

## Bank of South Pacific Ltd.

**Primary Credit Analyst:**

Derryl D'silva, Melbourne (61) 3-9631-2106; derryl\_dsilva@standardandpoors.com

**Secondary Credit Analyst:**

Sharad Jain, Melbourne (61) 3-9631-2077; sharad\_jain@standardandpoors.com

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# Bank of South Pacific Ltd.

## Major Rating Factors

### Strengths:

- Strong market position
- Good capitalization and profitability

### Weaknesses:

- High-risk economic and operating environment
- Concentrated funding profile and vulnerable liquidity position
- High credit-risk portfolio although adequate asset quality
- Unseasoned loan book

### Counterparty Credit Rating

B+/Stable/B

## Rationale

The ratings on Bank of South Pacific Ltd. (BSP) reflect the bank's strong market position, good capitalization and profitability, and adequate asset quality in a domestic context. Moderating factors include the bank's high credit-risk loan and investment portfolios, concentrated funding profile, high but potentially restricted liquidity position, and unseasoned loan book. BSP is Papua New Guinea's (PNG's) largest bank with total assets of PNG Kina (PGK) 9.4 billion (US\$3.2 billion) at year-end Dec. 31, 2010.

BSP is primarily vulnerable to Papua New Guinea's sovereign credit risk (local currency: BB-/Stable/B, foreign currency: B+/Stable/B) due to its large exposure to government securities: 41% of total assets at Dec. 31, 2009. This significant exposure is due to the high yield on sovereign debt that BSP is able to invest in because of its good access to retail funding. Ongoing economic growth in PNG has driven BSP's asset growth. A majority of loans are made to commercial enterprises that benefit from a developing economy, driven by buoyant commodity prices.

BSP dominates the PNG market, with about 55% of loans and deposits despite competition from larger international banks. BSP's leadership position is supported by its strong local franchise, branch network, brand, and status as PNG's only indigenous bank.

Given the bank's rapid loan growth over the past five years, we believe that it may face some asset quality deterioration due to the unseasoned nature of the loan book--particularly if new business growth were from high-risk sectors or from areas of noncore expertise. The rating has tolerance for a slight deterioration in asset quality over the medium term. BSP's gross nonperforming assets (NPAs) represented 0.9% of total loans at Dec. 31, 2009. Growth in the loan portfolio is expected to continue; if this happens on the back of strong underwriting standards, this will help maintain adequate asset quality.

Profitability is good, supported by BSP's high interest margins and strong revenue growth. Relative to some peers, the bank has been largely unaffected by the global financial crisis because of its limited exposure outside of PNG. Indeed, rapid loan-book growth saw the bank's earnings strengthen in fiscal 2009 to PGK378 million (before tax) for the year ended December 2009 from PGK284 million two years ago.

BSP's capital adequacy is adequate; risk-adjusted capital ratio (RAC) was 6% at Dec. 31, 2009. This ratio suggests

adequate capital strength, moderated by the business and operational risks associated with a high-risk economy.

### **Short-term credit factors**

BSP has a low-cost, although concentrated, funding profile. Liquidity is high--with 53.6% of total assets held in cash and government securities--but the bank does rely on the government's ability to service its debt. Limited lending opportunities and strong deposit growth have resulted in a low loan-to-deposit ratio of 50.29% at Dec. 31, 2009. BSP's liquidity is constrained by its dependence on the government to meet its obligations, and the uncertain economic and political environment in PNG.

## **Outlook**

The stable outlook on BSP reflects the bank's ability to maintain strong loan growth, its capacity to absorb a minor deterioration in asset quality and profitability, and its strong operating efficiency. That said, any improvement or deterioration in the sovereign's credit quality would likely affect BSP's ratings. In the event of the sovereign's ratings being raised, the bank's track record of strong business growth and its improving earnings profile could support a higher rating on BSP. Conversely, the rating on BSP could be lowered if the bank's asset quality experience deteriorated significantly; liquidity challenges arose from economic difficulties; and/or there were unexpected and significantly troubling consequences from acquisitions in the Solomon Islands and Fiji.

## **Profile: Dominant Market Position As The Largest Bank in PNG**

BSP's sound business profile is underpinned by its strong market position as the largest financial institution in PNG and its sound domestic banking franchise and strong brand image. Our view is that the bank's size and local brand recognition will continue to support its growth strategy. That said, BSP's performance will continue to rely on an economy that has demonstrated some growth momentum but is still susceptible to political instability and economic challenges.

Headquartered in Port Moresby, BSP is PNG's only indigenous bank. It has total assets of PGK9.4 billion at Dec. 31, 2009, and is involved in corporate and business banking, consumer banking, and treasury services. The bank has a strong and steady market share of about 55% of loans and deposits.

BSP has a sound domestic franchise with 64 branches and an electronic banking capability that includes more than 206 ATMs. The bank's branch network increases its access to low-cost deposits. Operations are managed within three main business units, Corporate and International (75% of total loan portfolio), Retail (13% of total loan portfolio), and Paramount (12% of total loan portfolio). BSP also owns BSP Capital Ltd., a share broking and funds management enterprise that primarily offers merchant banking services.

On the back of recent acquisitions in the Solomon Islands and Fiji, BSP's market position in the Pacific region has improved. BSP has about 30% market share in the Solomon Islands, and 20% market share in Fiji. Ongoing economic difficulties in these regions, however, continue to challenge BSP's ability to pursue significant growth. Along with the bank acquisition in Fiji, BSP had to purchase Colonial Fiji Ltd., a life insurance business, which it intends to sell in 2010.

## Support And Ownership: Well Diversified Shareholder Base

The reasonably well diversified shareholding comprises superannuation fund companies and other statutory organizations and finance companies. The top-10 shareholders account for about 90% of total shareholding, and most appear to be government-related companies. Recently, BSP signed an agreement with the International Finance Corporation (IFC), a member of the World Bank Group, and IFC Capitalization Fund, to issue 5% of new shares in BSP. This new issue, combined with the purchase of another 5% of equity from an existing shareholder, will see the IFC hold a 10% shareholding in BSP. As a new shareholder, IFC could not only provide BSP access to a sizeable amount of capital but also offer technical expertise, particularly in risk management and product development.

## Strategy: Maintain Leading Market Position In PNG And Build Leadership In Pacific

BSP's strategy is to maintain its leading market position across all business segments, while continuing to grow its loan portfolio. Apart from growing its loan portfolio, BSP is focused on mobilizing its low-cost deposits and diversify its funding base. Other ongoing strategies include: consistent growth of noninterest income (particularly foreign currency business); improvement in operational efficiency through enhancement of its information systems; and building its human resource expertise by providing adequate training opportunities.

While BSP has a medium-to-long-term strategy of market leadership in the Pacific, there are no immediate expansion plans or acquisitions that would require the introduction of new capital. We believe that the integration of recent acquisitions in the Solomon Islands and Fiji is near completion, particularly with respect to management, systems, and technology. Electronic banking (ATMs, EFTPOS, Internet, and phone banking) facilities will be introduced in the Solomon Islands in 2010 along with a new head office. At the same time, BSP intends to expand its loan book in the Solomon Islands and Fiji as economic conditions continue to improve in both.

Standard & Poor's considers BSP's management team to be capable and committed. The management team members are mostly from Australian major banks and from within PNG. The CEO also brings his diverse international banking-industry experience to the team.

## Risk Management

BSP's risk profile is characterized by its adequate asset quality, concentrated funding profile, and vulnerable liquidity position. Market risk is limited to interest rate risk and modest foreign exchange risk. The bank's broader risk-management framework is adequate for its risk profile.

There is a clear separation of the sales and lending activity within the bank, wherein respective business units are primarily responsible for new business growth and all lending activity and responsibility lie with the internal credit and risk division. The bank's reporting framework is adequate and the overall operating risk framework continues to improve, particularly in areas like succession planning and staff training.

### Credit risk

Asset quality is adequate by domestic standards and is closely linked with the PNG government's credit-risk profile because government securities account for almost half of total assets. The higher weighting in government securities

is a result of the high yield earned from sovereign debt. Generally, government securities represent low credit risk for domestic entities but BSP's exposure to PNG government securities leads to significant asset concentration.

Overall credit-approval processes and standards support the credit-risk profile. BSP aims to secure most of its loans, although this is mostly property where the net realizable value depends on the country's economic development and the efficiency of the judicial process during times of recovery.

Standard & Poor's believes that the bank will need to remain vigilant about its growth, particularly as it increases its exposure to corporate sectors. The loan book has grown rapidly since 2005 with a compounded annual growth rate of about 34%. BSP's loan portfolio largely consists of loans to corporate and commercial clients (75% of loan portfolio) in both private and public sectors, and residential real estate loans (17.6% of loan portfolio), while the balance is held with government entities.

Given the bank's rapid loan growth over the past five years, we believe that it may face some asset-quality deterioration due to the unseasoned nature of the loan book particularly if new business growth were from high-risk sectors or from areas not core to its expertise. The rating has tolerance for a slight deterioration in asset quality over the medium term. Additionally, potential delays in realizing underlying collateral--reflecting an undeveloped litigation system in PNG--can pressure the bank's asset-quality levels. BSP's gross NPAs represented 0.9% of total loans at Dec. 31, 2009. For regulatory reporting purposes, PNG's asset-quality standards are based on Australian Prudential Regulatory Authority (APRA) standards and are in line with international standards.

Loan provisions remain satisfactory for BSP's current level of asset quality, with loan-loss reserves to total loans at year-end Dec. 31, 2009, accounting for 3.4% of customer loans. Standard & Poor's believes that the weak legal system in PNG brings the realizable value of collateral into question and could undermine the adequacy of provisions. However, the bank's recoveries in past years have been good and we believe that its improving capacity to generate earnings through stronger loan growth should help it maintain its provisioning capability.

### **Funding and liquidity risk**

The funding profile is highly reliant on retail funding, albeit in low-cost deposits. Although funding flexibility is limited--with no access to wholesale funding capabilities--BSP is less affected by ongoing challenges in financial markets. Nevertheless, deposit growth is following a positive trend and as of December 2009 the deposit book grew by 30% to PGK7.5 billion. This has helped the bank grow its market share to 55% (previously 50%) of total deposits in the banking system. Standard & Poor's believes that the consistent flow of deposit funds--benefiting from BSP's wide branch network and its status as the largest and only indigenous bank in PNG--will support BSP's high market share of deposits.

The deposit mix has remained relatively unchanged, year on year. Current deposits represented 72.1% of total deposits at Dec. 31, 2009, while term deposits represented about 25.7%. Deposits from the Solomon Islands and Fiji make up the balance.

Similar to local banking industry peers, BSP is experiencing a short-term maturity mismatch. We believe, however, that the relative stability of the majority of BSP's deposits partially mitigates the impact of this. About 1.3% of deposits mature in more than 12 months, which compares with about 55% of loans having a maturity period greater than 12 months.

Although holding substantial on-balance-sheet liquidity, the bank's liquidity position is vulnerable to PNG's

high-risk economic environment, particularly if the government were unable to service its debt. The shallowness of the capital markets, such as a thin secondary market, could restrict the bank's flexibility to sell investments and thus affect liquidity. The bank had most of its liquid assets in cash and government securities (10.6% and 40.9% of total assets, respectively) as of December 2009. The large portion of liquid assets is due to high reserve requirements by the central bank and ample liquidity in the market. The central bank requires banks to hold a minimum of 25% of total customer deposits in the form of liquid assets. Additionally, banks are required to maintain a cash reserve ratio of 3% of customer deposits.

### **Market risk**

BSP's market risks mainly arise from the trading of assets and liabilities in conducting wholesale market activity. Overall foreign-exchange risk is not significant, and mainly includes currency-related exposure, funding exposure, and any overall net open position. Given that BSP has opted to provide foreign exchange currency to clients up to two days prior to settlement, the bank is primarily exposed to counterparty credit risk. Any foreign exchange risk is mitigated by fixing rates upon settlement. To manage these risks, the bank conducts daily revaluations of its portfolio, which is verified against pre-defined limits. Moreover, some of these risks are also hedged.

The asset-liability management committee (ALCO) maintains a formal asset-liability management process. The ALCO meets on a regular basis, and operates according to the policies and parameters established by the bank's board. The ALCO's mandate is to manage the structure of the bank's balance sheet, funding costs, interest and foreign-exchange rate risk, liquidity, and capital positions. In managing interest rate risks, the bank uses basic gap analysis and the impact of a 1% upside and downside risk on interest rates. The bank limits interest rate exposure to the extent where a +/- 200-basis-point shock should not reduce net interest income by more than 5%.

### **Operational and other risk**

BSP's operational risk framework is developing, but remains supportive to manage operational risks. General managers of each business unit are responsible for setting operational risk-tolerance levels, and identifying and controlling key operational risks within their respective business unit. A recent example of an operational risk event was a fraudulent cheque-clearing scheme by an employee that was discovered in fiscal 2009 and resulted in a provision of PGK15 million.

## **Profitability**

BSP's profitability is good and is a rating strength. The bank's sound operating performance is underpinned by a high net interest margin on the back of strong loan growth. Profit after tax improved to PGK257 million at the end of 2009 and is likely to grow at a similar rate in 2010 as the loan book continues to expand.

Standard & Poor's expects BSP to maintain high net interest margins because of its very low funding costs. The margin is also supported by BSP's holding of government securities and treasury bills. As a proportion of total interest income, BSP has an almost equal contribution of interest income from government securities (48.5%) as compared to that earned from its loan book (51.2%).

The bank's earnings mix is sound. As at December 2009, BSP's proportion of noninterest income decreased slightly to 34.7% of total revenues (39.1% in December 2008). Fees and commissions represented the majority of total noninterest income at 55.6%. BSP is able to compete with the larger Australian-owned banks in foreign-exchange business by meeting client's needs within tight deadlines through taking on small amounts of currency risk.

BSP's cost-to-income ratio is rising but on the back of an improving revenue base. This ratio has risen from 39.3% in 2007 to 46% in 2009 on investment in staff training, upgrades to information systems, and integration costs from recent acquisitions in the Solomon Islands and Fiji.

**Table 1**

<b>Bank of South Pacific Ltd. Profitability Ratios</b>					
	<b>--Year-ended Dec. 31--</b>				
<b>(%)</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Net interest income/average earning assets	6.8	6.8	6.3	6.7	N/A
Net interest income/revenues	65.3	60.8	57.9	61.0	53.0
Fee income/revenues	15.0	14.1	14.2	16.1	17.5
Market-sensitive income/revenues	14.4	20.5	24.4	18.9	28.6
Personnel expense/revenues	17.3	17.7	16.6	19.6	22.0
Noninterest expenses/revenues	46.2	37.0	39.3	51.8	54.7
New loan loss provisions/revenues	2.1	1.8	(0.9)	(0.4)	(1.3)
Net operating income before loan loss provisions/loan loss provisions	2,601.8	3,436.5	(6,681.6)	(12,628.9)	(3,490.5)
Net operating income after loan loss provisions/revenues	51.8	61.1	61.6	48.6	46.6
Pretax profit/revenues	52.1	53.1	59.3	47.9	46.6
Tax/pretax profit	32.0	30.6	32.6	32.2	30.2
Core earnings/revenues	35.2	44.9	42.3	33.2	32.6
Core earnings/average adjusted assets	3.2	4.4	3.8	3.0	N/A
Noninterest expenses/average adjusted assets	4.1	3.6	3.6	4.6	N/A
Core earnings/average risk-weighted assets	6.7	10.5	11.4	8.7	9.6
Core earnings/average adjusted common equity	32.8	44.8	45.7	35.6	34.7
Pretax profit/average common equity (%)	45.1	50.0	58.6	46.9	N/A

N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

## Capital

The bank's capitalization is considered adequate by international standards, with a RAC ratio of 6% at December 2009. The bank's capitalization is supported by BSP's sound internal capital generation. Additionally, the quality of capital is good, comprising mostly paid-in capital and retained earnings. In 2009, BSP successfully raised PGK75.5 million in Tier 2 capital, which was the first ever domestic Tier 2 instrument in PNG.

BSP comfortably meets its regulatory capital requirements. The bank's regulatory capital ratio of 18.3% at year ended Dec. 31, 2009 is significantly higher than the 12% minimum regulatory requirement. The higher regulatory capitalization results from BSP's low loans-to-assets ratio, and its significant holding of government securities. BSP's capital position is somewhat inflated by the fact that government securities do not carry any risk weight. The bank's capital position would come under pressure if the government could not meet its debt-servicing obligations.

BSP aims to pay strong returns to shareholders while also maintaining sound internal capital generation. The bank does not have an explicit dividend policy. In fiscal 2010, BSP distributed 70% of its income as dividends.

**Table 2**

<b>Bank of South Pacific Ltd. Capital Ratios</b>					
	<b>--Year-ended Dec. 31--</b>				
<b>(%)</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Adjusted common equity/risk assets	19.4	21.6	26.9	22.6	27.6
Tier 1 capital ratio	18.0	20.9	26.4	22.9	27.2
Adjusted total equity/adjusted assets	8.5	10.4	9.1	8.1	10.6
Adjusted total equity/managed assets	8.5	10.4	9.1	8.1	10.6
Adjusted total equity plus loan loss reserves (specific)/customer loans (gross)	24.6	31.8	35.8	32.2	34.6
Common dividend payout ratio	39.0	43.6	37.3	54.1	43.5

**Table 3**

<b>Bank of South Pacific Ltd. Summary Balance Sheet</b>					
	<b>--Year-ended Dec. 31--</b>				
<b>(Mil. PGK)</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
<b>Assets</b>					
Cash and money market instruments	1,188.3	718.6	978.3	415.8	390.4
Securities	3,838.3	3,363.1	2,919.3	2,376.7	1,481.9
Nontrading securities	3,838.3	3,363.1	2,919.3	2,376.7	1,481.9
Customer loans (gross)	3,768.3	2,394.3	1,591.4	1,196.4	903.0
Loan loss reserves	129.8	50.5	41.2	33.2	29.5
Customer loans (net)	3,638.6	2,343.8	1,550.3	1,163.3	873.5
Earning assets	7,798.5	6,041.4	5,048.3	3,717.9	2,563.9
Investments in unconsolidated subsidiaries (financial companies)	47.7	1.8	2.1	3.0	3.5
Intangibles (nonservicing)	21.3	0.0	9.4	9.4	3.0
Fixed assets	282.2	175.4	170.7	150.5	130.0
Accrued receivables	51.8	50.1	32.0	32.6	17.8
All other assets	329.6	155.0	166.8	585.7	52.3
Total assets	9,397.8	6,807.9	5,819.5	4,736.9	2,952.5
Intangibles (nonservicing)	21.3	0.0	9.4	9.4	3.0
Adjusted assets	9,376.5	6,807.9	5,819.5	4,727.5	2,949.5
<b>Liabilities</b>					
Total deposits	7,520.4	5,793.4	5,061.6	3,779.3	2,539.3
Noncore deposits	26.6	11.4	5.7	2.9	5.9
Core/customer deposits	7,493.8	5,782.0	5,055.9	3,776.4	2,533.4
Other borrowings	89.0	0.0	0.0	0.0	0.0
Other other borrowings	13.4	0.0	0.0	0.0	0.0
Other liabilities	854.4	270.2	186.2	561.3	107.4
Total liabilities	8,463.7	6,063.6	5,247.8	4,340.6	2,646.7
Total equity	934.1	744.3	571.7	396.3	305.8
Common shareholders' equity (reported)	934.1	744.3	571.7	396.3	305.8
Share capital and surplus	318.0	318.0	271.5	212.2	185.2
Revaluation reserve	68.8	31.1	32.2	32.2	16.3
Retained profits	553.9	394.4	264.9	147.6	100.7

**Table 3**

<b>Bank of South Pacific Ltd. Summary Balance Sheet (cont.)</b>					
Total liabilities and equity	9,397.8	6,807.9	5,819.5	4,736.9	2,952.5

PGK--Papua New Guinea kina. N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

**Table 4**

<b>Bank of South Pacific Ltd. Equity Reconciliation Table</b>					
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<b>(Mil. PGK)</b>	<b>--Year-ended Dec. 31--</b>				
	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Common shareholders' equity (reported)	934.1	744.3	571.7	396.3	305.8
Minus revaluation reserves	(68.8)	(31.1)	(32.2)	(32.2)	(16.3)
Minus nonservicing intangibles	(21.3)	0.0	(9.4)	(9.4)	(3.0)
Adjusted common equity	844.0	713.1	530.1	354.7	286.5
Plus general reserves	0.0	0.0	0.0	33.2	29.5
Minus equity in unconsolidated subsidiaries	(47.7)	(1.8)	(2.1)	(3.0)	(3.5)
Adjusted total equity	796.3	711.3	528.0	384.9	312.4

PGK--Papua New Guinea kina.

**Table 5**

<b>Bank of South Pacific Ltd. Profit And Loss</b>					
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<b>(Mil. PGK)</b>	<b>--Year-ended Dec. 31--</b>				
	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Net interest income	474.0	377.1	276.9	209.6	161.8
Interest income	582.9	436.0	313.2	235.2	179.7
Interest expense	108.9	58.9	36.3	25.6	17.9
Operating noninterest income	252.0	242.7	201.6	134.0	143.7
Fees and commissions	108.8	87.3	68.0	55.5	53.6
Trading gains	104.3	127.1	116.2	64.6	87.3
Other market-sensitive income	N/A	N/A	0.3	0.3	N/A
Net insurance income	6.6	0.0	0.0	0.0	0.0
Equity in earnings of unconsolidated subsidiaries	0.2	(1.2)	(0.9)	(0.6)	(0.5)
Other noninterest income	32.0	29.4	17.9	14.1	3.3
Operating revenues	725.9	619.8	478.5	343.5	305.5
Noninterest expenses	335.1	229.6	188.2	178.0	167.0
Personnel expenses	125.8	109.5	79.6	67.3	67.1
Other general and administrative expense	172.0	93.3	81.6	80.3	72.9
Net operating income before loss provisions	390.8	390.2	290.3	165.6	138.5
Credit loss provisions (net new)	15.0	11.4	(4.3)	(1.3)	(4.0)
Net operating income after loss provisions	375.8	378.8	294.7	166.9	142.5
Nonrecurring/special income	2.4	N/A	0.0	0.0	0.0
Amortization of intangibles	N/A	N/A	0.7	0.6	0.2
Impairment of intangibles	N/A	N/A	10.4	1.8	N/A
Pretax profit	378.1	328.8	283.6	164.5	142.2
Tax expense/credit	121.0	100.5	92.5	52.9	43.0
Net income (before minority interest)	257.1	228.3	191.1	111.6	99.2

Table 5

Bank of South Pacific Ltd. Profit And Loss (cont.)					
Net income before extraordinary	257.1	228.3	191.1	111.6	99.2
Net income after extraordinary	257.1	228.3	191.1	111.6	99.2

PGK--Papua New Guinea kina. N.A.--Not available. N/A--Not applicable. N.M.--Not meaningful.

Table 6

(Mil. PGK)	--Year-ended Dec. 31--				
	2009	2008	2007	2006	2005
Net income (before minority interest)	257.1	228.3	191.1	111.6	99.2
Minus nonrecurring/special income	(2.4)	0.0	0.0	0.0	0.0
Plus or minus tax impact of adjustments	0.8	0.0	0.0	0.0	0.0
Plus amortization/impairment of goodwill/intangibles	0.0	0.0	11.1	2.4	0.2
Core earnings	255.5	278.3	202.2	114.0	99.5

PGK--Papua New Guinea kina.

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### Ratings Detail (As Of June 30, 2010)\*

#### Bank of South Pacific Ltd.

Counterparty Credit Rating	B+/Stable/B
Bank Fundamental Strength Rating	
Local Currency	D
Subordinated (1 Issue)	B-

#### Counterparty Credit Ratings History

13-Sep-2007	Foreign Currency	B+/Stable/B
07-Dec-2005		B/Stable/B
10-Nov-2005		B/Positive/B
07-Dec-2005	Local Currency	B+/Stable/B
10-Nov-2005		B+/Positive/B

#### Sovereign Rating

Papua New Guinea (Independent State of)	
Foreign Currency	B+/Stable/B
Local Currency	BB-/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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