FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Hawaii's GOs 'AA+'; Outlook Negative

Fri 31 Jul, 2020 - 12:26 PM ET

Fitch Ratings - San Francisco - 31 Jul 2020: Fitch Ratings has assigned the following rating to the state of Hawaii general obligation (GO) bonds:

--$900 million taxable GO bonds of 2020, series FZ at 'AA+'.

In addition, Fitch has affirmed the state's following ratings:

--Issuer Default Rating (IDR) at 'AA+'.

--$6.9 billion in outstanding GO bonds at 'AA+'.

The Rating Outlook is Negative.

The 2020 series FZ bonds are scheduled to be sold via negotiation on Aug. 5, 2020.

SECURITY

The GO bonds are general obligations of the state that carry the full faith and credit pledge of the state.

ANALYTICAL CONCLUSION

The Negative Rating Outlook on Hawaii's 'AA+' IDR and GO bond ratings reflects the considerable financial pressure faced by the state as it confronts the economic impacts of the coronavirus pandemic. The sudden economic shock brought by the pandemic and the severe recession now unfolding are well beyond the routine cyclicality typically faced by state and local governments and reflected in IDRs. While Hawaii has a track record of very strong operating performance, its ability to absorb the shock and maintain financial resilience will be tested by the trajectory of the pandemic, mitigation measures and the subsequent economic recovery. Hawaii's globally important tourism industry, a pillar of the economy, is most affected, and its recovery will depend in part on the health and economic status of the markets from which visitors originate, and changes in domestic and international travel patterns.

The Negative Rating Outlook and evaluation of the state's credit quality going forward are informed by Fitch's coronavirus baseline and downside Fitch Analytical Stress Test (FAST) scenarios, as described further below. In the near term, the state will need to carefully manage the considerable economic and fiscal uncertainty caused by the pandemic. While the Negative Rating Outlook indicates the direction the rating is likely to move over a one- to two-year period, it does not imply that a rating change is inevitable.

The state's increasingly diversified economic base will help it maintain its financial flexibility in the medium term as it continues to successfully absorb the costs arising from pension and other post-employment benefit (OPEB) liabilities. The state's commitment to elevating pension contributions, and a requirement to report to the Legislature annually on a range of pension stresses, establishes a solid basis for managing the risks posed by its retirement obligations, which Fitch expects to remain high for the foreseeable future. Short- to medium-term suspension of OPEB prefunding will bolster the state's liquidity in the near term at the cost of prolonging paydown of its OPEB liabilities.

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 Oahu. The state's employment base and economy are diverse, with key sources of external support provided by tourism and a substantial federal presence. In the past two years, the state experienced small population declines, atypical relative to historically steady to strong annual population growth. These declines appear largely tied to 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.

In recent years, 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, in early 2020, state officials calculated tourism's current share of GDP at 17%, compared with 33% in 1988. This means that economic activity generated by its own residents has become increasingly important to the state. For the first quarter of 2020, state officials estimated that the leisure and hospitality sector accounted for 18% of the state's employment, comparable to the trade, transportation and utilities sector (17%) but noticeably less than the government/military sector (26%). While tourism activity has been subject to periodic declines historically, it has proven resilient over the long-term. Historical data indicate that major economic shocks suppress visitor arrival growth for around three years at the most, before resumption of the upward growth trend.

Although personal income levels are above average on a nominal basis, real spending power is curtailed by the state's high cost of living. Housing affordability has become a significant 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. Despite the pandemic, many residential, commercial and hotel projects are currently underway, and significant public-sector capital investments are being made in transportation infrastructure, schools and universities, and water and wastewater systems. The military continues to make sizable capital investments in its Hawaiian bases.

KEY RATING DRIVERS

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Revenue Framework: 'aaa'

General excise taxes (GET) and corporate and personal income taxes provided around 88% of Hawaii's fiscal 2019 general fund revenues. Total general fund revenues have performed solidly historically, in line with U.S. GDP over the past 10 years. Medium-term 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'

Over the medium term, 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 total personal income. Fitch's long-term liability burden calculation includes liabilities for the state's public schools, which are paid for by local governments in most other jurisdictions. Reforms to retiree benefits and higher contributions have helped to slow the growth of related liabilities. However, considerable progress on pension system and OPEB prefunding will take place only gradually.

Operating Performance: 'aaa'

The state is well positioned to address economic challenges given its increased reserves and control over a broad array of budget balancing options. Budget management is guided by frequent revenue forecasts and multiyear financial plans that provide input for policy adjustments as required.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--The Rating Outlook could be revised back to Stable if the state is able to effectively absorb the fiscal challenges triggered by a short but severe economic contraction and rebuild its financial resilience swiftly.

--The state's actions in managing retiree obligations reduce those long-term liabilities over time.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--An inability to address effectively the fiscal challenges triggered by the expected short-term but severe economic contraction, as evidenced by failure to make needed budget adjustments to the enacted fiscal 2019-2021 biennium budget, leaving the state less financially resilient at the end of the recovery period.

--Deterioration in operating performance tied to cyclicality beyond Fitch's expectations and slower than expected return to revenue growth and financial resilience.

--Economic performance that does not support Fitch's medium-term expectations for strong financial flexibility and revenue growth from a solid, increasingly diversified economic base.

--A diminished commitment to addressing the state's retiree liabilities.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

CREDIT PROFILE

CURRENT DEVELOPMENTS

Sectorwide Coronavirus Implications

The ongoing outbreak of coronavirus and related government containment measures worldwide create an uncertain global environment for U.S. state and local governments and related entities in the near term. While the state's most recently available fiscal and economic data may not fully reflect impairment, material changes in revenues and expenditures are occurring across the country and likely to worsen in the coming weeks and months as economic activity suffers and public health spending increases. Fitch's ratings are forward-looking in nature, and Fitch will monitor developments in state and local governments as a result of the virus outbreak as they relate to severity and duration, and incorporate revised expectations for future performance and assessment of key risks.

In its baseline scenario, Fitch assumes sharp economic contractions hit major economies in the first half of 2020 at a speed and depth unprecedented since World War II. Sequential recovery is projected to begin from the third quarter of 2020 onwards as the health crisis subsides after a short but severe global recession. GDP is projected to remain below its fourth-quarter 2019 level until mid-2022. Additional details, including key assumptions and implications of the baseline scenario and a downside scenario, are described in the report "Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases - Update" (https://www.fitchratings.com/site/re/10120570), published April 29, 2020 on www.fitchratings.com.

Coronavirus Impacts on Hawaii Economy

The state continues to experience the economic impact of the pandemic. The state's Department of Business, Economic Development and Tourism estimates GDP growth has declined by 12% in 2020 compared to 2019 (inflation adjusted). Worldwide containment efforts have particularly affected the state's tourism sector, one of the pillars of its economy. In the first five months of 2020, total visitor arrivals dropped almost 50%. State officials estimate that each month of lost tourism represents around $176 million in foregone tax revenues. Visitor numbers slowly increased to between 700 to 900 a day in early July, a small percentage of the 30,000 to 35,000 arrivals per day in early March. After many of the state's major hotels closed, almost 78% have now reopened.

The state has performed relatively well in terms of its health statistics, benefitting from its geographical isolation and mandatory quarantine rules. As of July 27, there have been 1,757 confirmed coronavirus cases, the majority on Oahu, with almost 10% requiring hospitalization and 26 deaths. However, the state has experienced recent infection spikes resulting in record levels of daily new cases. In response, the state might need to reclose certain businesses and activities.

To safeguard state residents' health while reactivating tourism, the state is preparing to implement a pre-travel testing program on Sept. 1, whereby travelers to the state would be able to avoid a 14-day quarantine requirement with evidence of a negative coronavirus test taken up to 72 hours prior to travel. Implementation of this alternative has been delayed from Aug. 1 due to increased outbreaks in some of the state's main travel markets. Non-essential inter-island travel without quarantine has been permitted since mid-June, but Maui County has now formally requested that it be reinstated given the sharp rise in new coronavirus cases on Oahu.

There has been progressive reopening of non-essential businesses across the state. A July survey indicates that 84% of businesses are now open. The state's plans for reopening public schools for the 2020-21 school year allow for a range of in-person, online and blended distance learning options. However, consideration is currently being given to delaying the start of the school year to provide extra time for staff training and site preparation. The University of Hawaii system will reopen its 10 campuses for the fall 2020 semester with in-person instruction.

The state's seasonally adjusted unemployment rate was almost 14% in June, compared with less than 3% a year prior. However, this represents considerable improvement over the historical high of almost 24% in April. Between January and May, the state lost approximately 127,700 non-agricultural jobs, a 19% decline. However, in June, there was an almost 4% uptick month over month, restoring approximately 20,900 jobs. The leisure and hospitality sector has taken the hardest hit. Between January and May, that sector lost approximately 77,400 jobs, a 60% decline. In June there was an almost 32% month-over-month increase, with the restoration of approximately 16,000 jobs. Meanwhile, over the January to June period, construction jobs grew 4% to approximately 32,700 jobs, reflecting the ongoing demand being generated by public- and private-sector construction projects.

Federal Aid Provides Some Support for State Budgets

Federal aid measures enacted in recent weeks will benefit state budgets and economies, although details remain fluid. The Families First Coronavirus Response included a 6.2 percentage point (pp) increase in the Federal Medical Assistance Percentage (FMAP) for Medicaid for every quarter of the national public health emergency. FMAP is the rate at which the federal government reimburses states for Medicaid spending. The state expects to receive an estimated $32 million for each quarter of the national emergency. The ultimate value of the FMAP rate increase will depend primarily on the state's actual Medicaid spending and the extent of the national public health emergency, which has been extended at least into the current quarter ending on Sept. 30.

Under the Coronavirus Aid, Relief and Economic Security (CARES) Act enacted on March 27, the U.S. Treasury department is distributing $150 billion to state and local governments from the Coronavirus Relief Fund (CRF) using a population-based formula. The statute limits the use of the CRF to coronavirus expense reimbursement rather than to offset anticipated state tax revenue losses. Hawaii received $1.25 billion from the CRF, with almost $863 million allocated to the state and over $387 million allocated to the city and county of Honolulu, the state's sole local government with more than 500,000 residents. The state has allocated $175 million to the counties of Hawaii, Kauai, and Maui on a formulaic basis. The Legislature has earmarked much of the remaining CARES Act moneys for programs to supplement rent and mortgage payments for lower-income families, provide food aid, buy additional personal protective equipment and other initiatives. However, actual distribution of these moneys will occur only after the administration learns whether or not congress will provide further federal aid to the states and/or adopt more flexible criteria for CARES Act reimbursements. Fitch notes the ongoing uncertainty surrounding which budget items will ultimately be reimbursable by CARES Act moneys.

The CARES Act also provides for supplemental federal aid for local school districts, passed through state departments of education with the Elementary and Secondary School Emergency Relief Fund (ESSER). The act allocates over $43 million to the state, with a minimum of approximately $39 million designated for local school districts, all to be spent within one year of receipt for a fairly broad set of allowable uses.

The Federal Reserve's $500 billion Municipal Lending Facility (MLF) provides a potential source of short-term liquidity for state and local governments. Under the MLF, the New York Federal Reserve Bank will set up a special-purpose vehicle (SPV) to directly purchase short-term debt issued by states, the District of Columbia, and the largest counties and cities. Given the program's terms, Hawaii could borrow up to $2.1 billion for three years to address the state's own cash flow needs. While the Legislature has authorized borrowing up to that limit, the administration currently plans to borrow $750 million in late 2020 for operating expenses and to give itself time to make necessary budget and service adjustments ahead of the fiscal 2021-2023 biennium. This short-term borrowing would be done as either a public offering or as an MLF loan if there is high market volatility in late 2020.

Coronavirus - Hawaii Liquidity Impacts

Fitch anticipates that Hawaii, consistent with all states, will address short-term liquidity pressure with no interruption in timely payments for key operating expenses, including debt service. Hawaii extended its deadline for filing personal and corporate income tax payments to July 20, slightly exceeding the federal government's extension. State officials advise that the delay in income tax receipts did not create any liquidity issues. The state's extension delayed collection of final income tax payments for the 2019 tax year but importantly did not delay withholding taxes or estimated state income taxes for the 2020 tax year. However, lower personal and corporate income tax collections attributable to the economic downturn will reduce cash flow.

Hawaii has the necessary financial flexibility to meet its altered cash flow demands. During fiscal years 2016 to 2019, the state consistently ended each year with between 184 and 186 days cash on hand. As of June 30, 2020, the state's treasury portfolio had a total market value of approximately $5.9 billion, primarily consisting of 'AAA' rated U.S. treasuries and agency securities, plus bank CDs. The state can inter-fund borrow from its harbors, highways and housing funds. The governor has considerable flexibility to modify the fiscal 2019-2021 biennium budget, as outlined below.

The state made key improvements to financial flexibility in the wake of the Great Recession, increasing budgetary and emergency reserves. The Emergency Budget and Reserve Fund (EBRF) balance rose to almost $404 million in fiscal 2020, from just under $10 million in fiscal 2011. However, due to appropriations for coronavirus-related costs, the current balance in the EBRF is $50 million and the state expects to maintain it at that level for some years.

The state also has around $191 million in its Hawaii Hurricane Relief Fund (HHRF), which functions as an additional working reserve in times of economic stress. The 2020 Legislature provided the governor with the option of using HHRF funds by appropriating $183 million for fiscal 2021 coronavirus-related budget shortfalls. However, the current plan is not to use the HHRF appropriation, subject to future needs.

Coronavirus - Hawaii Budgetary Update

Preliminary general fund tax revenues for fiscal 2020 indicate a decline of slightly over 6% compared to fiscal 2019. The state council on revenues' May 8 forecast projects tax revenues will decrease by a further 12% in fiscal 2021 ($2.3 billion), followed by a 12% rebound in fiscal 2022 and an annual growth rate of 3% for each of fiscal years 2023 to 2026. The projected fiscal 2022 rebound is subject to many variables, particularly related to the return of domestic and international tourism.

The governor has the executive authority to control spending by restricting, delaying or suspending appropriations. Although the governor cannot make supplemental appropriations without the Legislature's approval, he does have sufficient authority to make budget balancing decisions for the rest of the fiscal 2019-2021 biennium. This includes the power to pass emergency actions to achieve necessary labor and non-labor cost savings. The governor has already suspended collective bargaining, although his administration continues to work with the bargaining units on potential labor concessions.

For fiscal 2020, the administration and Legislature reduced expenditures, authorized $341 million in fund transfers and authorized the transfer of $350 million from the EBRF to the general fund. For fiscal 2021, the administration and Legislature eliminated $197 million in supplemental budget requests and proposed legislation, reduced the base budget by $205 million and authorized $40 million in fund transfers. The administration plans to negotiate approximately 10% furloughs from Nov. 1 for most non-sworn state employees to save $190 million in fiscal 2021. If necessary, the governor could implement such furloughs through an emergency declaration. The state made its full legislatively required contributions to the pension system in fiscal 2020 and has budgeted to do so again in fiscal 2021, but prefunding of retiree healthcare benefits will be suspended in fiscal 2021, under the governor's emergency authority, saving $390 million.

For the 2021 legislative session, the administration will undertake a program review to ensure state expenditures are in line with reduced revenue projections for the fiscal 2021-2023 biennium. If implemented as planned, the combination of program review reductions ($520 million annually), suspended OPEB prefunding ($370 million to $382 million annually), and 10% furloughs ($311 million annually) would more than offset repayment of the short-term borrowing or MLF loan ($270 million annually) and unemployment insurance loan interest payments ($35 million to $39 million annually) to ensure positive, albeit declining, general fund ending balances in fiscal years 2022 and 2023. While the Legislature would need to approve the program review reductions through the biennial budgeting process, the governor retains budget control authority and could line item veto budget items he disagrees with, and restrict funding and spending thereafter. In the event the administration's budget balancing initiatives are insufficient, the state could look to reduce its general fund balance further or borrow more from the MLF. Legislative action will be required to appropriate repayments to short-term borrowing or MLF loans. The governor could also implement layoffs.

The Legislature has the ability to increase taxes and authorize debt without voter approval. It can also unilaterally adjust the county transient accommodations tax allocation, which it has done since May. It might need to consider those options for the next biennium, along with refocusing the state's Medicaid program.

The state does not anticipate needing to provide extraordinary support for any of its four counties that would not be reimbursed by federal moneys, since the counties are in good financial position and supported by stable property tax revenues, or for its department of transportation, since the airports, harbors and highways each have sufficient cash to fund operations and are receiving federal funding support. While the Hawaii Health Systems Corporation could require state support, given losses from cancelled elective procedures and unbudgeted coronavirus-related expenses, eligible costs will likely be reimbursable by federal funds.

Updated FAST Analysis for Hawaii

The FAST scenario analysis tool, which relates historical tax revenue volatility to GDP to support the assessment of operating performance under Fitch's criteria, has now been adjusted to reflect GDP parameters consistent with Fitch's global coronavirus forecast assumptions. FAST is not a forecast, but it represents Fitch's estimate of possible revenue behavior in a downturn, based on historical revenue performance. Hence, actual revenue declines will vary from FAST results and Fitch expects the state will implement decisive corrective actions to offset them. FAST does provide a relative sense of the risk exposure of a particular local government entity compared to other local government entities.

The state's unaddressed FAST results under both the coronavirus baseline and downside scenarios indicate pressure on the state's financial resilience in the medium term, absent policy interventions. The state is working to counteract the downward pressure caused by the current sharp economic downturn. Nevertheless, the state's financial flexibility, particularly in the face of ongoing expenditure increases to address pension and OPEB liabilities, could be pressured by reduced revenue growth, expenditure growth that outpaces revenues and/or sustained reductions in reserves. The state's projected $842 million ending general fund balance for fiscal 2020 (10% of projected general fund spending) provides some initial cushion in conjunction with the EBRF and HHRF. However, the state's own financial plan indicates that the general fund balance could be completely drawn down in fiscal 2024.

The state has already identified budgetary savings to offset the majority of the FAST tool's first year revenue contraction and significant portions of projected funding shortfalls in the second and third years. The state has significant policy tools at its disposal, including its high independent revenue-raising capacity and options for further expenditure reductions. Notably, it has considerable flexibility in relation to its personnel budget. The state's response to revenue declines in the Great Recession points to its ability to address significant revenue downturns. The state reduced its general fund spending by approximately 14% during fiscal years 2010 and 2011, largely due to employee furloughs and executive department spending restrictions. Nevertheless, the state's current financial plan relies on significant reserve drawdowns, which suggests that at the end of the recovery period the state's financial resilience could be weakened.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			F
Hawaii, State of (HI) [General Government]	LT IDR	AA+ Rating Outlook Negative	Affirmed	A C N
• Hawaii, State of (HI) /General Obligation - Unlimited Tax/1 LT	LT	AA+ Rating Outlook Negative	Affirmed	A C N

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

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Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Hawaii, State of (HI)	EU Endorsed

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