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
24-Dec-2018	A	A1	Stable	Maintain	-
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	-

Rating Rationale and Key Rating Drivers

The ratings reflect the bank's sustained risk profile. The bank's lending portfolio continued ascending trajectory while NPLs continued witnessing declining trend; resulted in improved asset quality. BoK's ADR rationalized to ~54% (CY17: 52%). The bank's funding base includes customer's deposits and borrowings. The deposit base witnessed substantial growth; led by saving deposits. The bank has dependence on large ticket deposits from Government of Khyber Pakhtunkhwa (GoKP) and its related institutions. Stability is observed in such deposits, over the years, composing 62% of the public deposits. During 9MCY18, lesser reliance on borrowings from financial institutes was witnessed. Hence, spread inched up driven by improvement in cost structure. The bank is expanding its branch network in KPK and Punjab; establishing footprints in major cities especially Lahore and Karachi to compete with established banks. The management plans to further increase advances book with higher focus 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 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, in the wake of significant expansion in the loan book, 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 | Financial Institution(Jun-18),Methodology | Criteria | Rating Modifier(Jun-18),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-18)
Related Research	Sector Study | Commercial Bank(Jun-18)
Rating Analysts	Sehar Fatima | sehar.fatima@pacra.com | +92-42-35869504

Profile

Structure The Bank of Khyber (BoK) was established in 1991 under the BoK Act, passed by the Provincial Legislative Assembly of the province of Khyber Pakhtunkhwa (KP). It was awarded status of a scheduled bank in September 1994.

Background BoK initially was established with a vision to gradually promote Islamic banking. Currently, significant chunk of branches are dedicated Islamic banking branches.

Operations At present, 84 of its branches function as dedicated Islamic banking branches, whereas 84 branches cater conventional banking. A small sized scheduled bank with the network of 166 branches.

Ownership

Ownership Structure The Government of Khyber Pakhtunkhwa (GoKP) has majority stake in BoK (70%), whereas, Ismail Industries holds 24% shareholding. The remaining shareholding is widely dispersed among Financial Institutions and General Public.

Stability The major shareholding has been with provincial government since inception of the bank. It is expected to remain same in the foreseeable future.

Business Acumen The business acumen of the sponsor is considered adequate as the major shareholder is GoKP.

Financial Strength The financial strength of the sponsor considered strong as GoKPK is ranked third amongst provinces in terms of overall budget size. Nonetheless, the patronage of GoKPK helps the bank in mobilizing deposits from government institutions. Being the major shareholder of BoK, provincial government has demonstrated its support to the bank in the past and is also expected to do so in future.

Governance

Board Structure 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 official members. The remaining includes one representative of Ismail Industries, while two are independent members and the Managing Director.

Members' Profile Dr. Shahzad Khan Bangash, who worked at different departments of the Government, is the chairman of the board. Overall, the board's banking experience is relatively limited. As per the BoK Act, the president is appointed by the government.

Board Effectiveness The board monitors the key functional and risk areas through its three committees; i) Audit Committee, ii) Human Resource & Remuneration Committee, iii) Risk Management Committee.

Financial Transparency M/s. Grant Thornton Anjum Rahman, Chartered Accountants is the bank's auditor. The firm is listed in category "A" by the approved panel of auditors maintained by SBP. The auditor has expressed an unqualified opinion in its audit report for the year ended December 31, 2017. An interim review was conducted for the six months ending June 30th, 2018.

Management

Organizational Structure The bank's overall operations have been re-organized lately to bring cohesiveness within functions and augmenting efficiency of the organization. The functions are currently segregated into twelve divisions.

Management Team Mr. Saif ul Islam has been appointed as the new CEO of bank on December 4, 2018. He is a seasoned banker with forty years of diverse experience mainly in banking industry. Other senior management is consist of seasoned professionals.

Effectiveness The bank has ten committees in place at the management level with well-defined terms of reference to oversee its day-to-day operational matters and to take decisions to implement the strategy outlined by the board.

MIS Currently the Business Management Group (BMG) of BoK has three divisions namely; (i) Corporate/Commercial, (ii) Agriculture Finance and (iii) Credit management division, separately performing their functions.

Risk Management Framework The bank has implemented Core banking software – Bank Essentials. The bank follows a tier based loan evaluation process. Meanwhile, the bank has also developed an internal risk-rating model to determine obligor's overall risk profile. This would help the bank in keeping the quality of assets in line with the overall risk appetite of the bank.

Business Risk

Industry Dynamics The banking industry witnessed significant expansion in the loan book. Last year and YTD (2018) both witnessed huge deployments. This is expected to slow down. New projects require gestation period and additionally crowding-out effect may take place. Rising interest rates mean profitability of the sector would take support. Yet NPLs, as a result, may also transpire. CAR is reaching the maximum requirement by December 2018 (11.9%). This will create a challenge for some of the players.

Relative Position The bank of Khyber (BoK) is a small sized bank with deposits system share of 1.4% (CY17: 1.3%).

Revenues During 9MCY18, the Bank's interest earned remained largely same at PKR 10.6bln. NIMR showed an increase of ~14% YoY, driven by increase in lending portfolio. The bank's asset yield remained largely same while slight decrease witnessed in bank's cost of funds due to slight shift to lower cost deposits. Whereby, the Banks's spread depicted a slight increase to stand at 2.6% (CY17: 2.3%).

Performance Non-markup income came down to PKR 449mln (9MCY17: PKR 1.1bln) driven by significant decline in gain on sale of investments. The bank's non-markup expenses witnessed slight increase of 9% to stand at PKR 2.9bln. Hence, the bank's pre-provision operating profit declined to PKR 1.5bln (9MCY17: PKR 2.2bln), down 33% YoY. With slight reversal in provisioning, the Bank's net income stood at PKR 928mln (9MCY17: PKR 1.3bln), down 33% YoY.

Sustainability 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 (Steel and Cement sectors).

Financial Risk

Credit Risk During 9MCY18, Bank of Khyber's total earning assets declined by 19% mainly driven by decrease in investments (specifically government securities down by 41%). The sectoral mix revealed that top 3 private sectors, comprising commodity operations, Transmission of Energy and textile hold ~73% of advances in CY17 (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 slightly improved as reflected by NPLs to Gross Advances ratio (end-Sep18: 5%; end-Dec17: 6%; end-Dec16: 15%) – mainly due to the addition of PKR 10bln in the advances book. The bank's provisioning mainly covered as depicted by loan loss provision to non performing advances ratio (end-Sep18: 90%; end-Dec17: 90%; end-Dec16: 81%).

Market Risk Government securities continued to dominate the bank's investments which comprised 99% of total investments as at end-Sep18 (CY17: 99%). BoK's net investments of PKR 81bln constitute ~39% of total assets base.

Liquidity And Funding The bank's customer deposits inched up by 8% (CY17: ~1.4%), during 9MCY18. The deposits are mainly public deposit. The bank's ADR increased further to ~54% (CY17: 52%) as the bank remained rigorous towards government lending. CASA proportion slightly inched up 58% at end-Sep18 (end-Dec17: ~53%). Top-20 depositors' concentration decreased to 50% (CY15: 55%) but still on the higher side. The bank's borrowings from financial institutions dwindled as the focus is now diverting towards deposits base. Bank's liquidity position weakened on YoY basis as reflected in liquid assets as percentage of total deposits and borrowing (end-Sep18: 49%; end-Dec17: 54%; end-Sep17: 67%) on account of declined investment in government securities.

Capitalization The bank has reported a capital of PKR 14bln as at end-Sep18. At end-Sep18, CAR witnessed a decline with to 15.7% (end-Dec17: 20%) - Tier I dropping to 14.2% (end-Dec17: 19.5%). During 9MCY18, the bank has utilized its 5.3% CAR.

The Bank of Khyber

BALANCE SHEET	30-Sep-18	31-Dec-17	31-Dec-16	31-Dec-15
Earning Assets				
Advances (Net of NPL)	92,605	82,864	30,598	35,004
Debt Instruments	7,332	4,362	3,604	1,002
Total Finances	99,936	87,226	34,202	36,006
Investments	80,809	136,391	138,286	87,221
Others	2,675	2,282	16,393	17,686
	183,420	**225,899**	**188,881**	**140,913**
Non Earning Assets				
Non-Earning Cash	12,091	11,421	11,052	7,579
Deferred Tax	1,112	380	-	-
Net Non-Performing Finances	202	225	758	1,523
Fixed Assets & Others	7,881	7,207	5,709	5,144
	21,286	**19,233**	**17,519**	**14,245**
TOTAL ASSETS	**204,706**	**245,132**	**206,400**	**155,159**
Interest Bearing Liabilities				
Deposits	172,587	159,247	157,020	117,292
Borrowings	13,899	64,190	28,701	17,130
	186,486	223,437	185,721	134,422
Non Interest Bearing Liabilities	4,722	6,298	4,537	4,819
TOTAL LIABILITIES	**191,208**	**229,734**	**190,258**	**139,241**
EQUITY (including revaluation surplus)	**13,498**	**15,398**	**16,143**	**15,918**
Total Liabilities & Equity	**204,706**	**245,132**	**206,400**	**155,159**

INCOME STATEMENT	30-Sep-18 9M	31-Dec-17 Annual	31-Dec-16 Annual	31-Dec-15 Annual
Interest / Mark up Earned	10,618	14,375	12,049	10,869
Interest / Mark up Expensed	(6,657)	(9,576)	(7,643)	(6,442)
Net Interest / Markup revenue	**3,961**	**4,799**	**4,406**	**4,428**
Other Income	449	1,532	2,584	1,680
Total Revenue	**4,410**	**6,331**	**6,990**	**6,108**
Non-Interest / Non-Mark up Expensed	(2,975)	(3,758)	(3,209)	(2,688)
Pre-provision operating profit	1,531	2,692	3,871	3,539
Provisions	7	(104)	631	581
Pre-tax profit	1,524	2,795	3,240	2,959
Taxes	(597)	(1,005)	(1,219)	(1,169)
Net Income	**928**	**1,790**	**2,020**	**1,789**

Ratio Analysis	30-Sep-18 9M	31-Dec-17 Annual	31-Dec-16 Annual	31-Dec-15 Annual
Performance				
ROE	8% *	12%	14%	13%
Cost-to-Total Net Revenue	67%	59%	46%	44%
Other operating income/ Total net revenue	10%	24%	37%	28%
Capital Adequacy				
Equity/Total Assets	7%	6%	7%	9%
Capital Adequacy Ratio as per SBP	16%	20%	21%	24%
Funding & Liquidity				
Liquid Assets / Deposits and Borrowings	49%	54%	83%	73%
Advances / Deposits	54%	52%	20%	31%
CASA deposits / Total Customer Deposits	58%	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	168	166	150	130

** Annualized*

Rating Scale

Credit Rating Scale & Definitions

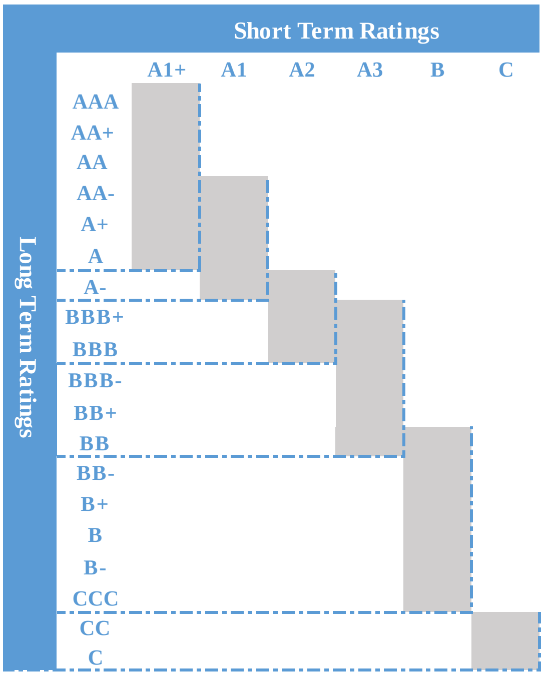
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings

AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA 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+ A 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+ BBB 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 and in economic conditions are more likely to impair this capacity.
BB+ BB 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+ B 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 CC C	**Very high credit risk.** Substantial 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.



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/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'.

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. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

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, the 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, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Disclaimer: PACRA's ratings are an assessment of the credit standing of entities/issue in Pakistan. They do not take into account the potential transfer / convertibility risk that may exist for foreign currency creditors. PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.

Regulatory and Supplementary Disclosure
(Credit Rating Companies Regulations,2016)

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