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Bank of South Pacific Ltd.

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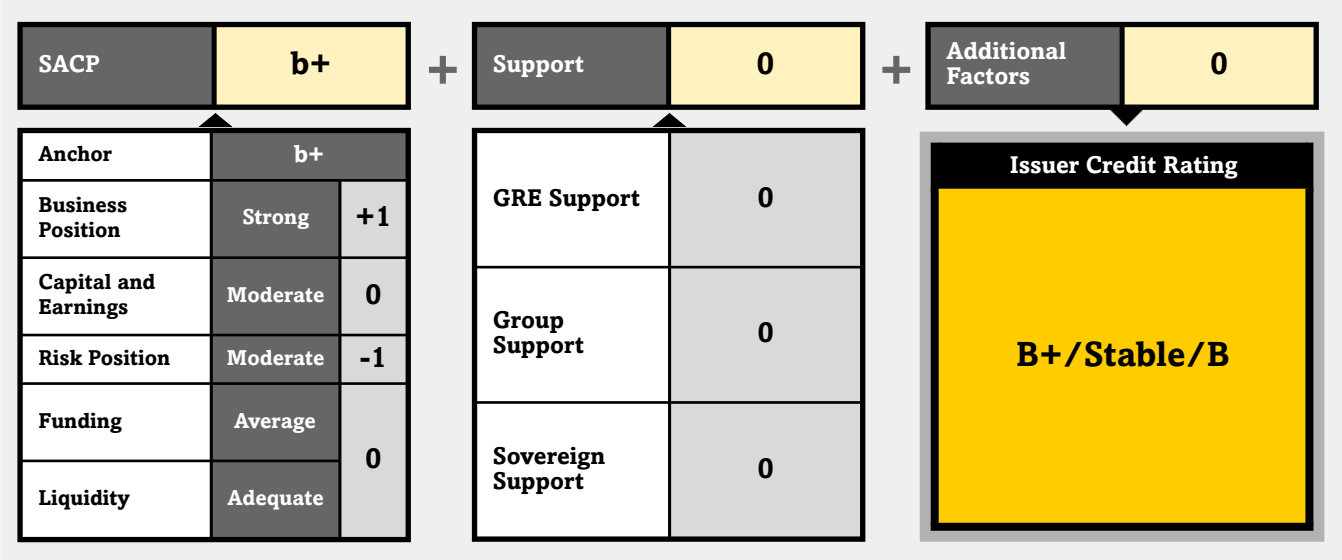
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Bank of South Pacific Ltd.



Major Rating Factors

Strengths:	Weaknesses:
<ul style="list-style-type: none"> • Strong domestic market position • Sound profitability 	<ul style="list-style-type: none"> • High credit-risk portfolio, although adequate asset quality in a domestic context • High-risk economic and operating environment • Vulnerability to erosion of confidence in Papua New Guinea

Rationale

Our ratings on Bank of South Pacific Ltd. (BSP) reflect the anchor stand-alone credit profile (SACP) for banks operating only in Papua New Guinea; plus BSP's "strong" business position, "moderate" capital and earnings, "moderate" risk position, "average" funding, and "adequate" liquidity.

Anchor:

Our bank criteria use our BICRA economic risk and industry risk scores to determine a bank's anchor standalone credit profile (SACP), the starting point in assigning an issuer credit rating (ICR). Our anchor SACP for a commercial bank operating only in Papua New Guinea is 'b+'. The BICRA score is informed by our evaluation of economic risk, whereby we view PNG's economy as being constrained by low income levels, high dependence on the minerals sector, and infrastructure shortcomings, security risks, and uncertainties around official registries in the judicial system. The risk of imbalances is heightened by a rapid rise in property prices and high current accounts deficits; credit risk is exacerbated by low income levels, name and sector concentrations, and weaknesses in the legal framework. With regard to

industry risk, our assessment of the Papua New Guinea banking industry is underpinned by the system's gaps in regulation, weaknesses in disclosure, and aggressive risk appetite. The banking system has access to very limited funding alternatives other than customer deposits, in our view.

The SACP for BSP is 'b+'.

Table 1

Bank of South Pacific Ltd. Key Figures					
--Year-ended Dec. 31--					
(Mil. PGK)	2012	2011	2010	2009	2008
Adjusted assets	13,330.9	11,659.4	10,011.1	9,376.5	6,807.9
Customer loans (gross)	5,025.2	4,469.0	4,250.0	3,768.3	2,394.3
Adjusted common equity	1,445.4	1,304.0	1,100.0	912.8	744.3
Operating revenues	1,316.9	1,133.9	949.1	721.2	619.8
Noninterest expenses	699.8	633.2	517.1	328.7	228.9
Core earnings	408.5	356.5	283.8	257.2	263.8

Business position:

We assess BSP's business position as 'strong'. We are of the view that BSP, given its market position in Papua New Guinea, Fiji, and the Solomon Islands, and its leading retail bank network, is on average less risky compared to other banks with a similar industry risk score, and therefore its business operations are less vulnerable to adverse operating conditions than the industry risk score illustrates.

In our opinion, it would be extremely challenging for any competitor, whether onshore or offshore, to replicate BSP's investment in its information technology infrastructure, and therefore its natural reach, which forms the backbone of its operations in the South Pacific. We are also of the view that BSP's direct relationship with its client base would make it difficult for its competitors to acquire its customer base.

Further solidifying our views around BSP's strong business position assessment relative to its competitors are BSP's:

- Dominant position in Papua New Guinea in terms of loans and advances and deposits (notwithstanding that BSP has a less dominant position in Fiji and the Solomon Islands, with these two jurisdictions accounting for only about 20% of the total loans and advances);
- Leading branch network in Papua New Guinea, Fiji, and the Solomon Islands;
- Use of technology to deliver innovative banking services to the most remote rural areas in Papua New Guinea by providing banking to the unbanked; and
- Our view is further strengthened by the strong annuity characteristics of BSP's revenues.

We view the concentration and diversification of BSP's business activities as slightly better than that of domestic banks, given the bank's retail stronghold, but we do note that BSP (similar to domestic banks) still has a significant exposure to sovereign risk in Papua New Guinea.

From a strategic perspective, we are of the view that BSP is well positioned to expand its business operations in the South Pacific, both in terms of its retail and commercial capabilities. In the retail banking market we expect BSP to further leverage its branch network and use innovative technological capabilities, whereas in the corporate banking

market, focus would be on matching services to client operations and linking them to chains of supply and distribution. We also expect BSP to increase its share of trade finance and foreign exchange related fee income.

We are of the view that the change at the helm of BSP would not have a significant bearing on the strategic direction of the bank. That said, we consider that it is likely that BSP would consolidate its current position post a period earmarked for high growth. Over the past number of years there was a move away from a one-size-fits-all service model to one that focuses on improving banking-service quality and availability to all customers throughout PNG. We view the composition and structure of the board and board subcommittees as adequate, given the nature and complexity of BSP's business activities.

Table 2

Bank of South Pacific Ltd. Business Position					
	--Year-ended Dec. 31--				
(%)	2012	2011	2010	2009	2008
Total revenues from business line (mil.)	1,316.9	1,133.9	949.1	723.5	619.8
Commercial & retail banking/total revenues from business line	92.6	90.6	91.2	99.7	100.0

Capital and earnings:

We assess BSP's overall capital and earnings position as moderate. Our assessment is pinned to BSP's projected risk-adjusted capital ratio (RAC ratio) estimate of 5.0%-5.5% (the static ratio is about 5.4%), which falls into the moderate category.

We project BSP's RAC ratio as falling post the acquisition of Credit Corporation, and estimate that it would be maintained in the range of 5%-6% over the short-to-medium term. In our projection we estimate net interest margins as remaining fairly flat, income growth as outpacing cost growth, above system growth in loans and advances, and a dividend payout ratio of around 65%.

The capital base of good quality total adjusted capital consists almost fully of ordinary share capital and retained earnings.

The regulatory environment is less developed compared to developing countries, and the Bank of Papua New Guinea has not yet adopted the Basel II capital regime. On a Basel I basis, BSP is adequately capitalised, and has a Tier 1 ratio of approximately 17.4% (above the minimum ratio of 8% required in Papua New Guinea).

The RAC ratio is considerably lower than that regulatory ratio, largely due to the Standard & Poor's risk-weighted sovereign exposures of 122%, compared to a 0% risk weight for regulatory purposes and the inclusion of a capital requirement for operational risk when no such requirement exists for regulatory purposes.

Table 3

Bank of South Pacific Ltd. Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	2012	2011	2010	2009	2008
Tier 1 capital ratio	17.4	19.8	19.7	18.0	20.9
Adjusted common equity/total adjusted capital	98.8	98.6	98.4	100.0	100.0

Table 3

Bank of South Pacific Ltd. Capital And Earnings (cont.)					
Net interest income/operating revenues	51.8	52.7	57.3	65.7	60.8
Fee income/operating revenues	19.3	17.8	16.0	15.1	14.1
Market-sensitive income/operating revenues	17.4	18.6	15.7	14.5	20.5
Noninterest expenses/operating revenues	53.1	55.8	54.5	45.6	36.9
Preprovision operating income/average assets	4.9	4.6	4.4	4.8	6.2
Core earnings/average managed assets	3.3	3.3	2.9	3.2	4.2

Risk position:

Risk position is assessed as moderate. Our moderate assessment for risk position takes into account BSP's higher concentration risk compared to that of peers with a similar economic risk score and product mix, and our views that operational risk is not fully covered under the standard assumptions of our risk adjusted capital framework.

We are of the view that BSP's concentration risk is higher than that of its peer banks with a similar economic risk score and product mix. BSP's higher concentration risk is largely reflected through the bank's:

- Loan concentration to the Treasury and Central Bank Bills of Papua New Guinea, which is in excess of 40% of the bank's total assets and;
- Single-name-concentration risk (calculated using a model based on a granularity adjustment) to large corporates that is higher than that of the majority of peers.

We are also of the view that operational risk is higher than that what our standard assumptions of our risk-adjusted capital framework would indicate. In this regard we note that BSP operates in an environment of heightened operational risks. We note, however, that the risk is somewhat ameliorated by our views around BSP's quality information technology architecture and infrastructure (including personnel), which measure up to developed world standards. We are also of the view that BSP's adoption of the Basel II Standardized Approach Methodology for operational risk results in increased levels of awareness of operational risk throughout the organization.

We've also taken note that BSP's gross non-performing loans statics is displaying an improving trend over the past few years for both the retail portfolio and the corporate portfolio, and that these improvements are largely due to an overall strong economic environment (although some slowing down will occur as the Papua New Guinea LNG main project runs off in 2014) and BSP's disciplined approach to improve the credit quality of the of the Fiji loan book.

Table 4

Bank of South Pacific Ltd. Risk Position					
	--Year-ended Dec. 31--				
(%)	2012	2011	2010	2009	2008
Growth in customer loans	12.4	5.2	12.8	57.4	50.5
Total managed assets/adjusted common equity (x)	9.2	9.0	9.1	10.3	9.1
New loan loss provisions/average customer loans	1.5	0.6	0.5	0.5	0.6
Net charge-offs/average customer loans	(0.1)	(0.3)	(0.5)	(0.7)	0.1
Gross nonperforming assets/customer loans + other real estate owned	1.3	2.1	2.1	0.9	1.0
Loan loss reserves/gross nonperforming assets	331.5	175.4	178.3	386.7	204.7

Funding and liquidity:

BSP's funding is assessed as average and liquidity is assessed as adequate, recognizing the stability of the funding profile, which is supported by the bank's strong market position and supportive depositor base. As the largest bank in Papua New Guinea, BSP benefits from strong and stable deposit and funding flows from retail, corporate, and government depositors and investors.

Our "average" view of BSP's funding also reflects the bank's access to central bank funding. BSP's liquidity position is assessed as being adequate, underpinned by: its high level of balance-sheet liquid assets (liquid assets comprised about 40% of total deposits in 2012), cash flow generated from its lending activities, and its reasonable stable and supportive deposit base.

Table 5

Bank of South Pacific Ltd. Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	2012	2011	2010	2009	2008
Core deposits/funding base	98.7	98.4	98.6	98.5	99.8
Customer loans (net)/customer deposits	44.2	45.9	51.2	48.6	40.5
Long term funding ratio	99.4	99.2	99.7	99.6	99.8
Stable funding ratio	175.9	178.6	173.3	177.7	218.7
Short-term wholesale funding/funding base	0.7	0.9	0.4	0.4	0.2
Broad liquid assets/short-term wholesale funding (x)	79.2	66.6	153.0	136.3	342.5
Net broad liquid assets/short-term customer deposits	58.1	62.8	60.3	62.5	89.9
Short-term wholesale funding/total wholesale funding	48.2	49.8	23.6	29.5	100.0

Table 6

Bank of South Pacific Ltd. RACF Risk-Adjusted Capital Framework					
	Exposure*	Basel II RWA	Average Basel II RW (%)	Standard & Poor's RWA	Average Standard & Poor's RW (%)
Credit risk					
Government and central banks	6,836,258,000	117,097,000	2	8,369,654,512	122
Institutions	14,148,000	14,148,000	100	20,310,240	144
Corporate	3,751,775,410	3,751,780,413	100	7,368,690,836	196
Retail	1,121,442,589	1,027,922,588	92	1,960,866,462	175
Of which mortgage	187,040,000	93,520,000	50	162,724,800	87
Securitization§	0	0	0	0	0
Other assets	1,808,322,000	1,729,810,000	96	5,269,966,971	291
Total credit risk	13,531,945,999	6,640,758,000	49	22,989,489,021	170
Market risk					
Equity in the banking book†	118,090,000	65,729,451	56	1,242,405,585	1,052
Trading book market risk	--	0	--	0	--
Total market risk	--	65,729,451	--	1,242,405,585	--
Insurance risk					
Total insurance risk	--	--	--	664,575,000	--

Table 6

Bank of South Pacific Ltd. RACF Risk-Adjusted Capital Framework (cont.)

Operational risk					
Total operational risk	--	0	--	2,424,735,887	--
	Basel II RWA		Standard & Poor's RWA	% of Standard & Poor's RWA	
Diversification adjustments					
RWA before diversification	6,706,487,451		27,321,205,493		100
Total Diversification/Concentration Adjustments	--		9,321,087,102		34
RWA after diversification	6,706,487,451		36,642,292,595		134
	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	Standard & Poor's RAC ratio (%)	
Capital ratio					
Capital ratio before adjustments	922,337,204	13.8	1,463,650,000		5.4
Capital ratio after adjustments†	922,337,204	17.5	1,463,650,000		4.0

*Exposure at default. §Securitisation Exposure includes the securitisation tranches deducted from capital in the regulatory framework. †Exposure and Standard & Poor's risk-weighted assets for equity in the banking book include minority equity holdings in financial institutions. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital.PGK--Papua New Guinea kina. Sources: Company data as of Dec. 31, 2012, Standard & Poor's.

Outlook: Stable

The stable outlook on BSP reflects Standard & Poor's expectations that BSP's business operations that are on average less vulnerable to adverse operating conditions compared to domestic competitors, and BSP's capacity to absorb a minor deterioration in asset quality and profitability without compromising our view and assessment of its capital and earnings and risk position.

The rating could be lowered if the sovereign rating on Papua New Guinea is lowered. In addition, the rating on BSP could also be lowered if the bank's asset-quality experience deteriorated significantly, or if significant operational risk events emerged and resulted in a fall in the bank's projected RAC ratio to a level below 3%. Potential liquidity challenges as a result of sovereign or economic difficulties could also put the rating under pressure, resulting in a reassessment of our funding and liquidity score on BSP to moderate from adequate.

In our view the rating is unlikely to be raised in the short-to-medium term, as the rating is constrained by that on the sovereign, primarily due to BSP's exposure to sovereign assets. The most likely scenario for a rating upgrade would be a sovereign rating upgrade, along with our forecast RAC ratio for BSP improving to above 7%.

Related Criteria And Research

- Group Rating Methodology, May 7, 2013
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011

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Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	4	5	6	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of July 31, 2013)

Bank of South Pacific Ltd.

Counterparty Credit Rating B+/Stable/B

Subordinated B-

Counterparty Credit Ratings History

01-Nov-2012 B+/Stable/B

10-Jul-2012 B+/Negative/B

06-Dec-2011 B/Stable/B

Sovereign Rating

Papua New Guinea (Independent State of) B+/Stable/B

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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