FITCH RATES $650MM CONNECTICUT GO REFUNDING BONDS 'AA'; OUTLOOK REMAINS NEGATIVE

Fitch Ratings-New York-16 May 2014: Fitch Ratings assigns an 'AA' rating to $650 million in state of Connecticut general obligation (GO) refunding bonds, 2014 series C.

The bonds are expected to sell via negotiated sale the week of May 19.

In addition, Fitch affirms the following outstanding ratings:

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

The Rating Outlook remains 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. Personal income tax (PIT) revenues have been volatile in the first year of the biennium, with the state taking proactive action to ensure a modest fiscal 2014 budgetary surplus to be deposited to the 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: 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 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.

Revenues in the first half of fiscal 2014 surged, with solid year-over-year gains in PIT collections prompting the state to elevate its forecast expectations. Following disappointing spring 2014 PIT collections, the state has reversed course, lowering forecast revenue growth and agreeing to a modest package of mid-biennium budget adjustments to ensure a $43 million deposit to the budget reserve fund (BRF), the state's rainy day fund.

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 0.9% in both 2012 and 2013, below the 1.7% national growth rates for both years. Job weakness continues, with April 2014 up only 0.7%, compared to 1.7% nationally, and with an unemployment rate of 6.9%, above the 6.3% national rate. Growth in finance and professional and business services, important sources of the state's wealth, has been weak, with finance rising only 0.3% in April and professional and business services flat.

The state remains the wealthiest as measured by personal income per capita, at 137% of the national average in 2013. Personal income growth in recent quarters continues at levels below the national average; fourth-quarter 2013 growth was 1% year-over-year in Connecticut, compared to 1.4% nationally.

The state's revised economic outlook through fiscal 2018 appears reasonable, in Fitch's view. It foresees improving performance after recent sluggish growth; gross state product gradually accelerates in 2014 and 2015 generally in line with national forecast expectations. Employment growth continues at a below-average level through the period, rising 0.8% in 2014 in the state compared to 1.7% nationally.

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 economic recovery notes (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, continued 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 revenue underperformance that required rescissions and other balancing actions. Revenue collections turned around late in the fiscal year, with higher PIT receipts, including from the timing impact of federal tax law changes, enabling the state to make a sizable deposit to the BRF to bring 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.

Fiscal 2014 PIT collections were well ahead of expectations in the first half of the year, although spring 2014 collections were significantly lower than forecast, with the state attributing volatility to the impact of 2013 federal tax rate changes on the timing of tax filings. The state's forecast surplus, which had risen to more than $500 million at the time of the January 2014 consensus revenue forecast, was lowered to $43.4 million as of the comptroller's April 30 report, still slightly above the original budget level. Reversing the January increase in projected revenues, the April consensus forecast reduced expected general fund revenues by $462 million, carrying forward lower collection trends into fiscal 2015 and beyond. In response, the state quickly adopted a modest mid-biennium budget revision in early May, incorporating the lower revenue outlook and including a range of limited revenue and expenditure adjustments. The forecast fiscal 2014 surplus is expected to be deposited into the BRF, bringing its balance to $314 million or 1.8% of general fund revenues. Fiscal 2015 remains in forecast balance.

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 2013 personal income, including new bonds issued since then. 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 23.9% of 2013 personal income, among the highest for U.S. states rated by Fitch and well above the 6.1% median.

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. 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

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