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**Research Update:**

## **Bank of South Pacific Ltd. Long-Term Rating Lowered To 'B' From 'B+' Following Sovereign Downgrade; Outlook Stable**

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## Research Update:

# Bank of South Pacific Ltd. Long-Term Rating Lowered To 'B' From 'B+' Following Sovereign Downgrade; Outlook Stable

## Overview

- On April 16, 2018, we lowered our sovereign ratings on PNG to 'B' from 'B+' on a deteriorating debt profile and lower economic growth.
- We are lowering our long-term issuer credit rating on BSP to 'B' from 'B+' reflecting the weakening of the sovereign credit profile. At the same time, we are affirming the short-term issuer credit rating on BSP at 'B'. We expect our ratings on the bank to remain no higher than our sovereign foreign currency rating on PNG.
- The outlook on the long-term issuer credit rating is stable.

## Rating Action

On April 30, 2018, S&P Global Ratings lowered its long-term rating on Papua New Guinea (PNG)-based Bank of South Pacific Ltd. (BSP) to 'B' from 'B+'. At the same time, we affirmed the short-term issuer credit rating on BSP at 'B'. The outlook on the long-term issuer credit rating is stable.

## Rationale

We downgraded BSP following our recent lowering of the sovereign rating on PNG (B/Stable/B) (see "Papua New Guinea Ratings Lowered To 'B' On Deteriorating Debt Profile And Lower Economic Growth; Outlook Is Stable," published on April 16, 2018).

The lower rating on PNG follows a period of much slower economic growth than we previously expected, and lower-than-expected government revenues leading to fiscal deficits and rising government debt and debt service costs. Lower-than-expected tax revenues from PNG's largest liquefied natural gas project's exports, along with natural disasters such as drought and earthquakes, have hindered revenues in recent years. These fiscal deficits, along with slower economic growth, have pushed the government debt to GDP ratio over the ceiling of 30%, and we forecast it to increase to about 40% by 2021.

The ratings on BSP reflect our view that the bank is exposed to the high-risk economic and operating conditions across PNG and other underdeveloped Pacific island nations. We may rate an entity above the sovereign foreign currency rating if, in our view, there is an appreciable likelihood that it would not default if the sovereign were to default. We do not assess this to be the case with BSP reflecting the bank's concentration in its domestic home market--at around 65% of BSP's operations--and its high exposure to government and central bank debt, at more than 100% of shareholders equity. Consequently, we expect our rating on the bank to remain no higher than our sovereign foreign currency rating on PNG. As a result, we have lowered our long-term rating on BSP to keep it equalized with our long-term foreign currency sovereign rating on PNG, which is one notch lower than our assessment of the bank's stand-alone credit profile (SACP) of 'b+'.

Despite the deteriorating operating environment in PNG, we forecast credit losses to remain broadly unchanged at between 0.7% and 0.8% (of average customer loans) over the next two years, in our base case. We expect provisioning levels to remain conservatively positioned at more than 300% of nonperforming loans. We expect local economic conditions to remain subdued and in many parts challenging in the near term. The subsequent slowdown in government spending and ongoing shortage of foreign exchange is likely to result in credit pressures remaining elevated in PNG, in our view, for both corporate and increasingly some small and midsize enterprises and personal customers. Single-name concentration has the potential to noticeably shift the level of nonperforming and past-due loans during periods of stress--with the top 20 exposures accounting for close to 150% of shareholders equity and about a quarter of the total loans on the bank's balance sheet.

Our ratings on BSP take into account its dominant market position as the largest commercial and retail bank in PNG, accounting for around 60% of lending and deposit activity, respectively. We believe the bank has a number of structural advantages over its competitors, including an extensive distribution model and affinity with customers as PNG's largest domestically owned bank.

We believe that BSP's price-maker advantage is underscored by its strong earnings metrics, with the bank reporting a return on equity on average of 30% over the last three years; we see this remaining unchanged in the near term. Despite our expectation of slower lending growth in PNG, stronger growth across other Pacific island nations and a broadly unchanged margin (at around 7.25%) should underpin a further increase in earnings. We forecast the bank's risk-adjusted capital--based on S&P Global Ratings' methodology--to remain modest, at between 4.2% and 4.7%, although we expect the bank's earnings to provide good cover for any foreseeable rise in credit losses without adversely affecting its capitalization.

Slower lending growth should support BSP's key funding metrics, which should remain strong by international comparisons. Almost entirely funded by customer deposits, we believe BSP's deposit base is likely to exhibit a reasonable

degree of stability, reflecting the limited number of alternative avenues to invest surplus liquidity beyond the banking sector, particularly in PNG. We forecast the bank's loan-to-deposit ratio to remain broadly unchanged at around 65% and its stable funding ratio at around 145%.

## Outlook

The stable outlook on BSP principally reflects the stable outlook on the sovereign foreign currency rating on PNG. As BSP's SACP of 'b+' is one notch above its issuer credit rating, we consider the rating has the buffer to absorb a modest deterioration in BSP's financial profile.

### Upside scenario

We see limited prospects for upward rating movement within the next year for BSP, partly because any improvement in the bank's SACP, by itself, would not result in an upgrade if our sovereign rating remains unchanged. Over the medium term, an improved outlook for PNG's credit quality will likely provide a segue to a higher rating for BSP.

### Downside scenario

We believe downward rating prospects are limited within the next few years. Similar to the upside potential, a lower rating on BSP would most likely arise following a further deterioration in the rating on the sovereign.

## Ratings Score Snapshot

	To	From
Issuer credit rating	B/Stable/B	B+/Negative/B
SACP	b+	b+
Anchor	b+	b+
Business position	Strong (+1)	Strong (+1)
Capital and earnings	Weak (0)	Weak (0)
Risk position	Moderate (-1)	Moderate (-1)
Funding and liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	0	0
ALAC Support	0	0
GRE support	0	0
Group support	0	0
Sovereign support	0	0

Additional factors	-1	0
Issue credit rating	CCC+	B-

## Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- General Criteria: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Related Research

- Papua New Guinea Ratings Lowered To 'B' On Deteriorating Debt Profile And Lower Economic Growth; Outlook Is Stable, April 16, 2018

## Ratings List

Downgraded; CreditWatch/Outlook Action; Ratings Affirmed	To	From
Bank of South Pacific Ltd. Counterparty Credit Rating	B/Stable/B	B+/Negative/B
Downgraded	To	From
Bank of South Pacific Ltd. Subordinated	CCC+	B-

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