FitchRatings

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

Fitch Ratings-New York-05 November 2015: Fitch Ratings assigns an 'AA' rating to $650 million in state of Connecticut general obligation (GO) bonds, consisting of:

--$585,000,000 GO bonds (2015 series F);
--$65,000,000 GO bonds (green bonds, 2015 series G).

The bonds are expected to sell via negotiated sale on Nov. 16, 2015.

In addition, Fitch affirms the 'AA' rating on approximately $15.4 billion in outstanding GO bonds.

The Rating Outlook is Stable.

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

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 strengthened 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 balance, 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 contributions and conservatively amortizes its unfunded liabilities over fixed periods. The state has adopted reforms to both pension and retirement 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

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. 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. The budget for the current biennium was balanced upon adoption and avoided reliance on non-recurring actions.

Since then the state has revised downward its fiscal 2015 revenue expectations and begun taking corrective actions. The governor has also outlined more extensive reforms to taxes, staffing and pensions, intended to improve budgetary sustainability and competitiveness. Fitch will monitor the impact of any proposals as they are finalized and state begins to deliberate on them. In the meantime Fitch expects the state to address near-term under-performance within its current budgetary framework. Evidence that the state's currently limited level of flexibility is insufficient to absorb 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 were tapped to resolve a $113 million remaining deficit from fiscal 2015. The remaining BRF balance, at $406 million, is 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 biennium budget for fiscal 2016-2017 avoided significant non-recurring actions, in contrast to the fiscal 2014-2015 biennium budget adopted two years ago. The budget elevated 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 September 2015 up 1.4% year-over-year, compared to 1.9% nationally, and with an unemployment rate of 5.2%, just over the 5.1% 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 September 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 141% of the national average in 2014. Personal income growth in recent quarters has been steady but below the national average; second-quarter 2015 growth was 3% year-over-year in Connecticut, compared to 4.1% nationally.

The state's economic outlook through fiscal 2020 foresees improving performance after sluggish growth in fiscal 2014. Employment growth is estimated to have measured 1.2% in fiscal 2015, with gains in the next biennium of 1.6% in fiscal 2016 and 0.9% in fiscal 2017. Personal income growth is estimated to have been 3.9% in fiscal 2015, with forecast growth of 3.6% in fiscal 2016 and 4.4% 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 and 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 $406 million, equal to 2.3% of fiscal 2015 general fund revenues, following the draw to close the fiscal 2015 deficit noted earlier.

VARIABLE PERFORMANCE IN JUST-ENDED BIENNIUM

The state's fiscal outlook varied considerably over the course of the fiscal 2014-2015 biennium, which ended on June 30. 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. Ultimately the comptroller certified the final year-end deficit of $113 million, which was 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. In contrast to the fiscal 2014-2015 biennium adopted budget, which relied on one-time actions, gaps in fiscal 2016-2017 were closed primarily through recurring actions, most notably tax rate increases. New revenues included raising the PIT top rate to 6.99%, from 6.7%, and extending the hospital provider tax and the corporation tax surcharge. Spending was forecast to grow 4.2% in fiscal 2016 and 3% in fiscal 2017. Both years were 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 2021. For transportation, the budget phased 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.

State revenues have underperformed since fiscal 2016 began, with state lowering its revenue outlook a cumulative $214 million to date, offset by $103 million in rescissions announced in September. Forecast underperformance is driven primarily by lower PIT receipts, both from estimated payments as well as withholding. The state will formally revise its outlook with the consensus forecast to be announced November 10.

Given budgetary underperformance, the governor has outlined several policy options intended to improve the state's fiscal sustainability and competitiveness over the long run. The outline includes tax law changes favorable for corporations, state staffing efficiencies, and pension changes to reduce risk of higher contributions.

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 totals $20.9 billion prior to the current sale, or 9% 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 2015 state pension report, the burden of net tax-supported debt and adjusted unfunded pension obligations of both systems equaled 23.2% 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. The governor has announced the outline of a proposal to implement additional changes to SERS intended to lower budgetary risk tied to future investment underperformance; the most notable proposal includes making the oldest tier of SERS into a pay-go plan, instead of advanced funding. Fitch will assess the plan and its potential impact after further details become available.

Contact:

Primary Analyst
Douglas Offerman
Senior Director
+1-212-908-0889
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst

Marcy Block
Senior Director
+1-212-908-0239

Committee Chairperson
Karen Krop
Senior Director
+1-212-908-0661

Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email: sandro.scenga@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

Fitch recently published an exposure draft of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015). The draft includes a number of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to fewer than 10% of existing tax-supported ratings. Fitch expects that final criteria will be approved and published by Jan. 20, 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

Applicable Criteria
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942
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)
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