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## Research Update:

# Outlook On Bank Of South Pacific Rating Revised To Negative On Rising Economic Risks In PNG

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## Table Of Contents

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Overview

Rating Action

Rationale

Outlook

Related Criteria And Research

Ratings List

## Research Update:

# Outlook On Bank Of South Pacific Rating Revised To Negative On Rising Economic Risks In PNG

## Overview

- We believe that Papua New Guinea's (PNG's) financial institutions face increasing risks stemming from increasing credit pressures on both the sovereign and broader operating environment as a result of lower global energy prices.
- As a result, we have revised our outlook on Bank of South Pacific Ltd. (BSP) to negative from stable. At the same time, we have affirmed the issuer credit ratings at 'B+/B'.
- Although we believe that important credit factors specific to BSP remain broadly unchanged, we consider it unlikely that BSP would be insulated from increasing credit pressures on both the sovereign and the broader operating environment as falling export revenues increase the risk to the government's financials and the economy's external vulnerabilities.

## Rating Action

On Oct. 26, 2015, Standard & Poor's revised its long-term issuer credit rating outlook on Bank of South Pacific Ltd. (BSP) to negative from stable. At the same time, we affirmed our 'B+' long-term and 'B' short-term ratings on the bank.

## Rationale

We note that the rating action does not reflect important credit factors specific to BSP, which remain broadly unchanged, in our view. Instead, the rating action reflects our view that PNG's economic resilience is under pressure from lower global energy prices, which in turn increases the risk within PNG's banking system. In particular, we believe the weakness in global energy prices will increase the pressure on PNG's economic growth in the short-to-medium term, as we expect lower export revenues to translate into lower government spending. We believe this could lead to a slowdown in business earnings, both directly and indirectly (via household income growth), which may trigger a subsequent rise in either idiosyncratic or system-wide credit losses for the banking sector; we note that lending to business accounts for close to 70% of lending for BSP. Furthermore, with BSP deriving a high proportion of funding from government and business sources, we believe increasing pressures on both government and business in PNG could slow the flow of funding into the banking sector, which may place a further constraint on lending opportunities for BSP.

At the same time, we note BSP invests a significant proportion of surplus

funds in Deposits, Treasury and Central Bank Bills of PNG, accounting for close to 30% of total assets (although we also note this is somewhat necessitated by a lack of lending opportunities in Papua New Guinea).

As a result, we consider it unlikely BSP would be immune to increasing credit pressures on both the sovereign and the broader operating environment.

## **Outlook**

The negative outlook on BSP reflects our opinion that the bank would be unlikely to avoid increasing credit pressures stemming from both the sovereign and broader operating environment as a result of lower global energy prices. We believe lower global energy prices raises the possibility that the PNG government will be unable to constrain its debt levels and that large fiscal and external imbalances will be slower to unwind than we previously expected. We believe that in the event of these factors leading to a slowdown in PNG's economic growth outlook over the short-to-medium term, there would be pressure on business earnings in PNG, prompting a rise in either idiosyncratic or system-wide credit stress, which could increase credit losses for BSP. Should the rating on the sovereign be lowered, we would expect to lower our issuer credit rating on BSP to 'B', from 'B+'.

### **Downside scenario**

We note that if BSP's issuer credit rating was lowered, we would expect to keep the issue rating on its subordinated debt unchanged at 'B-'. This is because a lower rating of 'CCC+' implies at least a one-in-three likelihood of default within 12 months, which we do not foresee given the rating action of BSP's issuer credit rating reflects increasing risks within PNG's banking system, rather than factors specific to BSP.

Although the broader economic backdrop behind any downward rating action on the sovereign is likely to imply a weakening in growth prospects for BSP, we believe downward rating pressures as a result of credit factors specific to the bank are unlikely within the next 12 months.

### **Upside scenario**

We would expect the rating to be revised to stable if the outlook on the rating of PNG government is similarly revised to stable.

## **Related Criteria And Research**

### **Related Criteria**

- Use of CreditWatch and Outlooks, Sept. 14, 2009
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology & Assumptions, Nov. 9, 2011
- Banks: Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Banks: Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 4, 2010

- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012

### Related Research

- Outlook on Bank of South Pacific Rating Revised to Negative on Rising Economic Risks in PNG, Oct. 26, 2015
- Papua New Guinea Outlook Revised To Negative On Possible Prolonged Fiscal And External Imbalances; Ratings Affirmed, Oct. 8, 2015
- Banking Industry Country Risk Assessment: Papua New Guinea, April 23, 2015

### Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Bank of South Pacific Ltd. Counterparty Credit Rating	B+/Negative/B	B+/Stable/B

Ratings Affirmed

Bank of South Pacific Ltd. Subordinated	B-
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