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DEPT. COMM. NO. 159

December 29, 2016

✓ The Honorable Ronald D. Kouchi
President and Members of the Senate
Twenty-Ninth State Legislature
State Capitol, Room 409
Honolulu, Hawaii 96813

The Honorable Joseph M. Souki
Speaker and Members of the House of Representatives
Twenty-Ninth State Legislature
State Capitol, Room 431
Honolulu, Hawaii 96813

Dear President Kouchi, Speaker Souki and Members of the Legislature:

For your information and consideration, I am transmitting a copy of the State of Hawaii Debt Management Policy (the "Policy") as required by Act 149/SLH 2015 (the "Act"). The Policy was reviewed and approved by Governor David Ige on December 28, 2016 as required by the Act. I am also informing you that the Policy may be viewed electronically on our Investor Relations webpage at: http://investorrelations.hawaii.gov/.

The Policy may also be accessed directly at: https://investorrelations.hawaii.gov/dbf/wp-content/uploads/sites/3/2014/02/Debt-Management-Policy-FINAL-dated-12-13-16-clean.pdf

Sincerely,

Wesley K. Machida

WESLEY K. MACHIDA
Director of Finance

Enclosure

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State of Hawaii
Debt Management Policy

12/13/2016

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DEBT MANAGEMENT POLICY

I. Goals and Objectives

The purpose of this Debt Management Policy (Policy) is to ensure that all debt issuances undertaken by the State of Hawaii (State) are completed in an efficient manner and in accordance with best practices. This Policy reflects the intent of the State to adhere to prudent financial management practices and commit to long-term capital and financial planning. This Policy will enable the State to foster consistency and optimize the use of its limited resources to meet its long-term capital needs.

The Policy establishes clear criteria for decision making with regards to debt issuance and debt management, determining reasonable thresholds and guidelines for issuance of debt, providing justification for the structure of debt, and reflecting constitutional provisions and statutory limitations on debt to a larger audience and stakeholders. The State intends to use debt efficiently to maximize the delivery of capital improvement projects throughout the State within acceptable levels of risk, balancing obtaining the best possible credit ratings, minimizing interest costs and optimizing future flexibility.

II. Scope and Authority

On June 26, 2015, Governor David Y. Ige signed Act 149, SLH 2015, directing the Director of Finance to submit a state debt management policy to the legislature to promote both transparency in budget-making and more informed decisions on capital improvement project and debt issuance authorizations, as recommended by the Government Finance Officers Association. The Department of Budget and Finance (B&F) plans, monitors and manages the issuance of State bonds. With respect to this Policy, the term "Departments" includes the Department of Budget and Finance and any Department which issues or may issue debt. The Policy will be applicable to all of the Departments' financing programs including Departments that do not currently have any debt outstanding but may issue bonds in the future. The guidelines and parameters on issuance of debt will be applicable to all debt obligations and financings of the State, barring specific exceptions identified in the Policy. Due to the unique nature of each of the Departments' financing programs, certain specific provisions of the Policy may not be applicable to each financing program; adherence to this Policy is required in applicable circumstances.

III. Administration of Debt Policy

Management responsibility for this Policy is delegated to the Director of Finance. The Director of Finance will have responsibility and authority for structuring, implementing, and managing all financing programs and for ensuring compliance with this Policy. The issuance of all debt issued by Departments of the State should be coordinated with and overseen by the Director of Finance and the Department of Budget and Finance.

IV. Debt Limits

All debt is to be issued pursuant to the provisions, restrictions and limitations of the Hawaii Constitution (Haw. Const.), Hawaii Revised Statutes (HRS), bond authorizations enacted by the legislature, other authorizing legal documents such as Bond Certificates and Bond Resolutions, and federal requirements.

A. Purpose of Debt

Debt may be issued for public purposes of respective Departments as authorized by law. The proceeds from a debt issuance will only be applied to the long-term purpose or project for which the issuance was approved, unless otherwise allowed by statute (HRS §39-2). The general purposes for which debt may be issued include, but are not limited to:

1. Capital projects including reconstruction and improvements
2. Refunding of outstanding debt
3. Cash management or interim financing (to the extent permitted by federal tax law)
4. Litigation settlements
5. Unfunded pension or healthcare long-term liabilities
6. Establishment and administration of any loan program as authorized by law
7. Land acquisition
8. Acquisition or purchase of physical assets or equipment
9. Significant capital maintenance that extends the useful life of the underlying asset
10. Works of art special fund
11. Information technology or software
12. Special purposes to finance facilities for schools and universities, child care, housing, health care, utilities, agriculture among other authorized purposes listed in HRS §39A
13. Coverage of policies of hurricane property insurance

Long-term debt may not be used to fund current operations and maintenance expenditures except as explicitly permitted within the HRS.

Departments must strive to only issue the amount of long-term debt necessary to fund the project or purpose for which the issuance was approved and any associated financing costs. Debt proceeds should be secured as close to the date of expenditure as possible, unless there are practical reasons to issue sooner, in which cases such reasons should be documented in the letter of intent to issue State debt (see **Section VI. A**).

To the extent debt proceeds remain unspent after the completion of a project, the issuing Department should develop a plan to expend those proceeds on other approved projects, to pay or defease existing debt obligations, or for any other lawful purpose in a timely manner.

B. State Financing Programs

Pursuant to HRS §26-8, the Department of Budget and Finance manages all State financing programs. The following section highlights the various authorized financing programs available to the Departments, many of which consist of active programs under which debt has been issued and is currently outstanding.

1. General Obligation Bonds

The Director of Finance, with the approval of the Governor, may issue general obligation (GO) bonds (HRS §39 Part I). All GO bonds are secured by the full faith and credit of the State, and the State must take action to ensure that sufficient revenues will be raised and provided from time to time for the purpose of payment of principal and interest on GO bonds. Interest and principal payments of the bonds will have first charge on the general fund of the State. Primary sources of general fund revenue, which may be applied towards GO debt service, include but are not limited to the State excise and income taxes.

Reimbursable GO Bonds: Reimbursable GO bonds may be issued on behalf of any Department subject to reimbursement of debt service payments from the beneficiary Department. By law, the Department is required to reimburse the general fund from revenues or user taxes, or both, derived from the public undertaking of the Department or improvements that were financed by reimbursable GO bonds.

2. Revenue Bonds

Departments are authorized to issue revenue bonds payable solely from the revenues, or user taxes, or any combination of both, of a public undertaking, improvement, system or loan program (HRS §39 Part III). Revenues include rates, rentals, fees, and charges prescribed for the use and services of, and the facilities and commodities furnished by, an undertaking. Departments may issue revenue bonds that are additionally backed by user taxes; however, such a pledge and the authority to levy user taxes must be authorized by the legislature (HRS §39-53). Revenue bonds *are not* secured by the full faith and credit of the State. Authorization of revenue bonds may be obtained either by filing a resolution with the governing body of the Department or by a certificate of the Department Head filed with the Director of Finance (HRS §39-54). Pursuant to HRS §39-68, the Director of Finance, when requested by the Department, will assist in the preparation and sale of revenue bonds. The following list represents the Departments' existing major revenue bond financing programs.

- **Airport System Revenue Bonds:** Department of Transportation, Airports Division (DOT-A) may issue airport system revenue bonds secured by net available revenue. Net available revenue represents generally, total operating revenues less total operating expenses excluding depreciation.

- **Harbor System Revenue Bonds:** Department of Transportation, Harbors Division (DOT-HA) has the authority to issue revenue bonds pledged by total operating and non-operating revenues (including but not limited to rates and charges assessed in relation with the services provided) deposited into the Harbor Special Fund after payment of any operating costs (excluding depreciation).

- **Highway Revenue Bonds:** Department of Transportation, Highways Division (DOT-HI) has the authority to issue revenue bonds secured by gross revenues in the Highway Revenue Special Fund, including but not limited to highway fuel license taxes, vehicle registration fees, vehicle weight taxes, and various vehicle surcharge taxes.

- **Department of Hawaiian Home Lands (DHHL) Revenue Bonds:** DHHL is authorized to issue revenue bonds secured by revenues generated from Program Lands including but not limited to rent and other fees derived from operation of the Program Lands.

- **Single Family Mortgage Purchase Revenue Bonds:** Hawaii Housing Finance and Development Corporation (HHFDC) is authorized to issue such revenue bonds payable from mortgage-backed pass-through securities backed by loans made to eligible borrowers on single family residences in the State.

- **Hawaii Rental Housing System Revenue Bonds:** HHDFC may issue revenue bonds pledged by revenues (net of operating expenses) from income, rent, fees and changes derived from operating the rental housing program.

- **Multifamily Housing Revenue Bonds:** HHFDC is authorized to issue revenue bonds on behalf of developers of multifamily housing projects, secured by loan payments from said developers under the loan agreement. Bonds issued under this financing program are excluded from any limitations on State debt established in this Policy. *The authorization and issuance of these bonds is governed solely by State statutes including HRS §201H.*

- **University of Hawaii Revenue Bonds:** The Board of Regents, the governing body of the University of Hawaii (UH), is authorized to issue revenue bonds, including interim financing, commercial paper and notes for University projects subject to majority vote of the board (HRS §304A Part VI). These bonds are secured by a pledge of university system revenues including rents, fees and charges such as tuition, room rentals and bookstore and parking revenues net of any operating expenses.

3. Financing Agreements

Any Department or Agency, with the approval of the Director of Finance, may enter into financing agreements including lease purchase agreement, installment sale agreement, certificate of participation, loan agreement and line of credit (HRS §37D). Given the nature of these obligations, such agreements also require additional authorization of the Attorney General. The University of Hawaii may enter into a financing agreement without the approval of the Director of Finance and of the Attorney General if the amount of the financing agreement is less than $3 million (HRS §37D-2). The statute also permits related agreements such as credit enhancement agreements. Obligations under the financing agreements or other related agreements are payable solely from appropriations or funds set aside in trusts that are set up for the specific purposes. They *are not* secured by the full faith and credit of the State and have no lien on revenues of any Department (HRS §37D-1). The following list represents the Departments' existing major financing agreement programs:

Lease Purchase Agreements:

- **DOT-Highways:** Under this financing program, the annual obligation is payable from funds appropriated for DOT-H.
- **DOT-Airports:** Under this financing program, the annual obligation is payable from funds appropriated for DOT-A.

Certificates of Participation (COP):

- **B&F COP:** Certificates issued by B&F are payable from any lawfully available funds of the State including the general fund.
- **Airport COP:** Certificates issued by DOT-A under this financing program are payable solely by lease rental payments and aviation fuel tax.
- **DHHL COP:** Certificates issued by DHHL are payable from funds appropriated for DHHL for such repayment.

Special Facility Revenue Bonds: These bonds are secured solely from the facility rental payments received under the special facility lease agreement.

- **Airport Special Facility Revenue Bonds:** Bonds issued by DOT-A under this financing program are payable from rental revenues collected from airlines or other related parties derived by the DOT-A.
- **Customer Facility Charge Revenues Bonds:** Bonds issued by DOT-A under this program would be payable from charges imposed on customers that rent automobiles from rental car companies located at the Airports and other revenues related to the rental car facilities.

Capital Lease and Equipment Lease: Any Department may enter into a capital lease agreement for office space or an equipment lease agreement, as needed, and as economically feasible.

Loan Agreements: Any Department may also enter into loan agreements which may be structured to leverage specific revenue streams.

4. Special Purpose Revenue Bonds

Special purpose entities may issue special purpose revenue bonds to finance facilities for schools and universities, child care, housing, health care, utilities, agriculture among other authorized purposes listed in the statutes (HRS §39A). In such cases, the Department serves as a conduit issuer and the bonds are payable solely from rental or other payments pledged in the contract. *The authorization and issuance of these bonds is governed solely by State statutes and is excluded from any limitations on State debt established in this Policy*.

C. Legal/Statutory Limits

General Obligation Bonds

Issuance of GO bonds is limited by the State Constitution. The maximum annual debt service on all general obligation debt, net of certain exceptions identified in the Constitution (Haw. Const. art. VII § 13), must be less than or equal to 18.5% of average general fund revenues over the past three fiscal years. Exceptions include bonds that mature in the current fiscal year, debt that has been defeased, revenue bonds, special purpose revenue bonds, reimbursable GO bonds, and other exceptions identified in the Constitution. The Director of Finance must ascertain the fulfillment of this criteria annually as well as after each issuance of new GO debt. This statement of debt limit may be found on the State's website (http://budget.hawaii.gov/finance/debt-management/debtlimit/). Additional GO debt can *only* be issued if this criteria is satisfied.

Other Obligations

The issuance of other obligations not statutorily limited are governed by limits and provisions in authorizing legal documents such as bond indentures, resolutions, and certificates. Any new debt issued under an existing indenture should adhere to all constraints in the legal documents and comply with any tests identified in the indenture such as additional bonds tests and rate covenants. Any new financing program should be designed to adhere to credit rating objectives, long-term capital planning, and financial goals among other factors unique to the program. Some of the financing programs and corresponding authorizing certificates which contain specific covenants and limitations are listed below. Any new financing program undertaken by a Department will be governed by its authorizing legal documents.

- **Airport System Revenue Bonds and COPs:** Certificate of the Director of Transportation dated May 1, 1969
- **Harbor System Revenue Bonds:** Bond Certificate of the Director of Transportation dated March 1, 1997
- **Highway Revenue Bonds:** Master Certificate of the Director of Transportation dated August 1, 1993
- **University Revenue Bonds:** Original Resolution adopted by the Board of Regents on November 16, 2001
- **Single Family Mortgage Purchase Revenue Bonds:** Resolution adopted by the Board prior to each issuance
- **Housing Rental Housing System Revenue Bonds:** Resolution adopted by the Board on September 16, 2004
- **DHHL Revenue Bonds:** Master Bond Indenture dated March 1, 2009
- **Green Energy Market Securitization Bonds:** Certificate of the Director of the Department of Business, Economic Development, and Tourism (Department that currently houses the Green Infrastructure Financing Program) dated November 13, 2014

Private Activity Bond (PAB) Allocation

The ability to issue private activity bonds is limited by a federal ceiling defined each calendar year. Every PAB must be issued within the total PAB volume limitation. B&F administers the allocation of the State's federal authorization among the various political subdivisions in accordance with HRS §39B. B&F, with the approval of the Governor, may assign all or any part of the allocation of the State to any issuer or any county for a specific calendar year or years. At the request of B&F, any issuer or county to which any part of the State's allocation has been assigned will return all or part of the assignment, in which case B&F may provide for its reassignment. Also, PABs are required to undergo an additional step of Tax Equity and Fiscal Responsibility Act (TEFRA) approval before such bonds can be issued.

TEFRA Hearing: Federal law requires that a public TEFRA hearing be held at least 14 days after the giving of published notice apprising the public of a proposed PAB and the nature and the location of the project. Following such public hearing, both the issuer and an appropriate elected official or legislative body with jurisdiction over the project must approve the PAB.

D. Financial Limits

In addition to legal limitations, financial and credit limitations must also be considered, such as target coverage levels and credit ratings goals, before issuing new debt. In conjunction with this Policy, B&F will undertake a Debt Affordability Study (Study) every two years in order to optimize the use of limited debt capacity while meeting public spending goals and to ensure the prudent use of debt and to preserve sufficient future debt capacity. The Study analyzes the Departments' debt profiles and presents relevant financial metrics to assess debt affordability. Before the issuance of any new debt, the analysis and recommendations of the most recent Study should be considered. In particular, the financial and credit impact of new debt must be evaluated. Departments will not issue debt that they cannot repay or that causes Departments to incur undue financial risk.

V. Debt Structuring

A. Types of Debt

1. Tax Status

Departments, in conjunction with bond counsel, will structure any bonds to have the most advantageous tax status given the nature of the project or facility being funded and the extent to which such bond proceeds are used for private activity. Fully tax-exempt bonds are the more economical option but come with the most restrictions. When flexibility is warranted, Departments may utilize less restrictive taxable bonds after careful consideration of the tradeoffs.

Tax-Exempt Bonds: The interest on tax-exempt bonds is excluded from gross income for federal income tax purposes. Departments will conservatively strive to maximize the amount of debt sold under this Policy using tax-exempt financing, taking into account tax considerations and the potential users and beneficiaries of the projects funded from bond proceeds. Departments will not use the "bad money" allocation for tax-exempt bonds to fund projects that are not otherwise eligible for tax-exempt financing.

Taxable Bonds: Taxable debt is issued when the facilities being financed are considered to have excessive "private business use" and do not qualify as an "exempt facility" under the Tax Code (Internal Revenue Code of 1986, as amended). The interest on these bonds is subject to federal income tax. Departments will issue taxable bonds when necessary to finance projects that are not eligible to be funded by tax-exempt debt.

AMT Bonds: These bonds are tax-exempt bonds whose interest is subject to an alternate minimum tax (AMT). Departments will utilize AMT Bonds to finance "exempt facilities" that are considered to have excessive "private business use" such as airport facilities or port facilities.

2. Fixed Rate or Variable Rate Bonds

Fixed Rate Bonds: Fixed rate bonds constitute bonds that have a fixed rate of interest until the stated maturity date. In view of cashflow predictability, fixed rate bonds will be the primary type of bonds issued by Departments.

Variable Rate Bonds: Variable rate bonds bear a variable interest rate which resets periodically based on a predetermined index or formula. Variable rate bonds can provide a lower borrowing cost over the long term than fixed rate bonds and can provide financial flexibility, but bear additional risks. In determining the use of variable rate debt, the following factors should be considered: interest rate risk, liquidity risk, remarketing risk, and tax risk. Any Department issuing variable rate debt should evaluate the impact of rising or considerably higher rates to verify the Department's ability to pay debt service on all outstanding obligations. Departments will limit the amount of variable rate debt to no more than 20% of all outstanding debt for each financing program.

3. Short-Term Debt

Departments may issue short-term debt (any debt with a final maturity of five years or less) including revolving loans, lines of credit, commercial paper, and bond anticipation notes, for the following purposes:

1. To fund projects during their initial phase when they are not generating any revenues, so as to minimize capitalized interest and reduce overall cost of borrowing for the project
2. To fund interim cash flow needs

Commercial Paper (CP): These are short-term obligations typically backed by a line of credit with a bank and have a maturity of up to 270 days. CP can be issued incrementally as funds are needed and then refunded with a bond once projects are completed to take advantage of lower short-term rates during the construction period.

Revolving Loans or Lines of Credit (HRS §37D-9): These agreements allow a borrower to withdraw, repay, and redraw funds from such a facility in any manner, up to the maximum amount agreed, and any number of times, until the agreement expires. Like CP, these agreements are effective interim financing tools.

Bond Anticipation Notes (BANs): BANs are usually used for capital projects and are repaid from the proceeds of long-term bonds issued at a later date. Departments may issue BANs with a maximum maturity of five years and maximum principal amount as authorized for the bonds that are expected to be issued (HRS §39-15 and §39-70).

4. Refunding Bonds

Departments may issue refunding bonds to prepay outstanding debt under any indenture for either debt service savings or restructuring. More specific refunding criteria is detailed in **Section VI Debt Issuance** (Subsection E on Refunding). B&F is also permitted to issue GO bonds to refund revenue bonds; however, such GO debt will be classified as reimbursable GO debt, payable from the same revenues that are pledged for the bonds being refunded.

5. Lien Levels (Senior, Subordinate)

Departments may issue revenue bonds with multiple liens on pledged revenues, but should primarily issue any long-term debt on the lowest cost senior lien. Different lien levels provide flexibility to issue necessary debt when constrained by capacity, cost, or credit considerations. Debt issued at a lower lien level often carries credit ratings below those of the senior most lien, and as such are issued and typically trade at higher yields. Departments should only use subordinated liens for certain types of obligations including unique transactions, back-up or secondary pledges of revenue, interim financings or commercial paper, or certain third-party obligations. There may also be unique circumstances in which a Department will want to "close off" its senior lien due to unfavorable provisions in the indenture, and make the subordinate lien the main working lien. In each case that subordinated liens are utilized, the Department should carefully weigh the costs and benefits to such an approach.

Senior Lien Debt: Debt that has the senior most claim on pledged revenues compared to any other outstanding debt. The seniority in the repayment structure results in the most favorable borrowing cost for these bonds.

Subordinate Lien Debt: Any debt that is junior in priority to senior debt is considered subordinate debt. In instances where issuance of senior lien debt is limited due to capacity or credit constraints, subordinate debt may be warranted. Such debt may also be used to incorporate certain structures or terms that cannot be accommodated under the senior lien.

6. Lease Revenue Obligations/Certificates of Participation

B&F will strive to maximize issuance of General Fund debt under the lowest cost program (GO). Departments may consider lease revenue obligations or certificates of participation (COP) if the type of asset or equipment being financed is not eligible to be paid from other sources. Departments may also choose to employ a COP structure if it wishes to fund debt service from available revenues rather than creating a direct lien on taxes or new revenues; existing available revenues must be sufficient to pay COP debt service.

7. Government Sponsored Financing Programs

Departments may elect to participate in federal and State programs intended to assist borrowing entities in financing capital projects at lower borrowing costs.

B. Debt Structure Elements

While this section provides several guidelines on various structuring elements, Departments may consider the following factors while analyzing tradeoffs to determine the optimal structure for each financing:

- Project requirements
- Nature of pledged revenues
- Cost effectiveness
- Impact on flexibility
- Market acceptance
- Statutory requirements

1. Term

The term of any debt should not exceed the lesser of the expected useful life of the project financed and the statutorily prescribed limit, if applicable. Issuing debt beyond the useful life of the project financed may result in negative tax consequences. For programs relating to financing loans, the term of any debt should not exceed the underlying loan term or loan amortization. The State's statutes provide guidelines on maximum allowable maturity for debt issued under the following financing programs.

General obligation bonds may have a maximum maturity of 25 years, while reimbursable GO bonds, which in effect are being repaid from revenues, are allowed a longer term of 35 years (Haw. Const. art. VII § 13). Revenue bonds, except for HHFDC revenue bonds, may be structured to have a term of up to 30 years (HRS §39-54 (b)). In accordance with this Policy, HHFDC may issue revenue bonds with a final maturity up to 40 years[1]. COPs are permitted a term that is the lessor of the useful life of the project or 30 years (HRS §37D-3).

2. Debt Service Structure/Amortization

General Obligation Bonds: By State Constitution, amortization of all long-term GO bonds must be structured with either annual level principal payments or annual level debt service payments. Principal repayment may be deferred to align with delayed project revenues or tax receipts or any other financial planning goals, but the first principal payment must be no later than five years from the date of issuance (Haw. Const. art. VII § 13).

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[1] Per HRS §201H-71, HHFDC is legally permitted to issue revenue bonds with a final maturity up to 60 years. This Policy sets a lower limit of 40 years for HHFDC revenue bonds.

Other Obligations: For other obligations, Departments should also strive for an approximately level debt service structure. If more than one series of bonds is being issued to fund a given project or set of projects, then each individual series may be structured with non-level debt service such that in aggregate the debt service on all series is approximately level. For revenue bonds, given the significance of debt service coverage levels, a proportional debt service structure may also be employed either at the series level or for the aggregate portfolio. Balloon maturities or back-loaded amortization structures are not advised and their use should be restricted to special situations with approval from the Department Head or the governing body and the Director of Finance. The approval request must be accompanied with a memo highlighting the need or benefit for the alternative amortization structure.

3. Coupon Structure

Bonds may be sold at such prices including par, a premium, or a discount. When evaluating the coupon structure for a bond issuance, Departments should factor in investor preference, the yield-to-call, yield-to-maturity and the potential to refund the bonds for debt service savings in the future. Bonds sold with original issuance premium or original issuance discount are permitted.

Original Issuance Premium (OIP): The premium over the par value of the bonds at the time of issuance arising from the difference between the issue price which is higher than the stated or redemption price.

Original Issuance Discount (OID): The discount from the par value of the bonds at the time of issuance arising from the difference between the issue price which is lower than the stated or redemption price.

4. Capitalized Interest

Capitalizing interest during the construction phase, before the project is in use, is allowed. Given the increased cost associated with capitalized interest, Departments will seek to minimize the use of capitalized interest. The period for which such interest may be capitalized may not extend for more than six months after project completion.

5. Payment of Interest

Current Interest Bonds (CIBs): All GO bonds, by law, must be structured as current interest bonds or serial bonds with interest payable at least once a year.

Capital Appreciation Bonds (CABs): CABs are instruments that allow issuers to defer interest payments, to address cash flow insufficiencies. Departments may structure certain maturities of revenue bonds as CABs, however, due to the high cost of borrowing, their use should be limited to special circumstances to fit broader structuring constraints related to sizing or pricing. By statute, only 10% of an issue may be structured as CABs and any use of CABs must be approved by the Governor and Director of Finance (HRS §39-54).

6. Debt Service Reserve Funds

Departments may create debt service reserve funds for revenue bonds or other obligations which benefit from a liquidity source enhancing the credit quality and making the bonds more marketable. Such reserves may be funded from cash on hand, bond proceeds or surety policies to the extent authorized by federal and State law. The use of a surety policy will be evaluated on a case by case basis. The reserves should be funded at reasonable levels or as defined in the indentures or certificate governing the issuance. Departments will also monitor compliance with other legal covenants in authorizing documents such as maintenance of adequate reserve levels for bonds that have such requirements. If drawn upon, reserves will be sufficiently replenished within permitted timelines.

7. Optional Redemption

All long-term debt with a term of ten years or longer must have an early redemption option and every effort must be made to avoid features that limit potential refunding opportunities in the future. Departments should structure the call date, and also call premiums, if desired, to maximize flexibility while taking into account prevailing market conditions, cost of the call option, and recommendations from the financial advisor and underwriter. The optional redemption date should be no later than ten years from issuance. Departments will avoid the sale of long-term non-callable bonds unless they have a final maturity date of ten years or less from the date of issuance, or if the price of such a call option is cost prohibitive. Taxable debt may be sold without an optional redemption feature or with a “make-whole” call feature subject to market demand.

8. Credit Enhancement

Bond Insurance: Departments may purchase bond insurance if it is prudent and advantageous to do so. Bond insurance will only be purchased by Departments if it is economically advantageous: the insurance premium is less than the present value of the debt service savings. Bond insurance may be purchased for the entire amount of an issue or for specific maturities based on a recommendation from the financial advisor or senior underwriter. For competitive sales, bond insurance may be purchased at the underwriter’s option and expense (bidder’s option).

Credit Facilities: Credit facilities such as letter of credit, line of credit, bond purchase agreements or other liquidity facilities will be considered based on need and cost-effectiveness. Departments will solicit bids from qualified financial institutions and select based on price, credit quality, financial stability, financial exposure, and terms and conditions. Qualified credit facility providers should have the following characteristics:

- Long-term ratings in the highest three rating categories from two nationally recognized credit rating agencies at the time of issuance, and
- Short-term ratings from at least two rating agencies, of at least “P-1”, “A-1” or “F1” at the time of issuance.

9. Negative Arbitrage

Investment of bond proceeds at rates lower than the bond yield result in negative arbitrage. When possible, Departments will seek to minimize negative arbitrage.

C. Use of Derivatives

The use of any kind of derivative instrument such as interest rate agreements or swaps is *not* permitted.

VI. Debt Issuance

A. Procedure

Pursuant to Administrative Directive No. 00-01 or as may be updated, Departments planning to issue State debt (bonds, leases, COPs, or financing agreements) must submit a letter of intent not less than ninety calendar days prior to the issuance. The letter must include the plan of finance and the plan of organization for the sale. The Department must provide a detailed rationale for the timing of the issuance of State debt. A detailed schedule of the expenditure of proceeds that complies with the Tax Code must be included. The Department must also submit the status of environmental and other project approvals for the projects to be funded with debt. In addition, within the letter, the issuing Department must confirm that all financial information required for the bond sale has been prepared as of the date of the letter of intent.

B. Professional Services

Departments may employ professional service providers in various capacities to execute a financing or provide ongoing advisory or monitoring services. Professional service providers will be selected pursuant to a competitive selection process pursuant to HRS §103D or as may be updated. Professional service providers listed in this **section B. Professional Services** and used for debt issuance are subject to the approval of the Director of Finance (HRS §39-5 and §39-55).

1. Underwriters

For negotiated sales, Departments may engage a team of underwriters to serve as senior manager, co-senior manager and/or co-manager. B&F, by an annual competitive selection process, maintains a pool of underwriters with desirable characteristics as to size, experience, geographic coverage, innovative financing ideas, experience of designated personnel, underwriting fee estimates, past performance, and additional criteria. Departments may choose one or more firm(s) from the pool for any financing. Any bank and/or authorized organization or group chosen to serve as an underwriter cannot serve as the financial advisor on the same deal. The selected underwriter(s) must share interest rates and takedown information prior to the sale date. The proposed takedown should be matched against comparable issues in the market with input from the financial advisor to determine the fairness of the proposed takedowns. Departments will strive for the lowest takedowns possible given the required services and outcomes needed for a financing. Selling groups, so long as they are located within the State, may also be employed to reach a larger retail base.

Syndicate: A group of underwriters organized for the purposes of sharing the risks of underwriting the issue, obtaining sufficient capital to purchase an issue, and broadening the distribution channels of the issue to the investing public. One of the underwriting firms will be designated as the syndicate senior manager or lead manager or book-running manager to administer the operations of the syndicate. There can also be appointed a co-senior manager, if required. It will be the role of the senior manager to (1) administer the allocation of State debt to the syndicate and the selling group as per the terms of the purchase contract (2) ensure compliance with MSRB (Municipal Securities Rulemaking Board) rules regarding priorities and allocations, and (3) provide a detailed report of the orders and allocations to the Departments.

Selling Group: A group of municipal securities dealers that assist with the broader distribution of bonds. Selling group members are able to participate in the initial distribution at a concession or dealer's allowance but do not participate in residual syndicate profits nor share any liability for any unsold balance. Firms participating in the selling group shall be domiciled or have a significant presence in the State.

2. Financial Advisors

Departments will select a financial advisor or pricing advisor that seeks to obtain the most favorable bond issuance outcome to the State and to assist in the issuance of all State debt and to assist in the ongoing management of the State's debt. The financial advisor may assist in structuring the issuance, analyzing financings and alternatives, negotiating terms and pricing, reviewing documents, and evaluating financial matters. B&F must also employ an Independent Registered Municipal Advisor (IRMA), as defined by the Securities and Exchange Commission (SEC) that can act in a fiduciary capacity on behalf of the State. Any firm hired in an advisory capacity should be registered with MSRB and should abstain from bidding on or underwriting the issuance on which they are advising.

3. Bond Counsel and Disclosure Counsel

All bonds issued by the State must be accompanied with a written legal opinion from bond counsel affirming (1) the Department is authorized to issue debt and has met all constitutional and statutory requirements necessary for issuance and (2) a determination regarding the income tax status of the debt.

A disclosure counsel should also be engaged to draft the preliminary official statement or other offering documents and ensure compliance with initial and continuing disclosure rules, regulations, and guidelines. The bonds must also be accompanied by written legal opinion from disclosure counsel affirming no material misstatements or omissions in any of the offering documents and/or exemption of registration requirements under the federal securities law. The same legal firm may serve in both capacities and the competitive selection process may be used for appointment to one or either role.

4. Trustee and Fiscal Agents

Departments may require a bond trustee, fiscal agent, and/or paying agent depending on the transaction. Departments may hire service providers in these capacities as needed (HRS §39-13).

5. Arbitrage Rebate Service Providers

Departments will maintain a system of record keeping and reporting to meet the arbitrage rebate compliance requirements of the Tax Code. Departments may contract an arbitrage rebate service provider to ensure compliance with the arbitrage rules on all outstanding debt. The arbitrage rebate service provider will calculate the accrued rebate liability and payments due to Internal Revenue Service and help with the filing of rebate forms and reimbursement requirements (if applicable). The expertise of such a service provider can and should be leveraged to provide advice on strategies to reduce arbitrage rebate liabilities.

6. Other Professional Services

Departments may retain such other professional services providers, including without limitation verification agents, escrow agents, and bondholder identification and notification services, as may be necessary or appropriate in connection with the issuance or ongoing maintenance of bonds.

C. Method of Sale

Departments will select the method of sale on a case-by-case basis, taking into account the most advantageous debt service cost and flexibility necessary or desirable in connection with the structuring, timing, and terms of the debt issuance. The Director of Finance determines the method of sale (HRS §39-5). The three primary methods of sale are competitive, negotiated, and private placement.

1. Competitive Sale

In a competitive sale, underwriters are requested to submit a bid which is a firm offer for purchase of bonds. A contract is awarded to the bidder with the lowest interest cost which is calculated based on one of the following three methods (HRS §39-5 (c)):

1. The dollar difference between the total interest payable on the bonds and any premium earned on the sale of bonds
2. The true interest cost (TIC) on the bonds (the rate necessary to discount the amounts payable on the respective principal and interest payment dates to the purchase price received for the bonds)
3. The opinion of the Department Head of governing body, in case of variable rate bonds

The most common method of award is the TIC on the bonds. The notice of sale containing terms and conditions of the competitive sale will be given at least once and at least five days prior to the date of the sale in the State and in a financial newspaper or newspapers published in any of the cities of New York, Chicago, or San Francisco. Conditions that are conducive for a competitive sale are:

- The bond market is stable and demand for municipal bonds is strong
- The credit rating is at least in the ‘A’ category
- The issuer is a regular borrower and the credit is well known to the market
- The bond structure is standard not requiring explanation or special marketing effort (traditional long-term fixed-rate bonds, no unusual call provisions or terms)
- Market timing is not critical to the pricing of the bonds

2. Negotiated Sale

In a negotiated sale, the bonds are sold directly to an underwriter or an underwriting syndicate preselected before the sale date. The underwriter(s) will be chosen through a competitive selection process and the underwriter’s fees are negotiated prior to the sale. Conditions that are conducive for a negotiated sale are:

- The bond market is volatile and demand for municipal bonds is weak
- The credit rating is below ‘A’ category
- The credit or bond structure requires explanation and active marketing effort
- The bonds are variable rate bonds
- The issue size is substantially large
- The bonds are targeted towards retail investors or other specific investors
- Market timing is critical to the pricing of the bonds
- The sale of the bonds must be coordinated with other related transactions
- The impetus for the transaction has been the result of significant innovation and efforts provided by one or more underwriter

3. Private Placement

In a private placement, debt is placed directly with a buyer, typically a commercial bank. Since terms are directly negotiated between the bank and issuer, extensive offering documents are not required, reducing the cost of issuance. Conditions that are conducive to a private placement are:

- The terms of a loan, including borrowing cost, are more advantageous than the capital markets
- The credit is weak or a rating cannot be obtained
- The desired structure is not available in the capital markets
- The bond proceeds are needed on short notice

D. Pricing

Process

Pursuant to HRS §26-8, B&F will participate in all pricings of State debt.

This section describes the general pricing process for a negotiated sale. Market conditions and nuances related to a specific issuance may require alternative steps/deviations from the process described. In the weeks leading up to the sale date for an issuance, interest rate scales are solicited from the underwriters to help determine a pricing strategy and an initial offering scale for the day of the sale. B&F and the issuing Department along with the financial advisor should review the detailed marketing plan and pricing strategy from the underwriters. Prior to the sale date or on the date of sale, a retail order period may be held to solicit smaller orders from individual investors. Orders submitted by retail investors from the State of Hawaii should be given preference when allotting bonds from the sale, followed by national retail investors. If it is determined that a separate retail order period will be held, Departments should make all efforts to ensure that the retail order period is scheduled to occur during business hours in Hawaiian Standard Time.

On the day of the sale, an interest rate scale is made known to potential investors through a pricing wire. An order period is conducted and may last several hours. During the order period, orders are placed by investors through the senior manager, the co-managers and selling group, if applicable. B&F, the issuing Department, and the financial advisor should have viewing access to the order book during the order period. After the order period closes, the senior manager, B&F, the issuing Department, and the financial advisor review the book of orders. Based on the amount and distribution of orders, the senior manager, B&F, the issuing Department, and the financial advisor determine whether any adjustments to the pricing of the bonds are necessary. After the bonds are repriced, the underwriters may accept the pricing adjustments or may check to see whether additional orders can be obtained and/or whether initial orders are withdrawn. Several iterations of this process may take place. When the senior manager (on behalf of the entire underwriting group), B&F and the issuing Department agree on a price, a verbal award is made. As B&F and the issuing Department engage in pricing discussions and structuring decisions prior to the sale, in addition to the interest rate scale, evaluation factors may include couponing structure, amortization structure, yield-to-call and yield-to-maturity analysis, and optional redemption features.

Underwriter Responsibilities

In a negotiated sale, the underwriter must provide:

- A marketing plan including potential target investors, pre-marketing activities, structural recommendations, a recommendation as to the use of retention, designation rules and proposed liabilities.
- A pre-pricing book including, but not limited to, the following information: a discussion of market conditions; the Department's past transactions, comparable issues in the market; and a pre-pricing scale.
- A final pricing book including, but not limited to, the following information: a discussion of market conditions leading up to and during the pricing; the final pricing wire; comparable issues in the market; orders and allotments; management fees and liabilities; bond distribution by firm; takedown and designation dollars by firm; member allotments and retention; and designations on net designated orders.

Financial Advisor Responsibilities

A financial advisor or pricing advisor should be utilized for negotiated transactions and should be present during all negotiations and calls with the underwriters. For every transaction, the financial advisor must provide:

- An independent pricing scale based on market conditions, the Department's past transactions, the yields in secondary market, as well as recent comparable transactions before the sale.
- A post-pricing memorandum evaluating and memorializing the pricing process and results after the sale to serve as reference for future transactions.

E. Refunding

Departments will monitor the debt portfolio for refunding opportunities at least annually. Departments may issue refunding bonds in order to:

- Achieve debt service savings
- Restructure debt service

- Modify indenture provisions which may include limitations on sources of payment or have other binding covenants
- Convert between variable rate and fixed rate structures or between tax-exempt and taxable status
- Restructure or refinance bonds that are in a state of distress due to market conditions, credit issues, issues with bond insurers or credit facility providers, or for other reasons that may eliminate or reduce risk

Departments may effect a current refunding or advance refunding as long as tax law permits. The term of the refunding bonds should not exceed the remaining term of the refunded bonds. In addition to debt service savings, the Department will consider the opportunity cost of refunding the bonds, the potential loss of call option flexibility, and the potential of refunding the bonds for greater savings in the future when evaluating refunding opportunities.

1. Refunding Criteria to Achieve Debt Service Savings

The refunding criteria below shall apply to refunding bonds issued for the purpose of achieving debt service savings.

Criteria for Selecting Refunding Candidates

- Each individual bond maturity must generate present value savings of at least 3% of refunded par. In addition, for advance refundings, each maturity must generate an escrow efficiency of 50% or more. Escrow efficiency is the net present value savings divided by the net present value savings of a perfect escrow (the sum of the net present value savings and negative arbitrage).
- In some cases individual maturities that produce savings below the thresholds above, but that are still positive on a net present value basis, may be included if they mature within 5 years of the call date, or represent the only remaining maturities of the bond issue being refunded. The resulting refunding in aggregate must meet or exceed the thresholds below.
- Individual maturities that do not meet the thresholds above may also be selected if their inclusion produces the desired debt service structure or savings pattern when combined with other maturities that produce substantial savings. However, such maturities may only be included, if the resulting refunding in aggregate meets or exceeds the thresholds described below.

Thresholds for Current Refunding

A current refunding should produce a total net present value savings of at least 3% of total refunded par.

Thresholds for Advance Refunding

An advance refunding should produce a total net present value savings of at least 5% of total refunded par. Additionally, the escrow efficiency should be greater than 50% to be eligible for an advance refunding (the negative arbitrage cannot be greater than the present value savings).

2. Restructuring Criteria

Departments may issue refunding bonds for the purpose of restructuring debt service to smooth out aggregate annual debt service or to achieve a more favorable matching of revenues pledged to meet debt service payments. Restructurings which significantly back-load debt service causing dissavings in certain years or restructurings which extend debt service beyond the original final maturity of the refunded bonds are not permitted unless there is a compelling public policy objective or business related objective. Such restructurings should still result in positive savings (gross or present value) and require approval from the Director of Finance. A memo detailing the restructuring objective must be submitted to the Director of Finance for approval. Departments must also consider the effect of such restructuring on the credit ratings of the financing program and the State.

3. Structure

General Obligation Bonds: GO refunding bonds must be structured with an annual level principal or annual level debt service structure (Haw. Const. art. VII § 13). Within the constraints of the constitutional structure requirements described, GO refunding bonds will aim to achieve a relatively annual level savings structure.

Other Obligations: Departments may structure non-GO refunding bonds with principal payments necessary to achieve a proportional or annual level savings structure. Other savings structures including upfront savings, deferred savings, and targeted savings for a series may be utilized in order to achieve an aggregate proportional or level savings structure from a portfolio perspective.

4. Escrow Structuring

Departments will structure refunding escrows using permitted securities per the State statutes (HRS §39-15 and HRS §39-71) or as dictated in related indentures or certificates. The escrow may consist of State and Local Government Securities (SLGS) which are purchased directly from federal government or open market securities (OMS) such a treasury bills and notes purchased on the open market. In circumstances where OMS provide material cost savings compared to SLGS, a certificate will be delivered to the Director of Finance from the financial advisor or qualified third party agent, who is not a broker-dealer, on each refunding issue. The certificate will state that the securities were procured through an arms-length, competitive bid process, that such securities were more cost-effective than SLGS, and that the price paid for the securities was reasonable within federal tax law guidelines.

VII. Debt Management

A. Credit Objectives and Ratings Strategy

The goal of the State is to provide sufficient financial flexibility to meet the objectives of each financing program while striving to secure and maintain the highest possible ratings for each program. Credit ratings provide an independent opinion regarding the State's ability and willingness to meet its financial commitments. Credit ratings issued by the bond rating agencies are a major factor in determining the cost of borrowed funds in the municipal bond market, and credit ratings are one of the tools used by investors when purchasing municipal obligations. It is the objective of the State to maintain its positive presence in the credit markets through the maintenance of and improvement of all relevant credit characteristics within its control. In order to meet credit objectives, Departments will strive to do the following:

- Maintain proactive communication with rating agencies about any material developments including upcoming issuances
- Schedule periodic calls and updates about the general economic and financial condition of the State or the Department
- Address specific credit concerns with tailored and well researched credit presentation and discussion

In doing so, the Departments will include B&F in their communications with rating agencies. In connection with new issuances, Departments will apply for ratings from at least two National Recognized Statistical Rating Organizations in order to ensure liquidity of its debt in the secondary market. Certain financing programs may maintain single ratings if limited issuances are anticipated.

Drivers of credit rating strategy:

- Security and structure of the deal in light of the rating criteria
- Market conditions coupled with investor preference for number of ratings and rating agency
- Time and resources invested to attain and maintain a rating over the life of a bond in addition to the initial cost of a rating

B. Investor Relations

B&F understands the importance of maintaining relations with all investors, including principal institutional investors. As a result, B&F undertakes an extensive investor outreach program for its financings. The program serves to proactively provide economic and financial information to all investors alike, in a manner that is unbiased and transparent. The State's website maintains a page (http://investorrelations.hawaii.gov/) dedicated to investor relations and the Departments will actively manage their pages in order to keep it up-to-date. The investor relations page provides information including but not limited to upcoming sales, bond ratings, revenue forecasts, pension and health benefit liabilities, pre-selected underwriters, and the State's contracted IRMA.

C. Arbitrage Rebate Monitoring and Filing

The Departments will monitor compliance with the arbitrage rebate rules for all of the State's outstanding debt. Departments will maintain necessary and appropriate records regarding the use and investment of bond proceeds.

D. Tax Compliance

In compliance with the Tax Code, Departments will monitor and maintain detailed records of the expenditure of tax-exempt bond proceeds and private business use of tax-exempt financed projects.

E. Continuing Disclosure

Departments are committed to full and complete disclosure and will comply with SEC Rule 15c2-12, by filing offering documents, financial statements and other operating data through Electronic Municipal

Market Access system (EMMA) no later than nine months after the end of the fiscal year ending June 30. Notice of material events must be filed within 10 business days. Material events may include:

1. Principal and interest payment delinquencies
2. Nonpayment-related defaults
3. Unscheduled draws on debt service reserve funds
4. Unscheduled draws on credit enhancements
5. Substitution of credit or liquidity providers or the failure of performance on the part of a liquidity provider
6. Adverse tax opinions or events affecting the tax-exempt status of any bonds
7. Modifications to rights of bond holders
8. Bond calls
9. Defeasances
10. Matters affecting collateral
11. Rating changes

F. Investment of Bond Proceeds and Reserve Funds

All bond proceeds must be invested in accordance with the State and federal tax law limitations. All investments must be consistent with permissible investments detailed in the State statutes, bond authorizing documents, and Investment Policy (HRS §39-69). With direction from a Department, the Director of Finance may also similarly invest idle funds in reserves or sinking funds. The University of Hawaii may hold and invest its revenue bond proceeds and reserve funds per HRS § 304A-2003.

G. Risk Management

Departments will evaluate each transaction to identify and manage the various risks associated with a transaction. On a best effort basis, Departments will try to mitigate or minimize exposure to these risks. The following risks should be assessed before issuing debt:

- Tax Status: Changes in public/private use of projects funded by tax-exempt funds could cause the bonds to become taxable. Untimely expenditure of tax-exempt bond proceeds could cause the bonds to become taxable.
- Default Risk: The risk that debt service payment will not be made on the due date.
- Liquidity Risk: The risk of having to pay a higher rate to the liquidity provider in the event of a failed remarketing.
- Interest Rate Risk: The risk that interest rates will rise, on a sustained basis, above levels that would have been set if the bonds were issued at fixed rate.
- Rollover Risk: The risk of the inability to obtain a suitable liquidity facility at an acceptable price to replace a facility upon termination or expiration of a contract period.

VIII. Exceptions to the Policy

While adherence to this Policy is required in applicable circumstances, the State recognizes that changes in the capital markets, State programs and other unforeseen circumstances may produce situations that are not covered by the Policy or require modifications or exceptions to achieve Policy goals. In these cases, the Director of Finance may consider and approve exceptions to provisions within this Policy. A memo detailing the rationale for an exception to the Policy must be submitted to the Director of Finance.

IX. Review and Amendments

The Director of Finance along with the Governor will review the Policy annually and recommend amendments, if required, to the legislature before any regular session.

X. Glossary

Bad Money: Limitations imposed by the Tax Code that restrict the amount of bond proceeds that may be used for non-qualifying activities, generally ten percent for governmental bonds and five percent for private activity bonds. Aggregate private use cannot exceed the lesser of the ten percent/five percent or $15 million.

Balloon Maturity: Final payment on a debt that is substantially larger than the preceding payments.

Capital Projects: Acquisition, purchase, construction, reconstruction, improvement, betterment, or extension of any undertaking.

Operations and Maintenance Expenses: Expenses associated with the maintenance and administration on a day-to-day basis. This does not include major capital maintenance expenditures which extend the useful life of the asset.

Departments: Any state department, board, commission, officer, authority, or agency which is charged by law with the administration of an undertaking or loan program. Specifically, Departments includes the Department of Budget and Finance and any Department which issues or may issue debt.

Undertaking: Any public works and properties, improvement, or system, tangible or intangible, owned or operated by the State or a department thereof, and any public activity, policy, or program undertaken by the State or a department thereof, and from which the State or department may derive revenues, or with respect to which the State or department may derive user taxes.