STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

Research

Summary:

Bank of South Pacific Ltd.

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Summary:
Bank of South Pacific Ltd.

SACP	b+
Anchor	b+	
Business Position	Strong	+1
Capital and Earnings	Moderate	0
Risk Position	Moderate	-1
Funding	Average	0
Liquidity	Adequate	

\+

Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

\+

Additional Factors	0

Issuer Credit Rating
B+/Stable/B

Major Rating Factors

Strengths:	Weaknesses:
• Strong domestic market position that is difficult to replicate, as it is the largest commercial bank in Papua New Guinea • Strong profitability, resulting from high margins, low credit costs, and good cost-control	• Concentrated and high-risk loan portfolio, weighted toward commercial and corporate lending • High-risk economic and operating environment • Vulnerability to erosion of confidence in Papua New Guinea

Rationale

The ratings on the Papua New Guinea-based Bank of South Pacific Ltd. (BSP) reflect the bank's dominant market position in commercial and retail banking in Papua New Guinea (PNG), in which we consider the bank has a number of structural advantages over its competitors. The ratings also reflect BSP's strong profitability, which we expect to be maintained through our outlook horizon. BSP's concentrated and high-risk lending portfolio and significant holding of Treasury and Central Bank Bills of PNG offset these strengths, in our view, as does its exposure to PNG and other under-developed Pacific island nations, which we consider to be a high-risk economic and operating environments.

We assess BSP's stand-alone credit profile as 'b+'.

Business position:dominant market position in its home region of PNG, supported by an increasing presence in other Pacific islands

We believe BSP exhibits a dominant and, more importantly, defendable market position in PNG, primarily underpinning our expectation that the bank is well placed to contend with the imbalances and inevitable cyclicality stemming from the under-developed and concentrated nature of PNG's economy--an economy heavily dependent on commodity prices. Headlining the bank's market dominance, BSP accounts for around 50% and 55% of lending and deposit activity, respectively, in PNG, supported by a significant (and growing) customer base of close to 1.6 million. Consistent with the banking landscape in PNG, corporate lending accounts for a disproportionate share of BSP's lending exposures, at around 70% of total lending, although we estimate the concentration to be less than that relative to other domestic peers, reflecting an increased emphasis on retail and small-to-medium enterprise (SME) banking. We also believe BSP's broader focus on the Pacific islands, in which the bank maintains a healthy market position in both Fiji and the Solomon Islands (at around 20% and 28% of system loans, respectively), adds to the diversity of its domestic business.

While we note the contribution of lending activities--which we consider as having stronger recurring characteristics relative to other forms of revenue generation--to operating revenues is somewhat low at around 54%, we take a neutral view in the context of assessing BSP's business stability. In our opinion, the banking sector in PNG can be characterized by surplus funding and limited lending opportunities, which typically results in higher operating revenue contributions from other business lines, which have proven quite resilient in recent years. Nevertheless, we anticipate that in the longer-run, operating revenues from lending activities will increase proportionally as an increasing coverage of PNG becomes "bankable", which should augur well for longer-term business stability.

Beyond the headline numbers that highlight BSP's dominant market position in PNG, we believe BSP has a number of structural advantages that, in our opinion, render the ability of competitors, whether onshore or offshore, to replicate, difficult. In particular, we note the bank's extensive physical branch network and significant investment in information technology infrastructure, and therefore its natural reach, which forms the mainstay of its operations in the South Pacific. While we believe these advantages may benefit retail and SME banking more so than corporate banking, we believe the use of technology to deliver banking services to the more remote and 'under-developed' parts of PNG's economy will increasingly benefit the bank in the longer-run. We also consider BSP's relationship with its customer base, stemming from its infrastructure investment and probable brand association--rather than pricing--would make it difficult for competitors to penetrate.

We believe BSP is well-positioned to expand its business operations in the South Pacific, which headlines its longer-term objectives, given its performance in developing a sound business base in the markets of Fiji and Solomon Islands over the past 10 years or so. To this point, we expect the recent announcement to acquire the banking operations of Westpac Banking Corp. (Westpac; AA-/Stable/A-1+) in the countries of Samoa, Cook Islands, Solomon Islands, Vanuatu, and Tonga, to largely complement BSP's existing franchise--we understand the size of the proposed acquisition will increase BSP's on-balance sheet assets by close to 10%--without compromising our view of the bank's franchise dominance in PNG (see Related Research).

Although we consider management at BSP to exhibit a higher tolerance for risk relative to its main competitors, we do not believe it compromises our view of their ability to deliver generally stable and upward trending operating revenues whilst maintaining a largely sound balance sheet structure, particularly when viewed within the context of PNG's operating environment.

Capital and earnings: modest risk-adjusted capitalization, reflecting high risk-weights attributed to Papua New Guinea, although earnings (and thus capital) generation is strong

We forecast the risk-adjusted capital (RAC) ratio for BSP at between 3.85% and 4.35% through the next 12-18 months (from a static 4.6% as at June 30, 2014). Importantly, our forecasts factor in our base case expectation that the acquisition of the formentioned banking operations from Westpac will proceed and that it will be funded through existing capital. We note that if the acquisition was not to proceed, our capital forecasts would revert to a range between 4.5% and 5.0% (although this would have no impact on BSP's overall rating). We also note that the Bank of Papua New Guinea (BPNG) has not yet adopted the Basel II capital regime. On a Basel I basis, BSP is adequately capitalized and has a Tier 1 ratio of 19.4% (above the minimum ratio of 8% required in PNG). The RAC ratio is considerably lower than that regulatory ratio largely because of the Standard & Poor's RAC ratio risk-weighting sovereign exposures and the calculation of capital requirements for operational risk (that do not form part of the Basel I risk-weighted assets). We also assess BSP's capital base to be of good quality, as total adjusted capital consists almost fully out of ordinary share capital and retained earnings.

Our forecasts factor in a largely unchanged earnings profile for BSP in 2015, before picking up again in 2016, underpinned by expectations of above-system organic lending growth (in addition to those assets acquired from Westpac) and a reasonably stable outlook for net interest margins, although we believe a move by the BPNG to introduce a trading band around the reference rate set by (the BPNG) will present a headwind to earnings from foreign exchange (until it is either amended or removed). We expect non-interest expenditure to be well-controlled, with a cost to income ratio unchanged and forecast at around 47%. Our forecasts also factor in our expectation that BSP's dividend-payout ratio will be maintained at around 64%.

Risk position: balance sheet characterized by single-name concentration, although credit quality of large corporates supports sound loss experience

We hold the view that BSP's lending portfolio exhibits a high degree of single-name concentrations, with the top 25 exposures accounting for more than 200% of shareholders equity. At the same time, the bank invests a significant proportion of funds in Deposits, Treasury and Central Bank Bills of PNG, accounting for close to 30% of total assets (or more than 250% of equity), although this is somewhat necessitated by a lack of lending opportunities in PNG.

In our opinion, BSP's name-concentration risk is somewhat balanced by the credit quality of the large corporates that it deals with, and the extent to which these corporates benefit from deal flows from multinational corporations. Although credit losses (as measured by new loan loss provisions) are reasonably high at around 120 basis points (bps), net charge-offs are significantly lower at around 20 bps, with the difference largely explained by the susceptibility to single-name concentrations and a conservative approach to provisioning, in our view--indeed, loan loss reserves as a proportion of customer loans remains broadly unchanged and very high at 4.6% in 2014. Non-performing assets continue to trend lower (around 70 bps, from close to 100 bps in 2013), although we remain mindful of the under-developed nature of PNG's economy and its nascent and highly-concentrated industries, which could see arrears rise quickly in a cyclical or structural downturn; as a result, we expect provisioning levels to remain, on the whole, conservatively positioned.

We are also of the view that operational risk is high for BSP. In this regard we note that BSP operates in an environment of heightened operational risks, such as infrastructure shortcomings and security risks. We note, however, that the risk is mitigated by our views around how BSP manages operational risk, with BSP's information technology architecture and infrastructure (including personnel) measuring up to developed world standards. Finally, while noting the general increased operational and execution risk associated with merger and acquisition activity, we understand transitional arrangements associated with the proposed acquisition of certain assets of Westpac are reasonably lengthy, which should moderate the forementioned risks. We also don't believe the proposed acquisition adds a substantial level of additional risk for BSP, as we expect the assets to be well-seasoned and not in a distressed state.

Funding and liquidity: sound funding profile and a high level of on-balance sheet liquidity

Our funding assessment for BSP takes into account the bank's very strong funding ratios, with a loan-to-deposit ratio of less than 55%, and its market position, which, at around 55% of system deposits, underpins our belief that the bank is not reliant on confidence-sensitive funding sources. BSP's stable funding ratio, which measures the bank's available funding sources relative to its funding needs over a one-year period, is also high at more than 160%, highlighting the stability of BSP's funding base--which is comprised almost entirely of deposits sourced from governments (inc. provincial and other state-owned enterprises), corporates, and retail customers. Despite BSP's stable funding structure and strong funding ratios, we have tempered our assessment to reflect the high risk operating environment, which could undermine the expected stability associated with deposits if a crisis of confidence in BSP (or a broader system-wide event) was to transpire. With stronger lending growth anticipated over the longer-term, we expect BSP's key funding ratios to moderate, although we expect them to remain very high by international standards; other funding sources are largely non-existent in PNG, leading us to believe growth will remain predominantly funded by deposits.

Our assessment of BSP's liquidity principally reflects our belief that the bank has sufficient liquidity sources to manage a short-term period (about six months) of general market stress. BSP's cover of short-term sources of funding is very good, with net-broad liquid assets covering around 52% of short-term customer deposits; although a significant proportion of customer deposits have a contractual maturity of less than one month (more than 90% in fiscal 2014), we believe the stability of BSP's deposit base is likely to prevail in the absence of stronger domestic competition for deposits. Coverage of maturing wholesale funding is ample, although this largely reflects the bank's lack of wholesale funding--as a result of the bank's limited reliance on confidence-sensitive funding, we currently do not foresee any large or unusual liquidity needs in the next 12-24 months.

Outlook: Stable

The stable outlook reflects our expectation that BSP will maintain its dominant market position in commercial and retail banking in PNG, which we expect to be supplemented by a gradually increasing presence through other Pacific islands. Importantly, the stable outlook factors in our expectation that BSP's announcement to purchase certain banking operations of Westpac throughout the Pacific islands will largely complement BSP's existing business base (and aspirations), and be of a quality that will not severely comprise the asset quality experience BSP's lending book currently exhibits. Further to this, the stable outlook factors in our expectation that BSP's projected RAC ratio will remain above 3% through the next 18-24 months, which incorporates the forementioned transaction.

We see limited prospects for downward rating pressures in the next two years for BSP, and expect any downward movements to come from either a downgrade in the sovereign rating on PNG or a material, unexpected, one-off event (for example, a significant credit loss stemming from BSP's lending portfolio, which exhibits a high degree of single-entity concentration). To the latter point, we believe BSP has significant headroom within its forecasted RAC ratio to absorb a significant loss (we believe a loss in capital of around 30% would be required) and a material deterioration in its asset quality experience (we believe charge-offs would need to increase to around 5% of customer loans).

We do not expect the ratings on BSP to be raised in the next 18-24 months. We consider it highly unlikely that BSP would be insulated from a default on the sovereign--primarily as a result of the bank's high exposure to the sovereign assets of PNG--and as such, limit the rating on BSP to that of the sovereign of PNG. In the unlikely event that the sovereign rating is raised in the forementioned timeframe, the ratings are likely to remain unchanged in the first instance, as we currently see little upside within our rating assessment on BSP.

Related Criteria And Research

Related Criteria

- Banks: Rating Methodology & Assumptions, Nov. 9, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Banks: Bank Hybrid Capital And Nondeferrable Subordinated debt Methodology And Assumptions, Jan. 29, 2015

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	4	5	6	7	8	**9**	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	**b+**	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-