RATING REPORT

The Bank of Khyber

REPORT DATE:
June 30, 2022

RATING ANALYSTS:
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RATING DETAILS

Rating Category	Latest Rating Long-term	Latest Rating Short-term	Previous Rating Long-term	Previous Rating Short-term
Entity	A+	A-1	A+	A-1
Rating Outlook	Stable		Stable	
Rating Date	*June 30, 2021*		*June 30, 2021*	

COMPANY INFORMATION

Incorporated in 1991; scheduled in 1994	**External auditors:** M/s A.F. Ferguson & Co.
Public Limited Company	**Chairman of the Board:** Mr. Shahab Ali Shah **Managing Director/Chief Executive Officer:** Mr. Muhammad Ali Gulfaraz
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. Muhammad Ali Gulfaraz is serving as the MD/CEO. Previously, he was member Board of Directors Fauji Foundation Pakistan. Mr. Muhammad holds his BA in economics and MSc in Managerial Economics from the University of California, Davis.

Profile of Chairman

Mr. Shahab Ali Shah is a senior 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: 1QFY22: Rs. 390m; FY21: Rs. 1.1b; FY20: Rs. 2.2b

Tier 1 Equity: 1QFY22: Rs. 16.6b; FY21: Rs. 16.2b; FY20: Rs. 16.6b

RATING RATIONALE

The ratings assigned to the Bank of Khyber (BoK) reflect its shareholding structure as majority stake is held by the sub-sovereign, the Government of KPK. The ratings are underpinned by Bank wide roll-out of core banking system coupled with ongoing branch network expansion plans to improve geographical footprint. The ratings take into account the impact of upward and downward movement in net worth and profitability in the last two years due to higher one-off gain on investments in CY20 which turned into loss, albeit small in CY21 and high operating expenses in the outgoing year on account of branch network growth and capacity building. Given incidence of fresh infection and weakening of asset quality indicators on account of impaired repayment capacity of businesses and obligors remains a key concern from ratings perspective. Focus on recouping the provisioning coverage going forward would be important. This is expected to be facilitated from management expectations of recovery from some large delinquent clients. VIS has been given to understand that the management has developed and started implementation of strategy for reduction of NPLs and improvement of portfolio quality; the outcome of the same will be ascertained over time.

As per medium-term strategy, the Bank plans to deepen its business relationship with existing corporate clients, add new blue-chip clients with rigorous efforts to increase trade and government-backed SME business. Moreover, special focus is expected to be placed on home remittance business for channeling forex through the formal sector; the same is expected to be aided through broadening of product suite and further supported through the digital banking platform. The ratings reflect elevated level of market risk exposure on account of sizable buildup of investment portfolio during the rating review period. While a sharp reversal in interest rates is unlikely at this point in time, proactive market risk management remains important in order to address any market risk therein.

The ratings reflect adequate liquidity profile of the bank in line with increase manifested in investment portfolio, sizable deposit mix and considerable proportion of liquid assets in terms of deposits & borrowings. However, given market conditions, managing asset-maturity mismatch would be challenging, going forward. Concentration risk on the liability side exhibited an improving trend as the contribution of top 50 depositors decreased on a timeline. The largest deposit pertained to government of KPK; however, this high-cost deposit is expected to be slightly tapered off to alleviate pressure on spreads. The ratings take into account the timeline lowering in Capital Adequacy Ratio (CAR) of the bank on account of increase in market risk weighted assets and dividend payouts. The Bank however has opted for bonus shares issue for FY-2021 to shore up the capital. Optimizing risk weighted assets growth would remain a key rating driver. The ratings remain dependent on managing CAR buffers aligned to the assigned ratings, improving asset quality indicators amidst growth strategy and market risk management on investment portfolio.

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 was 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. T-24 is a fully integrated software with modules lending, trade finance, retail operations, treasury, finance, compliance, business intelligence analytics, internet & mobile banking, risk and ADC. Necessary processes and system improvements are continuously being done to yield maximum benefit from the new system. Moreover, the Bank launched its mobile banking app with an improved user interface, higher performance and a host of new features to provide better user experience for customers on the digital platform. These technological advancements will also help in targeting growth for consumer and SME portfolio of the Bank. Underpinned by the implementation of core banking system, BoK embarked upon enhancing its market footprint as the number of total branches increased to 216 (FY20: 179) by end-FY21, including 110 Islamic and 106 conventional branches. This expansion along with other capacity building measures resulted in increase in operating expenses leading to reduction in profitability. Retail business in urban, rural and unbanked areas remains to be top priority in branch expansion and business strategy, which is expected to provide sustainable growth in low-cost deposit base of the Bank. During the ongoing year, the Bank plans to open 36 branches and 13 sub branches almost equally split between Islamic and conventional, with focus on remote locations to generate low-cost deposits.

Decline in advances portfolio & market share:

BOK's gross advances declined during FY21, a period when asset base grew due to higher focus of bank's management on portfolio consolidation and recovery activities as the repayment capacity of borrowers was adversely impacted in line with continuation of pandemic crisis for over two years. With the Omicron variant the surge in new cases continued till end-FY21, therefore the economic activity remained stunted and was marked by intervals of lockdown. Hence, with growth in industry advances, the Bank's market share, in terms of advances, declined to 1.3% (FY20: 1.6%) at end-FY21. Conventional banking continued to represent over two-thirds of the financing portfolio. Cumulative exposure in M/S Food Department – Govt. of Punjab and PASSCO Wheat was decreased during the outgoing year in line with management's effort to reduce sectoral composition. However, albeit decline, the contribution of risk-free public sector lending remained sizable accounting for almost three-fifths of the advances portfolio. Within the private sector lending, new disbursements were mainly made to blue-chip companies in the textile, microfinance, edible oil, chemicals and feed sectors; denomination of disbursements in private sector was relatively small. Going forward, the Bank plans to focus on sectors with sustained viability.

As per medium-term strategy, Conventional banking division plans to deepen its business relationship with existing corporate clients and addition of new blue-chip clients. The Bank plans to have special focus on home remittance business for channeling forex through the formal sector; the same is expected to be aided through broadening of product suite and further supported through the digital banking platform. On the asset side, the Bank intends to diversify financing portfolio by rationalizing exposure from government backed lending to private sector for fresh loans with potential of ancillary business and trade finance opportunities to improve markup spreads. Moreover, the bank plans to enhance its focus on consumer financing including salary loan for KPK government employees and SBP and Govt. facilitated SMEs programs. In addition, the bank intends to enhance participation in government housing schemes.

Weakening in asset quality:

Principal deferment under the SBP's Covid-19 relief program amounting to Rs. 12.0b was allowed which accounted for nearly 14.6% of conventional advances portfolio at end-1QFY21. As per the management, majority of the clients who availed deferment pertained to textile sector and have already started making timely payments. Asset quality indicators depicted weakening during the year as reflected by timeline increased gross and net infections; the same was majorly driven by delinquency of large petrochemical client. In term of sector composition, highest NPL growth was evidenced in petrochemical, trade, textile and housing sectors. Meanwhile, sugar sector remained unchanged while NPLs reported for food & beverage and miscellaneous manufacturing declined during the outgoing year. Moreover, the provisioning coverage also declined during the rating review period due to increase in NPLs and corresponding FSV benefit availed under the applicable prudential regulations. During FY20, the bank had additional general provisioning booked to cater to expected credit losses stemming from pandemic crisis; accordingly, the same buffer was utilized in view of the specific provisioning charge booked during FY21.

Market risk; sizable revaluation loss on securities booked:

BOK's investment portfolio exhibited sizable growth during the review period on the back of investment in government securities. Credit risk emanating from the portfolio is considered low as around 96% of the investment mix at end-1QFY22 was deployed in risk-free government securities. Heavy investment was made in short-tenure T-Bills in line with prevailing market interest rate scenario. Further the Bank has built a sizeable PIB portfolio with varying maturities; out of total PIB holdings one-third comprises of fixed rates instruments. The cumulative duration of the entire PIB portfolio was recorded 0.77x while the duration of fixed term PIBs stood at 1.37x at end-May'22. Total revaluation deficit on available for sale government securities was mainly a function of increasing interest rate scenario post relief provided by SBP by keeping policy rate low to support the economic activity during the coronavirus pandemic. The deficit was reported sizably high at end-Mar'22 in line with increasing bench mark rate. While a sharp reversal in interest rates is unlikely at this point in time, proactive market risk management is considered important in order to curtail potential mark-to-market losses on the PIB portfolio in case of any significant increase in interest rates.

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. These investments carry market risk, however considering the size of the equity portfolio, the associated risk emanating from the same is considered minimal. Going forward, exposure in listed equities is expected to remain at around current levels with no new sizable exposure to be made in view of recent lackluster stock market performance.

Liquidity indicators remained adequate:

Liquidity profile of the bank is considered adequate in line with increase manifested in investment portfolio, sizable deposit mix and considerable proportion of liquid assets in terms of deposits & borrowings. The slight improvement in liquidity indicators is underpinned by timeline decrease in the advances to deposit ratio during the rating review period. Liquid assets in relation to total deposits & borrowings – both adjusted for collateral given – exhibited a mixed trend. The aforementioned volatile trend was on account of liquid assets (adjusted) being recorded highest at end-FY21 owing to deployment of incremental liquidity in investment mix in line with consolidation of advances portfolio; however, as the lending activities picked pace during the ongoing year the quantum of adjusted liquid assets declined by end-1QFY22. The increase in repo-borrowings largely funded growth in treasury operations. Given significant asset-maturity mismatch exists, increase in repo borrowings is expected to be evidenced during the ongoing year as well. In this regard, VIS will continue to vigilantly monitor the liquidity indicators and maturity profile of the bank going forward.

The growth in deposit base was mainly driven by new customer acquisitions and deepening of the existing portfolio base during the outgoing year. As a result, the proportion of current and saving accounts (CASA) in overall deposit mix increased during the review period. However, retaining current deposits has relatively become difficult in line with benchmark rates being on the higher side creating significant opportunity cost against keeping capital in current accounts. Concentration risk on the liability side exhibited an improving trend as the contribution of top 50 depositors decreased on a timeline. The largest deposits pertained to government of KPK; however, this high-cost deposit is expected to be slightly tapered off to alleviate pressure on spreads. Growth in deposit base is expected to emanate from expansion of branch network, new liability side products and mobile banking platform. Going forward, the bank's strategy is to focus on reduction of cost of deposits, together with increase in the share of private deposits and CASA ratio.

Decline in profitability with sizable mark to market losses and high operating expenses:

Profitability of the bank has exhibited a decline owing to reduction in non-markup income on account of loss on securities recorded along with increase in operating cost on a timeline basis resulting from expansion of branch network and capacity building initiatives. Therefore, BoK reported a reduced bottom line of Rs. 1.1 (FY20: Rs. 2.2b) during FY21. Despite sizable growth in investment portfolio, total markup income earned was recorded lower predominantly on account of lower yield on advances and investments mainly due to prevailing interest rates. Subsequently, with sizable cut in yield on advances & investments, overall yield on interest bearing assets decreased the outgoing year. Going forward, mark-up spread of the bank is expected to improve mainly on account of notable reduction in proportion of high-cost deposits, increase in focus on low-cost Islamic and conventional banking deposits, rationalization of exposure to highly competitive government commodity financing and channeling the disbursements towards corporate clients, and increased focus on higher yielding government scheme-backed consumer financing. The non-markup income of the bank significantly reduced and was reported lower on account of reversal in interest rate scenario resulting in loss on securities booked amounting to Rs. 114.2m during FY21 as opposed to a sizable gain of Rs. 1.7b reaped in the preceding year. Further, operating expenses scaled up as the bank moved towards branch expansion and capacity building measures; therefore, an increase was evidenced in efficiency ratio. It is expected that the same measures would translate in corresponding improvement of business prospects in the medium to long-term

Dip in capital adequacy evidenced:

Paid-up capital of the Bank increased on account of issuance of bonus shares; the bonus shares allotment to shareholders during the period under review was an allocation from the appropriated profit as part of non-cash dividend. As a result of final cash dividend of Rs. 1.5/share paid for FY20; core equity of the Bank remained at FY20's level despite profit generation during FY21. BoK's dividend payout has been on an aggressive side in the past; however, going forward bank needs to remain conservative in order to reach the desired capital buffer while continuing to support loan and business growth. Further, higher pace of growth in NPLs in comparison to equity, net NPL in relation to Tier-1 capital (adjusted for specific provisioning) increased on the timeline basis during the ongoing year; however, the ratio correlates with the median values for the assigned rating.

Capital Adequacy Ratio (CAR) has dipped on a timeline to 13.9% by end-1QFY22 on account of increase in risk weighted assets; the increase was largely manifested in market risk weighted assets in line with notable growth in investment portfolio during the review period. The reduction in CAR was also partly an outcome of decrease in total eligible capital on account of dividend payment during the rating review period. As per the management, despite recent significant changes in the interest rate, CAR is still above the minimum regulatory requirement. However, going forward, checks on asset quality and growth of lending & investment portfolio need to be in place to avoid stress on capitalization indicators. We have been given to understand that to conserve capital for growth, the Bank is following a prudent balance sheet management strategy. Optimizing risk weighted assets growth would remain a key rating driver.

The Bank of Khyber Annexure I

FINANCIAL SUMMARY (Rs. in millions)					
BALANCE SHEET	**31-Dec-18**	**31-Dec-19**	**31-Dec-20**	**31-Dec-21**	**31-Mar-22**
Total Investments	94,233	146,911	113,479	184,399	256,407
Net Advances	95,012	109,742	129,063	124,549	139,219
Total Assets	223,095	306,305	288,300	358,606	459,280
Borrowings	34,842	94,656	57,063	110,069	198,190
Deposits & other accounts	171,168	182,168	203,072	221,876	235,660
Subordinated Sukuk (Tier II)	0	0	0	0	0
Subordinated Sukuk (Tier I)	0	0	0	0	0
Paid Up Capital	10,003	10,003	10,003	10,503	10,503
Tier-1 Equity	13,809	14,982	16,605	16,219	16,610
Net Worth	11,705	14,201	17,772	16,570	16,876
INCOME STATEMENT	**2018**	**2019**	**2020**	**2021**	**Q1'22**
Net Mark-up Income	5,139	4,918	6,762	6,789	1,886
Net Provisioning charge	-171	-21	1,610	832	99
Non-Markup Income	-526	1,112	2,878	1,023	388
Administrative Expenses	4,052	3,620	4,223	5,295	1,528
Profit Before Tax	707	2,413	3,806	1,680	647
Profit After Tax	466	1,458	2,152	1,104	390
RATIO ANALYSIS	**31-Dec-18**	**31-Dec-19**	**31-Dec-20**	**31-Dec-21**	**31-Mar-22**
Market Share (Advances) (%)	-	1.40%	1.60%	1.30%	1.40%
Market Share (Deposits) (%)	-	1.20%	1.10%	1.10%	1.20%
Advances to Deposits Ratio (%)	57.9%	57.7%	60.4%	58.3%	55.7%
Liquid Assets to Deposits & Borrowings (%)	50.2%	54.2%	46.1%	52.5%	47.3%
NPLs	4,658	5,027	7,276	10,521	11,109
Gross Infection (%)	4.70%	4.40%	5.40%	8.00%	7.60%
Provisioning Coverage (%) (incl. general prov)	89.2%	84.2%	80.3%	62.9%	59.9%
Net Infection (%)	0.60%	0.80%	2.00%	3.20%	3.30%
Cost of deposits (%)	4.70%	8.50%	6.10%	4.90%	-
Net NPLs to Tier-1 Capital (%)	3.90%	5.60%	14.70%	24.40%	27.30%
Tier-1 CAR (%)	12.23%	15.30%	17.33%	14.47%	13.68%
Capital Adequacy Ratio (C.A.R) (%)	12.30%	15.30%	19.40%	14.70%	13.90%
LCR (%)	109.7%	124.1%	130.5%	157.9%	132.8%
NSFR (%)	119.2%	118.3%	108.2%	129.7%	109.0%
Markup Spread (%)**	2.50%	2.30%	1.90%	1.80%	-
Efficiency (%)	71.50%	64.50%	54.30%	68.50%	68.60%
ROAA (%)	0.2%	0.5%	0.7%	0.4%	0.4%*
ROAE (%)	3.4%	10.1%	13.5%	6.5%	9.4%*

* 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	Annexure-III
Name of Rated Entity	The Bank of Khyber
Sector	Commercial Banks
Type of Relationship	Solicited

Purpose of Rating	Entity Ratings
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.
Disclaimer	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.

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
30-June-22	A+	A-1	Stable	Reaffirmed
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

Due Diligence Meetings Conducted

Name	Designation	Date
Mr. Atif Hanif	Head Islamic Banking	June 08, 2022
Mr. Muhammad Faisal	Head Treasury & IB	June 08, 2022
Mr. Irfan Saleem	Chief Financial Officer	June 08, 2022
Mr. Sher Muhammad	Head Conventional Banking	June 08, 2022
Mr. Mudasar Iqbal Head	Internal Audit	June 08, 2022
Ms. Sadia Bukhari	Head Enterprise Risk	June 08, 2022
Mr. Ihsan-ullah Ahsan	CRO	June 08, 2022