California, in 1989. Subsequently, he moved to Saudi American Bank in Riyadh, where he was involved in a project of centralizing operations. He has also attended the Management Associate Program at the Saudi American Bank. His first banking assignment in Pakistan was with Union Bank Ltd. from 1999 to 2006 as Head of Retail Banking, where he was a part of the core team that turned the bank into one of the most profitable banks of the country. In addition, he served on the Board of Union Leasing from 2001 to 2006. He is also serving as a Director of Sinthos Capital Holding Ltd.

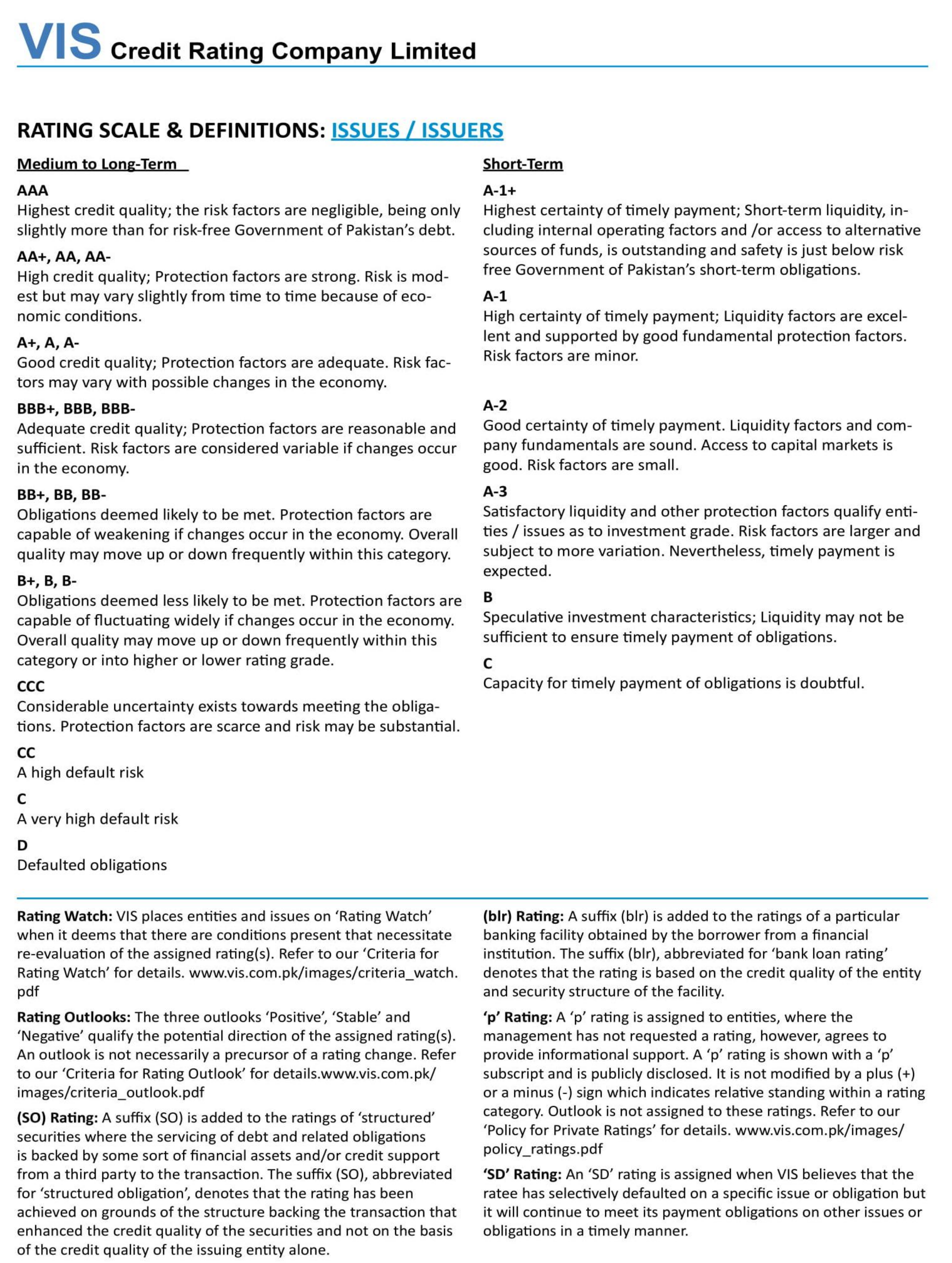
Mr. Tarin is a Master of Business Administration (MBA) in Management Sciences from Pepperdine University, Los Angeles, California.

FINANCIAL SUMMARY *(amounts in PKR millions) – Annexure I*

BALANCE SHEET	**2017**	**2018**	**2019**	**1H20***
Investments	38,267	28,925	36,245	133,219
Net Advances	85,851	98,354	105,375	100,935
Total Assets	166,855	176,571	205,688	288,900
Borrowings	35,582	18,052	31,973	106,169
Deposits & other accounts	110,278	132,664	148,854	157,256
Subordinated Loans	2,000	2,000	2,125	2,206
Paid Up Capital	23,431	23,431	23,431	23,431
Tier-1 Equity	10,177	11,627	6,331	9,552
Net Worth	13,181	14,387	10,772	12,798
INCOME STATEMENT				
Net Spread Earned	5,486	6,605	1,616	867
Net Provisioning / (Reversal)	-289	-1,269	-2,433	-939
Non-Markup Income	2,943	3,415	3,236	6,921
Administrative expenses	-6,434	-6,781	-8,051	-3,587
Profit/ (Loss) Before Tax	1,387	1,877	-5,829	3,180
Profit / (Loss) After Tax	1,135	1,330	-3,953	1,886
RATIO ANALYSIS				
Gross Infection	6.50%	6.45%	30.94%	32.81%
Provisioning Coverage	73%	78%	20%	20%
Net Infection	2.46%	2.17%	26.99%	28.66%
Cost of deposits	4.03%	8.55%	8.56%	9.14%
Gross Advances to Deposits Ratio	80%	77%	74%	68%
Net NPLs to Tier-1 Capital	20%	17%	403%	284%
Capital Adequacy Ratio (CAR)	10.94%	10.92%	5.81%	8.36%
Markup Spreads	3.73%	3.74%	1.09%	1.01%
Efficiency	92%	80%	184%	248%
FFO	NA	NA	NA	NA
Current Ratio	NA	NA	NA	NA
Gearing	NA	NA	NA	NA
ROAA	0.80%	0.80%	-2.10%	1.50%
ROAE	9.00%	9.60%	-31.70%	32.90%
Liquid Assets to Deposits & Borrowings	26.80%	29.90%	28.00%	29.10%

** Annualized*

ISSUE/ISSUER RATING SCALE & DEFINITIONS Appendix II



VIS Credit Rating Company Limited

RATING SCALE & DEFINITIONS: ISSUES / ISSUERS

Medium to Long-Term

AAA
Highest credit quality; the risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

AA+, AA, AA-
High credit quality; Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A-
Good credit quality; Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB+, BBB, BBB-
Adequate credit quality; Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB+, BB, BB-
Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B+, B, B-
Obligations deemed less likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC
Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC
A high default risk

C
A very high default risk

D
Defaulted obligations

Short-Term

A-1+
Highest certainty of timely payment; Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

A-1
High certainty of timely payment; Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2
Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3
Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B
Speculative investment characteristics; Liquidity may not be sufficient to ensure timely payment of obligations.

C
Capacity for timely payment of obligations is doubtful.

Rating Watch: VIS places entities and issues on 'Rating Watch' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). Refer to our 'Criteria for Rating Watch' for details. www.vis.com.pk/images/criteria_watch.pdf

Rating Outlooks: The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details.www.vis.com.pk/images/criteria_outlook.pdf

(SO) Rating: A suffix (SO) is added to the ratings of 'structured' securities where the servicing of debt and related obligations is backed by some sort of financial assets and/or credit support from a third party to the transaction. The suffix (SO), abbreviated for 'structured obligation', denotes that the rating has been achieved on grounds of the structure backing the transaction that enhanced the credit quality of the securities and not on the basis of the credit quality of the issuing entity alone.

(blr) Rating: A suffix (blr) is added to the ratings of a particular banking facility obtained by the borrower from a financial institution. The suffix (blr), abbreviated for 'bank loan rating' denotes that the rating is based on the credit quality of the entity and security structure of the facility.

'p' Rating: A 'p' rating is assigned to entities, where the management has not requested a rating, however, agrees to provide informational support. A 'p' rating is shown with a 'p' subscript and is publicly disclosed. It is not modified by a plus (+) or a minus (-) sign which indicates relative standing within a rating category. Outlook is not assigned to these ratings. Refer to our 'Policy for Private Ratings' for details. www.vis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when VIS believes that the ratee has selectively defaulted on a specific issue or obligation but it will continue to meet its payment obligations on other issues or obligations in a timely manner.

REGULATORY DISCLOSURES Appendix III

Name of Rated Entity	Silk Bank Limited
Sector	Commercial Banks
Type of Relationship	Solicited
Purpose of Rating	Entity & TFC Rating

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
12-Oct-20	A-	A-2	Rating Watch-Negative	Maintained
03-Jan-20	A-	A-2	Rating Watch-Developing	Reaffirmed on Rating Watch
27-Jun-19	A-	A-2	Stable	Maintained
29-Jun-18	A-	A-2	Positive	Maintained
30-Jun-17	A-	A-2	Stable	Reaffirmed
30-Jun-16	A-	A-2	Stable	Reaffirmed
30-Jun-15	A-	A-2	Stable	Reaffirmed
18-Dec-14	A-	A-2	Stable	Rating Watch Removed
30-Jun-14	A-	A-2	Rating Watch – Developing	Rating Watch – Developing
29-Jun-13	A-	A-2	Stable	Maintained
22-Oct-12	A-	A-3	Rating Watch – Developing	Maintained
18-Aug-11	A-	A-2	Rating Watch – Developing	Reaffirmed
25-Feb-11	A-	A-2	Rating Watch – Developing	Maintained

Rating Date	Medium to Long Term	Rating Outlook	Rating Action
RATING TYPE: TFC-1			
12-Oct-20	BBB+	Rating Watch-Negative	Maintained
03-Jan-20	BBB+	Rating Watch-Developing	Downgrade on Rating Watch
20-Nov-18	A-	Stable	Final
24-Apr-17	A-	Stable	Preliminary

Instrument Structure	Unsecured, subordinated privately placed Tier 2 TFC amounting to Rs. 2.0billion (inclusive of Green Shoe Option of Rs. 500million). The TFC has a tenor of 8 years with semi-annual profit payment frequency. Purpose of TFC issuance is to support the bank in strengthening its overall capitalization indicators.
Statement by the Rating Team	VIS, the analysts involved in the rating process and members of its rating committee do not have any conflict of interest relating to the credit rating(s) mentioned herein. This rating is an opinion on credit quality only and is not a recommendation to buy or sell any securities.
Probability of	VIS' ratings opinions express ordinal ranking of risk, from strongest to weakest,

<table>
<tr><td>Default</td><td>within a universe of credit risk. Ratings are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.</td></tr>
<tr><td>Disclaimer</td><td>Information herein was obtained from sources believed to be accurate and reliable; however, VIS does not guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. For conducting this assignment, analyst did not deem necessary to contact external auditors or creditors given the unqualified nature of audited accounts and diversified creditor profile. Copyright 2020 VIS Credit Rating Company Limited. All rights reserved. Contents may be used by news media with credit to VIS.</td></tr>
<tr><td>Due Diligence Meetings Conducted</td><td>
<table>
<tr><th></th><th>Name</th><th>Designation</th><th>Date</th></tr>
<tr><td>1</td><td>Mr. Khurram Khan</td><td>CFO</td><td>07-Aug-2020</td></tr>
<tr><td>2</td><td>Mr. Ali Kashif Rizvi</td><td>Head of Treasury</td><td>07-Aug-2020</td></tr>
<tr><td>3</td><td>Mr. Jawad Majid Khan</td><td>Head of Islamic Banking</td><td>07-Aug-2020</td></tr>
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