FITCH RATES CONNECTICUT'S $61.64MM GO RFDG NOTES 'AA'; OUTLOOK REMAINS NEGATIVE

Fitch Ratings-New York-03 December 2014: Fitch Ratings assigns an 'AA' rating to the State of Connecticut's (the state) $61.64 million in general obligation (GO) refunding notes (economic recovery notes, 2014 series A) - SIFMA index.

The bonds are expected to sell via negotiated sale on Dec. 8.

The Rating Outlook remains Negative.

SECURITY

The notes 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

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. Fiscal performance during the biennium to date has been challenged by ongoing revenue uncertainty, although the state has taken action to maintain forecast balance and was able to deposit a sizable fiscal 2014 surplus to its rainy day fund.

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: The state's 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 led to a delay in repaying deficit borrowing and hampered the rebuilding of the rainy day fund.

COMPARATIVELY HIGH DEBT LEVELS: Tax-supported debt is high for a U.S. state. This is partially attributable to the above-average role the state plays 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 pension contributions and maintains fixed amortization dates. 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 'AA' GO rating reflects its high 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 fiscal 2014-2015 budget was balanced only through a number of non-recurring resources, including the planned refinancing of outstanding economic recovery notes (ERNs) that were used to fund deficits in the last recession. The current sale is the second of two ERN refundings intended as part of the adopted budget's gap-closing plan.

Revenues in the first half of fiscal 2014 surged, with solid year-over-year gains in personal income tax (PIT) collections prompting the state to elevate its forecast expectations. Following disappointing spring 2014 PIT collections, the state reversed course and lowered forecast revenue growth down to just below originally budgeted levels. The state also adopted a modest package of mid-biennium adjustments to ensure a deposit to the budget reserve fund (BRF), the state's rainy day fund. Fiscal 2015 performance is tracking behind expectations, with a lowered revenue outlook in the November 2014 forecast prompting the governor to curtail current year spending. However, additional actions are likely needed to bring the state back to balance.

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 recent past economic recoveries. Employment rose 0.9% annually in both 2012 and 2013, below the 1.7% national growth rates for both years.

Job gains in the state have accelerated in recent months but remain below national levels. October 2014 levels were up 1.5% year-over-year, compared to 2% nationally, and with an unemployment rate of 6.4%, above the 5.8% national rate. Employment in financial activities, an important source of the state's wealth, has declined each year since the recession. Additionally, the sector fell 1.5% in October 2014 compared to one year earlier.

The state remains the wealthiest as measured by personal income per capita, at 135.5% of the national average in 2013. Personal income growth in recent quarters continues at levels below the national average. Second-quarter 2014 growth was 2.9% year-over-year in Connecticut, compared to 4.1% nationally.

The state's economic outlook through fiscal 2018 foresees gradually improving performance after the sluggish growth of 2014. Employment gains are projected to continue, albeit at only 0.9% in fiscal 2015 and 1% in fiscal 2016. The state expects to exceed its pre-recession employment level in late 2015. Personal income growth is forecast to rise to 4% in fiscal 2015 after the 1.4% rate of growth forecast for 2014. The state will update its economic outlook in February 2015.

SLOW ECONOMIC GAINS AFFECTING FISCAL RECOVERY

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

The unusually weak economic and revenue recovery underway since 2010 has prevented the state from making rapid progress in paying down the $916 million in ERNs used to close the fiscal 2009 budget gap and quickly rebuilding the BRF. This had been funded at $1.38 billion as of fiscal 2007, equal to 8.5% of general fund appropriations. At present, $580.8 million in ERNs remains outstanding, and the BRF stands at $519.2 million, equal to 3% of general fund appropriations, following deposit of the fiscal 2014 surplus of $248.5 million.

VARIABLE REVENUES IN CURRENT BIENNIUM

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 outstanding 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 state's fiscal outlook has varied considerably since the start of the biennium. After initially raising forecast fiscal 2014 revenue expectations largely due to strong PIT collections early in the fiscal year, spring 2014 PIT collections under-performed significantly. This reflected the continued impact on tax filings of 2013 federal tax rate changes. In response, the April 2014 consensus forecast reduced expected general fund revenues by $462 million, carrying forward lower collection trends into fiscal 2015 and beyond. The state quickly adopted a modest mid-biennium budget revision, including a range of limited revenue and expenditure adjustments to maintain balance through fiscal 2015.

Actual performance in fiscal 2014 exceeded the revised budget expectations. Actual revenues were only slightly ahead of the adopted level, with stronger sales taxes offsetting PIT weakness, while high budget lapses offset deficiencies. The state's comptroller certified that the state ended fiscal 2014 with a solid operating surplus of $248.5 million, well above the $43.4 million as of the revised budget. Deposit of the surplus to the BRF brings its balance to $519.2 million, or 3% of general fund revenues.

Fiscal 2015 performance is trending slightly below the state's earlier expectations. The November consensus forecast lowered forecast fiscal 2015 revenues by $59.1 million. Despite quick state action to curb hiring and other rescissions, at present the state's comptroller is forecasting a small fiscal 2015 year-end deficit of $44.8 million. The governor will announce an executive biennial budget for fiscal years 2016-2017 in February.

DEBT AND OTHER LIABILITIES

Connecticut's burden of debt and other liabilities is high compared to other states. Net tax-supported debt as of September 2014 totals $20.1 billion (9.2% of 2013 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 $581 million in ERNs and $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 their June 30, 2014 valuations, reported under GASB 67 standards, the state employees' retirement system (SERS) had assets sufficient to cover 39.5% of liabilities, and TRF had assets sufficient to cover 61.6% of liabilities. 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 35.6% and 52.8%. On a combined basis, the burden of net tax-supported debt and the adjusted unfunded pension obligations of both systems equal 24.6% of 2013 personal income, among the highest of U.S. states.

The state 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 calculated annual required contribution (ARC) to the TRF under a covenant linked to the pension bonds, and the SERS ARC is likewise fully funded. 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