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

Fitch Ratings-New York-23 July 2015: Fitch Ratings assigns an 'AA' rating to $500 million in state of Connecticut general obligation (GO) bonds, consisting of:

--$250,000,000 GO bonds (2015 series E);
--$250,000,000 taxable GO bonds (2015 series B).

The bonds are expected to sell via competitive bid on Aug. 4, 2015.

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

The Rating Outlook is revised to Stable from 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

STABLE OUTLOOK BUT NARROW MARGIN OF FLEXIBILITY: 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. During the last biennium, the state absorbed fiscal underperformance while ending with a higher rainy day fund than expected at the start of the biennium, and the adopted budget for the current biennium appears narrowly balanced while avoiding non-recurring actions, warranting the revision of the Outlook to Stable, from Negative. 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.

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 resumed 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.

HISTORICAL WILLINGNESS TO BUILD 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 balances, 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 pension contributions and conservatively amortizes its unfunded liabilities over fixed periods. Additionally, the state has adopted reforms to retirement pension and health liabilities.

RATING SENSITIVITIES

REBUILDING FISCAL FLEXIBILITY: The rating is sensitive to the state's ability to maintain balance over the near term while continuing to rebuild fiscal flexibility. The Stable Outlook assumes that the state's economic and fiscal performance makes progress toward that goal.

CREDIT PROFILE

The revision of the Rating Outlook to Stable, from Negative, on Connecticut's 'AA' rating reflects the state's ability over the last biennium to address revenue underperformance despite its still incomplete progress in rebuilding fiscal flexibility and within the constraints posed by its high fixed costs. The recently adopted biennium budget is based on conservative revenue assumptions, appears structurally balanced and avoids large non-recurring measures. Despite the revision to a Stable Outlook, Fitch cautions that economic gains during the current recovery have more often under-performed expectations, leaving the state unable to repeat its past practice of building large rainy day fund balances. Evidence that the state's currently limited level of flexibility is insufficient to absorb unforeseen fiscal challenges could result in a lower rating.

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 those balances are likely to be tapped to resolve a small remaining deficit from fiscal 2015, currently estimated at $71 million. The total BRF balance at present remains 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.

The recently adopted biennium budget for fiscal 2016-2017 avoids significant non-recurring actions, in contrast to the fiscal 2014-2015 biennium budget adopted two years ago. The budget elevates tax rates to cover spending needs, largely in fixed cost categories, leaving no material forecast surpluses to cushion against under-performance or augment the BRF and further narrowing the state's favorable tax rate gap with neighboring New York State, with which it shares the large and dynamic New York City metro area economy.

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 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 have accelerated over the last year but remain below national levels, with June 2015 up 1.7% year-over-year, compared to 2.1% nationally, and with an unemployment rate of 5.7%, above the 5.3% 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 thus far during 2015, with June 2015 financial activities employment rising 1.2% compared to one year earlier.

The state remains the wealthiest as measured by personal income per capita, at 135.4% of the national average in 2014. Personal income growth in recent quarters has been steady but below the national average; first-quarter 2015 growth was 3.5% year-over-year in Connecticut, compared to 4.4% nationally.

As of the state's recently adopted budget, the economic outlook through fiscal 2020 foresees improving performance after recent sluggish growth. Employment growth is estimated to have measured 1.2% in fiscal 2015, with gains in the next biennium of 1.2% in fiscal 2016 and 0.8% in fiscal 2017. Personal income growth is estimated to have been 3.2% in fiscal 2015, with forecast growth of 3.6% in fiscal 2016 and 4.2% 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; $520 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 $519.2 million, equal to 3% of fiscal 2015 general fund appropriations, before a draw to close the small fiscal 2015 deficit noted earlier.

VARIABLE PERFORMANCE IN JUST-ENDED BIENNIUM

The adopted budget for the fiscal 2014-2015 biennium, which ended on June 30, 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 surplus fiscal 2013 resources into the new biennium, restructuring and delaying repayment of outstanding ERNs, fund shifts with the transportation fund to benefit the general fund, and delaying the amortization of 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 varied considerably over the course of the biennium. After initially strong personal income tax (PIT) collections early in fiscal 2014, spring 2014 PIT collections under-performed significantly, reflecting the continued impact on state 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 emerged in fiscal 2014 and was deposited in the BRF, well above the $43.4 million assumed in the revised budget.

Fiscal 2015 performance trended below expectations through much of the year. Revenue collections under-performed, with successive consensus forecasts lowering expectations, and certain spending needs, notably in social services, exceeding budget. The state responded to each with rescissions and other actions to narrow the gaps. At present, the state projects a deficit of approximately $71 million; upon the comptroller certifying the final year-end balance, in September, the remaining deficit will be closed by a draw from the BRF.

FISCAL 2016-2017 BIENNIUM NARROWLY BALANCED

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. Gaps were closed primarily through recurring actions, most notably tax rate increases. New revenues include raising the PIT top rate to 6.99%, from 6.7%, and extending the hospital provider tax and the corporation tax surcharge. Spending grows 4.2% in fiscal 2016 and 3% in fiscal 2017. Both years are projected to end with minimal balances, at $0.8 million in fiscal 2016 and $2.5 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 year (FY) 2021. For transportation, the budget phases 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.

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 as of July 2015 totals $21.1 billion, or 9.4% 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 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 personal income, among the highest of U.S. states.

Despite the weak funded ratios of both plans, 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.

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 Stable.

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Applicable Criteria
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)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033