FitchRatings

Fitch Rates Hawaii's $857.6MM GO Bonds 'AA'; Outlook Revised to Positive

Fitch Ratings-San Francisco-28 April 2017: Fitch Ratings has assigned a 'AA' rating to the following general obligation (GO) bonds of the State of Hawaii:

--$575 million GO bonds of 2017, series FK;
--Approximately $237.6 million GO refunding bonds of 2017, series FL, FM, and FN;
--$45 million taxable GO bonds of 2017, series FO.

In addition, Fitch has affirmed the following ratings:

--Issuer Default Rating (IDR) at 'AA';
--$6.7 billion in outstanding state GO bonds at 'AA';
--$15.2 million in outstanding state certificates of participation (COPs) at 'AA-'.

The Rating Outlook has been revised to Positive from Stable.

The 2017 GO bonds are expected to be offered via negotiated sale during the week of May 8. The proceeds of series FK and FO will fund costs for various public improvement projects, including public facilities, schools, community colleges, universities, public libraries and parks, while series FL, FM, and FN will refund outstanding debt for interest savings.

SECURITY

The GO bonds are general obligations of the state of Hawaii that carry the full faith and credit pledge of the state. The COPs are secured by lease payments subject to legislative appropriation.

KEY RATING DRIVERS

The revision of Hawaii's Rating Outlook to Positive from Stable reflects ongoing improvements in the state's management of its substantial long-term liabilities, and Fitch's expectation that the state will maintain its existing strong financial flexibility as it continues to implement pension and other post-employment benefits (OPEBs) reforms. The state's 'AA' IDR and GO rating also reflect a history of strong revenue growth and rising reserves, as well as a resilient economy. The 'AA-' COPs rating is one notch below the state's IDR, consistent with Fitch's approach to rating appropriation-backed debt.

Economic Resource Base
The State of Hawaii encompasses seven inhabited islands and a total population of 1.4 million, two-thirds of whom reside on the island of Oahu. The state's employment base and economy is diverse, with key sources of external support provided by tourism and a substantial federal presence. Population and labor force growth have exceeded U.S. medians over the past 10 years and nominal personal income levels are relatively high, although below average in real terms as a result of the state's high cost of living.

Revenue Framework: 'aaa' factor assessment
General excise taxes on gross business receipts and personal income taxes provide approximately three-quarters of Hawaii's general fund revenue and have performed strongly historically, with growth rates just below U.S. GDP but well above inflation over the past 10 years. Prospects for ongoing revenue gains appear strong based on the state's resilient economy and above-average population growth. The state has full control over its revenues with no legal limits on potential increases.

Expenditure Framework: 'aa' factor assessment
Based on recent spending practices and continued strong revenue performance, Fitch expects that state expenditure increases will be in line with to marginally above revenue growth. Carrying costs for debt service and retiree benefits are somewhat elevated but are expected to remain manageable.

Long-Term Liability Burden: 'aa' factor assessment
Long-term liabilities for debt service and retiree benefits are moderate relative to personal income but higher than most other U.S. states. These totals, however, include liabilities for the state's public schools, which are accounted for independently in most other jurisdictions. Recent reforms to retiree benefits have helped to slow the growth of related liabilities but asset levels remain relatively low, particularly for the state's pension plan.

Operating Performance: 'aaa' factor assessment
The state is well-positioned to address economic challenges as a result of limited revenue volatility and substantial additions to reserves in recent years. Budget management is guided by frequent revenue forecasts and multi-year financial plans that provide input for policy adjustments as required.

RATING SENSITIVITIES

Maintained Financial Flexibility: The rating is sensitive to overall fiscal and operating performance, particularly in light of ongoing expenditure increases from recent pension and OPEB reforms. Deterioration in the state's operating performance could result in a revision of the Rating Outlook to Stable, while continued strong operating performance accompanied by the implementation of recent reforms would result in upwards pressure on the rating.

CREDIT PROFILE

Hawaii's economy has performed strongly in recent years with steady growth in tourism and a continued substantial military presence. Tourism activity has been subject to periodic declines historically but has proven resilient over the long term, and unemployment rates have been below the U.S. average for the past 15 years. The state also appears likely to benefit from ongoing consolidation of U.S. military activity in the Pacific.

Revenue Framework
The state relies on general excise taxes (GET) on business income and personal income taxes for three-quarters of general fund revenues. The GET is broad-based and captures income from the sale of services as well as goods, accounting for 45% of general fund revenues. Policy-adjusted performance for all general fund revenues has been strong historically, exceeding inflation but slightly below overall U.S. economic performance.

Fitch expects Hawaii's revenue growth, absent policy actions, to continue to increase more rapidly than inflation based on the state's resilient economy and above-average population growth. While revenue gains may be affected by periodic economic shocks, solid growth is expected over the long term.

The state has full legal authority to raise revenues and has regularly adopted measures to modify revenue sources and amounts.

Expenditure Framework
Hawaii provides a broad range of services to its residents with education and health and human services accounting for the bulk of general fund expenditures. Elementary and secondary education comprised approximately 34% of general fund spending (expenditures plus transfers out) in fiscal 2016, with higher education contributing an additional 10%. Health and welfare spending combined for 27% of general fund spending.

Fitch expects that the natural pace of spending growth will be in line with to marginally above expected revenue growth based on the state's current spending profile. The state will continue to see growth in spending for retiree benefits, education and health care, in particular, but ongoing revenue gains are likely to keep pace with expenditure increases.

Rising costs for Medicaid, in particular, may pressure future operating budgets. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth.

Federal action to revise Medicaid's programmatic and financial structure remains a possibility given previously stated support from Republican congressional leadership and the President for a basic restructuring of federal Medicaid funding to a capped amount. States generally have significant flexibility to deal with fiscal challenges, including shifts in federal funding, while maintaining fundamental credit quality. As Medicaid represents a sizable share of all states' budgets, significant changes could challenge that flexibility. Whether a change in Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increased liability burdens could negatively affect both the expenditure framework assessment and the IDR.

The state has a strong track record of expenditure reductions despite the large share of its budget devoted to education and health and human services. General fund spending fell by approximately 14% during fiscal years 2010 and 2011, largely due to employee furloughs and executive department spending restrictions, in response to reduced revenues. Looking ahead, the state's substantial expenses for debt service and retiree benefits could present a greater challenge for expenditure flexibility. Carrying costs for these items accounted for 16% of governmental funds expenditures in fiscal 2016, among the highest shares for states. Recent efforts to increase OPEB funding to full actuarial levels and to implement more conservative pension assumptions appear likely to increase this ratio further, and Fitch expects carrying costs to remain high relative to other states.

Long-Term Liability Burden

Long-term liabilities for debt and pensions are elevated but still moderate at 18.4% of personal income as of fiscal 2016, more than three times the median for states. This ratio has declined since Fitch's last review as a result of accounting changes that allocated a portion of the state's net pension liability to the University of Hawaii. Long-term liabilities include debt on behalf of the state's elementary and secondary schools, which represents roughly 40% of total debt. Amortization is fairly rapid, with 66% of outstanding principal due for repayment within 10 years.

The state reported a low 62% ratio of assets to liabilities in its pension plan as of fiscal 2016 based on actuarial results through June 30, 2015, which include an assumption of 7.65% investment returns. Under an assumption of 7% returns, Fitch estimates a funded ratio of 58% for the system. Contribution rates are determined by statute and adjusted periodically if the funding period exceeds 30 years. The most recent adjustments to contribution rates were adopted in 2011 with a package of pension reforms, and substantial additional increases are currently under consideration by the state legislature. The state pension board has also reduced investment assumptions to 7% for fiscal year 2016 and subsequent years.

Fitch expects these changes to increase both pension system assets and reported liabilities over the next several years, with a likely weakening of the reported funded ratio due to incremental increases in contribution rates as compared to the immediate adoption of lower investment return assumptions. Over the longer term, however, Fitch anticipates ongoing improvements in the state's pension funding and overall finances as a result of these actions.

The state has also made notable progress in funding OPEBs, moving from pay-go to nearly full funding of the actuarially determined annual required contribution within the span of several years. Legislation adopted in 2013 established a schedule for full funding by 2019 and the state currently expects to reach this target in fiscal 2018.

Operating Performance

Substantial reserves and a history of limited revenue volatility contribute to an assessment of strong financial resilience for the state in a moderate economic downturn. Based on historical results adjusted for the impact of policy action, Fitch estimates that a 1% decline in U.S. GDP would reduce state revenues by 2.6%, as compared to a median decline of 3.2% for all states. Combined general fund balances and reserves, which Fitch estimates at 18.6% of general fund revenues in fiscal 2016, provide a considerable cushion against revenue declines expected in a moderate recession.

The state has made key improvements to financial flexibility in the wake of the recession, increasing budgetary and emergency reserves substantially. Balances in the state's Emergency and Budget Reserve Fund rose from $9.7 million in fiscal 2011 to $100.9 million in fiscal 2016, with an increase to $310.7 million (4.4% of prior year revenues) in fiscal 2017. A new reserve policy adopted in 2016 sets a goal of 10% for such savings, committing a portion of ongoing tobacco revenues and general fund balance in years of strong revenue performance. In addition, the state has restored balances of $182.5 million in its Hawaii Hurricane Relief Fund, which has functioned as an additional reserve in times of economic stress.

Recent Budgetary Performance

The state recorded strong results for fiscal 2016 based upon an 8% increase in general fund tax revenues. Management reported an ending fund balance for the year on a budgetary basis of 14.5% of general fund revenues, as compared to 12.6% in fiscal 2015. The state projects a reduction in ending fund balance for 2017 to 7.2% due to one-time actions to supplement non-general fund reserves, fund capital needs, and write off internal debts. The sum of general fund balance plus reserves is projected to decrease by a smaller margin, from 18.6% to 14.1% of general fund revenues, as a result of these changes.

The state legislature is currently considering the governor's budget proposal for fiscal 2018. Major budget challenges include increases to pension contribution rates, impacts from recent labor arbitration awards, and a projected slow-down in revenue growth. Such factors have been taken into account in the state's multi-year financial plan and Fitch expects the state's operating performance to remain stable.

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Applicable Criteria
U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016) (https://www.fitchratings.com/site/re/879478)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/1022972)
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