RATING REPORT

The Bank of Khyber

REPORT DATE:
July 07, 2021

RATING ANALYSTS:
Syed Fahim Haider Shah
fahim.haider@vis.com.pk

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 30, 2021*		*June 30, 2020*	

COMPANY INFORMATION	
Incorporated in 1991; scheduled in 1994	**External auditors:** M/s EY Ford Rhodes
Public Limited Company	**Chairman of the Board:** Mr. Shahab Ali Shah **Managing Director/Chief Executive Officer (Acting):** Mr. Ihsan Ullah Ihsan
Key Shareholders (with stake 5% or more):	
Government of Khyber Pakhtunkhwa – 70.2%	
Ismail Industries Ltd – 24.4%	
Others (including general public) – 5.4 %	

APPLICABLE METHODOLOGY(IES)
VIS Entity Rating Criteria: Commercial Banks (June, 2020) **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. **Ihsan Ullah Ihsan** is serving as the acting MD/CEO since Dec'19. Previously, he was heading the risk management division of BoK. Mr. **Ihsan** completed his MBA from the Institute of Business Administration, Karachi and earned B.Sc. in Mathematics and Statistics from the University of Peshawar.

Profile of Chairman

Mr. Shahab Ali Shah is a civil servant and is presently serving as the Additional Chief Secretary Government of Khyber Pakhtunkhwa. He was appointed as the Chairman of the Board on May 27, 2021.

Financial Snapshot

Net Profit: 1QFY21: Rs. 439m; FY20: Rs. 2.2b; FY19: Rs. 1.3b

Tier 1 Equity: 1QFY21: Rs. 14.2b; FY20: Rs. 15.6b; FY19: Rs. 13.2b

RATING RATIONALE

The ratings assigned to the Bank of Khyber (BoK) reflect its shareholding structure, as majority stake is held by the Government of KPK. The ratings are supported by increase in advances portfolio and notable improvement in profitability led by higher net markup income and gain on sale of government securities. In accordance with the relief program of the State Bank of Pakistan, the bank deferred/rescheduled around 10% of advances portfolio by March 31, 2021. However, given incidence of fresh infection, asset quality indicators deteriorated during the year; which will require continuous monitoring from the bank. Capital Adequacy Ratio (CAR) of the bank is supported by major exposure in government commodity financing; replacement of the same with private lending may lead to increase in risk weighted assets and thereby decrease in CAR.

Implementation of core banking system: The bank has made major progress in terms of digitalization process. Rollout of Temenos T-24 core banking system in branches started in Nov'20 and completed within stipulated time on June 04, 2021. Implementation of T-24 core banking system is expected to reduce the likelihood of any data pipeline errors or delays and ensure that data-analysis and decision making is carried out timely and accurately since all the data is now centralized and available on real-time. Underpinned by the implementation of core banking system, BoK plans expansion in branch network. The bank increased the number of branches to 179 (FY19: 169) by end-FY20, including 91 Islamic and 88 conventional branches. During FY21, the bank plans to open 40 branches equally split between Islamic and conventional, with focus on remote locations to generate low-cost deposits.

Increase in advances portfolio and infection levels: Gross advances portfolio increased to Rs. 134.9b (FY19: Rs. 114.0b) by end-FY20, with growth largely manifested in conventional advances. Fresh disbursements were mainly channeled towards public sector. Resultantly, contribution of virtually risk-free public sector lending was recorded slightly higher at 60% (FY19: 57%). Three-fourth of overall advances portfolio remained concentrated in three sectors, namely commodity, textile, and miscellaneous manufacturing sectors.

In accordance with SBP relief program, the bank allowed a total principal deferment and rescheduling of Rs. 13.3b and markup rescheduling of Rs. 502m as of March 31, 2021. As per the management, majority of clients who availed deferment pertained to textile sector and have started making timely payments. Asset quality indicators deteriorated during the year as reflected by increased gross and net infections of 5.4% (FY19: 4.4%) and 2.0% (FY19: 0.8%) respectively, by end-FY20. In the absolute terms, non-performing loans increased to Rs. 7.3b (FY19: 5.0b).

Going forward, the bank plans to deepen its business relationship with existing corporate clients, add blue-chip clients, and reduce some exposure in commodity financing due to volatility in business and competitive markup rates. Moreover, the bank intends to enhance its focus on consumer financing including salary loan for KPK government employees, SMEs supported by upcoming government schemes, to improve markup spreads while increasing focus on trade finance.

Considerable gain on the sale of securities: BoK reduced its investment portfolio to Rs. 113.5b (FY19: Rs. 146.9b) by end-FY20 mainly by offloading long-duration PIBs to realize a sizeable gain of Rs. 1.7b (FY19: Rs. 290m). Investments in government securities amounted to Rs. 105.0b (FY19: Rs. 140.9b) due to reduction in T-bills to Rs. 28.9b (FY19: Rs. 69.3b) while PIBs exposure remained largely stable at Rs. 62.5b (FY19: Rs. 63.7b) out of which around Rs. 5.0b were floating rate. The investment in Ijarah Sukuk increased to Rs. 13.6b (FY19: Rs. 7.9b) by end-FY20. Total revaluation surplus on available for sale securities amounted to Rs. 511m at end-FY20 (end-FY19: deficit Rs. 2.4b). The credit risk emanating from available-for-sale portfolio of PIBs is considered minimal, however, the same is exposed to interest rate risk. Modified duration of PIBs stood lower at 1.25 yrs (FY19: 2.2 yrs). Going forward, the bank plans to maintain optimal mix of PIBs and T-bills portfoliokeeping in view the interest rate scenario..

Remaining investment portfolio comprised listed/unlisted TFCs/Sukuks and a modest exposure in equities. Barring non-performing TFCs/Sukuks against which the bank maintains adequate provisioning, net exposure in TFCs/sukuks pertained to counterparties carrying sound credit risk profile. Considering the size of equity portfolio, associated risk from the same is considered manageable.

Liquidity indicators remained adequate: The liquidity profile of the bank is considered adequate with collateral-adjusted liquid assets amounting to Rs. 98.0b (FY19: Rs. 104.9b). The decrease was mainly manifested in government securities, and lending to financing institutions. The outstanding balance of total borrowings was recorded lower at Rs. 57.06b (FY19: Rs. 94.7b) as the bank reduced repurchase agreement (repo) to Rs. 6.8b (FY19: Rs. 60.7b) in line with lower T-bills investments, partially offset by increase in Bai Muajjal borrowings to Rs. 39.4b (FY19: Rs. 26.7b) by end-FY20. Resultantly, liquid assets in relation to total deposits & borrowings – both adjusted for collateral given – decreased to 46.4% (FY19: 54.2%) by end-FY20. Advances-to-Deposit (ADR) ratio was recorded slightly higher 66.4% (FY19: 62.6%) by end-FY20.

Deposits concentration among top-10 customers increased slightly to 39.0% (FY19: 37.7%) as the impact of shedding of a major deposit due to high-cost was more than offset by increase in deposits by end-FY20. Comfort in related risk can be drawn by the fact that most of these deposits are related to the government of KPK. Going forward, the bank plans to shed some high-cost deposits. Growth in deposit base is expected to emanate from network expansion, increased focus on retail deposits with the launch of new liability side products and mobile banking platform; the same may also reduce concentration risk to a certain extent.

Growth in profitability led by increase in net markup income and sizable gain on sale of government securities despite higher general and specific provisioning: BoK earned total markup income of Rs. 25.7b (FY19: Rs. 24.7b) during FY20, as the impact of higher average earnings assets was partially offset by decrease in average yield on assets. With the decline in cost of funds due to lower interest rate environment and change in borrowings mix, the bank reported higher net markup income of Rs. 6.8b (FY19: Rs. 4.8b) during FY20. Resultantly, markup spread improved to 3.0% (FY19: 2.3%) during the year. Going forward, markup spread of the bank is projected to improve further mainly on account of decrease in high-cost deposits, increase in focus on low-cost Islamic and conventional banking deposits, reduction in exposure to low margin commodity financing and increased focus on high yield consumer financing.

The bank reported higher non-markup income of Rs. 2.9b (FY19: Rs. 1.1b) during FY20, driven largely by a sizeable gain on sale of government securities amounting Rs. 1.7b (FY19: Rs. 290m) and higher foreign exchange income of Rs. 613m (FY19: Rs. 285m) while fee, commission, & brokerage income remained stagnant during the year. Administrative expenses were recorded higher mainly with the increase in employees' compensation expense. With additional general provisioning of Rs. 1.1b made following a prudent stance in respect of potential credit losses in the portfolio due to the coronavirus situation, the bank recorded net provision expense of Rs. 1.6b during FY20 vis-à-vis net reversal of Rs. 21m in the corresponding year. Despite sizeable provisioning, profit before tax stood higher at Rs. 3.8b (FY19: Rs. 2.3b). Accounting for taxation, net profit increased to Rs. 2.2b (FY19: Rs. 1.3b). During 1QFY21, the bank posted a net profit of Rs. 439m (1QFY20: Rs. 548m).

Adequate capital adequacy ratio: Tier-I equity stood lower at Rs. 14.2b by end-1QFY21 (FY20: Rs. 15.6b) on account dividend payment of Rs. 1.5b during the period. Total equity amounted to Rs. 16.5b (FY20: Rs. 17.8b) with revaluation surplus of Rs. 907m (FY20: Rs. 1.2b) at end-1QFY21. CAR stood at 17.03% (FY20: 19.35%) at end-1QFY21; the decrease was due to increase in risk weighted assets to Rs. 93.0b (FY20: Rs. 89.8b) and decrease in total eligible capital to Rs. 15.8b (FY20: Rs. 17.4b). CAR is supported by major exposure in government commodity financing; replacement of the same with private lending may lead to increase in risk weighted assets and thereby decrease in CAR.

Corporate governance framework: The Board of Directors (BoD) at BoK consists of 8 members (FY19: 8). The BoD consists of 4 independent directors including female director, 3 non-executive directors and 1 executive director. Board composition changed as Mr. Shahab Ali Shah recently joined as the Chairman in place of Mr. Shakeel Qadir Khan. Mr. Shahab is a senior civil servant, presently serving as Additional Chief Secretary, Government of Khyber Pakhtunkhwa. Ms. Saleha Asif joined the Board as an Independent director in January 2021. Ms. Saleha carries over 25 years of strategy & management consulting, leadership development, executive coaching and corporate banking experience.

Mr. Ihsan Ullah Ihsan has been serving as the acting MD/CEO since December 2019. The process of appointing a new MD/CEO is currently underway and is expected to be completed soon. Moreover, Mr. Irfan Saleem Awan was appointed as the Chief Financial Officer (CFO) of the bank with effect from February 15, 2021. Mr. Irfan has over 20 years of experience in finance, compliance, enterprise risk management, strategic planning, and company secretarial and external audit in different organizations.

The Bank of Khyber Annexure I

FINANCIAL SUMMARY *(amounts in PKR billions)*				
BALANCE SHEET	**FY18**	**FY19**	**FY20**	**1QFY21**
Total Investments	94,233	146,911	113,479	117,164
Advances (net)	95,012	109,742	129,063	136,956
Lending to FIs	7,696	13,863	7,298	12,692
Cash & Balances	16,057	20,368	24,933	16,830
Operating Fixed Assets	2,295	3,335	3,472	3,473
Other Assets	7,802	12,086	10,055	9,913
Total Assets	**223,095**	**306,305**	**288,300**	**297,027**
Borrowings	34,842	94,656	57,063	55,331
Deposits & other accounts	171,168	182,168	203,072	214,984
Other Liabilities	4,486	14,108	9,450	9,480
Bills Payable & Others	895	1,172	944	782
Tier-1 Equity	13,809	14,982	16,605	15,544
Net Worth	11,705	14,201	17,772	16,451
Paid-Up Capital	10,003	10,003	10,003	10,003
INCOME STATEMENT	**FY18**	**FY19**	**FY20**	**1QFY21**
Net Mark-up Income	5,139	4,766	6,762	1,798
Net Provisioning/(Reversal)	(171)	(21)	1,610	88
Non-Markup Income/(Loss)	(526)	1,112	2,878	160
Operating Expenses	4,052	3,620	4,223	1,214
Profit Before Tax	707	2,261	3,806	653
Profit After Tax	466	1,306	2,152	439
RATIO ANALYSIS	**FY18**	**FY19**	**FY20**	**1QFY21**
Gross Infection (%)	4.7	4.4	5.4	5.2
Provisioning Coverage (%)	88	83.4	64.1	63.4
Net Infection (%)	0.6	0.8	2.0	2.0
Cost of Deposits (%)	4.7	8.5	6.2	n.a
Net NPLs to Tier-1 Capital (%)	3.9	5.6	15.7	17.6
Capital Adequacy Ratio (C.A.R) (%)	12.3	15.3	19.4	17.0
Markup Spreads (%)	2.5	2.3	3.0	n.a
Efficiency (%)	71.5	64.5	54.3	57.6
ROAA (%)	0.2	0.5	0.7	0.6*
ROAE (%)	3.4	10.1	13.5	10.3*
Liquid Assets to Deposits & Borrowings (%)	50.2	53.2	46.4	47.0

**Annualized*

ISSUE/ISSUER RATING SCALE & DEFINITIONS Annexure 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 Ratings

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
		RATING TYPE: ENTITY		
30-June-21	A+	A-1	Stable	Upgrade
30-June-20	A	A-1	Stable	Reaffirmed
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

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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Due Diligence Meetings Conducted

Name	Designation	Date
Mr. Atif Hanif	Head Islamic Banking	June 15, 2021
Mr. Muhammad Faisal	Head Treasury & IB	June 15, 2021
Mr. Azfar Latif	Head IT	June 16, 2021
Mr. Mudasar Iqbal	Head Internal Audit	June 16, 2021
Ms. Sadia Bukhari	Head Risk Management	June 16, 2021
Mr. Irfan Saleem	Chief Financial Officer	June 16, 2021
Mr. Sher Muhammad	Head Conventional Banking	June 17, 2021