FITCH RATES CONNECTICUT'S $500MM GO BONDS 'AA'; OUTLOOK REMAINS NEGATIVE

Fitch Ratings-New York-09 March 2015: Fitch Ratings assigns an 'AA' rating to $500 million in state of Connecticut general obligation (GO) bonds, consisting of:

--$400,000,000 GO bonds (2015 series A);
--$100,000,000 taxable GO bonds (2015 series A).

The bonds are expected to sell via negotiated sale on March 12, 2015.

In addition, Fitch affirms the ratings of GO and other related bonds of the state as detailed at the end of this release.

The Rating Outlook remains Negative.

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

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 has made some progress restoring 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.

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

REBUILDING FISCAL FLEXIBILITY: The rating is sensitive to the state's ability to continue progress in rebuilding fiscal flexibility and meet forecast assumptions in the context of slow economic and revenue growth and high fixed costs. Weaker performance could result in a downgrade.

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 last adopted budget, for the fiscal 2014 - 2015 biennium, to return to more structurally sustainable budgeting and rebuild flexibility. The budget relied on non-recurring resources to achieve balance, and although some progress has been made since then in rebuilding the rainy day fund, economic and revenue under-performance remain near-term risks. The governor's executive budget proposal for the fiscal 2016 - 2017 biennium, released last month, absorbs rising fixed costs, achieves narrow forecast balance and avoids reliance on non-recurring resources, but leaves the rainy day fund balance nearly unchanged.

Performance in fiscal 2015, which ends on June 30, is tracking slightly behind expectations, with revenues reforecast downward prompting the governor to implement two rounds of rescissions and additional proposed corrective actions in the executive plan for the fiscal 2016 - 2017 biennium.

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, with December 2014 up 1.6% year-over-year, compared to 2.3% nationally, and with an unemployment rate of 6.4%, above the 5.6% national rate. Employment in financial activities, an important source of the state's wealth, has declined almost continuously since the recession, and the sector fell 1.8% in December 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; third-quarter 2014 growth was 3.6% year-over-year in Connecticut, compared to 3.9% nationally.

The state's economic outlook through fiscal 2020 released with the governor's executive proposal foresees improving performance in fiscal 2015 and beyond after the sluggish growth of 2014. Employment gains are projected to improve to 1.7% in fiscal 2015, with growth in the next biennium of 1.4% in fiscal 2016 and 1.1% in fiscal 2017. Personal income growth is forecast to rise to 3.9% in fiscal 2015, with growth in the next biennium of 3.6% in fiscal 2016 and 4.9% 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 budget reserve fund (BRF, the state's rainy day fund) balance, then relied on the BRF balance to offset sharp 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; $520 million remains outstanding. The BRF had been funded at $1.38 billion as of fiscal 2007, equal to 8.5% of general fund appropriations. At present, the BRF stands at $519.2 million, equal to 3% of fiscal 2014 general fund appropriations.

VARIABLE PERFORMANCE 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. 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 due to strong PIT collections early in the fiscal year, spring 2014 PIT collections under-performed significantly, reflecting the continued impact on tax filings of 2013 federal tax rate changes. The state lowered its consensus forecast in response and quickly adopted mid-biennium revisions to maintain balance through fiscal 2015. Ultimately a solid, $248 million operating surplus was achieved and deposited in the BRF, well above the $43.4 million assumed in the revised budget.

Fiscal 2015 performance is trending slightly below the state's earlier expectations. The November 2014 and January 2015 consensus forecasts lowered the forecast fiscal 2015 outlook modestly, with the governor responding to both with mid-year rescissions. Additionally, certain spending, including for Medicaid, has exceeded forecast. At present the governor projects an additional $61.2 million in actions required to return to balance, although the state's comptroller's forecast a higher figure, at $101.2. Fitch expects the state's legislature to implement actions to resolve the projected gap in the course of approving the next biennium budget this spring.

PROPOSED BIENNIUM PLAN BALANCED

The governor's executive biennial budget for fiscal years 2016-2017 identifies baseline gaps of approximately $1.1 billion in both years, driven by higher Medicaid trends, rising employee wages and fringe benefits, and rising retirement benefit costs. The proposal closes both gaps with a range of revenue increases and spending reductions. New revenues include raising the hospital provider tax, extending the corporate tax surcharge and eliminating the sales tax exemption on clothing, offset by a two-step sales tax rate cut. Unlike the fiscal 2014 - 2015 biennium, the proposed budget avoids reliance on one-time resources. Both years are projected to end with minimal balances, at $3.2 million in fiscal 2016 and $5 million in fiscal 2017.

DEBT AND OTHER LIABILITIES HIGH

Connecticut's burden of debt and other liabilities is high compared to other states. Net tax-supported debt as of Feb. 2015 totals $20.3 billion, or 9.3% 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 $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%. As of Fitch's 2014 state pension report, the burden of net tax-supported debt and adjusted unfunded pension obligations of both systems equaled 24.6% of 2013 personal income, among the highest of U.S. states.

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 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.

RELATED CREDITS BEING AFFIRMED

Fitch also affirms the ratings on the following outstanding bonds of the state of Connecticut and related entities:

--State of Connecticut GO bonds and notes at 'AA';
--University of Connecticut state debt service commitment bonds at 'AA-';
--Connecticut Higher Education Supplemental Loan Authority state supported revenue bonds payable from special capital reserve funds at 'AA-';
--Capital City Economic Development Authority parking and energy fee revenue bonds, series 2004A, 2004B, and 2008D, at 'AA-';
--Connecticut Development Authority and Connecticut Innovations general fund obligation bonds, series 2004A, 2004B, 2004C, 2006A and 2014A, at 'AA-';
--Connecticut Health and Educational Facilities Authority (CHEFA) revenue bonds (child care facilities program) series G, at 'A+'.

The Rating Outlook for all of these GO and GO-linked ratings is Negative.

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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);
--'Pension Pressures Continue' (May 14, 2014).

Applicable Criteria and Related Research:
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
Pension Pressures Continue (2014 State Pension Update)
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=747605