RATING REPORT

The Bank of Khyber

REPORT DATE:
July 06, 2020

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 30, 2020*		*June 26, 2019*	

COMPANY INFORMATION	
Incorporated in 1991; scheduled in 1994	**External auditors:** M/s EY Ford Rhodes
Public Limited Company	**Chairman of the Board:** Mr. Shakeel Qadir Khan **Managing Director/Chief Executive Officer (Acting):** Mr. Ishan Ullah Ishan
Key Shareholders (with stake 5% or more):	
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. Ishan Ullah Ishan has been serving as the acting MD/CEO since the termination of Mr. Saif-ul-Islam in Sep'19. Previously he was heading the risk management division of BoK. Mr. Ishan 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. Shakeel Qadir Khan is a civil servant and is presently heading the Planning & Development Department, Government of Khyber Pakhtunkhwa. Mr. Shakeel Qadir Khan holds Bachelor's degree in in Electronics Engineering from University of Engineering & Technology besides Post Graduate Diploma in Management from University of Surrey, UK

Financial Snapshot

Net Profit: 1QFY20: Rs. 548m; FY19: Rs. 1.3b; FY18: Rs. 466m

Tier 1 Equity: 1QFY20: Rs. 15.0b; FY19: Rs. 15.0b; FY18: Rs. 13.8b

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 steady growth in advances portfolio, largely stable asset quality and adequate liquidity profile. The ratings also factor in improvement in profitability during FY19 as the bank recorded gain on sale of government securities vis-à-vis a significant loss in the corresponding period. With higher equity base and significant new exposure to public sector, the bank witnessed notable improvement in Capital Adequacy Ratio (CAR).

Consolidation in branch network: The bank continued to consolidate its network by decreasing loss making branches on a timeline basis. The bank was operating 169 branches at end-FY19 (FY18: 169; FY17: 166) across the country. Out of these branches, 84 were Islamic branches. During FY20, the bank plans to open 9 new Islamic banking branches in KPK; approval for the same has been received from the regulator.

Healthy growth in loan portfolio amid largely stable asset quality: Gross advances portfolio augmented to Rs. 114.0b by end-FY19 (FY18: Rs. 99.2b; FY17: Rs. 87.7b), with growth largely manifesting in Islamic Banking Group (IBG). New disbursements were mainly channeled towards public sector, whereby IBG took new exposure of Rs. 30b in M/S Food Department – Govt. of Punjab. Exposure in Power Holding (Pvt.) Ltd. remained unchanged at Rs. 28.1b at end-FY19. Three-fourth of overall advances portfolio remained concentrated in four sectors, namely commodity, textile, cement, metal products.

According to the management, impact of COVID-19 is expected to remain under control due to the fact that i) a high proportion of advances portfolio comprises short-term commodity exposure, ii) a large proportion of corporate portfolio comprises blue-chip clients, and iii) SME portfolio located in KPK region is where majority of businesses are relatively low-leveraged. Going forward, IBG plans to focus on pharmaceutical, telecom, and energy sectors. Convectional banking division plans to deepen its business relationship with existing corporate clients with enhanced focus on trade related business. Moreover, the bank plans to enhance its focus on consumer financing particularly salary loans to employees of government of KPK and shortlisted SME businesses like tobacco growers and fruit exporters operating in the province of KPK. The bank is projecting its advances portfolio to grow to Rs. 129b by end-FY20.

In terms of the bank's asset quality indicators, slight improvement was witnessed in gross infection while there was marginal increase in net infection due to largely stagnant specific provisioning with higher FSV benefit availed during FY19. In absolute terms, non-performing loans (NPLs) were recorded higher at end-FY19, mainly on account of fresh infection in sugar, metal products, and trade sectors.

Positive impact of lower interest rates on fixed rate long-term government securities: BoK enhanced its investment portfolio Rs. 146.9b by end-FY19 (FY18: Rs. 94.2b; FY17: Rs. 140.5b) mainly by taking fresh exposure in T-bills. Exposure in T-bills stood higher at Rs. 69.3b (FY18: Rs. 16.0b; FY17: Rs. 46.6b), while PIBs portfolio remained largely stagnant at Rs. 63.7b (FY18: Rs. 64.8b; FY17: Rs. 82.3b) at end-FY19. Total revaluation deficit on available for sale securities declined to Rs. 2.5b by end-FY19 (FY18: Rs. 4.5b), which mainly pertained to PIBs portfolio. Given considerable decline in interest rates during the ongoing year, deficit on the bank's PIBs portfolio has been converted into an adequate surplus of around Rs. 2b, as of June 22, 2020. While credit risk emanating from portfolio of government securities is considered minimal, the PIBs portfolio is exposed to interest rate risk. Modified duration of PIBs is 2.2yrs (FY18: 2.2yrs; FY17: 2.8yrs); around Rs. 40b of PIBs are set of mature by end-FY22. Currently there is no plan to increase exposure in fixed rate PIBs, though 3-year floaters may be considered by the management.

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 improved with the increase in collateral-adjusted liquid assets to Rs. 100.4b (FY18: Rs. 88.6b; FY17: Rs. 90.8b) owing to higher investment in government securities, higher cash & placements with other banks and lending to financing institutions by end-FY19. The outstanding balance of total borrowings stood higher at Rs. 94.7b at end-FY19 (FY18: Rs. 34.8b; FY17: Rs. 64.2b) as the bank mobilized repurchase agreement (repo) and Bai Muajjal borrowings to finance the investment portfolio. Resultantly, liquid assets in relation to total deposits & borrowings –

both adjusted for collateral given – increased to 53.3% by end-FY19 (FY18: 50.2%; FY17: 56.7%). Advances-to-Deposit (ADR) ratio was recorded higher 62.6% at end-FY19 (FY18: 57.9%; FY17: 55.1%).

Deposits concentration among top-10 customers decreased on a timeline basis to 37.7% (FY18: 40.3%). During 1QFY20, the bank shed another Rs. 29.3b worth of high-cost deposits to rationalize overall cost of funding. Comfort in related risk can also be drawn by the fact that most of these deposits are related to the government of KPK. The opening of new Islamic branches in remote locations and increased focus on retail deposits with the launch of five new current/saving account products may have a positive impact on concentration risk to a certain extent.

The bank's profitability improved mainly on the back of gain on sale of securities, lower provisions against infected portfolio and decrease in operating expenses due to one-off impact on defined benefit plan with the revision in projected unit credit method: BoK earned total markup income of Rs. 24.7b during FY19 (FY18: Rs. 14.7b; FY17: Rs. 14.4b) on account of increase in earnings assets along with higher yield on assets. The net markup income, however, was reported slightly lower during FY19 as the impact of improvement in average yield on markup bearing assets was more than offset by increase in cost of funding due to re-pricing of fixed deposits at higher rate and change in borrowings mix. Resultantly, markup spread of the bank decreased slightly to 2.3% during FY19 (FY18: 2.5%; FY17: 2.3%). Going forward, markup spreads are expected to improve owing to reduction in high-cost deposit base, growing proportion of current & saving deposits (1QFY20: 69.5%; FY19: 58.3%; FY18: 53.2%), along with increased focus on higher yielding consumer financing.

The bank reported higher non-markup income during FY19, as the impact of largely stagnant fee, commission, & brokerage income was more than offset by growth in foreign exchange income to Rs. 285m (FY18: Rs. 139m) and gain on sale of government securities amounting Rs. 290m vis-à-vis loss of Rs. 1.2b in the corresponding period. Administrative expenses were recorded lower with the decrease in employees' compensation expense mainly on account of amendment in the gratuity plan. Previously, the bank's policy was to pay gratuity equal to two months basic pay for each completed year of service which has now been revised to gratuity equal to one-month basic pay for each completed year. Profit before tax stood higher at Rs. 2.3b (FY18: Rs. 707m). Accounting for taxation, net profit of the bank increased to Rs. 1.3b (FY18: Rs. 446m; FY17: Rs. 1.8b). During 1QFY19, the bank posted a net profit of Rs. 548m (1QFY19: Rs. 187m).

Improvement in capital adequacy ratio: Paid-up capital of the bank remained unchanged during the period under review. Tier-I equity of the bank stood at Rs. 15b by end-1QFY20 (FY19: Rs. 15b; FY18: Rs. 13.8b). However, total equity increased Rs. 16.0b (FY19: Rs. 14.2b; FY18: Rs. 11.7b) with the conversion of revaluation deficit into surplus Rs. 1.0b by end 1QFY20. Capital Adequacy Ratio (CAR) improved to 16.3% by end-1QFY20 (FY19: 15.3%; FY18: 12.3%) on account of 1% relaxation in Capital Conservation Buffer requirements by the SBP and notable increase in total eligible capital despite steady in increase credit and market risk weighted assets. As per the management, the bank is in comfortable position with respect to its CAR in the light of SBP's COVID-19 relief, including release of capital buffers, deferment of the repayment of principal loan amount for corporate, SMEs, and household borrowers, and restructuring/rescheduling of loans.

Governance and Digitalization: The Board of Directors (BoD) at BoK consists of 8 members (FY18: 8), of which 5 are the representative of government and the reaming 3 are from the private sector. Composition of the BoD changed as Mr. Shakeel Qadir Khan joined as the Chairman in December 2019 while replacing Dr. Shahzad Khan Bangash.

Mr. Saif-ul-Islam, who replaced Mr. Shahbaz Jameel as the full-time Managing Director/Chief Executive Officer (CEO) in December 2018, was terminated by provincial government in September 2019. Mr. Ishan Ullah Ishan has been serving as the acting MD/CEO since then. As per the management, Mr. Saif-ul-Islam has recently been reinstated by the Peshawar High Court; a formal court order is likely to be received soon. Moreover, the position of CFO is currently vacant due to recent departure of Mr. Mahmood Ahmed Qureshi. The advertisement has been floated and a consultant has been engaged to conduct the hiring process.

The bank has made some progress towards digitalization. Digital and internet banking platforms have been introduced with a big bang approach in early FY20. BoK debit card acceptance on point-of-sale/internet will be completed by Sep'20, and micro-payment gateway will be implemented in digital banking platform by end-FY20 to enable e-commerce transactions. Implementation of core banking software - Temenos T24 - is scheduled to be rolled out by Nov'20. According to the management, whole network is planned to be converted to online branches within six to eight months period after the scheduled rollout.

The Bank of Khyber Annexure I

FINANCIAL SUMMARY *(amounts in PKR billions)*				
BALANCE SHEET	**FY17**	**FY18**	**FY19**	**1QFY20**
Total Investments	140,474	94,233	146,911	150,742
Advances (net)	83,369	95,012	109,742	112,382
Lending to FIs	1,529	7,696	13,863	8,414
Cash & Balances	12,173	16,057	20,368	14,530
Operating Fixed Assets	2,370	2,295	3,335	3,241
Other Assets	5,217	7,802	12,086	10,551
Total Assets	**245,132**	**223,095**	**306,305**	**299,860**
Borrowings	64,190	34,842	94,656	114,115
Deposits & other accounts	159,247	171,168	182,168	158,666
Other Liabilities	5,167	4,486	14,108	10,395
Bills Payable & Others	1,131	895	1,172	686
Tier-1 Equity	14,943	13,809	14,982	15,030
Net Worth	15,398	11,705	14,201	15,998
Paid-Up Capital	10,003	10,003	10,003	10,003
INCOME STATEMENT	**FY17**	**FY18**	**FY19**	**1QFY20**
Net Mark-up Income	4,799	5,139	4,918	1,489
Net Provisioning/(Reversal)	-123	-171	-21	140
Non-Markup Income/(Loss)	1,651	-526	1,112	650
Operating Expenses	3,758	4,052	3,620	1,067
Profit Before Tax	2,795	707	2,261	884
Profit After Tax	1,791	466	1,306	548
RATIO ANALYSIS	**FY17**	**FY18**	**FY19**	**1QFY20**
Gross Infection (%)	5.5	4.7	4.4	4.3
Provisioning Coverage (%)	89	88	83.4	83.7
Net Infection (%)	0.6	0.6	0.8	0.7
Cost of Deposits (%)	4.6	4.7	8.5	n.a
Net NPLs to Tier-1 Capital (%)	3.5	3.9	5.6	5.4
Capital Adequacy Ratio (C.A.R (%)	20	12.3	15.3	16.3
Markup Spreads (%)	2.3	2.5	2.3	n.a
Efficiency (%)	71.6	71.5	64.5	61.1
ROAA (%)	0.8	0.2	0.5	0.7*
ROAE (%)	11.4	3.4	10.1	14.5*
Liquid Assets to Deposits & Borrowings (%)	56.2	50.2	53.2	51.9

**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-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. Sher Muhammad	Head – Conventional Banking	June 23, 2020
Mr. Muhammad Atif Hanif	Head – Islamic Banking	June 22, 2020
Mr. Mohammad Faisal	Head – Treasury	June 22, 2020
Mr. Azfar Latif	Head – IT	June 22, 2020
Mr. Rahat Gull	Head – Budgeting	June 22, 2020