RATING REPORT

The Bank of Khyber

REPORT DATE:
June 27, 2019

RATING ANALYSTS:
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RATING DETAILS				
	Latest Rating		Previous Rating	
Rating Category	**Long-term**	**Short-term**	**Long-term**	**Short-term**
Entity	A	A-1	A	A-1
Rating Outlook	Stable		Stable	
Rating Date	*June 26, 2019*		*June 29, 2018*	

COMPANY INFORMATION	
Incorporated in 1991; scheduled in 1994	**External auditors:** M/s EY Ford Rhodes
Public Limited Company	**Chairman of the Board:** Dr. Shahzad Khan Bangash
Key Shareholders (with stake 5% or more):	**Managing Director/Chief Executive Officer:** Mr. Saif ul Islam
Government of Khyber Pakhtunkhwa – 70.2%	
Ismail Industries Ltd – 24.2%	
Others (including general public) –5.6 %	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria: Commercial Banks (March, 2018) http://www.vis.com.pk/kc-meth.aspx

The Bank of Khyber

OVERVIEW OF THE INSTITUTION

The Bank of Khyber (BoK) was established under the Bank of Khyber Act, 1991 and acquired the status of a schedule bank in 1994. BoK is listed on Pakistan Stock Exchange Limited (PSX) and is one of the three provincial-government owned commercial banks operating in Pakistan.

Profile of MD/CEO

Mr. Saif Ul Islam was appointed as the MD/CEO of the bank in December 2018. He has over 40 years of banking experience. He holds an MBA (E) in banking and finance.

Profile of Chairman

Dr. Shahzad Khan Bangash is a senior civil servant with extensive national and international experience. Dr. Bangash has also served at various positions abroad.

Financial Snapshot

Net Profit: 1QFY19: Rs. 186.7m; FY18: Rs. 466.1m; FY17: Rs. 1.8b

Net Equity: 1QFY19: Rs. 14.0b; FY18: Rs. 13.8b; FY17: Rs. 14.9b

RATING RATIONALE

The ratings assigned to the Bank of Khyber (BoK) reflect its shareholding structure, as majority shareholding of the bank is held by the Government of KPK. The ratings are supported by growth, though relatively slow, in advances portfolio, largely stable asset quality and adequate liquidity position. The ratings also factor in negative earnings trajectory on account of considerable loss on government securities. With lower equity base and expanding risky assets, capital adequacy ratio (CAR) has dropped to close to the minimum regulatory benchmark, which will be a major constraint for growth in risky assets, going forward.

Advances: Gross advances of the bank augmented to Rs. 99.2b by end-FY18 (FY17: Rs. 87.7b; FY16: Rs. 36.1b) mainly due to notable growth in conventional advances, partially offset by 14% decrease in loans related to the Islamic Banking Group (IBG). During FY18, IBG confined its lending operations in a bid to manage the bank's CAR. BoK has segregated conventional commercial & retail banking operations from corporate banking in order to enhance efficiencies. Corporate banking division plans to increase lending to poultry feed manufacturers due to eligibility to lower tax rate on incremental agri-lending. There is also a plan to increase lending to rated clients to ease-off some pressure from the CAR.

Commercial & retail banking division is planning to launch a new product related to BMR of marble industry in KPK, which will be funded through SBP refinance scheme. Moreover, the division will also participate in the SBP's Kamyab Jawan scheme. The bank anticipates around 30,000 applications worth Rs. 0.5m per application. As per management, there will be no impact on CAR due to government guarantee on exposure. In absolute terms, non-performing loans (NPLs) declined on a timeline basis owing to higher recoveries against classified portfolio, thereby mitigating the impact of incremental infection. Consequently, the bank exhibited slight improvement in asset quality indicators during FY18. The bank is projecting its advances portfolio to grow to Rs. 133.8b by end-FY19.

Investments: Investment portfolio of the bank decreased to Rs. 94.2b by end-FY18 (FY17: Rs. 140.5b; FY16: Rs. 141.6b) mainly due to divesture in government securities and a deficit on revaluation of available-for-sale securities. Government securities represented 92% (FY17: 96%) of overall investment portfolio at end-FY18, though share of PIBs increased to 69% (FY17: 59%). The credit risk arising from the investment portfolio is considered minimal, however, the same is exposed to interest rate risk as depicted by PIBs modified duration of 2.2 (FY17: 2.8; FY16: 3.6). Amidst rising interest rate scenario, the bank recorded a total revaluation deficit of Rs. Rs. 4.5b by end-FY18 (FY17: Rs. 468.7m) on government securities, of which Rs. 4.3b pertained to PIBs (FY17: 508.2b). As of May 30, 2019, the deficit on PIBs amounted to Rs. 4.8b. During FY19, Rs. 6.0b worth of PIBs are expected to mature (FY18: Rs. 5.0b). The management is expecting up to 150 basis points increase in policy rate and plans to reinvest the maturities at higher rates, which will positively impact the overall yield by around 70 basis points. Moreover, the bank intends to grow its T-bills portfolio to Rs. 25.0b by end-FY19 and will be funded through borrowings.

Remaining investment portfolio comprises listed/unlisted TFCs/Sukuks and exposure in equities. Barring non-performing TFCs/Sukuks against which the bank maintains adequate provisioning, net exposure in TFCs/sukuks pertain to counterparties carrying sound credit risk profile, while considering the size of equity portfolio, associated risk from the same is considered manageable. Going forward, the bank plans to divest its portfolio of TFCs to improve the CAR.

Liquidity: The liquidity profile of the bank remained largely stable as adjusted liquid assets remained at Rs. 88.6b at end-FY18 (FY17: Rs. 90.8b). Advances-to-Deposit (ADR) increased slightly, though still remained low, at 57.9% by end-FY18 (FY17: 55.1%).

The concentration risk is still considered on the higher side despite decrease in deposit concentration among top 10 customers to 40.3% (FY17: 45.0%), however, comfort can be drawn by the fact that most of these are related to the government of KPK. The opening of new Islamic branches in remote location and increased focus on retail deposits with the launch of Kamal Plus current account may positively impact the concentration risk to a certain extent. Total borrowings amounted to Rs. 34.8b at end-FY18 (FY17: Rs. 64.2b), however, the bank intends to increase borrowings to fund fresh investments during FY19.

Profitability: Total markup income of the bank increased slightly during FY18 as the impact of decrease in average markup bearing assets was offset by slightly higher yield. The average yield on advances improved in line with increasing interest rate, whereas the yield on investment portfolio remained largely stable. The average cost of funds increased marginally due to re-pricing of fixed deposits. Resultantly, the net markup income of the bank increased during FY18 with some improvement in spreads.

BoK reported a loss from non-markup avenues as the impact of healthy growth in fee, commission, & brokerage and foreign exchange income due to higher business volumes was fully offset by a loss on sale of securities amounting to Rs. 1.2b during FY18, as compared to a gain of Rs. 1.1b in the corresponding period. The administration expenses were recorded higher during FY18 mainly on account of higher depreciation expense, ATM charges, deposit protection premium, and asset write-off. Resultantly, net profit of the bank decreased to Rs. 466.1m during FY18 (FY17: Rs. 1.8b). During 1QFY19, the bank posted a net profit of Rs. 187m.

Capitalization: Paid-up capital of the bank remained unchanged during FY18. The Tier-I equity of the bank decreased to Rs. 13.8b by end-FY18 (FY17: Rs. 14.9b) owing to disbursement of cash dividend for FY17. Total equity decreased to Rs. 11.7b by end-FY18 (FY17: Rs. 15.4b) as the bank recorded a revaluation deficit on available for sales securities of Rs. 2.1b, compared to a surplus of Rs. 0.5b at end-FY17. With notable increase in advances portfolio, CAR decreased to 12.3% by end-FY18 (FY17: Rs. 20.0%) on account of significant reduction in total eligible capital and higher RAWs. The CAR of the bank stood lower at 12.09% at end-1QFY19 due to increase in RWAs despite some improvement in capital base. The bank plans to suspend cash dividend. As per the management, it will manage the CAR by increasing GoP guaranteed exposure, higher commercial & retail lending which carry low-risk weight, divest TFC portfolio, and issuance of Tier-II capital.

Governance and Digitalization: The Board of Directors (BoD) of BoK consists of 8 members. Mr. Saif-ul-Islam replaced Mr. Shahbaz Jameel as the full-time Managing Director/Chief Executive Officer (CEO) in December 2018. With regards to the number of independent directors, the bank is in compliance with revised code of corporate governance for listed companies, 2017 (CCG'17). The induction of female director is subject to availability of a casual vacancy. No director is schedule to retire in FY19. Apart from a few changes, the senior management depicted stability.

The bank has made significant progress towards digitalization with the recent signing-off of Temenos T24 core banking software. As per the roadmap, the bank plans to rollout digital and internet banking services with a big bang approach by the start of FY20. The rollout of core banking will start in the second half of FY20 and will be completed in phases in two years. Trainings for T24 has been planned.

FINANCIAL SUMMARY *(amounts in PKR billions)*				Appendix-I
BALANCE SHEET	**FY16**	**FY17**	**FY18**	**1QFY19**
Total Investments	141,602	140,474	94,233	90,205
Advances (net)	31,644	83,369	95,012	105,902
Lending to FIs	8,827	1,529	7,696	3,897
Cash & Balances	18,617	12,173	16,057	11,396
Operating Fixed Assets	2,071	2,370	2,295	2,266
Other Assets	3,639	5,217	7,802	10,114
Total Assets	**206,400**	**245,132**	**223,095**	**223,780**
Borrowings	28,701	64,190	34,842	32,307
Deposits & other accounts	157,020	159,247	171,168	171,632
Other Liabilities	3,609	5,167	4,486	7,007
Bills Payable & Others	928	1,131	895	705
Tier-1 Equity	14,685	14,943	13,809	13,996
Net Worth	16,143	15,398	11,705	12,129
INCOME STATEMENT	**FY16**	**FY17**	**FY18**	**1QFY19**
Net Mark-up Income	4,407	4,799	5,139	1,282
Net Provisioning/(Reversal)	631	-104	-172	54
Non-Markup Income/(Loss)	2,673	1,651	-526	151
Operating Expenses	3,209	3,758	4,052	1,034
Profit Before Tax	3,240	2,795	707	345
Profit After Tax	2,021	1,791	466	187
RATIO ANALYSIS	**FY16**	**FY17**	**FY18**	**1QFY19**
Gross Infection (%)	15.1	5.5	4.7	4.5
Provisioning Coverage (%)	80.3	89	88	84
Net Infection (%)	3.4	0.6	0.6	0.7
Cost of Deposits (%)	4.8	4.6	4.7	-
Net NPLs to Tier-1 Capital (%)	7.3	3.5	3.9	5.7
Capital Adequacy Ratio (C.A.R (%))	21.3	20	12.3	12.1
Markup Spreads (%)	2.7	2.3	2.5	-
Efficiency (%)	66.2	71.6	71.5	74.3
ROAA (%)	1.1	0.8	0.2	6.3
ROAE (%)	12.6	11.4	3.4	0.3
Liquid Assets to Deposits & Borrowings (%)	84.3	56.2	50.2	64.3

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 — Annexure-III

Name of Rated Entity	The Bank of Khyber
Sector	Commercial Banks
Type of Relationship	Solicited
Purpose of Rating	Entity Rating
Rating History	See table below
Instrument Structure	N/A
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 Default	VIS' ratings opinions express ordinal ranking of risk, from strongest to weakest, 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.
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Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
		RATING TYPE: ENTITY		
26-June-19	A	A-1	Stable	Reaffirmed
29-Jun-18	A	A-1	Stable	Reaffirmed
29-Jun-17	A	A-1	Stable	Reaffirmed
28-Jun-16	A	A-1	Stable	Reaffirmed
30-Jun-15	A	A-1	Stable	Reaffirmed
30-Jun-14	A	A-1	Stable	Reaffirmed
28-Jun-13	A	A-1	Stable	Maintained
29-Jun-12	A	A-1	Stable	Upgrade
08-Feb-12	A-	A-2	Rating Watch-Developing	Rating Watch-Developing
02-Jul-11	A-	A-2	Positive	Upgrade
24-Dec-10	A-	A-2	Stable	Maintained