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Bank of South Pacific Ltd.

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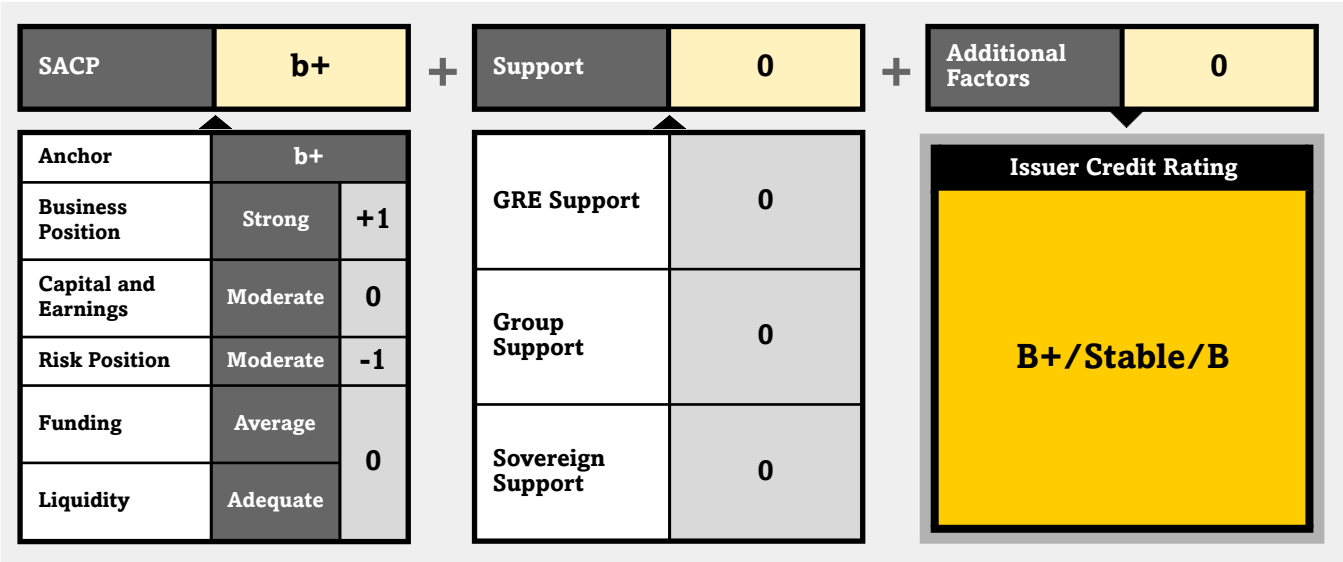
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Bank of South Pacific Ltd.



Major Rating Factors

Strengths:	Weaknesses:
<ul style="list-style-type: none"> Strong domestic market position that is difficult to replicate Sound profitability 	<ul style="list-style-type: none"> Concentrated and high-risk loan portfolio 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 stand-alone 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)	2013	2012	2011	2010	2009
Adjusted assets	15,675	13,331	11,659	10,011	9,376
Customer loans (gross)	5,583	5,025	4,469	4,250	3,768
Adjusted common equity	1,467	1,445	1,304	1,100	913
Operating revenues	1,556	1,317	1,134	949	721
Noninterest expenses	771	700	633	517	329
Core earnings	522	409	356	284	257

Business position:

We assess the business position of BSP--the largest bank in Papua New Guinea--as "strong"; the bank has a client base of approximately 1.3 million customers in PNG, increasing to 1.6 million customers when the Solomon Islands and Fiji are included.

We believe that for any competitor it would be challenging, whether onshore or offshore, to replicate BSP's investment in its information technology infrastructure, and therefore its natural reach, which forms the mainstay 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 competitors to acquire its customer base. We therefore believe that BSP's business position is on average less susceptible to business instability than are its domestic peers; in our view, BSP's business operations are therefore less vulnerable to adverse operating conditions than what our industry risk assessment illustrate. That said, we will continue to monitor BSP's market position relative to domestic peers.

Further solidifying our views around BSP's strong business position assessment relative to peers with a similar industry risk score is BSP's:

- Dominant position in PNG in terms of loans and advances and deposits (notwithstanding that BSP has a less dominant position in Fiji and the Solomon Islands; these two jurisdictions only account for about 20% of the total loans and advances);
- Strong annuity characteristics of revenues;
- Leading branch network in PNG, Fiji and the Solomon Islands; and
- Use of technology to deliver innovative banking services to the most remote rural areas in PNG by providing banking to the unbanked.

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

From a strategic perspective we view BSP as well positioned to expand its business operations in the South Pacific,

both in terms of its retail and commercial capabilities. We note that BSP is targeting, as part of its longer-term growth plans, financial services diversification and Pacific expansion; concomitantly cost control and productivity reviews are important focus areas. We believe that this strategic direction will not materially change BSP's credit risk profile over the short term.

In our view retail banking will continue to leverage from BSP's significant branch network and use of innovative technological capabilities to increase lending (including home loans and SME lending) and generate growth in eftPOS, mobile banking and ATM transaction activity. Work on BSP systems and channels continue, such as with the development of an automated cheque-processing and loan-origination engine and tablet instant account and agency model.

For the corporate bank, we note that the service and sales programs (Customer First) will continue to be the key focus area to uplift non-lending fees and cross-sell "Whole of Bank" solutions to BSP's client base.

We believe that governance structures, including the composition and structure of BSP's board of directors and board subcommittees, such as the remuneration & nomination committee and audit and risk compliance committee, are adequate given the nature and complexity of BSP's business activities.

Table 2

Bank of South Pacific Ltd. Business Position					
	--Year-ended Dec. 31--				
(%)	2013	2012	2011	2010	2009
Total revenues from business line (mil. PEK)	1,556	1,317	1,134	949	724
Commercial & retail banking/total revenues from business line	92.5	92.6	90.6	91.2	99.7

Capital and earnings:

We assess BSP's overall capital and earnings position as "moderate". We forecast BSP's projected RAC ratio to be maintained within a range of 4.5%-4.8% (the static ratio is circa 4.6%) over the short-to-medium term.

It is our view that the regulatory environment is less developed compared to developing countries; we also note that 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 13.4% (above the minimum ratio of 8% required in Papua New Guinea).

The RAC ratio is considerably lower than that regulatory ratio largely because of the Standard & Poor's RAC ratio risk-weighting sovereign exposures and the calculation of capital requirements for operational risk (that do not form part of the Basel I risk-weighted assets).

As noted above, we project that BSP's RAC ratio would be maintained in the range of 4.5%-4.8% over the short-to-medium term. The RAC ratio deteriorated compared to the prior period primarily because of the capitalization of software costs and an increase in risk-weighted assets; in our view these adjustments are anticipated to be of a once-off nature.

In arriving at our forecast ratio we make use of projections. Our projections include the following key assumptions:

- The net interest margin to remain fairly flat at around 6.3%;
- Loan growth to increase by about 11% per annum--slightly head of our view of system growth;
- Income growth to outpace cost growth; and
- A dividend-payout ratio of about 65%.

We are of the view BSP's quality of capital and earnings are better than that of peers that have a similar economic risk score. In this regard we note that BSP's ratio of core earnings to average adjusted assets is higher than that of peers.

Finally, we assess BSP's capital base to be of good quality, as total adjusted capital consists almost fully out of ordinary share capital and retained earnings.

Table 3

Bank of South Pacific Ltd. Capital And Earnings					
	--Year-ended Dec. 31--				
(%)	2013	2012	2011	2010	2009
Tier 1 capital ratio	13.9	17.4	19.8	19.7	18.0
Adjusted common equity/total adjusted capital	98.8	98.8	98.6	98.4	100.0
Net interest income/operating revenues	47.6	51.8	52.7	57.3	65.7
Fee income/operating revenues	18.4	19.3	17.8	16.0	15.1
Market-sensitive income/operating revenues	22.7	17.4	18.6	15.7	14.5
Noninterest expenses/operating revenues	49.5	53.1	55.8	54.5	45.6
Preprovision operating income/average assets	5.4	4.9	4.6	4.4	4.8
Core earnings/average managed assets	3.6	3.3	3.3	2.9	3.2

Risk position:

Risk position is assessed as "moderate". We believe that BSP's concentration risk is higher compared to that of peers who have a similar economic risk score and product mix; operational risk is also not fully covered in the standard assumptions of our risk-adjusted capital framework. In parallel we note that asset-quality trends compare favorable against those of peers possessing a similar economic risk score and product mix.

We are of the view that BSP's concentration risk is higher compared to peers with a similar economic risk score and product mix. In this regard, BSP's higher concentration risk is largely evidenced by:

- The banks' loan portfolio concentration to 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 peers with a similar economic risk score.

We note that BSP's name-concentration risk is somewhat ameliorated by the credit quality of the large corporates that it deals with, and the extent to which these corporates benefit from deal flows from multinational corporations.

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, such as infrastructure shortcomings, security risks, and uncertainties around official registries in the judicial system. We note, however, that the risk is mitigated by our views around how BSP manages operational risk,

with BSP's information technology architecture and infrastructure (including personnel) measuring 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.

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; these improvements are largely due to an overall buoyant economic environment and BSP's disciplined approach to improving the credit quality of the of the Fiji loan book. We view BSP's asset-quality ratios as better compared to those of peers with a similar economic risk score.

Table 4

Bank of South Pacific Ltd. Risk Position					
	--Year-ended Dec. 31--				
(%)	2013	2012	2011	2010	2009
Growth in customer loans	11.1	12.4	5.2	12.8	57.4
Total managed assets/adjusted common equity (x)	10.8	9.2	9.0	9.1	10.3
New loan loss provisions/average customer loans	1.8	1.5	0.6	0.5	0.5
Net charge-offs/average customer loans	0.2	(0.1)	(0.3)	(0.5)	(0.7)
Gross nonperforming assets/customer loans + other real estate owned	1.0	1.3	2.1	2.1	0.9
Loan loss reserves/gross nonperforming assets	513.1	331.5	175.4	178.3	386.7

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 PNG, BSP benefits from strong and stable deposit and funding flows from retail, corporate, and government depositors and investors and access to central bank funding; we note that the bank's net stable funding equals about 185%.

BSP's liquidity position also supports our assessment and is underpinned by:

- The bank's high level of on balance-sheet liquid assets (liquid assets comprised about 40% of total deposits in 2013);
- The cash flow generated from its lending activities;
- BSP's reasonable stable and supportive deposit base; and
- The bank's broad liquid assets-to-short-term wholesale funding ratio of about 10x.

We also note that BSP is not identified as an outlier bank in terms of our funding and liquidity metrics.

Table 5

Bank of South Pacific Ltd. Funding And Liquidity					
	--Year-ended Dec. 31--				
(%)	2013	2012	2011	2010	2009
Core deposits/funding base	93.4	98.7	98.4	98.6	98.5
Customer loans (net)/customer deposits	43.5	44.2	45.9	51.2	48.6
Long-term funding ratio	94.5	99.4	99.2	99.7	99.6
Stable funding ratio	184.5	175.9	178.6	173.3	177.7

Table 5

Bank of South Pacific Ltd. Funding And Liquidity (cont.)					
Short-term wholesale funding/funding base	6.1	0.7	0.9	0.4	0.4
Broad liquid assets/short-term wholesale funding (x)	10.5	79.2	66.6	153.0	136.3
Net broad liquid assets/short-term customer deposits	66.5	58.1	62.8	60.3	62.5
Short-term wholesale funding/total wholesale funding	90.2	48.2	49.8	23.6	29.5

Table 6

Bank of South Pacific Ltd. Risk-Adjusted Capital Framework						
(PGK)	Exposure*	Basel II RWA	Average Basel II RW (%)	Standard & Poor's RWA	Average Standard & Poor's RW (%)	
Credit risk						
Government and central banks	7,490,755,000	213,134,000	3	9,212,216,013	123	
Institutions	1,454,767,000	14,787,000	1	2,088,398,849	144	
Corporate	5,626,746,390	4,829,158,585	86	11,101,240,853	197	
Retail	750,562,610	666,599,113	89	1,442,962,648	192	
Of which mortgage	167,927,000	83,963,500	50	146,096,490	87	
Other assets	1,881,140,000	2,661,710,000	141	5,482,179,429	291	
Total credit risk	17,203,971,000	8,385,388,697	49	29,326,997,791	170	
Market risk						
Equity in the banking book¶	29,167,000	116,821,000	401	273,440,625	938	
Total market risk	--	116,821,000	--	273,440,625	--	
Insurance risk						
Total insurance risk	--	--	--	1,095,662,500	--	
Operational risk						
Total operational risk	--	0	--	1,788,902,166	--	
		Basel II RWA		Standard & Poor's RWA	% of Standard & Poor's RWA	
Diversification adjustments						
RWA before diversification		8,502,209,697		32,485,003,082	100	
Total Diversification/Concentration Adjustments		--		14,218,112,786	44	
RWA after diversification		8,502,209,697		46,703,115,868	144	
		Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	Standard & Poor's RAC ratio (%)	
Capital ratio						
Capital ratio before adjustments		1,181,187,000	13.9	1,485,661,000	4.6	
Capital ratio after adjustment§		1,181,187,000	13.9	1,485,661,000	3.2	

*Exposure at default. ¶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, 2013, Standard & Poor's.

Outlook: Stable

The stable outlook on BSP reflects Standard & Poor's expectations that BSP's business operations 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 in a low probability event if:

- The sovereign rating on Papua New Guinea is lowered;
- The bank's asset-quality experience deteriorated significantly; or
- A significant operational risk event 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

Related Criteria

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 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 28, 2014)

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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