FITCH DOWNGRADES CONNECTICUT'S GO BONDS TO 'AA-'; OUTLOOK STABLE

Fitch Ratings-New York-19 May 2016: Fitch Ratings has assigned an 'AA-' rating to the following State of Connecticut general obligation (GO) bonds:

--$510,820,000 GO refunding bonds (2016 series B).

The bonds are being offered via negotiated sale on or about May 24, 2016. The par amount is subject to change pending final sale.

In addition, Fitch has downgraded the state's Issuer Default Rating (IDR) and the rating on the state's GO bonds to 'AA-' from 'AA'. The ratings on debt linked to the state's IDR also have been downgraded, as detailed at the end of this release.

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

The downgrade reflects both negative underlying credit trends and the application of Fitch's revised U.S. Tax-Supported Rating Criteria, released April 18, 2016. The state has experienced chronic economic and fiscal challenges during the current expansion and consequently its scope of flexibility to address future cyclicality, in Fitch's view, has been reduced. Despite repeated, and generally structural, responses to bring the current biennial budget into balance, it remains unclear whether the state has succeeded in fully aligning its budget to potential future economic and revenue performance. The Stable Outlook at the 'AA-' rating level reflects Fitch's view that, despite its high fixed cost burden and ongoing economic uncertainty, recent state corrective actions have primarily been structural in nature, and state managers continue to pursue fiscal management changes to improve the state's longer term prospects.

Economic Resource Base:
Connecticut has a 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 previous economic cycles. Over the 2012 - 2015 period, employment in the state rose at roughly half of the pace enjoyed by the nation, and current employment remains below the pre-recession peak. The state is the wealthiest in the U.S. as measured by per capita personal income, although aggregate personal income gains have trailed the nation's and key finance and manufacturing sectors are experiencing only modest growth after the retrenchment of recent years.

Revenue Framework: 'aa' factor assessment
Tax revenues are diverse, with the largest tax source, personal income tax (PIT), subject to considerable cyclicality, particularly the component derived from capital gains. Sales, corporate income, transportation and gaming taxes serve to further diversify the tax base. Baseline growth prospects for taxes are limited given the state's mature, slowly growing economy. The state has unlimited legal ability to levy taxes.

Expenditure Framework: 'aa' factor assessment
As with most states, Connecticut's pace of spending growth is expected to be higher than that of revenues in the absence of policy action given the prominence of Medicaid; other social services, education, municipal aid, debt service and pension contributions add further to spending pressure. The state has consistently demonstrated the ability to manage its high fixed cost burden, including making full actuarial contributions.

Long-Term Liability Burden: 'a' factor assessment
The burden of debt and unfunded pension liabilities in relation to resources is elevated and among the highest for a U.S. state. Net tax-supported debt consists primarily of GO and transportation borrowings, with much of GO borrowing undertaken on behalf of local schools. Unfunded pensions, including for local teachers, are more significant, with high discount rates suggesting that future funded ratio erosion and higher contribution needs are a risk, despite an otherwise very conservative amortization policy.

Operating Performance: 'aa' factor assessment
Frequent revenue reforecasting allows the state to identify revenue underperformance and quickly implement corrective actions. Gap-closing capacity remains strong but is less robust than during past expansions given that the state has been unable to quickly rebuild reserve balances and it already has implemented tax increases and spending cuts in the course of the current expansion. Further expenditure adjustments remain a source of additional flexibility, although high fixed costs limit the state's scope of action.

RATING SENSITIVITIES
MAINTAINING FISCAL RESILIENCE: The rating is sensitive to the state's continued ability to manage comparatively weak economic recovery conditions and future economic and revenue downturns while maintaining an operating profile consistent with the current rating level. This is particularly important given that reserve balances are likely to remain low relative to history and potential budgetary needs. Evidence that through-the-cycle fiscal flexibility has deteriorated further could lead to a downgrade.

CREDIT PROFILE

Connecticut has a diverse, mature and wealthy economic base, with a slowly growing population and an aging demographic profile. In contrast to past economic recoveries, growth in the current expansion has been unusually slow and uncertain. Employment gains have been well below national averages and slower than past recoveries. The finance sector, with important banking and investment activity in Fairfield County and insurance activity in Hartford, saw sizable employment losses through the recession and well into the recovery. The state's large and sophisticated manufacturing sector has seen relatively flat employment since steep recessionary losses ended, although important defense-related manufacturing helps to anchor the sector. Tourism has grown in importance, but prospects for the state's gaming resorts are more uncertain amid rising competitive pressures. The state's unemployment rate has historically run below the nation's, but this trend has reversed in more recent years. Personal income per capita ranks highest among the states, at 141% of the national level, and aggregate personal income growth continues, albeit below national rates of growth.

Revenue Framework
Tax revenues for general fund needs are diverse, with PIT, corporate income and sales taxes serving as the primary tax sources. PIT receipts, particularly those derived from non-withholding, are particularly important but subject to volatility. The separate transportation fund receives a range of transportation-related receipts as well as resources from the general fund.

A mature economy and an older, more slowly-growing demographic profile result in a revenue profile that Fitch believes is likely to grow more slowly than national GDP over time.

The state has unlimited legal ability to raise tax revenues. Tax rate competitiveness is more of a factor in Connecticut than in some other states due to its relatively small size for a state and its proximity to neighboring states' urban employment centers. Transportation revenues, while dedicated for transportation needs, are statutorily, although not constitutionally restricted to transportation and have been subject in the past to frequent diversion for general needs.

Expenditure Framework
As with many smaller states by land area, Connecticut's scope of spending is very broad, with the state responsible for delivering or funding numerous services routinely funded at the local level in other states. Formula funding for local schools and subsidies for higher education highlight the state's sizable role in education, which also extends to funding teacher pension contributions and school capital. Municipal aid is also significant, although a recent sales tax-funded expansion included in the adopted fiscal 2015 budget was partly reversed given subsequent budgetary weakness. Common to states, Medicaid and other social services are the largest spending commitment, with rising needs pressuring total spending.

As with most states, spending is expected to be in line with to marginally above expected revenue growth without ongoing state action to control costs. This is largely driven by social service demands.

The state retains solid ability to cut spending despite several rounds of budgetary adjustment during the current and last biennia. Statute requires swift response in the event of forecast underperformance, either through rescissions, allotment cuts, or with legislative concurrence, depending on the size of the projected deficit.

Fitch views Connecticut's fixed costs as being relatively high, well above the U.S. state median, driven by an above average burden of debt and unfunded pensions. Debt service includes support for GO bonds issued for school construction, as well as past deficit borrowing and conversion to GAAP budgeting. The state consistently makes full actuarial contributions toward paying down its unfunded pensions.

Long-Term Liability Burden
Connecticut's long-term liability burden for debt and pensions is elevated and amongst the highest for a U.S. state, although it remains a moderate burden on resources and the state continues to contribute full actuarial contributions to its pensions.

Net tax-supported debt totaled $21.8 billion as of February 2016, or 9.1% of 2015 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 in pension bonds issued to improve the funded ratio of the teachers retirement fund (TRF).

Both of the state's two major pension systems, covering state employees and teachers, have relatively low funded ratios driven by weak contribution practices in the past; both plans have now received full annual actuarial contributions for years, the TRF under a covenant linked to GO pension bonds. Connecticut has pursued reforms for both plans, and both maintain conservative closed amortization schedules. The state is considering additional reforms to lower the burden of pensions over time.

Operating Performance
Fitch views Connecticut as having strong gap-closing capacity, although somewhat diminished given its economic and revenue performance in recent biennia. Expenditure and revenue actions,

particularly expenditure cuts, remain the state's primary sources of financial resilience given the relatively low balance of the budget reserve fund (BRF) and tax rate increases adopted in recent biennial budgets that make further increases more challenging. A partial draw on the BRF to close a fiscal 2015 ending deficit left its balance at $406 million, or 2.2% of fiscal 2015 net revenues, well below the nearly $1.4 billion peak in fiscal 2009. The BRF level is likely to be tapped again to close a remaining forecast $259 million gap in fiscal 2016, even after the extensive administrative and legislative actions already taken in the course of this fiscal year. Financial resilience is further supported by multiple revenue monitoring mechanisms, including consensus forecasting, and disciplined mechanisms to respond to identified budgetary weakness.

Along with relatively high fixed costs, the state continues to carry the burden of deficit notes issued during the last downturn, in contrast to past recoveries when surging tax receipts allowed past deficit notes to be repaid early and the BRF balance to be rebuilt. Despite this limitation and the challenges posed by its current slow recovery, the state's fiscal management has generally improved in recent biennia, with a greater reliance on structural solutions, continued full actuarial pension contributions and actions taken to correct a longstanding GAAP deficit.

Current Developments

The state is currently in the middle of its fiscal 2016-2017 biennium. Although the adopted biennial budget was structurally balanced and the revenue forecast appeared reasonable, fiscal 2016 quickly underperformed, resulting in several rounds of lower consensus revenue forecasts and administrative and legislative actions to close gaps. Gap-closing actions have themselves been mostly structural, including layoffs. The April 29 consensus forecast, the final update for fiscal 2016, lowered revenues further given disappointing PIT collections, primarily in capital gains related revenues. With only a short remaining timeframe before the fiscal year-end, the newly re-emerging gap for fiscal 2016, estimated at $259 million, is likely to be closed by a draw from the BRF.

Forecast fiscal 2017 revenues were lowered with each successive consensus update during fiscal 2016. The state legislature reached agreement last week on a $961 million package of budgetary adjustments to close the fiscal 2017 gap. Actions include additional layoffs, as well as trimming budgeted transfers of sales taxes for municipalities and transportation funding that had been included in the adopted budget. Consistent with fiscal 2016 actions, the fiscal 2017 legislative package emphasizes recurring actions, which is likely to make the size of fiscal 2018-2019 forecast gaps more manageable.

The state has implemented some administrative changes to budgeting supported by the governor, including changing the calculation of future expenditures, and is reviewing other fiscal changes, including additional pension reforms.

Related Ratings

In conjunction with the downgrade of the state's IDR, Fitch has downgraded by one notch the rating on the following bonds, whose ratings are linked to the state's rating. The Rating Outlook on all of the bonds is Stable.

--University of Connecticut state debt service commitment bonds to 'A+' from 'AA-';
--Connecticut Higher Education Supplemental Loan Authority state supported revenue bonds payable from special capital reserve funds to 'A+' from 'AA-';
--Capital City Economic Development Authority parking and energy fee revenue bonds, series 2004A, 2004B, and 2008D to 'A+' from 'AA-';
--Connecticut Development Authority and Connecticut Innovations general fund obligation bonds, series 2004A, 2004B, 2004C, 2006A and 2014A to 'A+' from 'AA-';

--Connecticut Health and Educational Facilities Authority (CHEFA) revenue bonds (child care facilities program) series G to 'A' from 'A+'.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

Applicable Criteria
U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=879478