FitchRatings

# FITCH DOWNGRADES HAWAII GOS TO 'AA'; OUTLOOK REVISED TO STABLE

Fitch Ratings-New York-15 June 2011: As part of its continuous surveillance effort, Fitch Ratings downgrades the following state of Hawaii bonds:

--Outstanding general obligation (GO) bonds to 'AA' from 'AA+';
--Outstanding certificates of participation (COPs) to 'AA-' from 'AA'.

The Rating Outlook is revised to Stable from Negative.

RATING RATIONALE:
--The downgrade reflects the state's minimal financial cushion against risks inherent in an economy dominated by the volatile tourism sector following the depletion of previously large balances as well as the state's significant and growing long-term liabilities.
--Hawaii's extensive tourist infrastructure underpins an economy dominated by tourism, and the geographic location limits economic diversification efforts.
--Debt levels are high, reflecting in part the state's broad responsibilities, particularly in education, though debt amortizes at an above-average pace. Pension funding levels are considered weak by Fitch's standard. Other post employment benefit obligations (OPEB) are also significant.
--Financial management is sound and includes quarterly revenue forecasting and long-term planning. Though revenue underperformance has resulted in deficits in the last two fiscal years, the state has repeatedly taken prompt action toward budget balance.

KEY RATING DRIVERS:
--Continued prompt actions to address changes in projected revenue collections.
--Success in rebuilding a reserve position which offsets volatility present due to the state's tourism-based economy.

SECURITY:
General obligations of the state of Hawaii carry a full faith and credit pledge of the state. The certificates of participation are secured by loan payments subject to legislative appropriation.
CREDIT SUMMARY:
The state of Hawaii's 'AA' GO rating reflects the state's sound financial management practices, its highly developed tourist economy which adds volatility to its revenue structure, high debt levels, and significant long-term liabilities. The downgrade reflects the state's minimal financial cushion against risks inherent in an economy dominated by the volatile tourism sector following the depletion of previously large balances as well as the state's significant and growing long-term liabilities.

Prior to the recent recession, with strong revenue growth, the combined general and reserve fund balances peaked in fiscal 2006 at $785.8 million or 15.9% of total general fund resources, with the reserve fund accounting for $53.5 million of the total. As revenue growth slowed in fiscal years 2007 and 2008, the combined balances declined to $405.2 million at the close of fiscal 2008. Increased reliance on the accumulated general fund balance was most noticeable in fiscal 2009 when Hawaii experienced a significant 9.5% decline in revenues. The state closed the fiscal year with a negative ending balance of $36.8 million after accounting for an overstatement of certain tax revenues, though $60.4 million remained in the reserve fund and approximately $180 million was available in the separate Hurricane Relief Fund.

The fiscal plan for the current biennium spanning fiscal years 2010 and 2011 was balanced through a mix of tax increases, reduced spending, modest debt restructuring, the application of federal stimulus monies, and employee furloughs. However, projected revenues have been revised downward several times over the course of the biennium, and despite delaying the payment of income tax refunds to be paid in fiscal 2010 into fiscal 2011 and a $57 million draw from the Hurricane Relief Fund, which was not previously expected to be drawn upon, the state ended fiscal 2010 in a negative position.

Continuing revenue weakness resulted in a new $220 million shortfall for fiscal 2011, which ends on June 30, and the state plans to balance through spending cuts, fund transfers, and the draw down of remaining balances in the Hurricane Relief and Emergency and Budget Reserve Funds. A general fund ending balance of $73.1 million is currently projected, with no other funded reserves.
Hawaii's most recent financial plan for the upcoming biennium, spanning fiscal years 2012 and 2013, addressed a gap of over $1 billion, a gap which had widened by $265 million following additional downward revenue forecast revisions in March and April of this year. Plans to close the gap include a balanced mix of spending reductions, savings resulting from labor negotiations, and temporary revenue measures that limit deductions and suspend exemptions for the duration of the biennium. While the plan projects that ending balances will grow from the projected fiscal 2011 level, absent extension of the temporary tax increases or offsetting spending reductions in the next biennium, Fitch expects it may be difficult to retain those balances in future years.

Hawaii's tourist industry relies heavily on California and Japan, although increased visitation from other countries, most recently Korea and Canada, has provided an offset to declining volumes from Japan following the events there in March. Following a sharp drop in 2001, the tourism sector saw strong growth that began in 2004 and continued to a record high in 2007, due in part to gains in domestic arrivals. The previous loss of two passenger air carriers and limited recovery of that service, combined with previously rising fuel costs and weakening consumer spending in the recession, played negatively on Hawaii's tourism industry in 2008 when arrivals dropped 10.8%. Visitor arrivals declined 4.5% in 2009 before rebounding by 8.7% in 2010. The state is currently projecting modest growth of 3.8% for 2011, though visitor arrivals for the first four months of the year are up 8.9%.

Following several years of strong gains, employment in the recession generally mirrored the national experience, down 0.9% in 2008, 4.4% in 2009, and 0.8% in 2010. Year-over-year growth in April 2011 was 1.3% as compared to 1.1% for the nation. While tourism remains dominant when compared nationally, Hawaii's employment in the service sectors is relatively near national levels. Unemployment for April 2011 was 6.1%, down from 6.7% one year prior and well below the U.S. rate of 9% for the month; Hawaii's unemployment rate has been consistently below that of the nation since 2001. Personal income growth has outpaced the nation for much of this decade, and 2010 per capita personal income now stands at 101.1% of the U.S., ranking Hawaii 17th among the states by this measure.
Hawaii's government is highly centralized, and the state is responsible for many functions, such as education, normally handled at the local level. Largely as a result of this structure, debt is and will remain high. As of July 1, 2010, net tax-supported debt totaled approximately $5.5 billion, which equates to 9.9% of 2010 personal income. Principal is retired at an above-average pace, with 67% of bonds due in 10 years. Funding levels for Hawaii's pension system remain a concern, with reported funded ratios having declined from 95% in 2000 to 61.4% as of June 30, 2010 and the unfunded liability exceeding $7.1 billion. Using Fitch's more conservative 7% discount rate assumption, the plan would be 55.3 % funded (see Fitch's report dated Feb. 17, 2011, 'Enhancing the Analysis of U.S. State and Local Government Pension Obligations' available on Fitch's website at 'www.fitchratings.com'). Further, the state's other post employment benefits obligation is large.

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In addition to the sources of information identified in the U.S. Tax-Supported Rating Criteria, this action was additionally informed by information from IHS Global Insight.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria', dated Aug. 16, 2010.
--'U.S. State Government Tax-Supported Rating Criteria', dated Oct. 8, 2010;
--'Enhancing the Analysis of U.S. State and Local Government Pension Obligations', Feb. 17, 2011.

For information on Build America Bonds, visit www.fitchratings.com/BABs

Applicable Criteria and Related Research:
Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=548605
U.S. State Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=564546