FITCH RATES $400MM CONNECTICUT GO BONDS 'AA'; OUTLOOK NEGATIVE

Fitch Ratings-New York-04 March 2014: Fitch Ratings assigns an 'AA' rating to $400 million in general obligation (GO) bonds of the State of Connecticut, consisting of:

--$300 million in GO bonds (2014 series A);
--$100 million in GO bonds (2014 series B) - SIFMA index bonds.

The bonds are expected to sell via negotiated sale on March 13.

In addition, Fitch affirms the following outstanding ratings:

--Approximately $14.5 billion outstanding GO bonds and notes at 'AA'.

The Rating Outlook is Negative.

SECURITY

GO bonds to which the full faith and credit of the state will be pledged for payment of principal and interest.

KEY RATING DRIVERS

NEGATIVE OUTLOOK BASED ON BUDGET VULNERABILITY: The Negative Outlook reflects the state's reduced fiscal flexibility at a time of lingering economic and revenue uncertainty. The adopted budget for the current biennium relied on one-time items and anticipated little near-term progress in rebuilding fiscal flexibility. Recent revenue momentum, if it continues, may allow the state to materially improve its reserve position.

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, and the state's large and important finance sector continues to weaken.

CYCLICAL REVENUES AND SPENDING PRESSURE: State revenue performance is cyclical, while high fixed costs limit its ability to respond during revenue downturns.

HISTORICAL WILLINGNESS TO BUILD BALANCES: During past economic recoveries the state has demonstrated a willingness and ability to rapidly repay deficit borrowing and rebuild its rainy day balance. The current slow recovery has hampered rebuilding of reserves in the current biennium.

HIGH DEBT: Tax-supported debt is high for a U.S. state. Most GO bonds, excluding GO bonds issued to fund the teachers' retirement system, amortize rapidly.

SIGNIFICANT PENSION OBLIGATIONS: Unfunded liabilities for employees are significant, including for state employee and teacher pensions. The state fully funds actuarially calculated pension contributions and maintains a fixed amortization date. Additionally, the state has taken steps to reform retirement pension and health liabilities.

RATING SENSITIVITIES

VULNERABILITY TO ECONOMIC AND REVENUE CHALLENGES: An inability to meet or exceed budgeted forecast expectations could lead to a downgrade.

SUCCESS IN RAISING RESERVE BALANCES: Improved fiscal flexibility provided by higher than forecast revenues and material progress in rebuilding reserves could stabilize the state's credit outlook.

CREDIT PROFILE

Connecticut's GO rating, at 'AA,' reflects its vast wealth and income resources, tempered by a comparatively high burden of debt, retirement liabilities and other fixed costs. The Negative Outlook is based on the state's inability in its adopted fiscal 2014 - 2015 budget to return to more structurally sustainable budgeting and rebuild flexibility at a time of unusually slow economic and revenue recovery.

The biennium budget was balanced only through a number of non-recurring resources, including refinancing the outstanding economic recovery notes (ERNs) that were used to fund deficits in the last recession. Significantly improved revenue collections in recent months and below budget expenditures have materially expanded the forecast fiscal 2014 surplus, despite the continued slow overall growth of the state's economy. The governor has proposed directing most of the forecast surplus to replenishing its reserves and reducing liabilities, steps which Fitch believes would improve the state's fiscal flexibility.

ECONOMY

Connecticut has a wealthy, 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. Employment rose 1.1% and 0.9% in 2011 and 2012, respectively, below the 1.2% and 1.7% national growth rates for the same years. Job weakness continues, with December 2013 up only 0.7%, compared to 1.7% nationally, and with an unemployment rate of 7.4%, above the 6.7% national rate. Employment in the finance sector, an important source of the state's wealth, continues to erode, down 1% in December 2013 year-over-year, while professional and business services, education and health, and leisure and hospitality continue to grow.

The state remains the wealthiest as measured by personal income per capita, at 137% of the national average in 2012. After lingering underperformance, personal income growth in recent quarters has accelerated to levels approaching the national average; third quarter 2013 growth was 3.5% year-over-year in Connecticut, compared to 3.6% nationally.

The state's revised economic forecast through fiscal 2018 appears reasonable, in Fitch's view. It foresees improving performance after recent sluggish growth; gross state product accelerates in 2014 and largely remains ahead of national averages. Employment growth continues at a below-average level in 2014, rising 0.8% in the state compared to 1.7% nationally. Employment gains accelerate thereafter although remain below the national averages.

RECENT FISCAL PERFORMANCE

Connecticut has a cyclical revenue system, and strong growth in some years historically has enabled the state to build large balances in the BRF. During recessionary periods, the state relies on the BRF to cover revenue declines, and bonding in the form of ERNs to cover year-end deficits. Prior to the 2008-2009 recession, an unusually severe one in the state, the BRF balance had risen to $1.38 billion in fiscal 2007, equal to 8.5% of appropriations; the statutory maximum is 10%.

The lingering slow recovery has stymied a full recovery from the last recession. To close persistent budgetary gaps in the fiscal 2008 - 2009 and 2010 - 2011 biennia, the state relied on spending cuts, tax rate changes and non-recurring resources, including federal stimulus funds and $916 million in ERNs. The BRF was depleted in fiscal 2010 and fiscal 2011. In fiscal 2012, persistent revenue underperformance and higher spending needs eroded forecast surpluses despite mid-year cuts and other balancing actions. The fiscal year ended with a deficit of $143.5 million, which was closed using fiscal 2011 surplus originally intended for early repayment of ERNs.

Fiscal 2013 began with persistent revenue underperformance that required rescissions and other balancing actions. Revenue collections turned around late in the fiscal year, with higher personal income tax receipts, including from the timing impact of federal tax law changes, enabling the state to make a sizable deposit to the BRF, bringing its balance to $271 million, a modest 1.4% of fiscal 2013 general fund revenues.

The fiscal 2014 - 2015 biennium adopted budget relied on a number of one-time measures to achieve narrow forecast surpluses of $4.4 million (fiscal 2014) and $3.1 million (fiscal 2015). These included shifting $221 million in fiscal 2013 surplus into the new biennium, restructuring the ERNs for $276 million in savings, fund shifts with the transportation fund to benefit the general fund, and a delayed start to amortizing the state's GAAP deficit. General fund revenues were forecast to grow 2.9% in fiscal 2014 and 3.7% in fiscal 2015. Tax law changes included extending a corporate tax surcharge that had been scheduled to expire. GO bonds to restructure the ERNs and pay down a portion of the GAAP deficit, while raising state debt, statutorily redirected any future general fund surpluses to the BRF and improved state liquidity.

The governor's proposed mid-biennium revision recognizes the recent, significantly improved revenue collections year-to-date but otherwise makes few significant changes to the adopted biennium plan. The fiscal 2014 surplus is now forecast at $504 million, due to personal income and sales tax gains combined with lower than expected spending needs. The governor's proposal assumes using $155 million in fiscal 2014 for tax refunds and $100 million for an excess contribution to the state's underfunded employee pension system. Most of the remaining surplus would be deposited to the BRF, with its balance projected at $543 million as of fiscal year end, equal to 3.1% of general fund revenues. The governor's proposal would elevate the maximum BRF balance to 15% of general fund expenditures, from 10%.

DEBT AND OTHER LIABILITIES

Connecticut's burden of debt and other liabilities is high compared to other states. Net tax-supported debt as of Dec. 2013 totals $20.2 billion, or 9.2% of 2012 personal income, including the current bonds. Three-quarters of net tax-supported debt is GO, a large share of which has been issued for local school capital needs. Borrowing also includes $573 million in ERNs.

Funding levels for the state's major pension systems remain a source of concern. As of June 30, 2013, the state employees' retirement system (SERS) was funded at 41.2% on a reported basis, and the teachers retirement fund (TRF) was funded at 55.2%, the latter having benefited from the 2008 issuance of pension bonds. Using Fitch's more conservative 7% investment return assumption (instead of the 8% rate assumed by SERS and the 8.5% rate assumed by TRF) reduces funded ratios to 37.1% and 47.4%, respectively. On a combined basis, the burden of net tax-supported debt and adjusted unfunded pension obligations equals 23.6% of 2012 personal income, among the highest for U.S. states rated by Fitch.

Connecticut has continued to demonstrate the ability and willingness to absorb the comparatively high fixed costs posed by its liabilities. The state fully funds an actuarially required contribution (ARC) to the TRF under a covenant linked to the pension bonds, and the SERS ARC is likewise fully funded. In addition to the proposed supplemental contribution to SERS noted earlier, several rounds of pension reforms have been implemented which in some cases elevated near-term contributions to accelerate funded ratio improvement over time. Moreover, both plans have maintained fixed amortization periods over which the unfunded liability is expected to be paid down.

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In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from IHS Global Insight.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. State Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. State Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033