FITCH RATES HAWAII'S $747MM GO BONDS 'AA'; OUTLOOK STABLE

Fitch Ratings-New York-09 October 2015: Fitch Ratings has assigned 'AA' ratings to the follow general obligation (GO) bonds of the State of Hawaii:

--$190,000,000 GO bonds of 2015, series ET;
--$35,000,000 GO bonds of 2015, series EU;
--$8,700,000 GO refunding bonds of 2015, series EV;
--$34,750,000 GO refunding bonds of 2015, series EW;
--$23,640,000 GO refunding bonds of 2015, series EX;
--$213,420,000 GO refunding bonds of 2015, series EY;
--$216,915,000 GO refunding bonds of 2015, series EZ;
--$25,000,000 taxable GO bonds of 2015, series FA.

The bonds are expected to be offered via negotiated sale on Oct. 15. The par amounts of the refunding series are subject to change.

In addition, Fitch affirms the following ratings:

--$5.8 billion in outstanding state GO bonds at 'AA';
--$20.6 million in outstanding state certificates of participation (COPs) at 'AA-'.

The Rating Outlook is Stable.

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

SOUND FINANCIAL MANAGEMENT: Hawaii's fiscal management practices are sound and include frequent revenue forecast updates, long-term financial planning, and a commitment to maintaining budget balance when revenues underperform. Fitch also views positively the state's commitment to building and maintaining financial reserves and prepaying long-term liabilities.

RESILIENT ECONOMY DESPITE CONCENTRATION: Hawaii's well-established tourism infrastructure underpins an economy dominated by leisure and hospitality, and there is also significant federal military exposure. Despite this concentration, the state's overall economic growth trend has proved relatively stable.

ELEVATED DEBT BURDEN: Hawaii's debt levels are high for a U.S. state government, and Fitch expects them to remain so. This largely reflects the state's direct responsibility for many functions delegated to local governments in other states, particularly K-12 education.

HIGH RETIREMENT LIABILITIES: The state's unfunded pension liability as a percentage of personal income is at the high end for U.S. states, and other post-employment benefit obligations (OPEB) are also significant. The state has prioritized addressing these liabilities through benefit and contribution reforms, including prefunding OPEB. Despite these efforts, the burden will likely remain well above-average for the foreseeable future.

APPROPRIATION SECURITY: COP payments require biennial state legislative appropriation, resulting in a rating one notch below the state's 'AA' GO rating. Statutorily, the governor's executive budget requests must include amounts sufficient to make lease payments, equivalent to debt service, on the COPs.

RATING SENSITIVITIES

The rating is sensitive to shifts in the state's fundamental credit characteristics, particularly its prudent fiscal management.

CREDIT PROFILE

Hawaii's 'AA' GO rating reflects the state's sound financial management practices, a concentrated but resilient economy, comparatively high debt levels for a U.S. state, and a large but manageable burden of retirement liabilities. Economic performance during the current expansion has generally been solid. State revenue growth coupled with prudent budget management has stabilized Hawaii's financial position, evidenced by strengthened reserve balances. Retirement liabilities are likely to remain high, although Hawaii has prioritized lowering the burden through benefit reforms and accelerating prefunding of obligations.

The 'AA-' rating on the COPs is linked to the state's GO rating as lease payments are subject to legislative appropriations for essential state facilities.

ECONOMIC STRENGTHS ANCHORED BY TOURISM

Hawaii's economy is dominated by leisure and hospitality and government, the latter reflecting a significant federal military presence. Together they accounted for nearly one third of the state's 2014 real GDP. Although subject to external shocks and broader economic cycles, the tourism sector in Hawaii is resilient and has tended to recover quickly, providing an important cornerstone for the state's economic growth.

During the current expansion the tourism industry has been very strong. Two key indicators, visitor arrivals and visitor expenditures, reached historic highs in calendar year (CY) 2014, with continued gains recorded through the second quarter of 2015. The state forecasts ongoing growth for CY 2015, with current trends continuing in 2016 and beyond.

Hawaii's large military presence makes it vulnerable to federal deficit reduction, although the state has benefitted from recent military consolidations and serves a strategic role that limits downside risk. The negative impact of any near-term federal cuts should be manageable given expectations of offsetting military investment.

Labor market conditions are very strong at present, having benefitted from several consecutive years of growth after the last recession. The unemployment rate, at 3.5% in August 2015, is well under the 5.1% national rate for August 2015 and well below the 4.3% level reported by the state one year earlier.

Employment gains have continued through the current expansion but more recently have been below comparable national rates. August 2015 employment is up 2% in Hawaii vs. one year ago, just below the 2.1% rate for the U.S. overall. Growth picked up more recently from 2014, when employment in Hawaii for the year rose only 1.1%, vs. 1.9% nationally, reflecting a slowdown from rapid post-recession increases. Hawaii surpassed its pre-recession jobs peak in August 2014 and to date has regained approximately 130% of the jobs lost in the last recession.

Personal income growth outpaced the nation for the last decade, increasing 52.9% versus 46.5% for the U.S. overall. Per capita personal income (PCPI) growth has been closer to the national trend, reflecting Hawaii's above-average population growth over that span. PCPI in 2014 equals 100% of the U.S. level, ranking Hawaii 22nd amongst the states.

RESERVES PROVIDE FLEXIBILITY

A key component of Hawaii's sound fiscal management has been its practice of setting aside resources in several reserves to protect against future fiscal uncertainties, including from economic and revenue cyclicality as well as negative shocks such as hurricanes.

Prior to the recession, the state built up a sizable cushion, with total reserves (including the general fund ending balance, the emergency and budget reserve fund-EBRF, and the Hawaii hurricane relief fund-HHRF) peaking at $786 million (16% of total general fund resources) in fiscal 2006.

During the recession, economic and revenue contraction required the state to implement corrective actions, including boosting revenues, cutting expenditures and drawing from then-ample reserve levels. After hitting a low in fiscal 2011 of $157 million (3.1% of general fund resources), Hawaii's commitment to reserve funding has led to steady improvement. Fiscal 2015 ended with an estimated $1.1 billion in the state's reserve funds, or 16.7% of general fund revenues; together the EBRF and HHRF held $273 million.

FISCAL GAINS RESUME

After a strong rebound early in the economic recovery, revenue growth unexpectedly stalled in fiscal year 2014 with actual general fund tax revenues declining 1.8%, instead of the 4.1% growth forecast as of Sept. 2013. General excise tax (GET) revenues were down 4.1% and PIT revenues up only 0.6%. The state attributed PIT performance to taxpayer actions in anticipation of January 2013 federal tax law changes, consistent with the experience of many other states.

Additionally, the robust economic gains the state had experienced following the recession had tempered somewhat, affecting broader tax collections. Consistent with the state's executive authority to manage expenses, the state took action to curb spending. Although expenditures exceeded revenues by $179 million, the state retained a $665 million carry over balance.

Fiscal 2015 performance returned to stronger growth, based on unaudited preliminary figures. As of its September 2014 forecast, the state's council on revenues (COR) had forecast 3.5% yoy general fund tax revenue growth in fiscal 2015, but actual general fund tax revenues rose 6.8%; GET and PIT revenues rose 18.5% and 13.9%, respectively. Expenditures, meanwhile, rose 2.2%. The state estimates that fiscal 2015 general fund revenues exceeded expenditures by $163 million, with the carryover balance rising to $828 million.

Going forward, the COR projects continued steady gains, with fiscal 2016 and 2017 general fund tax revenue rising 6% and 5.5%, respectively; these gains appear reasonable in Fitch's view compared to the rapid gain experienced in fiscal 2015, assuming currently favorable economic trends continue.

Meanwhile, expenditures are forecast to rise 7.2% in fiscal 2016 and 10.2% in fiscal 2017. Although the result is projected deficits in fiscal 2016 and 2017 of $76 million and $376 million, respectively, the spending forecast incorporates additional EBRF deposits of $10 million and $100 million in fiscal 2016 and 2017, respectively, and another $164 million is allocated in fiscal

2017 to fully fund the state's OPEB ARC. Fitch views the state's willingness to prioritize building budgetary and prefunding retiree obligations to be a notable credit positive for the state.

COMPARATIVELY HIGH BONDED DEBT

Hawaii's state government is directly responsible for many functions, such as K-12 education, that are routinely delegated to the local level in other states. Largely as a result, debt is comparatively high for a U.S. state and expected to remain so. On pro forma basis (inclusive of $250 million in new money for the series ET, EU and FA GO bonds), Hawaii's net tax-supported debt totaled approximately $6.6 billion, which equates to 10.2% of 2014 personal income. Principal is retired at a rapid pace, with 63% of GO principal repaid in 10 years. The vast majority of the state's debt is in GO bonds.

FOCUS ON CONTROLLING RETIREMENT LIABILITIES

The state's obligations for both retiree pensions and healthcare are significant, but the state has repeatedly pursued corrective actions in recent years to reduce the liabilities over time, including devoting significant contributions to prefund OPEB.

The funded ratio of the Employees' Retirement System of the State of Hawaii (ERS), the pension system covering state and local employees, has stabilized in recent years after weakening during the downturn. Despite a recent history of making contributions near the actuarially-calculated level, the funded ratio remains low, at 61.4% on a reported basis as of June 30, 2014. Using Fitch's 7% discount rate assumption rather than the 7.75% used by the system, the ERS was only 56.7% funded.

Recent pension reforms include a new tier for hires beginning in fiscal 2013, the phased reduction in the discount rate to 7.5% by fiscal 2017, and shortening the amortization period.

Fitch estimates that about three-fourths of the system liability is attributable to state general employees and teachers. On a combined basis, net tax-supported debt and the state share of adjusted unfunded pension obligations represent a high 22.8% of personal income, among the highest of the states.

COMMITMENT TO PREFUNDING OPEB

The state's OPEB obligations are substantial, but have improved following statutory adoption of a pre-funding plan. As of June 30, 2014, Hawaii reported an OPEB unfunded actuarial accrued liability (UAAL) of $8.5 billion which was down notably from the June 30, 2011 reported OPEB UAAL of over $13 billion. The improvement largely reflects the actuarial recognition of the state's statutory pre-funding plan and subsequent use of a higher discount rate assumption.

In 2013, the legislature adopted a bill requiring full funding of the OPEB ARC by fiscal 2019, including a mechanism to transfer state tax revenues if needed to ensure full contributions. The state has incorporated full ARC funding into its multi-year financial plan by fiscal 2017. Fitch views the statutory commitment to pre-funding its OPEB as a credit strength despite the near-term budgetary impact.

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Fitch recently published an exposure draft of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015). The draft includes a number of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to fewer than 10% of existing tax-supported ratings. Fitch expects that final criteria will be approved and published by Jan. 20, 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

In addition to the sources of information identified in Fitch's Master Criteria, this action was additionally informed by information from Global Insights.

Applicable Criteria
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942
Tax-Supported Rating Criteria (pub. 14 Aug 2012)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. State Government Tax-Supported Rating Criteria (pub. 14 Aug 2012)
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