FITCH RATES CONNECTICUT'S GO BONDS 'AA'; OUTLOOK STABLE

Fitch Ratings-New York-09 March 2016: Fitch Ratings has assigned an 'AA' rating to the following State of Connecticut general obligation (GO) bonds:

--$550,000,000 GO bonds (2016 series A).

The bonds are expected to sell via negotiated sale on or about March 16, 2016.

In addition, Fitch affirms the 'AA' rating on approximately $15.9 billion in GO bonds of the state.

The Rating Outlook is Stable.

SECURITY

The bonds are general obligations to which the full faith and credit of the state will be pledged for payment of principal and interest.

KEY RATING DRIVERS

HIGH WEALTH LEVELS: Connecticut is the nation's wealthiest state as measured by per capita personal income. Economic recovery has been slow and uneven since the recession. Employment performance has recently accelerated and job growth has strengthened in the state's large and important finance sector after eight consecutive years of erosion.

CYCLICAL REVENUES AND SPENDING PRESSURE: The state's revenue performance is cyclical, while high fixed costs including for labor, retirement obligations and some services limit its ability to respond during revenue downturns.

LIMITED RAINY DAY FUND BALANCES: During past economic recoveries the state has rapidly repaid deficit borrowing and rebuilt its rainy day fund balance. In contrast, the current slow recovery has limited the state's ability to repay deficit borrowing and rebuild its rainy day fund balance, leaving the state more vulnerable to future fiscal shocks. Strengthened rainy day fund mechanisms in the recently adopted budget will only fully take effect after several biennia.

COMPARATIVELY HIGH DEBT LEVELS: Tax-supported debt is high for a U.S. state. This is partially attributable to the state's above-average role in relation to local levels of government when compared to most other states. Most GO bonds, excluding GO bonds issued to fund the teachers' retirement system, amortize rapidly.

SIGNIFICANT PENSION OBLIGATIONS: Net liabilities for retired employees are significant, including for state employee and teacher pensions. The state fully funds actuarially calculated contributions and conservatively amortizes its unfunded liabilities over fixed periods. The state has adopted reforms to both pension and retirement health liabilities and is considering additional pension restructuring.

RATING SENSITIVITIES

REBUILDING FISCAL FLEXIBILITY: The rating is sensitive to the state's ability to maintain balance over the near term while absorbing revenue cyclicality and rebuilding fiscal flexibility. The Stable Outlook assumes that the state makes progress toward those goals through near-term budgetary adjustments and longer-term fiscal reforms. A limited or insufficient state response or persistent economic and revenue setbacks could lead to a rating downgrade.

CREDIT PROFILE

Connecticut's 'AA' GO bond rating is based on the state's wealth and income resources tempered by high levels of debt, retirement obligations and other fixed costs. The state's progress in recovering from the last downturn remains incomplete given slow economic performance, tepid revenue growth and a low rainy day fund balance relative to historical fiscal cyclicality.

Despite its overall wealthy economy and evidence of recent economic acceleration, gains during the current expansion have been slower than in past recoveries, and the state's important finance sector is only gradually returning to growth. Balances in the budget reserve fund (BRF, the state's rainy day fund) rose given unexpected gains early in the last biennium, but were tapped to resolve a $113 million remaining deficit from fiscal 2015. The remaining BRF balance, at $406 million, is low relative to the state's spending base and its historical experience with revenue volatility. The state continues to carry outstanding deficit notes issued during the last recession.

As with fiscal 2015, fiscal 2016 revenue expectations have weakened relative to earlier forecasts, with the state implementing reductions in a special legislative session and taking other administrative actions to address a cumulative $324 million budget gap. Although projected revenues were tracking near the lowered targets for several months, the comptroller's March 1 forecast update now anticipates another downward revision based on the impact of financial market volatility on personal income tax collections.

Prior to and in proposed mid-biennium budget revisions, the governor has outlined more extensive reforms to taxes, staffing and pensions, intended to improve budgetary sustainability and competitiveness. Fitch views the proposals as a starting point for deliberations on fiscal management reforms that could strengthen the state's financial posture over the longer term, assuming consensus can be achieved. In the meantime Fitch expects the state to address near-term under-performance within its current budgetary framework, a challenge made more acute by the recent revenue forecast change. Evidence that the state's currently limited level of flexibility is insufficient to absorb fiscal challenges could result in a lower rating.

WEALTHY, DIVERSE ECONOMY

Connecticut has a wealthy, mature and diverse economy anchored by a large finance sector and important manufacturing and education and health sectors. The last downturn in the state was severe and the recovery has been very slow compared to previous economic cycles. Over the 2012 - 2014 period, employment rose 0.8% to 0.9% annually, roughly half of the rate of growth enjoyed by the nation as a whole during the same period.

Job gains in the state accelerated in 2015 but remain below national levels, with Dec. 2015 up 1.4% year-over-year, compared to 2% nationally, and with an unemployment rate of 5.2%, over the 5% national rate. Employment in financial activities, an important source of the state's wealth, declined continuously from 2007 through 2014 measured on an annual basis. The sector appears to have returned to growth during 2015, with Dec. 2015 financial activities employment rising 1.9% (on a three month moving average basis) compared to one year earlier.

The state remains the wealthiest as measured by personal income per capita, at 141% of the national average in 2014. Personal income growth in recent quarters has been steady but below the national average; third-quarter 2015 growth was 4.1% year-over-year in Connecticut, compared to 4.6% nationally.

The state's economic outlook through fiscal 2020 foresees improving performance after sluggish growth in fiscal 2014. Employment growth is estimated to have measured 1.2% in fiscal 2015, with gains in the next biennium of 1.5% in fiscal 2016 and 0.9% in fiscal 2017. Personal income growth is estimated to have been 4.1% in fiscal 2015, with forecast growth of 3.9% in fiscal 2016 and 3.8% in fiscal 2017.

SLOW ECONOMIC GAINS AFFECTING FISCAL RECOVERY

Connecticut has a cyclical revenue system and relatively high fixed costs, including for labor agreements, pension contributions, Medicaid, and debt service. In the past, the state diverted strong revenue growth during expansionary economic periods to accumulate a large BRF balance, then relied on the BRF to offset sharp recessionary revenue declines as well as bonding in the form of economic recovery notes (ERNs) to cover year-end deficits.

The unusually slow economic and revenue expansion underway since 2010 has prevented the state from making rapid progress in paying down the ERNs used to close the fiscal 2009 budget gap; $353 million remains outstanding from the original balance of $916 million. The BRF had been funded at $1.38 billion as of fiscal 2007, equal to 8.5% of general fund appropriations. At present, it stands at $406 million, equal to 2.3% of fiscal 2015 general fund net appropriations, following the draw to close the fiscal 2015 deficit noted earlier.

ADOPTED BUDGET AVOIDED ONE-TIME ACTIONS

The adopted biennial budget for fiscal years 2016-2017 resolved current services gaps of approximately $1.1 billion in both years that were driven by higher Medicaid trends, rising employee wages and fringe benefits, and higher retirement benefit costs. In contrast to the fiscal 2014-2015 biennium adopted budget, which relied on one-time actions, gaps in fiscal 2016-2017 were closed primarily through recurring actions, most notably tax rate increases. New revenues included raising the PIT top rate to 6.99%, from 6.7%, and extending the hospital provider tax and the corporation tax surcharge. Spending was forecast to grow 4.2% in fiscal 2016 and 3% in fiscal 2017. Both years were projected to end with minimal balances, at $0.8 million in fiscal 2016 and $2.4 million in fiscal 2017.

The adopted budget included substantial changes to address state transportation needs and strengthen BRF funding mechanisms, although full implementation of the latter is delayed until fiscal 2021. For transportation, the budget phased in a shift of a portion of general sales taxes to the special transportation fund while authorizing additional bonding for roads and other transportation needs; municipalities will likewise receive a portion of sales taxes formerly collected in the general fund.

FISCAL 2016 - 2017 BUDGET UNDERPERFORMING

State revenues have underperformed since fiscal 2016 began, with state lowering its revenue outlook a cumulative $244 million in the first half of the fiscal year, offset by $304 million in reductions and other legislative actions. Revenue pressure is expected to persist, with the comptroller having lowered the current year forecast given concerns about non-withholding PIT receipts, leaving a forecast deficit of $220 million.

Given the state's persistent budgetary underperformance during this recovery, the governor has outlined several policy options intended to improve its fiscal sustainability and competitiveness over the long run. The outline includes tax law changes favorable for corporations, state staffing efficiencies, and pension changes to reduce risk of higher contributions.

The governor has submitted proposed budget revisions for fiscal 2017 to close a $560 million gap; this figure incorporated the fiscal 2017 impact of weaker fiscal 2016 revenues through January, but does not yet reflect the fiscal 2017 impact of the comptroller's latest downward revenue revision. Under the governor's proposal, the forecast gap would be addressed almost entirely by spending changes, including extending fiscal 2016 mid-year budget cuts, position reductions, and across-the-board agency reductions.

DEBT AND OTHER LIABILITIES HIGH

Connecticut has continued to demonstrate the ability and willingness to absorb fixed costs for its debt and retirement liabilities, which are high compared to other states. Net tax-supported debt totals $21.8 billion prior to the current sale, or 9.3% of 2014 personal income. Three-quarters of net tax-supported debt is GO, a large share of which has been issued for local school capital needs. GO borrowing includes $2.3 billion to support the teachers retirement fund (TRF).

Funding levels for the state's major pension systems remain a source of concern. As of its June 30, 2015 funding valuation, the state employees' retirement system (SERS) had assets sufficient to cover 43.3% of liabilities. As of June 30, 2014, the corresponding figure for TRF equaled 59%. Using Fitch's more conservative 7% return assumption (instead of the 8% used by SERS and the 8.5% used by TRF) would lower the plans' respective ratios to 39% and 50.6%. As of Fitch's 2015 state pension report, the burden of net tax-supported debt and adjusted unfunded pension obligations of both systems equaled 23.2% of personal income, among the highest of U.S. states.

Despite the weak funded ratios of both plans and their higher than average discount rates, Connecticut maintains a conservative amortization approach relative to other states and has fully baselined the plans' resulting high contributions. The ARC for both has now been fully funded for years; for the TRF bonds, the state fully funds the ARC under a covenant linked to the GO pension bonds.

Several rounds of pension reforms have been implemented which in some cases elevated near-term contributions to accelerate funded ratio improvement over time. The governor has proposed additional changes intended to lower budgetary risk tied to future investment underperformance; the most notable proposal includes shifting the oldest liabilities of SERS into a pay-go plan, instead of advanced funding. Fitch will assess any potential reform impact after further details become available.

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Fitch recently published exposure drafts of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015 and Exposure Draft: Incorporating Enhanced Recovery Prospects into U.S. Local Tax-Supported Ratings, dated Feb. 2, 2016). The drafts include a number of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to fewer than 10% of existing tax-supported ratings. Fitch expects that final criteria will be approved and published by the end of the first quarter of 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

In addition to the sources of information identified in Fitch's Master Criteria, this action was additionally informed by information from Global Insights.

Applicable Criteria
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942
Tax-Supported Rating Criteria (pub. 14 Aug 2012)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. State Government Tax-Supported Rating Criteria (pub. 14 Aug 2012)
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