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INVESTORS SERVICE

Rating Update: **MOODY'S DOWNGRADES STATE OF HAWAII'S GENERAL OBLIGATION RATING TO Aa2 FROM Aa1, 2009 CERTIFICATES OF PARTICIPATION TO Aa3 FROM Aa2, AND 2006 CERTIFICATES OF PARITICPATION TO A1 FROM Aa3; OUTLOOK IS STABLE**

Global Credit Research - 17 May 2011

APPROXIMATELY $5.1 BILLION OUTSTANDING G.O. DEBT, $40 MILLION OUTSTANDING 2009 CERTIFICATES OF PARTICIPATION, AND $24 MILLION 2006 CERTIFICATES OF PARTICIPATION AFFECTED BY RATING ACTION

State
HI

Opinion

NEW YORK, May 17, 2011 -- Moody's Investors Service has downgraded the rating on the State of Hawaii's outstanding general obligation bonds to Aa2 from Aa1, affecting approximately $5.1 billion in outstanding debt. Concurrently, Moody's has downgraded the rating on the state's 2009 certificates of participation to Aa3 from Aa2 (approximately $40 million outstanding) and the state's 2006 certificates of participation to A1 from Aa3 (approximately $24 million outstanding).

RATINGS RATIONALE

The downgrade incorporates Hawaii's strained financial operations following the recession-driven revenue fall-off over the last several years; near depletion of reserves planned for the end of fiscal 2011; GAAP negative available balances representing consecutive years of balance sheet deterioration as one-time solutions were used to resolve recent budget shortfalls; pension funded ratios that are low relative to other states and are projected to decline near-term; high debt ratios, in part reflecting debt issues for K-12 school capital projects; and growing expenses for other post employment benefits (OPEB). The state's vital tourism industry is showing signs of improvement although related revenue growth projections were lowered in a March 2011 special forecast to factor in the natural disasters in Japan, higher petroleum prices, and the full impact from the state's decision to delay paying fiscal 2010 tax refunds until fiscal 2011. Hawaii's audited financial results have been late since fiscal 2007, a weak trend that detracts from the state's other relatively strong governance practices such as multi-year financial planning and quarterly binding consensus revenue forecasting.

The 2009 certificates of participation are rated one notch below the state's general obligation rating, reflecting the subject-to-appropriation nature of the obligation. The two-notch distinction between the general obligation rating and the 2006 certificates of participation incorporates the appropriation risk as well as the more limited essentiality of the project financed, a new office building for the Department of Hawaiian Homelands' headquarters.

Credit strengths are:

*Well-established multi-year and quarterly consensus forecasting by the state's council on revenues

*Strong executive power to reduce spending

*Historical fiscal conservatism; prompt action to address revenue shortfalls

*Continued military housing construction helps offset slow residential and commercial markets

*Liquidity is sufficient for the state to avoid short-term cash flow borrowing

*Rapid amortization of debt; no exposure to variable rate debt or derivative products

Credit challenges are:

*Vulnerability to shifts and/or extended downturns in its tourism-based economy, resulting in revenue falloff and budget shortfalls

*Recent downward revenue revisions incorporate slower than expected state and global economic recoveries

*Depleted reserves reduce state's ability to address further revenue erosion

*Large state and local government employment sector contributes to spending pressure for salary and benefit settlements

*Debt ratios likely to remain high given state-level capital funding, especially for education

*Pension funding levels likely to decline over near term and remain low relative to other states despite recent reforms; high other post-employment benefit (OPEB) liability

DETAILED CREDIT DISCUSSION

REVENUE UNDERPERFORMANCE STRAINS FINANCIAL OPERATIONS

Hawaii's financial operations have been strained as the state struggles to regain balance following the revenue deterioration of the last several years. The latest projections for fiscal 2011 revenues are about 8% below the most recent peak (fiscal 2008). The January 2011 forecast called for 3% year-over-year revenue growth for fiscal 2011. However, a special revised forecast this spring now calls for a 1.6% decline compared to the prior year. The out year projection remains about the same, with 11% growth expected in fiscal 2012 although the base has now been lowered.

Hawaii's revenue performance has been weaker than expected for several reasons: 1) the overall slow pace of national and international economic recoveries which affect the state's vital tourism industry; 2) the distorting impact of tax refund delays (about $187 million) from fiscal 2010 to fiscal 2011; and more recently 3) the natural disasters in Japan, a major source of tourism for the state, as well as global petroleum price movements attributable to political upheaval in the Middle East.

FISCAL 2011 GAP EMERGES; 2012-213 BIENNIAL BUDGET CLOSES LARGE SHORTFALL

As in recent years, Hawaii faced another large operating deficit for the upcoming biennium (2012-2013) amounting to $539 million (10% of operating revenues) in fiscal 2012 and $498 million (8.6%) in fiscal 2013. A 4% gap also emerged for the current fiscal year (fiscal 2011) and given the limited time to resolve the shortfall, solutions are largely one-time. The emergency budget reserve (EBR) will be nearly depleted and the state will also use the balance in its Hurricane Relief Fund (HRF). While the state plans to recapitalize the HRF, any immediate need for funds would likely necessitate borrowing.

The recently adopted budget for the next biennium was balanced mostly with recurring solutions. The shortfalls were resolved with $329 million of revenue enhancements in fiscal 2012 and $323 million in fiscal 2013, while expenditure reductions total $319 million and $458 million in the first and second years of the biennium, respectively. A number of revenue enhancements are temporary, such as the suspension of general excise tax exemptions. There are also temporary limitations on itemized deductions and delays in the increase of the standard deduction and personal exemption. For fiscal 2012 only, the rental motor vehicle surcharge will increase and a portion of that will be transferred to the general fund. The state will also cap the amount of transient accommodations taxes that flow to counties and the Hawaii Tourism Authority. The legislature could decide to keep the temporary measures in place in the future in the event of continued revenue under performance.

On the spending side, the 2012-2013 biennial budget includes reductions in TANF and Medicaid services as well as public welfare, some of which will likely take time to implement. The state has settled with its largest union for a 5% pay cut, eliminating the furlough days that were imposed last year, and 50/50 sharing of healthcare costs which had previously been funded 60% by the state and 40% by employees. There are also lump sum program cuts that will affect most agencies and departments.

BALANCE SHEET DETERIORATION REFLECTS ONE-TIME BUDGET BALANCING ACTIONS AND DEPLETION OF RESERVES

Strong reserve levels are important for Hawaii given the state's heightened vulnerability to national and international shifts in its essential tourism-based economy. The currently low reserve levels leave Hawaii with reduced flexibility to address additional shortfalls that may emerge. Following the 2001 recession, Hawaii rebuilt its reserves to a very strong 20% of revenues which provided flexibility to address the 2008 recession. However, by the end of fiscal 2009 available reserves (unreserved undesignated general fund balance plus the EBR) were significantly reduced and the state recorded a negative GAAP available balance. This was in contrast to the prior recession when the state's reserves hit a low of about 7.5% at the end of fiscal 2003.

The state's audited financial statement have been late for four consecutive years. Preliminary results for fiscal 2010 show continued negative GAAP general fund balances. The state has employed one-time actions for budget relief in recent years including: the use of reserve balances from both the EBR and the HRF; debt restructurings; and tax refund delays. As a result, we expect available balances will also be GAAP negative at the end of fiscal 2011, representing three consecutive years of balance sheet deterioration. Fiscal 2012 revenues are projected to exceed the prior peak (fiscal 2008) and the 2012-2013 biennial budget incorporates small year-end budget surpluses. However, Hawaii's available reserve levels are expected to remain modest as the state begins to restore structural budget balance after several years of relying on non-recurring solutions, including the federal stimulus funds that all states received.

SLOW ECONOMIC RECOVERY IN LINE WITH NATION; FEDERAL DEFENSE SPENDING ADDS STABILITY

Hawaii has typically exhibited countercyclical employment patterns. However, recent trends have followed the national and international economies, indicating a shift toward more cyclical performance. The recent recession has been particularly challenging for Hawaii's tourism-based economy since both national and international visitation has been affected at the same time. Hawaii is likely to remain a premier tourism destination over the long term although near term economic prospects are muted by the recent natural disasters in Japan and high oil prices that in part have driven airfares up. On a positive note, Hawaii's unemployment rate of 6.3% in March remains well-below the national average (8.8% the same month) and the state's employment trends are less volatile than in other tourism dependent states such as Florida and Nevada.

Federal defense spending in Hawaii, dictated by the island's strategic geographic importance, plays a large part in the state's economy. Federal activity amounts to about 13% of Hawaii's gross state product, with much of it defense related. The large federal defense presence provides a continuing and stable source of employment and income which helps to offset the state's dependence on tourism. This is augmented by federal transfer payments for Social Security and federal retirement benefits which also support the state's economy. The state economy should continue to benefit over the near term from military expansion plans and the privatization of military housing.

DEBT BURDEN REMAINS AMONG THE HIGHEST IN NATION; LOW PENSION FUNDED RATIO

Hawaii compares unfavorably with other states on measures such as debt ratios that are among the highest in the nation, pension funding levels that are below average, and OPEB liabilities that are nearly twice the size of the state's annual operating budget. The state employees' retirement system had a 61.5% funded ratio as of June 30, 2010, continuing a decade-long declining trend driven by weak market performance and changes in actuarial assumptions for life expectancy, future salary increases, and investment returns. The state generally makes its statutorily required contributions to the retirement system but has not always met the actuarially required contribution, which also contributes to the low funded ratio.

Recently adopted pension reforms are expected to improve the funding levels of the state's retirement system over the long term. Benefits will be reduced for new hires after June 30, 2012, and employer contributions will incrementally grow from 15% to 17% of payroll. However, by delaying the increase in contributions the state saves money and funded ratios are projected to decline to a new low of 58.6% in 2015. Even after twenty years, the funded ratio is still expected to be less than 70%. A moratorium on enhancement of retirement benefits remains in effect until the funded ratio reaches 100%.

While Hawaii does not engage in short-term borrowing for cash flow purposes, some liquidity strain is indicated by payment deferrals at the end of fiscal 2009 and the delay of fiscal 2010 personal income tax refunds until fiscal 2011. Hawaii has no exposure to variable rate debt or derivative products, and payout of the state's general obligation debt is relatively rapid with 95% of principal repaid in 15 years.

Hawaii's OPEB obligation is quite sizeable at $7.2 billion for state employees and $1.6 billion for teachers, reflecting full health benefits paid by the state. These amounts are larger than the size of Hawaii's annual general fund revenues which totaled about $4.8 billion in fiscal year 2010. For the present time, the state plans to continue funding these obligations on a pay-go basis as is the case in many other states.

Outlook

The rating outlook for Hawaii is stable at the Aa2 rating level reflecting expectations of revenue growth beginning in fiscal 2012; recent signs of economic stabilization as tourism rebounds; a decreased reliance on one-time resources to balance the 2012-2013 biennial budget; and the state's proactive measures to improve the funded status of its retirement systems. The stable outlook also reflects our expectation that the state will manage its budget challenges and make appropriate adjustments as needed to restore budget balance in the event that the economic recovery is more prolonged and/or weaker than currently projected, resulting in revenue shortfalls.

What would change the rating up?

*Rebuilding and maintenance of strong reserve levels.

*Reduced economic volatility and sustained job growth.

*Restoration and maintenance of structural budget balance.

*Significant improvement in pension funded ratios, and sooner than currently projected.

What would change the rating down?

*Economic weakening leading to employment erosion.

*Further deterioration of revenue trends leading to budget imbalance, liquidity pressure, and narrowing of financial position.

*Increased use of non-recurring solutions to balance budget.

*Deterioration of pension funded ratios below already low levels

The principal methodology used in this rating was Moody's State Rating Methodology published in November 2004.

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