The Pakistan Credit Rating Agency Limited

# Rating Report

# The Bank of Khyber

**Report Contents**



**Rating History**

| Dissemination Date | Long Term Rating | Short Term Rating | Outlook | Action | Rating Watch |
|---|---|---|---|---|---|
| 25-Jun-2018 | A | A1 | Stable | Maintain | - |
| 29-Dec-2017 | A | A1 | Stable | Maintain | - |
| 21-Jun-2017 | A | A1 | Stable | Maintain | - |
| 30-Jun-2016 | A | A1 | Stable | Maintain | - |
| 30-Jun-2015 | A | A1 | Stable | Maintain | - |

**Rating Rationale and Key Rating Drivers**

The ratings reflect BOK's sustained risk profile of the bank. Spreads remained low; showed a downward trend. NPLs has seen slight decreasing trend which improved asset quality. The bank has dependence on large ticket deposits from Government of Khyber Pakhtunkhwa (GoKP) and its related agencies. However, stability is observed in such deposits over time showing a 62% of the public deposits. The bank is expanding its branch network with high focus on KPK and Punjab; However, slightly establishing footprints in other cities especially Lahore and Karachi to compete with established banks. The management plans to increase advances book with higher focus preferably on infrastructure. With desired credit growth, nurturing strength of management team is essential. The ratings incorporate association of the bank with the Government of Khyber Pakhtunkhwa (GoKP). The bank raised a sizeable liquidity from repo transactions. This was deployed in lending – generating a spread. Going forward, the bank will do well to enhance the bank’s deposit base, eliminating the mismatch and creating room.

The ratings are dependent on bank's ability to hold its risk profile, while maintaining its relative market position. Improvement in the technology platform is critical to foster the control environment including reporting framework. Meanwhile, any significant infection in asset quality, thereby weakening the bank's risk absorption capacity, and/or any intervention compromising the governance standards would impact negatively.

**Disclosure**

| | |
|---|---|
| **Name of Rated Entity** | The Bank of Khyber |
| **Type of Relationship** | Solicited |
| **Purpose of the Rating** | Entity Rating |
| **Applicable Criteria** | Methodology \| Correlation between long-term and short-term rating scale(Jun-17),Methodology \| Bank Rating(Jun-17) |
| **Related Research** | Sector Study \| Commercial Bank(Jun-18) |
| **Rating Analysts** | Jhangeer Hanif \| jhangeer@pacra.com \| +92-42-35869504 |

| BANK OF KHYBER (BOK) PROFILE | |
|---|---|
| **Incorporated** | 1991 |
| **Profile** | A small sized scheduled bank with the network of 166 branches. |
| **Legal Status** | Listed |
| **Head Office** | Peshawar |

## INDUSTRY SNAPSHOT

The banking sector has experienced highest growth in terms of advances in 2017 over the last decade. As a consequence, there is mounting pressure on capital adequacy ratio of the banks. The challenge is exacerbated as the internal generation of capital (profits) are witnessing a dip. Some relief on income side is expected with recent uptick in interest rates.

## OWNERSHIP

- The Government of Khyber Pakhtunkhwa (GoKP) has majority stake in BoK (70%), whereas, Ismail Industries holds (24%). The remaining shareholding is widely dispersed.

## GOVERNANCE

- Board composition is in line with the parameters set in the BoK Act. At present the board comprises eight members, out of which four are GoKP nominees, including two officio members. The remaining includes one representative of Ismail Industries, while two are independent members and the Managing Director.
- Dr. Shahzad Khan Bangash, who worked at different departments of the Government, is the chairman of the board.

## MANAGEMENT

- The senior management team at BoK comprises seasoned professionals; majority having long term association with the bank.
- Current Acting Managing Director– Mr. Muhammad Shahbaz Jameel – was appointed by the government in Oct-17. He is a seasoned banker with twenty five (25) years of diverse experience at leading multinational financial institutions.

## RISK MANAGEMENT

- BoK has established separate risk management, credit management and compliance and internal control divisions.
- During CY17, Bank of Khyber's earning assets grew by 20%. Main driver of growth was advances to government (advances up by 170%).
- The sectoral mix revealed that top 3 private sectors, comprising commodity operations, Transmission of Energy and textile hold ~73% of advances (CY16: 56%).
- The client concentration remained high with top 20 customers demonstrating ~69% of BoK's overall advances (Dec16: 46%).
- BoK's proportion of Islamic advances as a percentage of total advances increased nominally (CY17: 47%; CY16: 16%).
- The quality of assets improved as reflected by NPLs to Gross Advances ratio (CY17: 6%; CY16: 15%) – mainly due to the addition of PKR 53bln in the advances book.
- The bank availed a cumulative FSV benefit of ~PKR 422mln. The bank's provisioning mainly covered as depicted by loan loss provision to non performing advances ratio (CY17: 90%; CY16: 81%).
- Government securities continued to dominate the bank's investments which comprised 99% of total investments in CY17 (CY16: 99%). BoK's net investments of PKR 136,391mln constitute ~60% of total assets base.
- The Bank's non-performing book largely remained the same in 1QCY18. Significant shrink was witnessed in 1QFY18; investment book clocked in at PKR 101bln. The redemption primarily incurred in government securities.

## BUSINESS RISK

- During CY17, the Banks's NIMR showed an increase of ~9%, due to significant rise in earning assets.
- On the other side Banks's spread showed a slight decline to be stayed at 2.3% (CY16: 2.6%) which is on the lower side, owing to the markup expense inched up.
- Non-markup income came down– a factor of decline in gain on sale of investments. BoK able to control its non-markup expenses by slight increase of 17% - operating costs on the back of addition in branches. Hence, the bottom-line clocked-in at PKR 1.7bln (CY16: PKR 2.0bln).
- During 1QCY18, BOK's interest income witnessed ~18% growth followed by 35% growth in NIMR to stand at PKR 1.4bln. However, other operating income witnessed a decline (1QCY18: PKR 169mln, 1QCY17: PKR 366) primarily on account of decline in unrealized gain on sale of investments. Consequently, with increased non-markup expenses and reduced provisioning expense the net profits for the quarter increased to PKR 448mln (1QCY17: 358mln), up 25% YoY.
- Going forward, BoK, while expanding its branch network, has identified Karachi and Lahore, as Hubs to expand its operations. The bank while having cautious approach, intends to increase its advances especially in infrastructure especially Steel and Cement amongst others. Going forward, the maintenance of profitability will be important for the bank.

## CAPITAL & FUNDING

- The growth in bank's customer deposit is a concern during CY17 which is only up by 1.4% (CY16: ~34%).
- The deposit are mainly public deposit which are 62%. The advances-to-deposits ratio increased further to ~52% (CY16: 20%) as the bank remained rigorous towards government lending. CASA proportion slightly inched up 53% at end-Dec17 (end-Dec16: ~61%).
- Top-20 depositors' concentration decreased to 50% (CY15: 55%) but still on the higher side.
- The bank raised a sizeable liquidity from repo transactions (PKR 42bln). This was deployed in lending – generating a spread. Going forward, the bank will do well to enhance the bank's deposit base, eliminating the mismatch and creating room in the ADR.
- Bank's liquidity position weakened on YoY basis as reflected in liquid assets as percentage of total deposits and borrowing (1QCY18: 41%; CY17: 54%; 1QCY16: 74%; CY16: 82%) which needs attention.
- At end-Mar18, CAR witnessed a decline with Tier I dropping to 16.4% with the total stand at 16.5%.

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**Financial Summary**

# The Bank of Khyber

| BALANCE SHEET | 31-Mar-18 | 31-Dec-17 | 31-Dec-16 | 31-Dec-15 |
|---|---|---|---|---|
| **Earning Assets** | | | | |
| Advances (Net of NPL) | 97,118 | 82,864 | 30,598 | 35,004 |
| Debt Instruments | 4,315 | 4,362 | 3,604 | 1,002 |
| Total Finances | 101,433 | 87,226 | 34,202 | 36,006 |
| Investments | 101,084 | 136,391 | 138,286 | 87,221 |
| Others | 2,465 | 2,282 | 16,393 | 17,686 |
| | **204,982** | **225,899** | **188,881** | **140,913** |
| **Non Earning Assets** | | | | |
| Non-Earning Cash | 8,888 | 11,421 | 11,052 | 7,579 |
| Deferred Tax | 534 | 380 | - | - |
| Net Non-Performing Finances | 182 | 225 | 758 | 1,523 |
| Fixed Assets & Others | 7,006 | 7,207 | 5,709 | 5,144 |
| | **16,610** | **19,233** | **17,519** | **14,245** |
| **TOTAL ASSETS** | **221,591** | **245,132** | **206,400** | **155,159** |
| **Interest Bearning Liabilities** | | | | |
| Deposits | 146,169 | 159,247 | 157,020 | 117,292 |
| Borrowings | 54,058 | 64,190 | 28,701 | 17,130 |
| | 200,227 | 223,437 | 185,721 | 134,422 |
| **Non Interest Bearing Liabilities** | 7,282 | 6,298 | 4,537 | 4,819 |
| **TOTAL LIABILITIES** | **207,509** | **229,734** | **190,258** | **139,241** |
| **EQUITY (including revaluation surplus)** | **14,082** | **15,398** | **16,143** | **15,918** |
| **Total Liabilities & Equity** | **221,591** | **245,132** | **206,400** | **155,159** |

| INCOME STATEMENT | 31-Mar-18 | 31-Dec-17 | 31-Dec-16 | 31-Dec-15 |
|---|---|---|---|---|
| | 1Q | Annual | Annual | Annual |
| Interest / Mark up Earned | 3,626 | 14,375 | 12,049 | 10,869 |
| Interest / Mark up Expensed | (2,229) | (9,576) | (7,643) | (6,442) |
| **Net Interest / Markup revenue** | **1,397** | **4,799** | **4,406** | **4,428** |
| Other Income | 132 | 1,532 | 2,584 | 1,680 |
| **Total Revenue** | **1,529** | **6,331** | **6,990** | **6,108** |
| Non-Interest / Non-Mark up Expensed | (978) | (3,758) | (3,209) | (2,688) |
| Pre-provision operating profit | 588 | 2,692 | 3,871 | 3,539 |
| Provisions | (101) | (104) | 631 | 581 |
| Pre-tax profit | 689 | 2,795 | 3,240 | 2,959 |
| Taxes | (241) | (1,005) | (1,219) | (1,169) |
| **Net Income** | **448** | **1,790** | **2,020** | **1,789** |

| Ratio Analysis | 31-Mar-18 | 31-Dec-17 | 31-Dec-16 | 31-Dec-15 |
|---|---|---|---|---|
| | 1Q | Annual | Annual | Annual |
| Performance | | | | |
| ROE | 12% * | 12% | 14% | 13% |
| Cost-to-Total Net Revenue | 64% | 59% | 46% | 44% |
| Other operating income/ Total net revenue | 9% | 24% | 37% | 28% |
| Capital Adequacy | | | | |
| Equity/Total Assets | 6% | 6% | 7% | 9% |
| Capital Adequacy Ratio as per SBP | 17% | 20% | 21% | 24% |
| Funding & Liquidity | | | | |
| Liquid Assets / Deposits and Borrowings | 41% | 54% | 83% | 73% |
| Advances / Deposits | 67% | 52% | 20% | 31% |
| CASA deposits / Total Customer Deposits | 63% | 53% | 61% | 59% |
| Intermediation Efficiency | | | | |
| Asset Yield | 7% * | 7% | 7% | 9% |
| Cost of Funds | -4% * | -5% | -5% | -5% |
| Spread | 3% * | 2% | 3% | 3% |
| Outreach | | | | |
| Branches | 166 | 166 | 150 | 130 |

** Annualized*

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# ENTITY CREDIT RATING SCALE & DEFINITIONS

Credit rating reflects forward-looking opinion on credit worthiness of underlying entity; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

## LONG TERM RATINGS

| | |
|---|---|
| AAA | **Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments. |
| AA+<br>AA<br>AA- | **Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events. |
| A+<br>A<br>A- | **High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions. |
| BBB+<br>BBB<br>BBB- | **Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances or economic conditions are more likely to impair this capacity. |
| BB+<br>BB<br>BB- | **Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met. |
| B+<br>B<br>B- | **High credit risk**. A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business, and economic environment. |
| CCC<br>CC<br>C | **Very high credit risk**. "CCC" Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. "CC" Rating indicates that default of some kind appears probable. "C" Ratings signal imminent default. |
| D | Obligations are currently in default. |

## SHORT TERM RATINGS

**A1+:** The highest capacity for timely repayment.

**A1:**. A strong capacity for timely repayment.

**A2:** A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.

**A3:** An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.

**B:** The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.

**C:** An inadequate capacity to ensure timely repayment.

**Rating Watch**
Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. Rating Watch may carry designation – Positive (rating may be raised, negative (lowered), or developing (direction is unclear). A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled.

**Outlook (Stable, Positive, Negative, Developing)**
Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business or financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

**Suspension**
It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, a suspended rating should be considered withdrawn.

**Withdrawn**
A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, or e) the entity/issuer defaults.

**Rating Team Statements**
(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**
i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)
iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term "family members" shall include only those family members who are dependent on the analyst and members of the rating committee

**Restrictions**
(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)
(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)
(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

**Conduct of Business**
(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)
(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.
(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)
(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)
(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

**Independence & Conflict of interest**
(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity
(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)
(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)
(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)
(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst's area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)
(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

**Monitoring and review**
(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)
(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)
(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)
(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)
**Probability of Default**
(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)
**Proprietary Information**