S&P Global Ratings

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Hawaii; Appropriations; General Obligation

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Credit Profile		
US$375.0 mil GO bonds ser 2016FG due 10/01/2036		
Long Term Rating	AA+/Stable	New
US$353.465 mil GO rfdg bnds ser 2016FH due 10/01/2031		
Long Term Rating	AA+/Stable	New
US$25.0 mil taxable GO bnds ser 2016FJ due 10/01/2036		
Long Term Rating	AA+/Stable	New
US$3.925 mil GO rfdg bnds ser 2016FI due 10/01/2033		
Long Term Rating	AA+/Stable	New
Hawaii GO		
Long Term Rating	AA+/Stable	Upgraded
Hawaii GO (wrap of insured) (AMBAC & AGM) (SEC MKT)		
Unenhanced Rating	AA+(SPUR)/Stable	Upgraded
Hawaii GO (wrap of insured) (FGIC & AGM) (SEC MKT)		
Unenhanced Rating	AA+(SPUR)/Stable	Upgraded
Hawaii GO (MBIA) (National)		
Unenhanced Rating	AA+(SPUR)/Stable	Upgraded
Hawaii APPROP		
Long Term Rating	AA/Stable	Upgraded
Hawaii GO		
Unenhanced Rating	AA+(SPUR)/Stable	Upgraded

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings raised to 'AA+' from 'AA' its long-term rating and underlying rating (SPUR) on Hawaii's general obligation (GO) bonds and to 'AA' from 'AA-' its long-term rating on the state's certificates of participation (COPs).

At the same time, we assigned our 'AA+' long-term rating to Hawaii's following planned bond issues:

- $375 million series 2016 FG GO bonds,
- $353 million series 2016 FH refunding GO bonds,
- $4 million series 2016 FI refunding GO bonds, and
- $25 million series 2016 FJ taxable GO bonds.

The outlook on all the state's debt ratings is stable.

The upgrades reflect our view that Hawaii's fiscal position and outlook have continued to strengthen, aided by formalization of its reserve policy and demonstrated commitment to managing its long-term liabilities. Favorable revenue trends have enabled the state to accumulate impressive general fund ending balances and budget reserves that, in our view, add to its capacity to weather the potential for economic softening. Early in fiscal 2017, Governor David Ige signed an administrative directive specifying an unassigned general fund carryover balance of at least 5% and an emergency and budget reserve fund (EBRF) balance of at least 10% of prior-year revenues as state objectives. On a combined basis, the state's general fund and EBRF balances at the end of fiscal 2016 exceeded this 15% target. While financial reserves remain particularly important for Hawaii given its above-average fixed costs stemming from its relatively large long-term liabilities, it has achieved an especially strong position.

The 'AA+' GO rating reflects our view of:

- The state's strong financial position, which has weathered several major economic stressors during the past 15 years;
- Strong liquidity, particularly when including pooled cash balances available to the general fund for temporary interfund borrowing;
- The prioritizing of contributions to the retiree health care benefits system, resulting in a lowering of actuarial estimates of the state's long-term liability;
- Management's well-established, proactive budget monitoring practices, including frequent revenue forecast updates from the independent Council on Revenues (COR), which facilitates prompt identification of potential budget adjustments for budget alignment;
- The governor's executive authority to restrict all executive branch expenditures through such actions as cutting spending midyear without legislative approval or cutting or delaying disbursements during the course of a fiscal year; and
- Other strong constitutional protections, including requiring budget balance, that allow for tax increases with legislative approval and give GO bonds first-lien priority before all other disbursements.

Partly offsetting the above strengths is our view of:

- Hawaii's inherent susceptibility to exogenous shocks that have potential to hurt its tourist sector, which accounts for 17% of state GDP;
- The below-average funded status of the state's retirement system and generally higher-than-average debt ratios because of the state's centralized provision of public sector services; and
- Large, other postemployment benefit (OPEB) liability although a 2013 statutory requirement will increase annual contributions until fiscal 2019, when they would equal the actuarially recommended level.

All GO bonds are secured by Hawaii's full faith and credit, which the state considers the highest priority in payment according to its constitution. None of the refunding bonds include later maturity dates than the existing debt to be refunded.

Hawaii began fiscal 2017 in a strong position. On a combined basis, its fiscal 2016 general fund ending balance ($1.03 billion) together with its EBRF ($100.9 million) and Hawaii Hurricane Relief Fund (HHRF--$182.4 million) equaled 19.2% of general fund expenditures. The state has accumulated these balances in recent years by maintaining conservative fiscal practices even as the economy has continued to expand. Chief among these are budgetary controls, including the governor's requirement that agencies restrict 5% of budget appropriations. This practice has given rise to larger-than-budgeted spending lapses, which have resulted in larger ending balance than anticipated. In fiscal 2016, for example, there was $149.1 million in lapsed spending versus the $80 million assumed in the enacted budget.

For fiscal 2017, the potentially slower rate revenue growth contributes to the state's projected $368 million (4.8% of expenditures) operating deficit. However, a significant portion--$299 million of the expected deficit--stems from the state's scheduled prefunding of its retiree health care benefits liability and further capitalizing its EBRF. And even with the deficit, the state would end the year with combined reserves of $1.1 billion, or 14.9% of expenditures. The projected operating gap has shrunk from the state's earlier forecasts. Likewise, the multiple-year forecast shows that in fiscal 2018, the state's operating position would return to positive territory ($237.8 million) whereas it previously had projected a relatively small, $36 million deficit for the year. We believe the state has positioned itself to accommodate the somewhat slower economic and revenue growth anticipated in its multiple-year general fund forecast.

In September 2016, the independent Hawaii COR revised its projected revenue growth for fiscal 2017 to 5.5% from 5.0%. It also confirmed that revenues in fiscal 2016 had increased by 8.0% versus the 6.1% growth rate that had been anticipated as of May 2016. As with recent forecasts, the COR's near-term revenue estimates were adjusted higher while it continues to anticipate slowing economic growth in future years. Consistent with this, the COR maintained its 5.0% revenue growth projection for fiscal 2018 while lowering it to 4.4% from 5.0% in fiscal 2019 and to 4.4% from 4.5% for fiscal years 2020 and 2021.

Despite this, at the end of fiscal 2021, Hawaii's general fund would have almost $3.0 billion in combined reserves, equal to 38% of expenditures, which we view as very strong. The state's multiple-year general fund forecast illustrates that even in the context of more gradual growth the state's fiscal capacity could enable it to make continued progress toward more fully funding its large long-term obligations while maintaining strong budgetary reserves. An outright recession, as opposed to just slower growth, however, would likely test Hawaii's capacity to sustain a weaker revenue environment while adhering to its current multiple-year fiscal plan.

As an island-economy state, Hawaii is inherently vulnerable to the negative effects of certain types of exogenous shock-events. On the other hand, as an importer of diesel and oil fuels--which Hawaii relies on to generate over 70% of its electricity--the state has been a clear beneficiary from what appears to be a secular decline in oil prices. In the 12 months ended September 2015, residential, industrial, and commercial customers realized 18% to 32% savings in the cost of electricity. Certain broad economic metrics, moreover, suggest a more resilient economy than popularly perceived. For instance, although Hawaii was not immune to the Great Recession, relative to the nation, per capita personal income in the state actually increased to 104% in 2009 from 101% in 2007.

Notwithstanding the longer-term expectation of more subdued economic growth, Hawaii's financial position has improved in the current year thanks to a strengthening visitor industry, which in 2015 enjoyed a fourth consecutive year of record-setting visitor arrivals. Visitor arrivals are on track to reach a new record again in 2016. Total visitor expenditures in 2015 increased 3.2% from 2014 and 1.6% year-to-date in 2016 on a trajectory to have grown by 44% compared with 2010. Revenue per available room was up by 4.3% in 2015, and the state projects that through 2016, it will have grown by 62% since 2010. These trends, along with consistently high occupancy rates, suggest the state's key industry, leisure and hospitality (which makes up 17% of Hawaii's employment base versus 10.1% for the nation), is currently healthy. In our view, strength in the tourist sector has contributed to pushing down Hawaii's unemployment rate to 3.7% for 2015, well below 4.5%, which the state's economist considers to be Hawaii's natural jobless rate. As of July 2016, Hawaii's unemployment rate was even lower, at 3.3%.

Throughout the latter part of 2015 and continuing into 2016, however, a strong U.S. dollar and flagging U.S. consumer confidence has weighed on the pace of improvement in the various trends throughout the visitor industry. Some of the strongest gains occurred from 2011 through 2013, with more incremental improvement since then. Relative to the U.S. as a whole, personal income in Hawaii has slid slightly, to 100%, from its prior level, which was slightly above that of the U.S. Growth of Hawaii's GDP, the broadest measure of its economy, suggests that Hawaii remains stuck in a slow growth mode, as it has expanded more slowly than national GDP for six consecutive years. Nevertheless, the state's economy has proved relatively resilient to exogenous shocks (i.e., the Sept. 11 terrorist attacks, the SARS epidemic). Still, we view Hawaii's economy as having some unique vulnerability to unanticipated shocks originating from external events.

A strong U.S. dollar, especially vis-à-vis the Japanese Yen, can be a source of drag to Hawaii's economy. Visitors from Japan make up 17.6% of arrivals, making it easily the second most significant source of origination, behind only the U.S. mainland, which still constitutes the majority, at 62.2%. The state's tourist base is diversifying, however, with arrivals from Canada having almost doubled since 2006. Likewise, visitors from China have increased more than three-fold. As with Japan, however, we see potential for some softening ahead when it comes to tourists from Canada and China. Despite having increased visitors from these two countries--both of which have entered weaker economic patches--they still represented a combined and relatively minor 8.2% of total arrivals in 2015.

Hawaii's economy is also subject to changes in federal spending. The federal government accounted for 12.6% of state GDP in 2013, according to the Bureau of Economic Analysis' most recently available data. More than half of federal spending in the state is military related, making Hawaii's economy susceptible to cutbacks under the federal Budget Control Act of 2011 (BCA). Most significantly, the BCA's sequestration has translated to $400 million in reduced military contracts being awarded in Hawaii ($2.0 billion, compared to $2.4 billion). The effects of the cutbacks emerged in 2015 when the number of military personnel receded by 8.4% to 46,764 following a record level of personnel in 2014. Still, the 2015 level of military personnel based in Hawaii remained higher than all but three years since 1960. The incomes of these personnel and households have a stabilizing influence on the rest of the state economy, in our view.

The state's real estate market is healthy, with low foreclosure rates (just 0.02% in Honolulu, which is 70% of Hawaii's real estate market) and rising home prices. Indeed, a chronic shortage of housing relative to demand keeps upward pressure on home prices throughout the state and poses a threat to the state's longer-term economic growth prospects. Whereas Hawaii saw roughly 6,000 new housing units per year constructed throughout the 1980s, the number has fallen to approximately 2,000 to 3,000 in recent years. Upward pressure on home prices is likely to persist given that Hawaii estimates there is demand for 6,500 new units per year. In our view, construction trends in the 1980s likely reflected unsustainably strong demand from Japanese investors at that time. State officials attribute the more recent slower construction trends to increased environmental, zoning, and permitting process rules.

Although Hawaii's debt burden of $6.48 billion of tax-supported state GO, COP, and highway (gas tax) debt is high, in our view, translating to $4,520 per capita (based on estimated 2015 population), it reflects the centralized nature of state and local government in Hawaii. Hawaii's debt level stands out as high relative to other states' in part because the state assumes numerous functions that are performed at the local level in other states. The above-average fixed costs for debt and retiree benefits liabilities is somewhat offset by Hawaii's below-average Medicaid-related expenditures. Whereas in fiscal 2015, Medicaid represented 19.3% of state general fund budgets, on average, for Hawaii the figure was 13.8%, according to National Assn. of State Budget Officers' data. This reflects the effect of a state law mandating that employers provide health insurance to most full-time employees in Hawaii.

Based on the analytic factors we evaluate for states, we have assigned Hawaii a composite score of '1.8' on a four-point scale in which '1' is strongest.

Outlook

We have assigned a stable outlook to Hawaii's ratings. Notwithstanding the progress and commitment Hawaii has demonstrated with regard to its long-term liabilities, we believe these obligations currently represent a constraint on the state's ratings from further upward movement. The main downside risk we see to the state's ratings stems from the potential for economic underperformance that could lead to deteriorating fiscal performance. However, we believe the state's ratings can withstand most reasonable downside scenarios, however, given its reserve position. We also expect the state's ratings will be sensitive to any material deterioration in its pension funded status from its current level.

Governmental Framework

Hawaii's constitution requires that the state operate on a balanced budget, including on an intrayear basis, as it monitors revenues and expenditures throughout the year and makes necessary adjustments to ensure that general fund expenditures do not exceed current general fund revenues and unencumbered cash balances. There are no constitutional restrictions on the state's ability to raise taxes or other revenues, but property tax authority rests with the counties. Approval of taxes is by simple majority vote of the legislature, and the legislature has broad legal latitude to adjust spending levels. The governor has authority to restrict all executive branch expenditures and to cut spending midyear without legislative approval via such methods as cutting or delaying spending on education, but in practice this is politically difficult.

Hawaii is not a voter-initiative state, and no vote is required to issue GO bonds or increase taxes. GO bonds in Hawaii have a first-lien status, prior to all other payments, and the issuance of GO bonds must be authorized by a majority vote of the legislature.

The Hawaii state government is highly centralized, and as such, the level of assistance to local governments is high. The state directly runs the public school system, as well as the university and community college systems. It also administers the public welfare system and operates prisons, harbors, and airport systems. The county functions are primarily property related (police, fire, streets, water, sewer, and parks). That being said, Hawaii is less exposed to fiscal pressures from rising health care and Medicaid costs than are most states. Hawaii's Prepaid Health Care Act of 1974 effectively mandates that employers provide health care coverage for any employees who work 20 hours or more per week. This has resulted in historically high rates of health care coverage in Hawaii. The transition to complying with the Federal Patient Protection and Affordable Care Act has, therefore, been more incremental in Hawaii than in most states. Indeed, in fiscal 2015, Medicaid represented about 15.9% of total state expenditures in Hawaii versus

27.4% on average for all states, according to the National Assn. of State Budget Officers.

On a four-point scale in which '1' is the strongest, we have assigned a score of '1.7' to Hawaii's governmental framework.

Financial Management

Financial Management Assessment (FMA): Strong

We consider the state's management practices strong under our FMA methodology. An FMA of strong indicates our view that practices are strong, well embedded, and likely sustainable. Among the highlights of the state's management techniques are statutorily required six-year operating and capital budgets that are updated by the governor and finance staff annually for legislative approval. The COR provides quarterly revenue forecasts for inclusion in the biennial budget, budget updates, and the multiyear financial forecast. State finance staff identifies budget variances throughout the year, and the governor is empowered to curtail expenditures without legislative approval, if required. The finance staff and treasury adhere to an official investment policy, and investment performance is disclosed monthly. There are statutory debt caps, including a calculation to ensure that the total amount of debt service payments required will not cause the state to exceed its debt limit of 18.5% of the average of three prior years' general fund revenues. The state constitution requires that all state debt begin to amortize principal within five years of issuance, mature within 25 years, and have either level debt service or level principal payments. State law disallows the use of swaps or other derivative products. The legislatively created EBRF provides for a small, controlled emergency fund. A formalized reserve policy has been established with a target of 5% for the unassigned general fund carryover balance and 10% for the EBRF. Additionally, legislatively mandated debt policies and a debt affordability study are expected to be completed by the end of 2016.

Budget management framework

COR, a seven-member, independent revenue forecasting body, prepares revenue forecasts at least quarterly, but also in special sessions when fiscal conditions warrant. The executive branch and legislature are required to consider the council's estimates in the budget process. Should they use a different forecast, this development and the rationale must be publicized.

Spending is controlled through an allotment system, and the Hawaii Department of Budget and Finance monitors expenditures throughout the year. Budget adjustments are implemented periodically throughout the fiscal year as the state deems necessary. Restrictions can be implemented at any time but are usually imposed at the beginning of the fiscal year. Adjustments requiring legislative action are handled during the legislative session, which begins shortly after the start of the third quarter; in extraordinary circumstances a special legislative session may be called. The governor has unilateral authority to restrict executive branch spending. Legislative approval is required to authorize spending, to impose new taxes, or to increase existing taxes.

Beginning with 2010, the state has demonstrated willingness to provide timely--and structural--budget solutions when confronting previously projected budget deficits. As described above, the enacted deficit-closing solutions have been mostly structural. Deficits are not carried forward, but soft revenue performance and an expiration of the previous solutions contribute to a projected shortfall of revenue compared with baseline spending trends, necessitating either adjusted service levels or enhanced revenues for the upcoming biennium.

On a four-point scale in which '1' is the strongest, we have assigned a score of '1' to Hawaii's financial management.

Economy

We anticipate Hawaii's economy to produce slow but relatively steady growth in the upcoming years. From 2004 through 2014, total personal income in the state grew faster than in the nation, at a 4.3% compound average growth rate versus 3.9%. On a projected basis, our forecast, based on IHS Connect modeling, looks for growth of 4.0% and 4.1% in 2016 and 2017, respectively, with growth remaining below 5.0% through 2019. As of 2015, per capita personal income is 100% of the nation.

State GDP, on the other hand, has been growing more slowly than U.S. GDP, and the gap has widened more recently. Over the past 10 years, state GDP grew in real terms at an average annual rate of 0.96%, which is slightly below the average U.S. annual rate of GDP growth of 1.21%. In the past five years, state GDP increased by 1.20%, on average, versus the U.S., which increased by 1.84%. In 2015, IHS Connect estimates that Hawaii's GDP grew by 1.7%, below the national rate of growth, 2.6%, and forecasts somewhat slower growth of 1.3% in 2016.

Sluggish GDP growth notwithstanding, population growth rates have been above average. During the past 10 years, Hawaii's population has increased 1.03% per year, on average, versus 0.85% for the nation. However, the population is growing older, which has pushed up the state's age-dependency ratio to 60.7% in 2014 from 58.4% in 2012. This puts the state in a slightly weaker demographic position, in our view, than the nation as a whole, which has a ratio of 60.2%. IHS Connect estimates that Hawaii's aging 65-plus population represents 16% of its total population, one of the highest proportions of the elderly among all the states. Additionally, this proportion is expected to increase to 20% by 2024, making Hawaii the sixth-most-aged state in the country. This could result in a challenge for the state in funding government services for the elderly as the working-age population will barely increase over the next decade.

It's been common for Hawaii's unemployment rate to be lower than the nation's. The state's unemployment rate was 3.6% in 2015, well below that of the nation, which was 5.3% for the year. As of July 2016, the seasonally adjusted preliminary unemployment rate was 3.3%. Tourism will likely always be an important part of Hawaii's economy--but to a lesser degree than in the past. Whereas various elements of the tourism industry accounted for 33% of state GDP in 1988, now it's only 17%.

Although the state's COR now anticipates the visitor industry will proceed at a slightly reduced pace, it continues to expect the construction sector to pick up much of the slack. That's why the more tempered activity in the construction sector since late 2013 poses a risk to the state's rate of overall economic growth.

Home prices and the cost of living are high in Hawaii relative to the nation, but the state's real estate sector proved considerably more stable than it did in most of the rest of the nation during the recession. Unlike many markets throughout the U.S., Honolulu's housing market (70% of Hawaii's real estate market) decline during the Great Recession was only moderate, roughly 11% from peak (in 2006) to trough (in 2009), according to the state. This compares to a 31.5% decline in home prices nationally during the same time period (the national measure is according to the S&P/Case-Shiller Home Price Index). We attribute the better performance of Honolulu's--and by extension, the state's--housing market throughout the recession to the fact that the five state-headquartered banks originate most of the home mortgages in Hawaii and, during the middle 2000s, refrained from heavy subprime lending. The state reports that Honolulu city and county rates of foreclosures are well below national averages and below those of comparable metropolitan areas around the country.

Construction activity has tended to correlate with job growth during the past several years. As of the first quarter of 2016, Hawaii is the 14th-fastest growing state, led primarily by a surge in the construction sector. Strong gains in the construction sector are a result of new development on the island state. New residential and commercial projects promise construction jobs, which should continue to see healthy gains. After the recent quarter, the construction sector is just shy of its prerecession peak, experiencing considerable 19.1% year-over-year growth. Housing starts, after dipping by 15.1% in 2011, followed by a 5.4% increase in 2012, rebounded with a 25.2% increase in 2013. But they then slid back in 2014, with an 18.5% decline in new housing starts, according to IHS Connect. In 2015, housing starts once again rebounded, however, increasing by 59.3%. IHS Connect forecasts that housing starts will continue to increase for the next few years until 2018 when they will again resemble pre-Great-Recession totals.

On a four-point scale in which '1' is strongest, we have revised our score of Hawaii's economy to '1.8' from '2.0'.

Budgetary Performance

After having used a significant portion of its EBRF and Hawaii Hurricane Relief Fund (HHRF; "rainy day" reserves) during and in the aftermath of the Great Recession, Hawaii has commenced rebuilding these balances. After four consecutive annual increases in ending balances, fiscal 2014 marked the first year in which the balance declined, albeit modestly. Combined ending and rainy day fund balances as of June 30, 2014, were $748 million, down from $868 million in fiscal 2013. Combined balances increased in fiscal 2015, to $918 million, and are on track to end fiscal 2016 at $1.1 billion. According to the general fund financial plan, which is built on COR revenue forecasts, the outlook is for fiscal performance to soften somewhat, however. At this time, the state's fiscal 2017 ending balance plus rainy day funds are projected to be $965.3 million, or 12.5% of expenditures. This is up considerably from the state's 2014 projection, which showed balances dropping to $405.7 million, or 5.8% of expenditures. Two consecutive administrations have made building and maintaining Hawaii's budget reserves a priority. A formalized state reserve policy has been established with the administration committed to targeting maintaining budget reserves equal to 10% or more of general fund revenues, which we view favorably.

Liquidity

At the end of fiscal 2015, cash and equivalents across all governmental funds totaled $692.9 million, or 13% of general fund expenditures. Cash is monitored on a daily basis, with daily reports reflecting the state's investment positions. The state forecasts its liquidity needs on a one-year-forward basis, including recurring and known expenditures (debt service payments and payroll), and makes investments to provide liquidity on those dates. Annual cash flow is generally predictable although the state has made several downward revisions of forecast revenue growth following the recession. The state monitors and manages its disbursements with greater-than-average scrutiny to provide for positive general fund balances at fiscal year-end. The state has the statutory ability to borrow internally with the approval of the director of finance. The state has not done any external borrowing for cash flow purposes; it is permitted to issue GO bonds to fund a deficit but never has.

Audited financial statements

Audited fiscal results for 2015 published in the state's comprehensive annual financial report indicate that general fund tax revenues rebounded by 7.4% after having declined by 2.3% in fiscal 2014. Revenues for fiscal 2014 consisted primarily of the general excise and use taxes (approximately 52% of revenues) and the individual and corporate income tax (approximately 35%). Education expenditures (including kindergarten through grade 12 and higher education) accounted for 50% of expenditures, followed by human services and health-related expenditures, which totaled 32%. The audited combined ending assigned and unassigned fund balance in fiscal 2015 was $1.59 billion, or 30% of expenditures. The balance represents a solid increase from the fiscal 2014 level, when it was $1.34 billion, or 26% of expenditures.

We believe the state's reserve position is strong although slightly less liquid than at the end of fiscal 2012 given the changes in the state's cash position. At the end of fiscal 2015, general fund cash was $204 million, up from $114 million at the end of fiscal 2014.

The EBRF, created by the legislature in 1999, is normally funded from 15% of tobacco settlement funds. However, this revenue was diverted to the state general fund during fiscal years 2012 and 2013. Pursuant to state statutes, Hawaii's general fund plan resulted in $55.5 million of deposits into the HHRF in each of fiscal years 2014 and 2015. The deposit was made in fiscal 2014 and has been deposited for fiscal 2015 as well. At the governor's request, the legislature agreed to additional supplemental EBRF and HHRF deposits of $50 million each in fiscal 2014. Across two consecutive administrations, the state's commitment to replenish these funds remains intact and is a departure from earlier plans to allow the reserves to become-depleted. For fiscal 2017, the state will deposit $201.4 million in the EBRF. We believe the replenishment and commitment to maintain these funds represent a strengthening of the state's credit quality.

On a four-point scale in which '1' is strongest, we have assigned a score of '1.4' to Hawaii's budgetary performance.

Debt And Liability Profile

Issuance of GO bonds must be authorized by a majority vote of the legislature, and each year, the GO authorization bill authorizes the aggregate amount of GO bonds that may be issued to finance capital improvement projects. The bill also contains a calculation to ensure that the total amount of debt service payments required will not cause the state to exceed its debt limit of 18.5% of the average of the preceding three years' general fund revenues. The state constitution requires that all debt begin to amortize principal within five years of issuance, mature within 25 years, and have level debt service payments. State law disallows the use of swaps or other derivative products.

Hawaii's debt ratios, as of June 30, 2015, on a per capita and percentage basis were high, in our view, with direct state debt approximately $6.48 billion, or $4,524 per capita, 9.5% of total state personal income, and 8.1% of state GDP, among the highest of all the U.S. states. Hawaii's high per capita debt is attributable to the state's assumption of many functions that, in other states, are generally financed by local governments, including education, health, and welfare. Debt levels, however, rose rapidly during the 1990s as the state shifted from pay-as-you-go capital spending to GO bonds. However, debt amortization is rapid, with 67% of principal repaid within 10 years and 100% repaid within 20 years. Total annual tax-supported debt service (GO bonds, appropriation-backed debt, and the state highway fund) equaled $753 million in fiscal 2015, or about 12.1% of the expenditures from the general and state highway funds, which we consider high.

Pension liabilities

Pension benefits are administered by the Employees' Retirement System (ERS) of the State of Hawaii, which began operation on Jan. 1, 1926. The system is a cost-sharing, multiple-employer, defined-benefit pension plan that covers all regular employees of the state and each of its counties, including judges and elected officials. The system covers 119,006 active and retired beneficiaries as of June 30, 2015, up from 115,350 in 2013. Following implementation of Governmental Accounting Standards Board (GASB) statement 67 and 68, the state recognized a net pension liability of $6.2 billion for fiscal 2015. This translates to $4,328 on a per capita basis and 9.1% of total personal income, both of which we view as high.

The funded ratio based on the market value of pension system assets declined slightly in fiscal 2015 to 62.4% from 63.9% in 2014, which we view as below average. The funding level decreased steadily through 2012 from a high of more than 95% in fiscal 2000. A lower funded ratio is partly due to the state adopting a lower rate of return assumption (7.75%) beginning for fiscal 2011 compared with years prior, which assumed an 8% rate of return on pension system assets. In addition, the state's prior practice (which was ended in 2005) of reducing employer contributions when investment returns exceeded the assumed rate of return contributes to the ERS' currently relatively low funded ratio.

Annual pension contributions are set according to statutory formula. Throughout much of the 2000s, employer contribution rates resulted in actual contributions that roughly aligned with the actuarially recommended level. Since 2011, however, the contribution rate has repeatedly been applied to a smaller-than-expected state government workforce, the growth of which was constrained in response to the Great Recession. As a consequence, actual contributions have fallen short of the actuarially recommended level, though they are typically above 90% of it. Nevertheless, thanks in large part to the state's pension reforms, it projects amortizing its unfunded liability within 26 years, down from 40 years in 2010.

Among the state's pension reforms was the creation, in fiscal 2011, of a new benefits tier for new members hired on or after July 1, 2012. The new benefits tier generally offers a lower level of benefits and requires higher employee contributions. As the mix of active plan members transition to the new tier, employee contributions will increase as the noncontributory plan members retire and are replaced with new members. Other reforms include restricting pension spiking and other similar practices that elevated the state's long-term liability. Since 2012, strong investment gains of 12.3% (fiscal 2013) and 17.4% (fiscal 2014) and the pension reforms have improved the ERS' funded ratio. However, weaker returns in fiscal 2015 of 4.23% caused the system's funded ratio (using market value of assets) to decline to 62% from 64% in fiscal 2014. Preliminary fiscal 2016 returns were also weak, at negative 0.9%, which is well below actuarial assumptions. The ERS Board of Trustees has opted to lower the rate of return assumption because of future long-term projections by its investment consultant and actuary--now on a path to decline to 7.50% from 7.75% by fiscal 2017. Although such a change puts additional negative pressure on the system's funded ratio, it reflects a more conservative orientation with regard to managing long-term pension liabilities. Furthermore, the state also plans on shifting from equal monthly payments to providing a single payment at the beginning of the fiscal year. This is estimated to reduce the unfunded actuarial accrued liability between $180 million and $260 million over a 10-year period.

OPEB risk assessment

In 2013, Hawaii enacted legislation (Act 268), which initiated a schedule for prefunding the state's retiree health care benefit liability. Under the legislation, the state's prefunding of the OPEB liability would ramp up to 100% of the annual required contribution (ARC) by fiscal 2019 from 20% of the ARC in fiscal 2015. However, the administration has accelerated the escalating contributions so that, according to the governor's proposal, the state would contribute the full ARC in fiscal 2018, one year ahead of the law's schedule. To put the contribution differential into perspective, the state's pay-as-you-go cost in fiscal 2016 is $333 million while the full ARC is $742.8 million (down from over $1.0 billion prior to the reform legislation). The state accelerated its implementation of the prefunding in fiscal years 2014 and 2015. In those two years alone, the state contributed $134 million above what Act 268 called for. The state is contributing an additional $97.6 million above the Act 268 schedule in fiscal 2017 and plans to contribute an additional $74.3 million in fiscal 2018. Although the state's effort to prefund its OPEB liability contributes to fiscal pressure in fiscal 2017, we believe it illustrates the policymakers' increased commitment in recent years to addressing its liabilities.

By adopting the higher funding trajectory, the Employer-Union Health Benefits Trust Fund's actuary incorporated a higher discount rate to measure the state's liability. This had the effect of lowering the state's estimated unfunded OPEB liability, estimated at $9.1 billion in fiscal 2015, or 33% less than the liability as of fiscal 2013 when Act 268 was signed into law.

In general, we view the state's willingness to begin confronting its OPEB liability as favorable. Although at $6,386, the state's per capita OPEB liability remains high as of fiscal 2015, it's down considerably from fiscal 2012 when it stood at $9,770 per capita.

It's common that pension and OPEB reform efforts produce material improvement in key metrics only as a result of sustained commitment on the part of policymakers and sometimes over many years. While the effects of Hawaii's Act 268 and its various pension reforms do not result in an immediate improvement to our rating on the state, we view them as important to its ability to maintain its current rating through economic cycles while also enhancing its potential for a higher rating.

On a four-point scale in which '1' is the strongest, we have assigned a score of '3.3' to Hawaii's debt and liability profile.

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