

The Virgin Islands Consortium

In Stinging Blow To USVI, S&P Further Downgrades Territory's Matching Fund And Gross Receipt Tax Bonds

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In roughly 24 hours following Fitch's downgrade of the territory's bonds and its issuance of a negative outlook, S&P -- another major U.S. ratings firm whose guidance investors depend on heavily when making decisions -- has downgraded the territory's matching fund (rum cover-over) and gross receipt tax bonds further into junk status, with the firm basing its decision on "fiscal pressures". S&P also gave the territory a negative outlook; the firm's last downgrade of the territory's bonds came [in January](#).

With two of the three major U.S. ratings firms issuing the USVI stinging downgrades and outlooks almost in tandem, a third action by Moody's would not come as a surprise. And the downgrades could not come at a worse time for the territory; even before the latest downgrades, the Government of the Virgin Islands (G.V.I.) already had no access to the bond market, which the G.V.I. had used yearly to meet a structural deficit of roughly \$100 million. Lawmakers and the Mapp administration have since attempted to address the money issue by enacting new tax laws while implementing belt-tightening measures, but so far these moves have not produced substantial results.

S&P says the 'CCC+' rating on the matching fund and gross receipt tax bonds reflect its view of USVI's persistent fiscal and liquidity pressures in the face of a continued inability to access the capital markets, as reflected in growing payables despite the adoption of its recent five-year plan, said S&P Global Ratings credit analyst Oladunni Ososami. S&P says it believes ongoing liquidity pressures and the potential inability of the territory to meet ongoing business operation obligations indicate near-term liquidity pressures consistent with its "Criteria for Assigning 'CCC+', 'CCC', 'CCC-', and 'CC' Ratings" (published Oct. 1, 2012, on RatingsDirect).

While repayment of the notes may not face an immediate liquidity crisis in the next 12 months, given the current deposit of pledged revenue to the trustee account for next year's debt service, S&P believes repayment of the notes appears unsustainable in the long term, given the territory's dependence on future favorable conditions to meet its financial commitments.

"Although the territory adopted the five-year economic growth plan in March, it has continued to deal with liquidity pressures without access the capital market. Current liquidity levels are about three days' cash, augmented in part by a significant amount of payables which continues to grow, and estimates show the territory could be facing a negative cash balance by the end of August without any additional cash flow management initiatives, which we believe leaves USVI vulnerable to a total depletion of cash before the end of the current fiscal year," said Ms. Ososami.

She added, "The negative outlook reflects our view that the territory's five-year plan to address the current budget pressures is optimistic and remains uncertain as to whether the measures are adequate to address financial pressures without market access," added Ms. Ososami. It also reflects the uncertainty as to whether bond repayments will remain insulated if financial conditions worsen.

S&P's assessment of USVI's financial state

The USVI's economy was significantly affected by the Great Recession and its aftermath, as well as the shutdown of the Hovensa oil refinery plant, which was its largest employer. Facing declining revenues and significant structural budget imbalance following the recession, the territory has relied primarily on debt issuance to close budgetary gaps, which has led to a high debt burden. Total tax-backed debt for the territory was approximately \$1.95 billion, or \$18,930 per capita. Since 2009, the USVI has issued over \$1.05 billion in debt to fund operating deficits, of which \$525 million is backed by GRT revenue bonds and the balance by its matching fund loan bonds.

The USVI closed fiscal 2016 with an \$89.6 million accumulated deficit, which increased from \$74 million in 2015, according to its latest audited financial statements. For fiscal 2017, management projected to close with about a \$100 million operating shortfall at the beginning of the year. While cost-cutting measures throughout the year may have narrowed the deficit, it is our expectation that the territory will close fiscal 2017 with significant deficits similar to 2016 levels, given that year-to-date revenues have fallen below projections. Management estimates that with the corrective measures proposed, the USVI will have a structural balance for the fiscal 2018 budget. However, the budget assumes the adoption of significant changes to health care retiree costs, the reduction of employee positions, and additional revenues from unproven revenue enhancement initiatives and does not include the amount necessary to fully fund its actuarially determined contribution (ADC) to its pension system, which is only 19.6% funded.

At the end of fiscal 2015, the territory's unfunded pension liabilities totaled about \$4.1 billion, equating to a 19.6% funded ratio, and its pension plans are projected to become insolvent by fiscal 2023. Although a more current valuation will not be available until October 2017, we believe that the territory's pension liabilities have increased due to its weaker-than-assumed returns and history of not fully funding its annual ADCs.

USVI's pension funding shortfall as of the 2015 actuarial valuation was \$171.7 million, or 22% of the fiscal 2018 budget, bringing the total funding shortfall to 32% of the 2017 budget. We also believe the pension plans could become insolvent sooner than projected and given recent court rulings on pension obligations in various municipal restructuring proceedings, we view pension obligations as strong as debt obligations in the event of restructuring. The unfunded liability was largely not addressed in the five-year plan but management has indicated it will be in fiscal 2018.

In the adopted plan, a portion of the economic development commission benefits received is expected to be used to fund the ADC, but the funding does not start until 2020. In our view and given the current fiscal pressures, failure to adopt a plan that adequately and sustainably addresses the pension unfunded liabilities while maintaining its commitment to address deficits in the next few years would weaken our view of the territory's credit quality.

The USVI's significant structural imbalance, lack of access to the capital markets, and persistent liquidity needs make nonpayment of its obligations increasingly likely absent significant changes in its financial and economic conditions. In our view, a greater risk could come under a scenario where persistent fiscal deterioration and an inability to further delay its payables lead to USVI's capacity or willingness to pay debt service being compromised, or persistent lack of market access diminishes its incentive to continue to honor its commitments in the face of more immediate needs.

The USVI, like other territories, has a more centralized governance structure than the U.S. states. We believe the non-disbursement of payments in territories has a more severe effect on the operations of their component agencies and has a cascading effect even on those component agencies which do not directly rely on allotments for ongoing operations. For example, in the USVI, as a result of nonpayment of allotments to local hospitals, the hospitals owe a significant amount to their vendors and suppliers, including the territory's Water and Power Authority (WAPA), thereby contributing to WAPA's growing fiscal pressures. While the territory has used payables to mitigate its liquidity

pressure, it will need to address the payables to sustain services in the near future. An unanticipated inability to manage payables in the immediate term could significantly affect its liquidity and credit quality.

Although we recognize the existence of a purported statutory lien, nevertheless, as outlined in our report "For U.S. Municipal Debt, Credit Fundamentals Remain The Key To Ratings" (published May 4, 2016), we've observed a shift in recent years in how some U.S. municipal issuers treat the pledges and promises on their government obligation and other tax-backed bonds during bankruptcy or fiscal distress. In our view, legal protections, whether in bond documents or by operation of law, can strengthen a bondholder's recovery prospects. However, we've observed that when an issuer's creditworthiness deteriorates to the point where bondholders' main comfort is to rely on the legal provisions for payment, the situation isn't nearly as straightforward as it may have appeared when the bonds were issued.