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After Puerto Rico's Debt Crisis, Worries Shift to Virgin Islands.

CHARLOTTE AMALIE, V.I. — The United States Virgin Islands is best known for its powdery beaches and turquoise bays, a constant draw for the tourists who frequent this tiny American territory.

Yet away from the beaches the mood is ominous, as government officials scramble to stave off the same kind of fiscal collapse that has already engulfed its neighbor Puerto Rico.

The public debts of the Virgin Islands are much smaller than those of Puerto Rico, which effectively declared bankruptcy in May. But so is its population, and therefore its ability to pay. This tropical territory of roughly 100,000 people owes some \$6.5 billion to pensioners and creditors.

Now, a combination of factors — insufficient tax revenue, a weak pension system, the loss of a major employer and a new reluctance in the markets to lend the Virgin Islands any more money — has made it almost impossible for the government to meet its obligations. In January, the Virgin Islands found itself unable to borrow and nearly out of funds for basic government operations.

The sudden cash crunch was a warning sign that the financial troubles that brought Puerto Rico to its knees could soon spread. All of America's far-flung territories, among them American Samoa, Guam and the Northern Mariana Islands, appear vulnerable.

"I don't think you can say it's a crisis, but they have challenges — high debt, weak economies and unfunded pensions," said Jim Millstein, whose firm, Millstein & Company, advised Puerto Rico on its economic affairs and debt restructuring until this year and has reviewed the situation in Guam and the Virgin Islands. He called the combination of challenges in the territories "a recipe for trouble in the future."

For decades, these distant clusters of islands in the Caribbean and the Pacific have played critical roles as American listening posts, wartime staging grounds, practice bombing ranges and even re-entry points for astronauts splashing down in the Pacific.

The military presence buoyed their small economies, and a federal tax subsidy made it relatively easy for them to issue bonds. Over the years, they have collectively borrowed billions of dollars to build roads, run schools, treat drinking water and fund hospitals.

Congress has generally relied on the Government Accountability Office to monitor the financial health of the territories, but it did not intervene over the years when the auditors brought back reports of "formidable fiscal challenges" or "serious internal control weaknesses" on the islands. Not, at least, until Puerto Rico went over the edge.

Now the G.A.O. auditors are back, re-examining the debt and repayment ability of each territory, amid concerns that other crushing debt burdens may have escaped notice. An agency spokesman, Fuller O. Griffith, said it would report by the end of the year on "federal options to avert the future

indebtedness of territories.” It is not clear what those options will be.

“Washington can’t appropriately manage its relationship with the states, much less the territories,” said Matt Fabian, a partner at Municipal Market Analytics.

Even the states are not immune, despite their legal status as sovereigns. Illinois, stuck in political gridlock, is just days from entering its new fiscal year without a balanced budget, in violation of its own constitution. The ratings agencies warn that Illinois’s bond rating is in peril of being downgraded to junk. Once that happens, as the territories show, hedge funds move in and economic management becomes a series of unpleasant choices.

American Samoa, one of the smallest territories, lost one of the biggest engines of its economy in December when a big tuna cannery closed after being required to pay the federal minimum wage. Moody’s Investors Service then put the territory’s debt under negative outlook, citing its fragile economy.

In the Northern Mariana Islands, the depleted public pension fund was wreaking such fiscal havoc in 2012 that the territory declared it bankrupt, but the case was thrown out. The government then tried cutting all retirees’ pensions 25 percent, but the retirees have been fighting the cuts, and the fund is nearly exhausted anyway.

Even Guam, which enjoys the economic benefit of several large American military installations, has been having qualms about its debt after Puerto Rico’s default.

“Puerto Rico’s troubles provide a teachable moment for Guam,” said Benjamin Cruz, the speaker of the legislature, who recently helped defeat a proposal to borrow \$75 million to pay tax refunds. “Spending borrowed money is too easy.”

But the debt dilemma is now most acute in the Virgin Islands — the three main islands are St. Thomas, St. Croix and St. John — where the government has been struggling ever since a giant refinery closed in 2012, wiping out the territory’s biggest nongovernment employer and a mainstay of its tax base.

Its troubles began to snowball last July, when Puerto Rico defaulted on most of its debts.

Last August, Fitch downgraded the Virgin Islands’ debt to junk, citing the territory’s chronic budget deficits and habit of borrowing to plug the holes, like Puerto Rico.

More downgrades followed, and in December, Standard & Poor’s dealt the territory a rare “superdowngrade” — seven notches in one fell swoop — leaving it squarely in the junk-bond realm. That scared away investors and forced it to cancel a planned bond offering in January.

The failed bond deal meant there was not enough cash to pay for basic government operations in February or March. As a stopgap, the territory diverted its workers’ pension contributions.

The Virgin Islands’ governor, Kenneth E. Mapp, said he had no intention of defaulting on any bonds.

“I didn’t ask anybody for debt relief, so don’t put me in the debt-relief boat,” Mr. Mapp said in an interview at Government House, the ornate seat of the territorial government, perched on a hillside overlooking the lush palms and bougainvillea of the capital, Charlotte Amalie, located on St. Thomas.

Still, Mr. Mapp is contending with many of the same problems that proved too much for Puerto Rico, driving it in May to seek bankruptcylike protection under a new law for insolvent territories, known

as Promesa. Puerto Rico is now embroiled in heated negotiations over how to reduce its roughly \$123 billion in debts and unfunded pensions.

When Congress drafted the Promesa law last year, it made it possible for the other American territories to seek the same kind of help.

Now, even though the Virgin Islands maintains it has no intention of defaulting on its debts — and has even given creditors new protections — the mere prospect of bankruptcy has spooked the markets, putting borrowed money beyond the territory's reach and greatly limiting its options.

In something of a self-fulfilling prophecy, by giving territories the option to declare bankruptcy, Congress seems to have made such an outcome more likely.

"That innocuous provision, when sent to the bond market, said, 'Here's an escape valve for your debt obligations,'" said Mr. Mapp. "That changed the whole paradigm."

The problem is that in Puerto Rico, Promesa is turning out to shred the many legal mechanisms that governmental borrowers use to make their debts secure. These include liens and allowing creditors access to the courts.

"Under Promesa, all the security structures are dissolving," Mr. Fabian said.

Investors who thought they were secured creditors before now find themselves holding moral obligation pledges, which are not enforceable.

After the Virgin Islands' bond offer fell through in January, the fuel supplier to its electric authority stopped shipments, saying it had not been paid; the authority was already in court with its previous fuel supplier, which had not been paid either.

Then came the House of Representatives' plan to repeal and replace the Affordable Care Act. Mr. Mapp saw the federal money that the Virgin Islands relies on for its public hospitals going up in smoke.

Mr. Mapp scrambled. He reactivated a five-year economic plan that had been languishing and pushed higher taxes on alcohol, cigarettes and soft drinks through the legislature. He fought for a permanent electric rate increase. He got \$18 million in new federal funds for health care. He struck a deal to tax Airbnb rentals.

He hired collection agents to go after delinquent property and income taxes. He scheduled auctions for delinquent properties. He hired a team to work on the pension system, which is in severe distress, with only about six years' worth of assets left.

Until recently, the pension system was chasing high returns by investing in high-risk assets, like a \$50 million placement in life viaticals — an insurance play that is, in effect, a bet that a selected group of elderly people will die soon. It also made loans to an insolvent inter-island airline, a resort that went bankrupt, and a major franchisee of KFC restaurants. The territory's inspector general has declared the loans illegal.

Mr. Mapp said he hoped to start restructuring the pension system in the fall. Already, he said, the government had stopped diverting the workers' pension contributions, as residents began filing their tax returns and payments in April. The tax payments eased the immediate liquidity crisis.

Recently, he met with the Treasury Secretary, Steven Mnuchin, to discuss possible incentives to

attract tech business to the Virgin Islands. And he hopes to return to the capital markets.

“The fact that we didn’t complete the sale in January gives the impression that our market access is constrained,” said Valdamier O. Collens, the territorial finance commissioner.

Investors have nothing to worry about, said the governor. For decades, the Virgin Islands has used a lockbox arrangement that makes default all but impossible.

Merchants collect sales taxes and send the money to a trustee for the bondholders. Not a cent goes to the territorial government, including the pension fund, until the bond trustee gets enough to make all scheduled bond payments for the coming year.

“We have no access to the moneys before the bondholders are paid,” Mr. Mapp said. “These moneys are taken out of the pie before the pie is even in the oven. Our debt has never been in jeopardy.”

But in Puerto Rico, such lockbox arrangements have turned out to be one of the thorniest disputes of the bankruptcy proceedings. And Mr. Collens, the finance commissioner, is all too aware that the same dynamic could upend the Virgin Islands, too.

“We know that there has been a contagion effect with Puerto Rico,” Mr. Collens said. “The market saw that by the stroke of a pen, Congress could create a Promesa for the rest of the territories.”

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