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Research Update:

Rating On PNG's Bank Of South Pacific Ltd. Raised To 'B+' On Revised Assessment Of Business Position; Outlook Negative

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Overview

- The long-term issuer credit rating on Bank of South Pacific (BSP) has been raised to 'B+' from 'B'. The outlook on the long-term rating is revised to negative. The short-term issuer credit rating is affirmed at 'B'.
- The rating action reflects a revision of our assessment of BSP's business position to "strong" from "adequate", recognizing the bank's dominant and increasingly important role in within the Papua New Guinea financial system.
- In our view BSP's business stability benefits from its entrenched importance to PNG's banking system, a position that has been strengthened with recent investment and commitment to building in its operational infrastructure, which is unlikely to be replicated by any of its competitors.

Rating Action

On July 10, 2012, Standard & Poor's Ratings Services raised its long-term counterparty credit rating on Papua New Guinea-based Bank of South Pacific (BSP) to 'B+' from 'B'. The short-term rating is affirmed at 'B'. The outlook is revised to negative.

Rationale

The rating upgrade reflects a revision of our assessment of BSP's business position to "strong" from "adequate," recognizing the bank's dominant and increasingly important role within the Papua New Guinean (PNG) financial system. In our view, BSP's business stability benefits from the bank's entrenched importance to PNG's banking system--a position that has been strengthened by the bank's recent investment and commitment to building its operational infrastructure, in a move that we see as unlikely to be replicated by any of the bank's competitors.

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.

Our bank criteria use the BICRA economic risk and industry risk scores to

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determine a bank's SACP, the starting point in assigning an issuer credit rating. The anchor SACP for a bank operating only in PNG 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 the 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 PNG banking industry is underpinned by gaps in regulation, weaknesses in disclosure, and aggressive risk appetite. The banking system has access to very limited funding alternatives other than customer deposits.

The SACP for BSP is 'b+'.

The revised assessment reflects that BSP has a "strong" business position takes into account our opinion that BSP's revenues are likely to be more stable as a result of the investments being made in its retail banking channels improving revenues from more stable non-interest income sources. The appetite for aggressive growth is likely to remain subdued following a series of acquisitions in recent years that are outside of its home base in PNG; these acquisitions should help BSP offset a downturn in one part of its business or in its geography, because of the improved diversity. Additionally, the continued investment in BSP's retail banking channels infrastructure should reduce the impact of direct competitors within PNG. We view the concentration and diversification of BSP's business activities as slightly better than that of its peers, given the bank's retail stronghold, but note that BSP still has a significant exposure to sovereign risk in PNG.

We assess BSP's overall capital and earnings position as "moderate". Our assessment is pinned to BSP's projected risk-adjusted capital (RAC) ratio, which we estimate to be in the region of 5.75%-to-6.25% in the next one-to-two years (the static ratio is about 5.4% at Dec. 31, 2011). This makes the bank's capital and earnings assessment fall into the "moderate" category. We are of the opinion that BSP's RAC ratio would track upward, largely due to BSP's ability to generate capital internally. BSP's capital base is of good quality, as total adjusted capital consists almost fully of ordinary share capital and retained earnings. On a Basel I basis, BSP is adequately capitalized, is subject to local regulation, and has a Tier 1 ratio of approximately 19.8% (above the minimum ratio of 12% required in PNG). The RAC ratio is considerably lower than the regulatory ratio, largely due to the Standard & Poor's RAC ratio risk-weighting for sovereign exposures (for regulatory purposes, a risk weight of 0%). For the regulatory capital purposes, sovereign exposures made up 0% of the total risk-weighted assets, whereas for RAC calculation purposes, sovereign exposures made up 30% of the total risk-weighted assets.

We assess BSP's risk position as "moderate". This risk position assessment largely factors in BSP's large exposure to PNG's Treasury and central bank

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bills, single-name concentration risk, and the rapid growth that the bank experienced during the past five years (coupled with a vast number of strategic initiatives). With respect to the rapid growth, we are of the opinion that the risks that could emanate from the afore-mentioned would be from an operational nature, and that the operational risk charge in our RAC methodology would not adequately cover all operational risks. We note, however, that BSP has adopted the Basel II standards for operational risk measurement.

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. BSP's liquidity position is assessed as "adequate", underpinned by the bank's high level of balance-sheet liquid assets (liquid assets comprised about 49% of total deposits in 2011), cash flow generated from its lending activities, and its reasonable stable and supportive deposit base.

Although BSP is assessed as being of high systemic importance to the PNG financial system, no rating benefit of this has been factored into the bank's rating, due to our assessment of the PNG's government's tendency to support financial institutions as "uncertain". Furthermore, even without the benefit of any rating uplift stemming from potential government support, our issuer credit rating on BSP is currently at the same level as the foreign currency rating on PNG government (B+/Negative/B).

We have raised the issue ratings on BSP's non-deferrable senior subordinated debt to 'B-' from 'CCC+', which is two notches below BSP's issuer credit rating.

Outlook

The negative outlook reflects the negative outlook on PNG government, given that BSP and the PNG government ratings are currently at the same level. The alignment of outlooks reflects our view that banks are affected by many of the same economic factors that cause sovereign stress. This sovereign stress can cause, among other things, a sharp deterioration in a bank's asset values, more expensive foreign currency liquidity, shortages in local currency liquidity, a harsher regulatory environment, mandated changes in credit terms, higher taxes, and declining public services. These developments can exacerbate domestic economic conditions and increase bad debts for banks. Under our criteria, a bank needs to meet a number of conditions to have ratings higher than the foreign currency ratings on the country of domicile. We are of the opinion that BSP does not meet those conditions. In particular, we note that BSP has a material exposure to the sovereign and it does not maintain a net external asset position.

The rating could be lowered if the sovereign rating of PNG government is lowered. In addition, the rating on BSP could also be lowered if the bank's

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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".

Conversely the rating would likely be revised to stable if the outlook on the rating of PNG government is revised to stable.

Ratings Score Snapshot

Issuer Credit Rating	To B+/Negative/B	From B/Stable/B
SACP	b+	b
Anchor	b+	b+
Business Position	Strong (+1)	Adequate (0)
Capital and Earnings	Moderate (0)	Moderate (0)
Risk Position	Moderate (-1)	Moderate (-1)
Funding and Liquidity	Average and Adequate (0)	Average and Adequate (0)
Support	0	0
GRE Support	0	0
Group Support	0	0
Sovereign Support	0	0
Additional Factors	0	0

Related Criteria And Research

- Banks: Rating Methodology & Assumptions, Nov. 9, 2011
- Group Rating Methodology for Banks, Nov. 9, 2011
- Bank Industry Country Risk Assessment Methodology & Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology & Assumptions, Oct. 24, 2011

Ratings List

Upgraded

Ratings raised; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Bank of South Pacific Ltd.		
Issuer credit rating	B+/Negative/B	B/Stable/B

Bank of South Pacific Ltd.

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Subordinated

B-

CCC+

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