# FITCH RATES HAWAII'S $550MM GO BONDS 'AA'; OUTLOOK POSITIVE

Fitch Ratings-San Francisco-28 January 2019: Fitch Ratings has assigned a 'AA' rating to the following general obligation (GO) bonds of the State of Hawaii:

--$454 million GO bonds of 2019, Series FW;
--$50 million GO bonds of 2019, Series FX;
--$46 million GO bonds of 2019, Series FY.

In addition, Fitch has affirmed the following ratings:

--Issuer Default Rating (IDR) at 'AA';
--$7.2 billion in outstanding GO bonds at 'AA';
--$4 million in outstanding certificates of participation (COPs), series 2009A (State Office Building) at 'AA-'.

The Rating Outlook is Positive.

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.

ANALYTICAL CONCLUSION

The 'AA' IDR and GO bond ratings reflect expectations for a continued strong operating performance and 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. The Positive Outlook 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 the costs arising from its pension and other post-employment benefit (OPEB) reforms.

Economic Resource Base
The State of Hawaii encompasses seven inhabited islands and a total population of 1.4 million, over 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. In the past two years, the state has experienced small population declines, which are atypical relative to its history of steady to strong annual population growth. These declines appear largely tied to recent military redeployments to the mainland (which are not expected to continue), reduced international in-migration (in response to current federal immigration policy), and a slightly declining birthrate.

KEY RATING DRIVERS

Revenue Framework: 'aaa'
General excise taxes (GET) on gross business receipts and personal income taxes provide over three-quarters of Hawaii's general fund revenue and have performed solidly historically, with growth rates exceeding inflation but slightly below U.S. GDP over the past 10 years. Prospects for ongoing revenue gains appear strong based on the state's economy where long-term diversification trends have bolstered economic resiliency. The state has full control over its revenues with no legal limits on potential increases.

Expenditure Framework: 'aa'
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 absent offsetting policy action. Carrying costs for debt service and retiree benefits are somewhat elevated for a U.S. state but are expected to remain manageable.

Long-Term Liability Burden: 'a'
Long-term liabilities for debt and retiree pension benefits are well above the median for U.S. states and are elevated but still in the moderate range relative to personal income. These totals include liabilities for the state's public schools, which are accounted for as local government obligations in most other jurisdictions. 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'
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
STRONG LONG-TERM FINANCIAL FLEXIBILITY: The rating is sensitive to overall fiscal and operating performance, particularly in light of ongoing expenditure increases from pension and OPEB reforms. Fitch expects that the state will maintain its high degree of financial flexibility through economic cycles as it continues to address its high pension and OPEB liabilities, which is the basis of the Positive Outlook. Deterioration in the state's operating performance tied to cyclicality beyond Fitch's expectations, or a diminished commitment to addressing its retiree liabilities, could result in a revision of the Outlook to Stable.

CREDIT PROFILE

Hawaii's economic performance has been solid with increasing economic diversification, steady growth in tourism, and a continued substantial military presence. As evidence of increasing economic diversification, state officials calculate tourism's current share of GDP at 17%, compared to 33% in 1988. The leisure and hospitality sector currently accounts for 20% of the state's employment, comparable to the trade, transportation and utilities and government sectors. This is nearly twice the percentage for the U.S. as a whole.

Tourism activity has been subject to periodic declines historically but has proven resilient over the long term. Visitor numbers and visitor spending are at record levels, airline seat capacity to Hawaii is growing, and hotel room capacity is expanding. However, the rate of growth for visitor arrivals and spending is expected to slow.

For well over a decade, the state's unemployment rate has been below the U.S. average and it is now exceptionally low. Personal income levels are above average on a nominal basis, although real spending power is curtailed by the state's high cost of living.

Housing affordability is a growing issue for Hawaii with well above average median single family house prices (when comparing Honolulu with other comparably sized U.S. cities). State officials advise that considerably fewer houses are being constructed than local and out-of-state demand could absorb. Although high construction costs appear to be a barrier for some already permitted projects, many residential, commercial, and hotel projects are currently underway across the state. In addition, significant public sector capital investments are currently being made in the state's transportation infrastructure, schools, and universities and the military continues to make sizeable capital investment in its Hawaiian bases.

Revenue Framework

The state relies on general excise taxes (GET) on business income and personal income taxes for the majority of its general fund revenues. The GET is broad-based and captures income from the sale of services as well as goods, accounting for over 48% of general fund revenues in fiscal 2018. The state is working to improve GET collections from on-line retailers and individual vacation rental units, which would bolster growth. Net income taxes from corporations and individuals account for a further 35% of general fund revenues. Policy-adjusted performance for all general fund revenues has been solid historically, exceeding inflation but slightly below overall U.S. economic performance.

Fitch expects Hawaii's revenue growth, absent policy actions, generally to increase in line with GDP going forward based on the state's resilient and growing economy. While revenue gains may be affected by periodic economic shocks, strong growth is expected over the long term.

In January 2019, the Council on Revenues lowered its forecast for fiscal 2019 general fund tax revenue growth to a still strong 4.2% from the prior forecast of 5%. The council expects slower economic growth in fiscal 2019 than in fiscal 2018 (almost 8%) due to international and national economic uncertainties and a likely slowing in the growth rates for visitor arrivals and spending. The council maintained its 4% growth forecast for fiscal years 2020 to 2025. The governor's proposed fiscal 2019-2021 biennium budget assumes a more conservative 3.5% annual growth rate.

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 total governmental fund expenditures (inclusive of federal funding). Elementary, secondary, and higher education comprised approximately 35% of total governmental fund expenditures in fiscal 2018. Health and welfare spending combined for approximately 36% of total governmental fund expenditures. 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 appears less likely in the near term given divided control in Congress. The state does not have expenditure risk associated with voter initiatives.

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. The state's multiyear forecasts anticipate expenditure growth of between 2% and 3% annually through fiscal 2025; however, this forecast does not incorporate the costs of labor contracts that have yet to be settled. There is a constitutional expenditure ceiling that can only be exceeded with a two-thirds vote of the legislature. Apart from fiscal 2007, appropriations for recent years (including the governor's proposed fiscal 2019-2021 biennium budget) have not exceeded the expenditure ceiling.

The state has a strong track record of making expenditure reductions when needed 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 prefunding of retiree benefits could present a greater challenge for expenditure flexibility. Carrying costs for these items accounted for 16% of governmental expenditures in fiscal 2018, among the highest shares for states. The phase-in of OPEB contributions to full actuarial levels as of fiscal 2019 and higher employer pension contributions through fiscal 2021 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 high for a U.S. state. They are elevated but still in the moderate range at approximately 22% of personal income as of fiscal 2018, more than three times the median for states, as reported in Fitch's 2018 State Pension Update. This ratio excludes the net pension liability attributed to the University of Hawaii. The ratio appears to be on an upward trajectory in the short-term based on more conservative assumptions included in recent actuarial valuations. Long-term liabilities include debt issued for the state's elementary and secondary schools, which represents about 40% of total debt. (Most other jurisdictions account for these as local government obligations.) Amortization is fairly rapid, with 61% of outstanding principal due for repayment within 10 years.

The state reported a low 55% ratio of assets to liabilities in its pension plan as of fiscal 2018 based on actuarial results through June 30, 2017 and an assumption of 7% investment returns. Under an assumption of 6% returns, Fitch estimates a 51% ratio of assets to liabilities for the system. Contribution rates are determined by statute and adjusted periodically if the actuarial funding period exceeds 30 years. The state increased contribution rates in 2012 and again in 2017, and has consistently budgeted for its full statutory contribution.

Substantial pension reforms were approved by the state legislature in 2011 and included lower benefit levels for new hires and provisions to discourage pension spiking, in addition to higher contribution rates. In addition, the state's pension system has reduced investment return assumptions by 0.75% since 2014. Despite the immediate negative impact on the plan's funded condition, Fitch expects these changes and rising contribution rates to position the plan for funding progress if it achieves its more conservative assumptions. The state pension system projects modest annual improvements in reported funded ratios, leading to full funding by 2043.

The state also carries a high liability for accrued OPEBs, which it regards as legally protected. The state has made notable progress in prefunding OPEBs, moving from pay-as-you-go to full funding of the actuarially determined contribution (ADC); under the new accounting standard, OPEB liabilities are discounted at 7%. Legislation adopted in 2013 established a schedule for full ADC funding by 2019, which the state has achieved. The general fund pays for 76% of the total, with the remainder funded through non-general funds of the state. The 2013 legislation also established an irrevocable OPEB trust that now has a balance of nearly $1.3 billion. Nevertheless, the total OPEB liability continues to grow (to $10.7 billion in fiscal 2019) and it represents a very high 13% of personal income.

Assuming the state makes full contributions over time, under current actuarial assumptions the state would fully fund its share of the pension system in 2043 and its OPEB plan in 2045.

## 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 2.5%. The state's reserves provide a considerable cushion against revenue declines expected in a moderate recession.

The state made key improvements to financial flexibility in the wake of the Great Recession, increasing budgetary and emergency reserves substantially. A budget reserve policy adopted in

2016 sets a goal of 10% of prior year budgeted revenues for such savings, committing a portion of ongoing tobacco revenues and general fund balance in years of strong revenue performance. Balances in the state's Emergency Budget and Reserve Fund (EBRF) rose to almost $376 million in fiscal 2018 (5% of prior fiscal year budgeted revenues), from $9.7 million in fiscal 2011. The EBRF is budgeted to grow to $384 million (5% of prior fiscal year budgeted revenues) in fiscal 2019.

In addition, the state has a balance of almost $183 million in its Hawaii Hurricane Relief Fund, which has functioned as an additional working reserve in times of economic stress.

Along with frequent consensus revenue forecasting noted above, the state relies on multiyear financial planning, with general fund flexibility supported by an unassigned carryover balance that is targeted at 5% of prior year general fund revenues through the forecast period. On a budgetary basis, the state reported a fiscal 2018 net general fund deficit of $144 million (less than 2% of total general fund expenditures) leaving the carryover balance at $750 million. Additional modest deficits are forecast through fiscal 2021, which would lower the carryover balance to $382 million, although this forecast excludes the impact of additional executive and legislative action on the budget.

These deficits reflect pressure tied to the state accommodating increased pension and OPEB contributions within its long-range spending envelope. Fitch views the state as having a degree of fiscal flexibility sufficient to cover routine program spending growth while absorbing the rising demands for prefunding its retiree liabilities.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

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Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)

https://www.fitchratings.com/site/re/10024656