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Bank of South Pacific Ltd.

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Bank of South Pacific Ltd.

SACP	b+

\+

Support	0

\+

Additional Factors	0

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

ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

Issuer Credit Rating
B+/Negative/B

Major Rating Factors

Strengths:	Weaknesses:
• Strong domestic market position as Papua New Guinea's largest commercial bank • Extensive distribution model and significant investment in information technology that we believe is difficult to replicate • Strong profitability, stemming from the bank's high margins, low credit costs, and good cost-control	• Concentrated and higher-risk loan portfolio, weighted toward commercial and corporate lending • High-risk economic and operating environment • Vulnerability to erosion of confidence in Papua New Guinea

Outlook:

The negative outlook on Bank of South Pacific Ltd. (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, should they eventuate.

Downside scenario

We believe lower global energy prices raise the possibility that the Papua New Guinea (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. We believe the pressures on both the sovereign and banking sector in PNG are broadly similar. Consequently, we would expect to lower our issuer credit rating on BSP to 'B' from 'B+', should a similar action take place on the PNG sovereign rating. However, we would expect to keep the issue rating on its subordinated debt unchanged at 'B-'.

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 to revise the outlook to stable if pressures on both the sovereign and broader operating environment in PNG abated. A significant improvement in the outlook for PNG's external position over the next few years would be supportive of a return to stable outlook for both the banking sector, and BSP, in our opinion.

Rationale

The ratings on the PNG-based BSP reflect its dominant market position as the largest commercial and retail bank in PNG, and one in which we consider the bank to have a number of structural advantages over its competitors, including an extensive distribution model and affinity with customers as PNG's largest domestically-owned bank, which should position the bank well to defend its market share as business growth slows in the short-term in response to a slowdown in economic growth following the fall in global energy prices. The ratings also reflect BSP's strong profitability, which we expect it to maintain through our outlook horizon, despite our expectation of both increasing competition and slower system growth.

BSP's concentrated and higher-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 underdeveloped Pacific island nations, which we consider to be high-risk economic and operating environments. We expect credit losses to rise as the impact from the fall in global energy prices filters through to increasing cash flow pressure for some customers, although we expect the impact to be modest and manageable for the bank.

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

Anchor:

The starting point for our ratings on BSP primarily reflects our assessment of PNG's macro-environment. This is because we expect PNG to account for more than two-thirds of BSP's business base over the next two years, notwithstanding a measured increase in business in other Pacific island nations.

We view PNG's economy as being constrained by low income levels and a heavy dependence on the resources sector, and while we believe liquefied natural gas production will likely contribute to stronger economic growth over the longer term, lower global energy prices may undermine PNG's economic resilience in the short term. Although government debt is relatively low, fiscal flexibility is limited by PNG's reliance on resources, which itself is largely funded through external sources, and the need to address significant infrastructure gaps and basic services. The risk of rising credit losses for the banking sector stems from PNG's underdeveloped and concentrated economy, with failure of single projects and nascent institutions heightened by the vulnerability to falls in export resource prices and single-entity concentrations. Further, legal infrastructure and judicial system delays also pose challenges in enforcing creditor rights. We regard banking supervision in PNG as relaxed, with regulation gaps and poor disclosure highlighting its shortcomings, although limited market distortions and a high degree of foreign ownership in PNG's banking sector moderates some of the banking systems structural risks, as does the relatively vanilla nature of its operations. The banking system is fully funded by customer deposits, although its access to other funding sources, if required, would be severely limited, in our view.

Table 1

Bank of South Pacific Ltd. Key Figures					
	--Year-ended Dec. 31--				
(Mil. PGK)	2015	2014	2013	2012	2011
Adjusted assets	18,086	15,706	15,605	13,331	11,659
Customer loans (gross)	9,068	7,085	5,583	5,025	4,469
Adjusted common equity	1,730	1,502	1,275	1,445	1,304
Operating revenues	1,547	1,499	1,534	1,317	1,134
Noninterest expenses	646	657	749	700	633
Core earnings	577	553	522	409	356

PGK--Papua New Guinea kina.

Business position: Dominant market position in its home region of PNG, supported by an increasing presence in other Pacific-island nations

We believe BSP exhibits a dominant and, more importantly, defendable market position in PNG, which accounts for about 70% of BSP's business base, primarily underpinning our expectation that the bank is well placed to contend with the imbalances and inevitable cyclicality stemming from the underdeveloped and concentrated nature of PNG's economy--an economy heavily dependent on export commodity prices, and now having to contend with a deep fall in global energy prices. Headlining the bank's market dominance, we note BSP accounts for around 55% of lending and deposit activity, respectively, in PNG, supported by a significant (and growing) customer base of close to 1.7 million (across all operating regions).

Consistent with the banking landscape in PNG, corporate lending accounts for a disproportionate share of BSP's lending exposures, at around 65% of total lending, although we estimate the concentration to be less than that relative to other domestic peers--primarily the (unrated) domestic operations of the Australian-based Westpac Banking Corp. (Westpac; AA-/Stable/A-1+) and Australia and New Zealand Banking Group Ltd. (ANZ; AA-/Stable/A-1+), both of whom account for close to the remaining majority of banking activities in PNG--reflecting BSP's increased emphasis on retail and small and midsize enterprise (SME) banking. And 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 its 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.

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 65% as of Dec. 31, 2015, 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 underdeveloped 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 affinity--rather than pricing--would make it difficult for competitors to penetrate.

We believe the recently acquired banking operations from Westpac in the pacific countries of Samoa, Cook Islands, Solomon Islands, Tonga, and Vanuatu (June 2016) provide a timely offset to our expectations of slower business growth in PNG, and continue the longer-term expansion theme of BSP's operations in the South Pacific. We note BSP's operations outside of PNG account for about 30%, with Fiji alone accounting for about 20%. And while BSP's market share within these island nations is not nearly as dominant as it is in PNG, it is overall on the rise, and we expect further growth to add to the diversity of its domestic business--without compromising our view of the bank's franchise dominance in PNG.

Table 2

Bank of South Pacific Ltd. Business Position					
	--Year-ended Dec. 31--				
(%)	**2015**	**2014**	**2013**	**2012**	**2011**
Total revenues from business line (currency in millions)	1,547	1,499	1,534	1,317	1,134
Commercial banking/total revenues from business line	45.8	52.4	48.0	N/A	N/A
Retail banking/total revenues from business line	37.1	34.9	32.7	N/A	N/A
Commercial & retail banking/total revenues from business line	82.9	87.3	80.6	92.6	90.6
Other revenues/total revenues from business line	15.8	12.3	19.1	6.3	8.3
Return on equity	28.1	30.0	28.7	29.4	29.2

N/A--Not applicable.

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 to remain broadly unchanged at between 4.0% and 4.5% through the next 12-18 months--from 4.2% as of Dec. 31, 2015, which came in as expected following the acquisition of the forementioned banking operations from Westpac. We 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 with a Tier 1 ratio of 19.0% (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, with total adjusted capital consisting almost entirely of ordinary share capital and retained earnings.

Our forecasts factor in a modest increase in earnings for BSP in both 2016 and 2017, underpinned by expectations of above-system organic lending growth, although we expect some margin pressure as a result of stronger competitive pressures in response to slower system growth stemming from a slowdown in economic growth. Although not anticipated, we believe a possible withdrawal of excess liquidity in the banking system by the government (and related entities) could also represent a headwind to earnings growth for BSP. We expect credit losses (new loan loss provisions) to increase in response to deteriorating economic backdrop, although given the bank's reserve cover for nonperforming loans is already healthy at more than 250%, we expect the increase to be modest. We also expect noninterest expenditure to remain well-controlled, with a cost to income ratio unchanged and forecast at around 42%. Finally, our forecasts also factor in our expectation that BSP's dividend-payout ratio will be maintained at around 65%.

Table 3

Bank of South Pacific Ltd. Capital And Earnings

	--Year-ended Dec. 31--				
(%)	**2015**	**2014**	**2013**	**2012**	**2011**
Tier 1 capital ratio	19.0	19.4	13.9	17.4	19.8
S&P RAC ratio before diversification	4.2	N.A.	N.A.	N.A.	N.A.
S&P RAC ratio after diversification	3.3	N.A.	N.A.	N.A.	N.A.
Adjusted common equity/total adjusted capital	98.8	98.6	98.6	98.8	98.6
Net interest income/operating revenues	65.0	59.0	48.3	51.8	52.7
Fee income/operating revenues	20.1	20.4	18.6	19.3	17.8
Market-sensitive income/operating revenues	11.6	17.8	23.0	17.4	18.6
Noninterest expenses/operating revenues	41.8	43.8	48.8	53.1	55.8
Preprovision operating income/average assets	5.3	5.3	5.4	4.9	4.6
Core earnings/average managed assets	3.4	3.5	3.6	3.3	3.3

N.A.--Not available.

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 close to 150% of shareholders equity. At the same time, the bank invests a significant proportion of funds in Deposits, Treasury and Central Bank Bills of PNG (including statutory deposits), accounting for close to 30% of total assets (or close to 300% of equity), which exposes the bank to sovereign credit stresses, although this is somewhat necessitated by a lack of lending opportunities in PNG. In both instances, we believe the concentration of BSP's assets is likely to be broadly consistent with that of the domestic operations of ANZ and Westpac.

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 1.1% of average customer loans in 2015, net charge offs are significantly lower at around 0.20% (of average customer loans), 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 around 5.0% of customer loans. We remain mindful of the underdeveloped 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.

On that point, we note that nonperforming loans increased sharply in 2015 to around 1.9% of average customer loans (from around 0.70% in 2014), stemming in-part from the "regrading" of some assets acquired from Westpac, and broad-based pressures in PNG. We understand heightened oversight and reporting has lead to an improvement in the performance of some of the acquired assets, while more broadly, we understand integration of acquired assets from Westpac has proceeded with little trouble. Nevertheless, we expect both nonperforming loans and charge offs to remain relatively elevated while global energy prices remain depressed--despite the bank having limited direct exposure--although we expect charge offs to remain reasonably low at between 0.20% and 0.30% of average customer loans, well below our normalized loss expectations (through the cycle) for the bank, at closer to 1.80%.

Finally, 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.

Table 4

Bank of South Pacific Ltd. Risk Position					
	--Year-ended Dec. 31--				
(%)	**2015**	**2014**	**2013**	**2012**	**2011**
Growth in customer loans	28.0	26.9	11.1	12.4	5.2
Total managed assets/adjusted common equity (x)	10.5	10.5	12.4	9.2	9.0
New loan loss provisions/average customer loans	1.1	1.2	1.8	1.5	0.6
Net charge-offs/average customer loans	0.2	0.2	0.2	(0.1)	(0.3)
Gross nonperforming assets/customer loans + other real estate owned	1.9	0.7	1.0	1.3	2.1
Loan loss reserves/gross nonperforming assets	254.3	639.5	513.1	331.5	175.4

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 60%, 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 150%, highlighting the stability of BSP's funding base--which is comprised almost entirely of deposits sourced from governments (including 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 continue their measured deterioration of recent years, although we expect them to remain very strong by international standards; other funding sources are largely nonexistent 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 75% in fiscal 2015), 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; while we believe government funding sources may prove less stable than recent experience should they be called upon for operational purposes, which may increase outflows beyond our expectations, we believe the bank has the liquidity resources to meet any unanticipated increase in outflows.

Table 5

Bank of South Pacific Ltd. Funding And Liquidity

	--Year-ended Dec. 31--				
(%)	**2015**	**2014**	**2013**	**2012**	**2011**
Core deposits/funding base	97.2	97.4	93.4	98.7	98.4
Customer loans (net)/customer deposits	59.1	53.2	43.5	44.2	45.9
Long term funding ratio	97.9	98.2	94.5	99.4	99.2
Stable funding ratio	152.6	162.4	185.9	175.9	178.6
Short-term wholesale funding/funding base	2.3	2.1	6.1	0.7	0.9
Broad liquid assets/short-term wholesale funding (x)	20.8	25.7	10.5	79.2	66.6
Net broad liquid assets/short-term customer deposits	52.4	52.4	66.5	58.1	62.8
Short-term wholesale funding/total wholesale funding	79.7	74.9	90.2	48.2	49.8

External Support:

Our issuer credit rating on BSP is the same as its SACP, reflecting our view of the low likelihood of extraordinary government support should such a need arise. Although we consider BSP to be a highly systemically important bank in PNG, we believe the political and institutional frameworks in PNG remain weak, which could constrain the government's ability to provide timely support, if needed. We also regard the ability of the government to support the banking system as being hindered by the government's own reliance on the banking system, which funds more than half of the government's domestic debt.

Additional rating factors:

If we were to lower the issuer credit rating on BSP, 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 that the rating action on the issuer credit rating on BSP reflects increasing risks within PNG's banking system, rather than factors specific to BSP.

Related Criteria And Research

Related Criteria

- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Bank Capital Methodology And Assumptions, Dec. 6, 2010
- Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework, June 22, 2012
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Banks: Methodology For Mapping Short- And Long-Term Issuer Credit Ratings For Banks, May 4, 2010
- Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Commercial Paper I: Banks, March 23, 2004
- 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

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-

Ratings Detail (As Of April 20, 2016)

Bank of South Pacific Ltd.	
Counterparty Credit Rating	B+/Negative/B
Subordinated	B-

Ratings Detail (As Of April 20, 2016) (cont.)	
Counterparty Credit Ratings History	
26-Oct-2015	B+/Negative/B
01-Nov-2012	B+/Stable/B
10-Jul-2012	B+/Negative/B
06-Dec-2011	B/Stable/B
Sovereign Rating	
Papua New Guinea (Independent State of)	B+/Negative/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. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.