Bank of South Pacific Limited and Subsidiaries

Condensed financial statements

For the half-year ended

30 June 2018

Contents of the Condensed Financial Statements

DIRECTORS' REPORT

The Directors of Bank of South Pacific Limited ("the Bank" or "BSP") present the financial report on the consolidated entity consisting of the Bank and its controlled entities (collectively referred to as "the Group") for the half-year ended 30 June 2018.

Directors and officers

The names of the Directors and officers of Bank of South Pacific Limited during or since the end of the half-year are:

Sir K G Constantinou, OBE	Mr R Fleming, CSM
Mr S Davis	Ms F Talao
Mr G Robb, OAM	Mr E B Gangloff
Mr R Bradshaw	Mr A Mano
Mr A Sam	Dr F Lua'iufi

Principal activities

The principal activity of the Bank of South Pacific Limited (BSP) is the provision of commercial banking and finance services. The Group's activities also include stock broking, fund management and life business services throughout Papua New Guinea and the Asia Pacific region. BSP is a company listed on the Port Moresby Stock Exchange (POMSoX), incorporated under the Companies Act of Papua New Guinea, and is an authorised Bank under the Banks and Financial Institutions Act of Papua New Guinea. The Group is also licensed to operate in the Solomon Islands, Fiji Islands, Cook Islands, Samoa, Tonga, Vanuatu and Cambodia. The registered office is at Douglas Street, Port Moresby.

Review of operations

The net profit of the Group for the half year ended 30 June 2018, after tax was K418.289 million (half year ended 30 June 2017: K370.885 million).

In the directors' opinion, the attached condensed financial statements and notes thereto are in accordance with the PNG Companies Act 1997, including compliance with accounting standards and giving a true and fair view of the financial position and performance of the Bank and the Group .

Dated and signed at Port Moresby this 22nd day of August 2018.

Sir Kostas Constantinou, OBE	Robin Fleming, CSM
Chairman	Chief Executive Officer/ Director

Report on review of interim financial information

to the Directors of Bank of South Pacific Limited

Introduction

We have reviewed the accompanying condensed interim statements of financial position of Bank of South Pacific Limited (the Bank) and its subsidiaries (the Group) as at 30 June 2018 and the related condensed interim statements of comprehensive income, changes in shareholders' equity and cash flows for the half-year then ended and notes, comprising a summary of significant accounting policies and other explanatory notes. The Directors are responsible for the preparation and presentation of this condensed interim financial information in accordance with International Accounting Standard 34, 'Interim Financial Reporting'. Our responsibility is to express a conclusion on this condensed interim financial information based on our review.

Scope of review

We conducted our review in accordance with International Standard on Review Engagements 2410, 'Review of interim financial information performed by the independent auditor of the entity'. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying condensed interim financial information is not prepared, in all material respects, in accordance with International Accounting Standard 34, 'Interim financial reporting'.

Restriction on distribution or use

This report is made solely to the Directors of the Group, as a body. Our review work has been undertaken so that we might state to the Directors those matters which we are required to state to them in our review report and for no other purpose. We do not accept or assume responsibility to anyone other than the directors of the Group, as a body, for our review work, for this report or for the conclusion we have formed.

PricewaterhouseCoopers

PricewaterhouseCoopers

Jonathan Seeto
Partner
Registered under the Accountants Act 1996

Port Moresby
22 August 2018

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CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

FOR THE HALF YEAR ENDED 30 JUNE 2018

All amounts expressed are in K'000	Note	Group Half Year Ended 30 June 2018	Group Half Year Ended 30 June 2017	Bank Half Year Ended 30 June 2018	Bank Half Year Ended 30 June 2017
Interest income	2(a)	758,487	700,763	710,364	662,893
Interest expense	2(a)	(83,035)	(74,799)	(75,092)	(68,757)
Net interest income		**675,452**	**625,964**	**635,272**	**594,136**
Fee and commission income	2(b)	181,659	188,292	166,693	175,327
Other income	2(c)	186,790	149,298	195,288	166,836
Net banking operating income		**1,043,901**	**963,554**	**997,253**	**936,299**
Net insurance premium income		69,190	62,598	-	-
Investment revenue		73,879	65,554	-	-
Increase in policy liabilities		(27,148)	(28,293)	-	-
Policy maintenance and investment expense		(54,992)	(43,918)	-	-
Claims, surrender and maturities		(52,671)	(41,665)	-	-
Share of profits from associates and jointly controlled entities		6,265	2,757	-	-
Net insurance operating income		14,523	17,033	-	-
Net operating income before impairment and operating expenses		1,058,424	980,587	997,253	936,299
Impairment on loans and advances	2(d)	(28,871)	(31,620)	(24,490)	(24,398)
Operating expenses	2(e)	(434,258)	(424,726)	(394,656)	(387,205)
Profit before income tax		**595,295**	**524,241**	**578,107**	**524,696**
Income tax expense		(177,006)	(153,356)	(168,238)	(145,753)
Net profit for the period		**418,289**	**370,885**	**409,869**	**378,943**
Other comprehensive income					
Items that may be subsequently reclassified to profit or loss					
Translation of financial information of foreign operations to presentation currency		(9,068)	30,772	(3,186)	16,210
Items that will not be reclassified to profit or loss					
Net movement in asset revaluation		(1,006)	(232)	-	-
Other comprehensive income, net of tax		(10,074)	30,540	(3,186)	16,210
Total comprehensive income for the period		**408,215**	**401,425**	**406,683**	**395,153**
Earnings per share – Basic and diluted (toea)		**89.5**	**79.4**	87.7	81.1

The attached notes form an integral part of these condensed financial statements.

CONDENSED STATEMENTS OF FINANCIAL POSITION
AS AT 30 JUNE 2018

		Group		Bank	
All amounts expressed are in K'000	Note	As at 30 June 2018	As at 31 December 2017	As at 30 June 2018	As at 31 December 2017
ASSETS					
Cash and balances with Central Bank		1,264,932	1,139,408	1,031,661	920,015
Treasury and Central Bank bills		3,014,380	3,298,626	2,981,568	3,287,162
Amounts due from other banks		690,086	949,214	609,401	887,337
Statutory deposits with Central Banks		1,707,781	1,664,166	1,646,028	1,606,884
Other financial assets		2,492,668	2,457,327	2,060,398	2,062,341
Loans, advances and other receivables from customers	4	12,071,958	11,209,493	10,872,663	10,094,470
Property, plant and equipment		702,276	738,670	555,308	574,305
Assets subject to operating lease		54,583	70,689	54,583	70,689
Investment in associates and joint ventures		159,033	154,135	18,971	19,157
Investment in subsidiaries		-	-	348,400	338,400
Intangible assets		165,369	107,818	140,957	100,750
Investment properties		134,058	134,020	-	-
Deferred tax assets		193,345	181,934	213,813	200,021
Other assets		296,359	264,361	246,887	202,142
Total assets		**22,946,828**	**22,369,861**	**20,780,638**	**20,363,673**
LIABILITIES					
Amounts due to other banks		134,819	160,400	219,573	238,272
Customer deposits		18,444,864	17,901,692	17,249,547	16,843,756
Subordinated debt securities		75,525	75,525	75,525	75,525
Other liabilities		1,394,176	1,382,888	575,307	596,633
Provision for income tax		97,958	31,708	93,435	25,231
Other provisions		203,156	189,313	186,176	173,254
Total liabilities		**20,350,498**	**19,741,526**	**18,399,563**	**17,952,671**
SHAREHOLDERS' EQUITY					
Ordinary shares		372,463	373,001	372,463	373,001
Retained earnings		1,896,000	1,904,462	1,764,101	1,777,627
Other reserves		323,637	346,388	244,511	260,374
Equity attributable to the members of the Bank		2,592,100	2,623,851	2,381,075	2,411,002
Minority interest		4,230	4,484	-	-
Total shareholders' equity		**2,596,330**	**2,628,335**	**2,381,075**	**2,411,002**
Total equity and liabilities		**22,946,828**	**22,369,861**	**20,780,638**	**20,363,673**

The attached notes form an integral part of these condensed financial statements.

CONDENSED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

FOR THE HALF-YEAR ENDED 30 JUNE 2018

All amounts expressed are in K'000	Share Capital	Reserves	Retained earnings	Minority interest	Total
GROUP					
Balance at 1 January 2018	**373,001**	**346,388**	**1,904,462**	**4,484**	**2,628,335**
Changes on initial application of IFRS 9	-	-	(17,098)	-	(17,098)
Net profit	-	-	418,289	-	418,289
Other comprehensive income	-	(10,074)	0	-	(10,074)
Total comprehensive income	-	(10,074)	401,191	-	391,117
2017 final dividend paid	-	-	(428,023)	-	(428,023)
Share buyback	(538)	-	-	-	(538)
Profit attributed to minority interest	-	-	254	(254)	-
Total transaction with owners	(538)	-	(427,769)	(254)	(428,561)
Movement in asset revaluation reserve	-	(12,677)	18,116	-	5,439
Balance at 30 June 2018	**372,463**	**323,637**	**1,896,000**	**4,230**	**2,596,330**
Balance at 1 January 2017	**373,101**	**266,090**	**1,670,595**	**4,551**	**2,314,337**
Net profit	-	-	370,885	-	370,885
Other comprehensive income	-	30,540	-	-	30,540
Total comprehensive income	-	30,540	370,885	-	401,425
2016 final dividend paid	-	-	(371,154)	-	(371,154)
Share buyback	(46)	-	-	-	(46)
Profit attributable to minority interest	-	-	-	44	44
Total transaction with owners	(46)	-	(371,154)	44	(371,156)
Movement in asset revaluation reserve	-	(5,229)	3,737	-	(1,492)
Balance at 30 June 2017	**373,055**	**291,401**	**1,674,063**	**4,595**	**2,343,114**
BANK					
Balance at 1 January 2018	**373,001**	**260,374**	**1,777,627**	**-**	**2,411,002**
Changes on initial application of IFRS 9	-	-	(16,307)	-	(16,307)
Net profit	-	-	409,869	-	409,869
Other comprehensive income	-	(3,186)	-	-	(3,186)
Total comprehensive income	-	(3,186)	393,562	-	390,376
2017 final dividend paid	-	-	(425,204)	-	(425,204)
Share buyback	(538)	-	-	-	(538)
Total transaction with owners	(538)	-	(425,204)	-	(425,742)
Movement in asset revaluation reserve	-	(12,677)	18,116	-	5,439
Balance at 30 June 2018	**372,463**	**244,511**	**1,764,101**	**-**	**2,381,075**
Balance at 1 January 2017	**373,101**	**209,375**	**1,576,974**	**-**	**2,159,450**
Net profit	-	-	378,943	-	378,943
Other comprehensive income	-	16,210	-	-	16,210
Total comprehensive income	-	16,210	378,943	-	395,153
2016 final dividend paid	-	-	(369,179)	-	(369,179)
Share buyback	(46)	-	-	-	(46)
Total transaction with owners	(46)	-	(369,179)	-	(369,225)
Movement in asset revaluation reserve	-	(5,229)	3,737	-	(1,492)
Balance at 30 June 2017	**373,055**	**220,356**	**1,590,475**	**-**	**2,183,886**

The attached notes form an integral part of these condensed financial statements.

CONDENSED STATEMENTS OF CASH FLOWS
FOR THE HALF-YEAR ENDED 30 JUNE 2018

		Group		Bank	
		Half Year Ended		Half Year Ended	
		30 June		30 June	
All amounts expressed are in K'000	Note	2018	2017	2018	2017
CASH FLOW FROM OPERATING ACTIVITIES					
Interest received		730,204	705,284	669,486	665,895
Fees and other income		379,336	356,922	355,944	340,754
Interest paid		(80,900)	(73,025)	(73,338)	(69,522)
Amounts paid to suppliers and employees		(365,733)	(340,145)	(355,097)	(289,862)
Operating cash flow before changes in operating assets and liabilities		**662,907**	**649,036**	**596,995**	**647,265**
Increase in loans, advances and other receivables from customers		(879,050)	(679,080)	(791,804)	(490,863)
Increase in customer deposits		543,172	796,610	405,791	598,530
Increase in statutory deposits with the Central Banks		(43,615)	(57,931)	(39,144)	(54,978)
Net cash flow from operations before income tax		**283,414**	**708,635**	**171,838**	**699,954**
Income taxes paid		(124,782)	(115,927)	(114,094)	(113,216)
Net cash flow from operating activities		**158,632**	**592,708**	**57,744**	**586,738**
CASH FLOW FROM INVESTING ACTIVITIES					
(Increase) / decrease in government securities		231,807	(424,851)	291,229	(371,744)
Expenditure on property, plant and equipment		(61,538)	(73,802)	(58,198)	(58,264)
Proceeds for disposal of property, plant and equipment		705	847	560	847
Additional funding of subsidiaries		-	-	(10,000)	(19,308)
Net cash flow from / (used in) investing activities		**170,974**	**(497,806)**	**223,591**	**(448,469)**
CASH FLOW FROM FINANCING ACTIVITIES					
Share buyback		(538)	(46)	(538)	(46)
Dividends paid		(428,023)	(371,154)	(425,204)	(369,179)
Net cash flow used in financing activities		**(428,561)**	**(371,200)**	**(425,742)**	**(369,225)**
Net increase/(decrease) in cash and cash equivalents		**(98,955)**	**(276,298)**	**(144,407)**	**(230,956)**
Effect of exchange rate movements on cash and cash equivalents		(9,068)	30,772	(3,184)	16,210
Cash and cash equivalent at the beginning of the year		1,928,222	2,159,202	1,569,080	1,773,337
Cash and cash equivalents at the end of the period	9	**1,820,199**	**1,913,676**	**1,421,489**	**1,558,591**

The attached notes form an integral part of these condensed financial statements.

1. Statement of significant accounting policies

1.1 Statement of compliance

The half year report is prepared in accordance with International Financial Reporting Standard IAS 34 'Interim Financial Reporting'. The half year financial report does not include notes of the type normally included in an annual financial report and should be read in conjunction with the most recent annual financial report.

1.2 Basis of preparation

The condensed financial statements are denominated in Papua New Guinea Kina, which is the reporting currency of the Group. All financial information presented in Papua New Guinea Kina has been rounded to the nearest thousand kina, unless otherwise stated.

The condensed financial statements have been prepared on the basis of historical cost, except for the revaluation of non-current assets and financial instruments. Cost is based on the fair values of the consideration given in exchange for assets.

The accounting policies and methods of computations adopted in preparation of the half-year financial report are consistent with those adopted and disclosed in the Group's 2017 financial report for the financial year ended 31 December 2017 other than as disclosed in 1.3.

1.3 Changes in accounting policies

The Group has adopted IFRS 9 as issued by the IASB in July 2014 with a date of transition of 1 January 2018, which resulted in changes in accounting policies and adjustments to the amounts previously recognised in the financial statements. The Group did not early adopt IFRS 9 in previous periods.

As permitted by the transitional provisions of IFRS 9, the Group elected not to restate comparative figures. Any adjustments to the carrying amounts of financial assets and liabilities at the date of transition were recognised in the opening retained earnings of the current period. Consequently, for notes disclosures, the consequential amendments to IFRS 7 disclosures have also only been applied to the current period. The comparative period notes disclosures repeat those disclosures made in the prior year.

The adoption of IFRS 9 has resulted in changes to accounting policies for recognition, classification and measurement of financial assets and financial liabilities and impairment of financial assets. IFRS 9 also significantly amends other standards dealing with financial instruments such as IFRS 7 'Financial Instruments: Disclosures'.

Set out below are disclosures relating to the impact of the adoption of IFRS 9 on the Group. Further details of the specific IFRS 9 accounting policies applied in the current period (as well as the previous IAS 39 accounting policies applied in the comparative period) are described in more detail in section 1.4 below.

Classification and measurement of financial instruments

The measurement category and the carrying amount of financial assets and liabilities in accordance with IAS 39 and IFRS 9 at 1 January 2018 for the Group are compared as follows:

	IAS 39		IFRS 9	
	Measurement Category	Carrying Amount	Measurement Category	Carrying Amount
Financial Assets		**PGK'000**		**PGK'000**
Cash and balances with central banks	Amortised cost	1,205,196	Amortised cost	1,205,196
Loans and Advances	Amortised cost	11,209,493	Amortised cost	11,209,493
Investment securities	Amortised cost (Held to maturity)	5,608,905	Amortised cost	5,591,806
	FVPL (Designated)	147,048	FVPL (Designated)	147,048
		18,170,642		**18,153,543**

There were no changes to the classification and measurement of financial assets and liabilities.

Reconciliation of impairment allowance balance from IAS 39 to IFRS 9

The following table reconciles the Group's prior period's closing impairment allowance measured in accordance with the IAS 39 incurred loss model to the new impairment allowance measured in accordance with the IFRS 9 expected loss model at 1 January 2018:

Measurement category	Loan loss allowance under IAS 39	Reclassification	Remeasurement	Loan loss allowance under IFRS 9
	PGK'000	PGK'000	PGK'000	PGK'000
Loans and receivables (IAS 39)/Financial assets at amortised cost (IFRS 9)				
Cash and balances with central banks	-	-	-	-
Loans and advances to Customers	577,186	-	(11,258)	565,928
Investment securities	-	-	17,098	17,098
Total loan loss allowance loans and receivables	**577,186**	**-**	**5,840**	**583,026**
Loan commitments and financial guarantee contracts				
Provisions (Letters of credit)	-	-	3,707	3,707
Provisions (Financial guarantees)	-	-	3,155	3,155
Undrawn Loans & others	-	-	4,396	4,396
Total loan loss allowance loan commitments and financial guarantee contracts	**-**	**-**	**11,258**	**11,258**
Total Loan loss allowance	**577,186**	**-**	**17,098**	**594,284**

1.4 Financial Risk Management

The following section discusses the Group's risk management policies. The measurement of expected credit loss (ECL) under IFRS 9 uses the information and approaches that the Group uses to manage credit risk, though certain adjustments are made in order to comply with the requirements of IFRS 9.

1.4.1 Credit Risk

The Group incurs risk with regard to loans, advances and other receivables due from customers and other monies or investments held with financial institutions. Credit risk is the likelihood of future financial loss resulting from the failure of clients or counter-parties to meet contractual obligations to the Group as they fall due.

Credit risk is managed by analysing the risk spread across various sectors of the economy and by ensuring risk is diversely spread by personal and commercial customer. Individual exposures are measured using repayment performance, reviews and statistical techniques. Comprehensive credit standards and approval limits have been formulated and approved by the Credit Committee. The Credit Committee (which reports to the Board through the Executive and Chief Executive Officer) is responsible for the development and implementation of credit policy and loan portfolio review methodology. The Credit Committee is the final arbiter of risk management and loan risk concentration.

The Group has in place processes that identify, assess and control credit risk in relation to the loan portfolio, to assist in determining the appropriateness of provisions for loan impairment. These processes also enable assessments to be made of other classes of assets that may carry an element of credit risk. The Group assigns quality indicators to its credit exposures to determine the asset quality profile.

1.4.1.1 Credit Risk Measurement

a) Loans and advances (incl. loan commitments and guarantees)

The estimation of credit exposure for risk management purposes is complex and requires the use of models, as the exposure varies with changes in market conditions, expected cash flows and the passage of time. The assessment of credit risk of a portfolio of assets entails further estimations as to the likelihood of defaults occurring, of the associated loss ratios and of default correlations between counterparties. The Group measures credit risk using Probability of Default (PD), Exposure at Default (EAD) and Loss Given Default (LGD).

Credit risk grading

The Group uses an internal credit risk grading system that reflects its assessment of the probability of default of individual counterparties. Borrower and loan specific information collected at the time of application (such as disposable income, and level of collateral for retail exposures; and turnover and industry type for wholesale exposures) is fed into this rating model. This is supplemented with external data such as credit bureau scoring information on individual borrowers. In addition, the models enable expert judgement from the Chief Risk Officer to be fed into the final internal credit rating for each exposure. This allows for considerations which may not be captured as part of the other data inputs into the model.

The Group's rating method comprises 11 rating levels for instruments not in default (1 to 11) and three default classes (12 to 14). The master scale assigns each rating category a specified range of probabilities of default, which is stable over time. The rating methods are subject to an annual validation and recalibration so that they reflect the latest projections in the light of all actually observed defaults.

1.4.1.2 Expected Credit Loss Management

IFRS 9 outlines a 'three-stage' model for impairment based on changes in credit quality since initial recognition, as summarised below:

A financial instrument that is not credit-impaired on initial recognition is classified in 'Stage 1' and has its credit risk continuously monitored by the Group.

If a significant increase in credit risk ('SICR') since initial recognition is identified, the financial instrument is moved to 'Stage 2' but is not yet deemed to be credit-impaired. Please refer to note 1.4.1.2.1 for a description of how the Group determines when a significant increase in credit risk has occurred.

If the financial instrument is credit-impaired, the financial instrument is then moved to 'Stage 3'. Please refer to note 1.4.1.2.2 for a description of how the Group defines credit-impaired and default.

Financial instruments in Stage 1 have their ECL measured at an amount equal to the portion of lifetime expected credit losses that result from default events possible within the next 12 months. Instruments in Stages 2 or 3 have their ECL measured based on expected credit losses on a lifetime basis. Please refer to note 1.4.1.2.3 for a description of inputs, assumptions and estimation techniques used in measuring the ECL.

A pervasive concept in measuring ECL in accordance with IFRS 9 is that it should consider forward- looking information. Note 1.4.1.2.3 includes an explanation of how the Group has incorporated this in its ECL models.

The following diagram summarises the impairment requirements under IFRS 9.

Change in credit quality since initial recognition

Stage 1	**Stage 2**	**Stage 3**
(Initial recognition)	(Significant increase in credit risk since initial recognition)	(Credit-impaired assets)
12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses

The key judgements and assumptions adopted by the Group in addressing the requirements of the standard are discussed below:

1.4.1.2.1 Significant Increase in Credit Risk

The Group considers a financial instrument to have experienced a significant increase in credit risk when one or more of the following quantitative, qualitative or backstop criteria have been met:

- ✓ Qualitative Criteria - if the instrument meets one or more of the following criteria:
  - Significant adverse changes in business, financial and/or economic conditions in which the borrower operates
  - Actual or expected forbearance or restructuring
  - Actual or expected significant adverse change in operating results of the borrower
  - Significant change in collateral value (secured facilities only) which is expected to increase risk of default
  - Early signs of cash flow/liquidity problems such as delay in servicing of trade creditors/loans
- ✓ Quantitative criteria - applies to performing loans risk graded at 10 or 11 as per BSPs credit rating system which are 'watch list' categories. By definition, these have experienced a SICR event since inception hence needs to be classified as Stage 2, with lifetime PDs applicable. This criteria applies regardless of whether loans in these two RGs are in arrears or not i.e. the 30 day backstop clause does not apply.

Backstop - A backstop is applied and the financial instrument considered to have experienced a significant increase in credit risk if the borrower is more than 30 days past due on its contractual payments. The Group has not used the low credit risk exemption for any financial instrument in the year ending 31 December 2018.

1.4.1.2.2 Definition of default and credit-impaired assets

The Group defines a financial instrument as in default, which is fully aligned with the definition of credit-impaired, when it meets one or more of the following criteria:

Quantitative criteria

The borrower is more than 90 days past due on its contractual payments.

Qualitative criteria

The borrower meets unlikeliness to pay criteria, which indicates the borrower is in significant financial difficulty. These are instances where:

- The borrower is in long-term forbearance
- The borrower is deceased
- The borrower is insolvent
- The borrower is in breach of financial covenant(s)
- An active market for that financial asset has disappeared because of financial difficulties
- Concessions have been made by the lender relating to the borrower's financial difficulty
- It is becoming probable that the borrower will enter bankruptcy
- Financial assets are purchased or originated at a deep discount that reflects the incurred credit losses.

The criteria above have been applied to all financial instruments held by the Group and are consistent with the definition of default used for internal credit risk management purposes. The default definition has been applied consistently to model the Probability of Default (PD), Exposure at Default (EAD) and Loss given Default (LGD) throughout the Group's expected loss calculations.

1.4.1.2.3 Measuring ECL – Explanation of inputs, assumptions and estimation techniques

The Expected Credit Loss (ECL) is measured on either a 12-month (12M) or Lifetime basis depending on whether a significant increase in credit risk has occurred since initial recognition or whether an asset is considered to be credit-impaired. Expected credit losses is the product of the Probability of Default (PD), Exposure at Default (EAD), and Loss Given Default (LGD), defined as follows:

- The PD represents the likelihood of a borrower defaulting on its financial obligation (as per "Definition of default and credit-impaired" above), either over the next 12 months (12M PD), or over the remaining lifetime (Lifetime PD) of the obligation.
- EAD is based on balance sheet exposure plus any undrawn balances. It also includes financial guarantees and Letters of Credit that are within scope for IFRS 9.
- Loss Given Default (LGD) represents the Group's expectation of the extent of loss on a defaulted exposure. LGD varies by type of counterparty, type and seniority of claim and availability of collateral or other credit support. LGD is expressed as a percentage loss per unit of exposure at the time of default (EAD).

The Group used statistical models to convert historical PDs into forward looking lifetime PDs. The conversion process looks at the historical relationship between long-term PDs for a particular year and the observed (annual) default rate for the same year (known as the 'Z-factor') and a set of systematic factors for the year. The Group has performed historical analysis and identified the key economic variables impacting credit risk and expected credit losses which are as follows:

- GDP Growth (%)
- Change in Unemployment (%)
- Change in S&P 500 (%)
- Change in Energy Index (%)
- Change in Non-Energy Index (%)
- Change in the Proportion of Downgrades (%)

These are then compared to the expected systematic factors and long-term PDs for a future year to estimate the PiT PDs for that future year. Forecasts of these economic variables (the "base economic scenario") are provided by the Group's Strategy team and provide the best estimate view of the economy over the next five years. Z-factors are estimated for five years based on forecast systematic data and all future years from year 6 are adjusted using Z- factors which diminish in magnitude from the one estimated for year 5.

EAD is based on the amounts the Group expects to be owed at the time of default, over the next 12 months (12M EAD) or over the remaining lifetime (Lifetime EAD). For example, for a revolving commitment, the Group includes the current drawn balance plus any further amount that is expected to be drawn up to the current contractual limit by the time of default, should it occur. Off balance sheet items exposed to credit risk are also included under the scope of IFRS 9, which include financial guarantees and letters of credit

Loss Given Default (LGD) represents the Group's expectation of the extent of loss on a defaulted exposure. LGD varies by type of counterparty, type and seniority of claim and availability of collateral or other credit support.

All BSP loans are assigned a security category and LGD rates have been aligned to each category based on blended BASEL II and internal BSP experience. The group intends to transition to BSP internal LGD rates as additional historical data becomes available.

1.5 IFRS 15, *Revenue from Contracts with Customers*

IFRS 15 'Revenue from contracts with customers' (effective 1 January 2018) is a converged standard from the IASB and FASB on revenue recognition and replaces IAS 11 and IAS 18. The new standard is based on the principle that revenue is recognised when control of a good or service transfers to a customer – so the notion of control replaces the existing notion of risks and rewards.

The Group had adopted the new 5-step process for the recognition of revenue:

- identify contracts with customers
- identify the separate performance obligations
- determine the transaction price of the contract
- allocate the transaction price to each of the separate performance obligations, and
- recognise the revenue as each performance obligation is satisfied.

The Group has completed an assessment of its existing revenue streams and contracts, and the implementation of IFRS 15 did not have a significant impact on the existing revenue and recognition.

2. Operating profit before income tax

Operating profit before income tax is determined after including:

(a) Net interest income

All amounts expressed are in K'000	Half Year Ended 30 June 2018	2017	Half Year Ended 30 June 2018	2017
Interest Income				
Loans, advances and other receivables from customers	553,583	503,369	504,913	464,671
Treasury bills	102,430	94,530	101,705	94,300
Central Bank bills	-	83	-	83
Other financial assets - Inscribed stock	100,367	101,249	100,214	101,099
Other loans and advances	2,107	1,532	3,532	2,740
	758,487	**700,763**	**710,364**	**662,893**
Less:				
Interest Expense				
Customer deposits	71,599	64,527	63,213	58,435
Other banks	7,293	6,141	7,736	6,191
Subordinated debt securities	4,143	4,131	4,143	4,131
	83,035	**74,799**	**75,092**	**68,757**
	675,452	**625,964**	**635,272**	**594,136**

(b) Fee and commission income

Product related	96,130	106,104	90,181	100,950
Trade and international related	8,141	9,591	7,719	9,021
Electronic banking related	59,864	55,694	54,980	52,606
Other	17,524	16,903	13,813	12,750
	181,659	**188,292**	**166,693**	**175,327**

(c) Other income

Foreign exchange related	151,802	133,577	137,201	122,036
Operating lease rentals	4,547	4,968	4,547	4,968
Insurance claim – aircraft *	19,243	-	19,243	-
Other**	11,051	10,753	34,297	39,832
	186,643	**149,298**	**195,288**	**166,836**

**Insurance claim relates to an operating lease aircraft which was burnt during a political riot.*
***Other income for Bank includes K26.4m (2017:K32.7m) dividends received from subsidiaries, which is eliminated upon consolidation.*

(d) Impairment on loans and advances

New write offs	38,962	33,786	38,372	33,645
Net new and increased individually assessed provisioning	19,618	31,910	16,538	25,686
Recoveries during the period	(29,709)	(34,076)	(30,420)	(34,933)
	28,871	**31,620**	**24,490**	**24,398**

(e) Operating expenses

	Group		Bank	
	Half year ended 30 June		Half year ended 30 June	
All amounts expressed are in K'000	2018	2017	2018	2017
Staff costs	193,471	184,617	179,074	170,260
Depreciation	42,281	42,161	38,866	39,875
Computing	57,223	60,140	48,872	51,942
Premises and equipment	45,686	47,573	41,398	43,702
Administration and other costs	95,597	90,235	86,446	81,426
	434,258	**424,726**	**394,656**	**387,205**

3. Dividends

On 25 May 2018, the directors declared a final dividend of 91 toea per share for the year ended 31 December 2017 which was paid on 22 June 2018. The declared final gross dividend amount was K428.023 million (June 2017: K371.154 million). Net dividend paid after dividend withholding tax was K420.976 million (June 2017: K363.302 million).

4. Loans, advances and other receivables from customers

	Group		Bank	
All amounts expressed are in K'000	As at 30 June 2018	As at 31 December 2017	As at 30 June 2018	As at 31 December 2017
Gross loans, advances and other receivables from customers net of reserved interest	12,665,730	11,786,679	11,425,223	10,633,419
Less allowances for losses on loans, advances and other receivables from customers	(593,772)	(577,186)	(552,560)	(538,949)
Net loans, advances and other receivables from customers	**12,071,958**	**11,209,493**	**10,872,663**	**10,094,470**
Economic sector risk concentrations				
Commerce, finance and other business	6,433,623	5,910,485	5,688,512	5,240,355
Private households	2,649,814	2,421,546	2,365,700	2,154,022
Government and public authorities*	337,677	374,109	337,677	374,109
Agriculture	288,036	249,295	266,367	230,958
Transport and communication	1,219,482	1,149,570	1,150,780	1,072,975
Manufacturing	239,491	226,427	209,471	194,981
Construction	903,835	878,061	854,156	827,070
	12,071,958	**11,209,493**	**10,872,663**	**10,094,470**

**Total by Government ownership at 30 June 2018 was K2.7b (31 December 2017: K2.8b).*

5. Capital adequacy and liquid assets ratio

The Group is required to comply with various prudential standards issued by the Bank of Papua New Guinea (BPNG), the official authority for the prudential supervision of banks and similar financial institutions in Papua New Guinea. Additionally, subsidiaries and branches in Fiji (RBF), Solomon Islands, Cooks Islands, Samoa, Tonga, Vanuatu and Cambodia are required to adhere to prudential standards issued by the Reserve Bank of Fiji, Central Bank Solomon Islands, The Financial Supervisory Commission, Central Bank of Samoa, National Reserve Bank of Tonga, Reserve Bank of Vanuatu and National Bank of Cambodia respectively. One of the most critical prudential standards is the capital adequacy requirement. All banks are required to maintain at least the minimum measure of capital to risk-weighted assets to absorb potential losses. The BPNG follows the prudential guidelines set by the Bank of International Settlements under the terms of the Basel Accord. The BPNG revised prudential standard 1/2003, Capital Adequacy, prescribes ranges of overall capital ratios to measure whether a Bank is under, adequately, or well capitalized, and also specifies the leverage capital ratio. The Group complies with the prevailing prudential requirements for total capital and leverage capital. As at 30 June 2018, the Group's total capital adequacy ratio and leverage capital ratio satisfied the capital adequacy criteria for a 'well-capitalised' bank. The minimum capital adequacy requirements as set out under the standard is as follows: capital adequacy ratio for Tier 1 is 8%, total capital adequacy is 12% and the leverage capital ratio is 6%.

The measure of capital used for the purposes of prudential supervision is referred to as base capital. Total base capital varies from the balance of capital shown on the Statement of Financial Position and is made up of tier 1 capital (core) and tier 2 capital (supplementary), after deducting the value of investments in other banks and financial institutions. Tier 1 capital is obtained by deducting from equity capital and audited retained earnings (or losses), intangible assets including deferred tax assets. Tier 2 capital cannot exceed the amount of tier 1 capital, and can include subordinate loan capital, specified asset revaluation reserves, un-audited profits (or losses) and a small percentage of general loan loss provisions. The leverage capital ratio is calculated as Tier 1 capital divided by total assets on the balance sheet.

Risk weighted assets are derived from on-balance sheet and off-balance sheet assets. On balance sheet assets are weighted for credit risk by applying weightings (0, 20, 50 and 100 per cent) according to risk classification criteria set by the BPNG. Off-balance sheet exposures are risk weighted in the same way after converting them to on-balance sheet credit equivalents using BPNG specified credit conversion factors.

	As at 30 June 2018		As at 31 Dec 2017	
Risk weighted capital ratios	**K'000**	**%**	**K'000**	**%**
Tier 1 Capital	1,762,029	15.8%	2,212,167	21.3%
Tier 1 + Tier 2 Capital	2,537,909	22.7%	2,549,443	24.5%
Leverage capital ratio		7.8%		10.0%

6. Contingent liabilities and commitments

The primary purpose of credit related commitments are to ensure that funds are available to a customer as required. Guarantees and standby letters of credit, which represent irrevocable assurances that the bank will make payments in the event that a customer cannot meet its obligations to third parties, carry the same credit risk as loans. Cash requirements under guarantees and standby letters of credit are considerably less than the amount of the commitment because the Group do not generally expect the third party to draw funds under the agreement.

Commitments to extend credit represent the unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. With respect to credit risk on commitments to extend credit, the Group is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss, though not difficult to quantify, is considerably less than the total unused commitments since most commitments to extend credit are subject to customers maintaining approved specific credit standards. While there is credit risk associated with the remainder of commitments, the risk is considered to be modest, since it results from the possibility of unused portions of loan authorisations being drawn by the customer and, second, from these drawings subsequently not being repaid as due. The total outstanding contractual amount of commitments to extend does not necessarily represent future cash requirements, since many of these commitments will expire or terminate without being funded.

Off-balance sheet financial instruments

The following table indicates the contractual amounts of the Bank and Group's off-balance sheet financial instruments that commit it to extend credit to customers.

	Group		Bank	
All amounts expressed are in K'000	As at 30 June 2018	As at 31 December 2017	As at 30 June 2018	As at 31 December 2017
Standby letters of credit	36,403	35,637	36,403	35,637
Guarantees and indemnities issued	328,525	367,866	306,039	352,525
Trade letters of credit	47,590	60,505	44,603	58,462
Commitments to extend credit	1,913,425	1,775,357	1,777,861	1,676,944
	2,325,943	2,239,365	2,164,906	2,123,568

Commitments for capital expenditure

Amounts with firm commitments, and not included in the accounts as at 30 June 2018 amounted to K47.5 million (31 December 2017: K32.7 million).

Contingent liability

A number of legal proceedings (including potential claims where management cannot reasonably quantify) against the Group were outstanding as at 30 June 2018. Based on information available at 30 June 2018, the Group estimates a contingent liability of K21.4 million in respect of these proceedings (31 December 2017: K18.6 million).

Statutory deposit with Central Banks

	Group		Bank	
All amounts expressed are in K'000	As at 30 June 2018	As at 31 December 2017	As at 30 June 2018	As at 31 December 2017
Cash reserve requirement – *requisite reserve requirement of respective countries*	1,707,781	1,664,166	1,646,028	1,606,884

Operating lease commitments – predominantly premises

	Group		Bank	
All amounts expressed are in K'000	As at 30 June 2018	As at 31 December 2017	As at 30 June 2018	As at 31 December 2017
Not later than 1 year	44,016	32,434	41,147	29,333
Later than 1 year and not later than 5 years	62,815	70,974	60,572	67,333
Later than 5 years	16,517	20,418	15,985	19,591
	123,348	123,826	117,704	116,257

7. Derivative financial instruments

In the normal course of trading, the Bank and Group enter into forward exchange contracts. The Group do not actively enter into or trade in complex forms of derivative financial instruments such as currency and interest rate swaps and options.

Exposures in foreign currencies arise where the Group transacts in foreign currencies. This price risk is minimised by entering into counterbalancing positions for material exposures as they arise. Forward and spot foreign exchange contracts are used.

Forward exchange contracts outstanding, stated at the face value of the respective contracts are:

All amounts expressed are in '000

As at 30 June 2018		USD	AUD	EURO	GBP	JPY	NZD	CAD	HKD	SGD	PHP	Other	Total
Selling	FCY	(49,947)	(761)	(180)	(250)	(274,111)	(794)	(250)	(1,839)	(1,100)	-	(4,589)	-
	Kina	(164,299)	(1,849)	(689)	(1,079)	(8,147)	(1,769)	(622)	(771)	(2,653)	-	(15,095)	(196,973)
Buying	FCY	10,431	43,400	35	350	-	2,250	20	500	370	16,000	14,208	-
	Kina	34,311	105,481	134	1,510	-	5,015	50	210	892	986	46,735	195,324

As at 31 December 2017		USD	AUD	EURO	GBP	JPY	NZD	CAD	HKD	SGD	PHP	Other	Total
Selling	FCY	(21,155)	(572)	-	(270)	(540,715)	(1,474)	(66)	(366)	(463)	-	(950)	-
	Kina	(68,354)	(1,442)	-	(1,175)	(15,503)	(3,384)	(170)	(151)	(1,119)	-	(3,068)	(94,366)
Buying	FCY	6,801	9,850	-	-	56,000	320	-	-	314	-	9,573	-
	Kina	21,974	24,841	-	-	1,606	735	-	-	759	-	30,931	80,846

There is no material difference between the fair value and face value of the contracts.

8. Related parties

Related parties are considered to be enterprises or individuals with whom the Group is especially related because either they or the Group are in a position to significantly influence the outcome of transactions entered into with the Group, by virtue of being able to control, dominate or participate in a fiduciary capacity, in decision-making functions or processes. The Group conducted transactions with the following classes of related parties during the period:

- Directors and/or parties in which a director has significant influence.
- Key management personnel and other staff and/or parties in which the individual officer has significant influence.

A number of banking transactions are entered into with these related parties in the normal course of business, and include loans, deposits, property rentals, share transfers and foreign currency transactions. These transactions are carried out on commercial terms and market rates.

Significant related party balances relating to loans and advances to customers are as follows:

	Group	
All amounts expressed are in K'000	As at 30 June 2018	As at 31 December 2017
Loans to :		
Parties where the related party interest is primarily in a director capacity	665,565	586,656
Parties where the related party interest is primarily in an executive capacity	36,678	38,522
General staff	6,517	6,472
	708,760	**631,650**

9. Notes to condensed statements of cash flows

For the purpose of the cash flow statements, cash and cash equivalents comprise the following balances with less than 90 days maturity.

	Group As at 30 June		Bank As at 30 June	
All amounts expressed are in K'000	2018	2017	2018	2017
Cash and balances with Central Banks	1,264,932	1,294,048	1,031,661	1,098,547
Amounts due from other banks	690,086	913,095	609,401	804,304
Amounts due to other banks	(134,819)	(293,467)	(219,573)	(344,260)
	1,820,199	1,913,676	1,421,489	1,558,591

10. Segment information

The following is an analysis of the Group's revenue and results by reportable operating segment for the periods under review:

All amounts expressed are in K'000

Half Year Ended 30 June 2018	PNG Bank	Non PNG Banks	Non Bank Entities	Adjust Inter Segments	Total
Net interest income	552,296	108,770	13,383	1,003	675,452
Other income	253,764	108,766	6,089	(170)	368,449
Net insurance income	-	-	15,223	(700)	14,523
Total operating income	**806,060**	**217,536**	**34,695**	**133**	**1,058,424**
Operating expenses	(311,450)	(113,746)	(8,929)	(133)	(434,258)
Impairment expenses	(18,144)	(9,104)	(1,623)	-	(28,871)
Profit before income tax	**476,466**	**94,686**	**24,143**	**-**	**595,295**
Income tax	(148,330)	(23,978)	(4,698)	-	(177,006)
Net profit after income tax	**328,136**	**70,708**	**19,445**	**-**	**418,289**
Half year Ended 30 June 2017					
Net interest income	518,271	97,632	10,061	-	625,964
Other income	236,971	94,782	8,586	(2,749)	337,590
Net insurance income	-	-	17,033	-	17,033
Total operating income	**755,242**	**192,414**	**35,680**	**(2,749)**	**980,587**
Operating expenses	(313,982)	(99,193)	(12,484)	933	(424,726)
Impairment expenses	(14,805)	(12,271)	(4,544)	-	(31,620)
Profit before income tax	**426,455**	**80,950**	**18,652**	**(1,816)**	**524,241**
Income tax	(128,032)	(20,761)	(4,563)	-	(153,356)
Net profit after income tax	**298,423**	**60,189**	**14,089**	**(1,816)**	**370,885**

11. Reclassification of Comparative Amounts

Certain amounts in the comparative condensed financial statements and note disclosures have been reclassified to conform to the current year's presentation. The reclassification includes transfer from cash and cash with Central Bank to statutory deposits with Central Bank amounting to K65,788 for both Bank and Group. Management believes that the reclassification more appropriately reflects the nature of the underlying asset and did not have any impact on prior year's profit or loss.

12. Subsequent events

There are no adjusting events after the end of the reporting period.