State of Connecticut
General Obligation Bonds

Executive Summary

Kroll Bond Rating Agency (KBRA) has affirmed the long-term rating of **AA**- and revised the outlook to **Negative** from **Stable** on the State of Connecticut's outstanding general obligation bonds. This rating applies to all of the state's outstanding general obligation bonds, but excludes bonds backed by a letter of credit or liquidity facility. The state has approximately $19 billion of general obligation debt outstanding.

KBRA has also **affirmed** the long-term rating of **AA-** and revised the outlook to **Negative** from **Stable** on the State of Connecticut General Fund Obligation Bonds 2014 Series A issued by Connecticut Innovations, Inc. KBRA views the obligation of the State to pay debt service on the 2014 Series A Bonds as tantamount to the general obligation security of the State.

This affirmation is based on KBRA's **U.S. State General Obligation Rating Methodology**.

Security

The state's outstanding general obligation bonds are secured by Connecticut's full faith and credit pledge. All general obligation bond debt service of the State of Connecticut ("the State") is deemed appropriated without further action by the state Legislature.

Key Rating Strengths
• Current leadership has demonstrated an ability and willingness to make adjustments during the fiscal year to maintain budget balance.
• A strong financial management framework exists for tracking revenues and monitoring budget performance as well as an established mechanism for adjusting budgeted expenditures during the fiscal year.
• Connecticut has the highest personal per capita income in the country at $68,704 for calendar year 2015.
• Available cash balances provide good liquidity for operations, without utilization of external borrowing.

Key Rating Concerns
• State's inability over the last three years to maintain balanced financial operations without significantly reducing the budget reserve fund. The State is projecting that the budget reserve fund will be depleted by the end of FY 2017.
• State's continued difficulty in accurately projecting personal income tax levels impacted by the performance of volatile financial markets, specifically capital gains taxes, and continued lack of significant growth in wage levels across the State.
• State's relatively high budgetary burden related to fixed costs, specifically debt service, pension contributions and OPEB obligations.
• State debt burden is high, compared to other states, on a per capita basis and as a percentage of personal income.

- Connecticut has a relatively high level of unfunded pension liabilities.

Rating Summary

KBRA has revised the outlook on the State of Connecticut's general -obligation bond rating to **Negative** from **Stable** based on the State's continuing difficulty in accurately projecting income tax revenues and the resulting draw down on the State's budget reserve fund (BRF) to zero at the end of FY 2017. The outlook revision also reflects the increased budget pressure on the State going into the FY2018-FY 2019 biennium due to recent downward revenue revisions. Since FY 2015, the State has revised its revenue estimates for personal income tax revenue and has consistently made budget adjustments to restore fiscal balance during the fiscal year. However, when significant downward revisions to revenue estimates are made based on April income tax collections, the State has limited ability to make sufficient spending cuts to offset these revenue shortfalls before the end of the fiscal year on June 30 and has drawn on the BRF to fund end of year deficits. The depletion of the BRF reduces the State's flexibility in managing future revenue shortfalls and other budget pressures.

The income tax revenue revisions over the last few years have primarily been due to lower than expected collections of estimated and final payments although the withholding portion of the income tax revenue has also been subject to revisions. Historically, withholding taxes represent 60%-70% of total personal income tax collections with estimated and final payments representing the balance. Estimated and final personal income tax collections include taxes on capital gains, dividends and estimated personal income tax payments. A large portion of the estimated and final income taxes are generally collected in April of the fiscal year. Approximately half of the estimated and final collections, or 15% of total personal income tax collections, represent taxes on capital gains, which is impacted by financial market performance and taxpayer decisions on the sale of securities. Capital gains tax collections reflect capital gains taken in the immediately preceding tax year. The State has found it difficult, as have other high wealth states, to project the level of estimated and final income taxes since 2012. Actual annual estimated and final collections have been lower than budgeted levels in five out of six years since FY 2012, including FY 2017. The State's continuing slow recovery from the Great Recession has also challenged management's ability to accurately budget and grow income tax withholding tax revenues.

Based on the State's April 30, 2017 consensus revenue estimates, the Office of Policy and Management (OPM) revised its revenue projections for FY 2017 downward by a net $410 million. This downward revision is due to significantly lowered estimates for both the withholding and estimated and final portion of the State income tax. For FY 2017, annual income tax collections are now projected to be $532 million, or approximately 5%, lower than originally budgeted for FY 2017. Based on the April 2017 consensus revenue estimates for FY 2017, the withholding portion of the income tax is now projected to grow by 2.2% over FY 2016, compared to the January 2017 revenue estimate of 2.8%. The estimated and final portion of the income tax is now projected to decline by 9.4% over FY 2016, compared to the January 2017 revenue estimates of 2.8% growth in FY 2017.

Based on its monthly letter dated May 19, 2017, OPM is projecting a $322.7 million deficit in the general fund for FY 2017. On May 10, 2017, Governor Dannel Malloy submitted a deficit mitigation plan to the General Assembly, as required by statute, which outlined his plan for balancing FY 2017 operations. The plan included drawdown the remaining $236 million in the State's BRF to balance FY 2017 operations. The BRF was funded at $519 million at the end of FY 2014 and has been drawn down in each fiscal year since then.

The State closely monitors its budget to actual financial performance on a monthly basis. Under state statutes, the governor may implement a certain level of expenditure reductions, or rescissions, without legislative approval, to maintain a balanced budget and may submit proposals to the General Assembly for additional reductions if necessary. Over the last several years, the governor has implemented expenditure reductions a number of times through this process and the General Assembly has taken action at the request of the governor. If the monthly statement on financial performance indicates a projected General Fund deficit greater than 1.0% of total General Fund appropriations, the governor is required to submit a report to the General Assembly that outlines a plan to reduce expenditures and prevent a deficit.

On February 8, 2017, Governor Malloy presented his proposed FY 2018-FY 2019 biennium budget to the General Assembly. The baseline biennium budget for the $18 billion General Fund includes a gap of $1.7 billion in FY 2018 and $1.9 billion in FY 2019. The governor's biennium budget closes these budget gaps through a combination of revenue enhancements and expenditure reductions. The spending reductions are largely structural in nature and the revenue enhancements do not raise the major State taxes. For FY 2018 and FY 2019, the proposed budget includes savings resulting from collective bargaining savings, implementation of municipal cost sharing of pension costs for the Teacher's Retirement System (TRS), some adjustments to municipal aid and changes to the tax structure for hospitals. These FY 2018 spending cuts are expected to roll forward with some adjustments to balance the FY 2019 budget. The proposed FY 2018 and FY 2019 budget, though inclusive of areas of uncertainty, represents the administration's efforts to change the structure of its budget, as well as address inequities in its school funding system. The State has taken steps to address its long term financial risks, as evidenced by the State's restructuring of the future stream of pension obligation for its state employment retirement system (SERS) to increase stability and predictability.

On May 22, 2017, it was announced that the governor and state employee union leaders had reached a tentative agreement on a new five-year contract. The agreement will generate savings to the State of $1.5 billion over the FY 2018 /FY 2019 biennium, which is the level included in the governor's February budget, and will reduce the State's level of pension contributions going forward. The agreement would freeze all State employee wages over the next three years, increase employee pension and healthcare contributions and make other changes to reduce costs in both the State retirement and healthcare plans. The State has also agreed not to lay off any unionized State employees over the next four fiscal years which , in KBRA's view, will limit the State's options for managing its budget in the coming biennium and beyond. The agreement must be approved by the leadership of the specific unions and the rank and file membership, as well as the General Assembly.

Based on the April 2017 revenue consensus estimates, projections for income tax revenues were revised downward for FY 2018 and FY 2019 by $597 million and $864 million, respectively. On May 25, 2017, the governor released a revised FY 2018/FY 2019 biennium budget reflecting current revenue estimates. The withholding portion of the income tax is now projected to increase 1.9% and 2.1% in FY 2018 and FY 2019, respectively. The growth rate for estimated and final income taxes is now projected to be 0% and 1% in FY 2018 and FY 2019, respectively. The budget gaps for FY 2018 and FY 2019 created by the recently projected revenue shortfalls are closed primarily through the elimination of the General Fund funding of the State's municipal aid grant program for municipalities across the State. OPM stated that the elimination of the General Fund transfers for this purpose represents a structural budget change going forward. The revised biennium budget does not include any funding for the BRF.

The State's constitution provides that the General Assembly must adopt a balanced budget. The FY 2018-FY 2019 biennium budget is currently being discussed by both houses of the legislature. The legislative session ends June 7. In the event that a budget is not passed by then, OPM states that state statutes provide the governor with broad authority to maintain state operations. Under state statute, debt service is "deemed appropriated" and would be paid.

In KBRA's view, several areas of risk exist in the revised governor's biennium budget for FY 2018 and FY 2019, including union ratification of the recent labor agreement negotiated between union leaders and the governor and legislative agreement on the municipal cost sharing of TRS pension costs and elimination of funding for the municipal aid grant program. KBRA views the State's agreement to not lay off unionized employees as limiting the State's option for budget management. The State's relatively high fixed cost structure, with combined debt service, pension costs and OPEB cost representing approximately 20% of annual governmental funds expenditures, also reduces budget flexibility.

Based on the review of the four KBRA Rating Determinants included in KBRA's methodology for rating state general obligation debt, KBRA has determined that the ratings assigned to all of the four Rating Determinants remain consistent with previously designated levels. KBRA continues to assign an overall rating of AA- to the State's general obligation bonds. KBRA's Rating Determinant ratings are summarized as follows:

- Management Structure, Budgeting Practices and Policies: AA+
- Debt and Additional Continuing Obligations: AA-
- Financial Performance and Liquidity Position: A+
- State Resource Base: AA-

Outlook: Revised to Negative from Stable

KBRA's revision of the State's outlook to **Negative** from **Stable** reflects the State's ongoing difficulty in accurately projecting State revenues, the recent drawdown of the BRF and the risks reflected in the proposed FY 2018-FY 2019 biennium budget currently under discussion in the General Assembly. The outlook revision also reflects uncertainty as to the accuracy of future revenue projections going forward. The depletion of the BRF reduces the State's flexibility in managing future revenue shortfalls and other budget pressures. KBRA recognizes that the governor's proposed FY 2018-FY 2019 budget includes elements of a sustainable budget framework for the State, which addresses underlying economic changes and long term financial challenges. KBRA will continue to monitor both the trends in personal income tax collections and the State's progress in restructuring the expenditure side of its general-fund budget.

In KBRA's view, the following factors may contribute to a rating upgrade:

- Trend of accurate revenue projections leading to budget stability in the General Fund.
- Trend of structurally balanced budgets and actual financial results showing General Fund operating surpluses.
- Sustained increase in funding level of State's budget reserve fund.
- Significant increase in the funded ratios for the State's pension systems.

In KBRA's view, the following factors may contribute to a rating downgrade:

- Continued pressure on personal income tax collections from volatility in the financial markets, further shifts in the State's employment base or decline in economic activity.
- Failure to take actions necessary to maintain budget discipline and balanced financial operations.
- Significant reliance on non-recurring revenues to balance the budget.

Conclusion

KBRA has affirmed the long-term rating of **AA**- and has revised the outlook to **Negative** from **Stable** on the State of Connecticut's outstanding general obligation bonds. This rating applies to all of the state's outstanding general obligation bonds, but excludes bonds backed by a letter of credit or liquidity facility.

KBRA has also **affirmed** the long-term rating of **AA-** and revised the outlook to **Negative** from **Stable** on the State of Connecticut General Fund Obligation Bonds 2014 Series A issued by Connecticut Innovations, Inc. KBRA views the obligation of the State to pay debt service on the 2014 Series A Bonds as tantamount to the general obligation security of the State.

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Related Publications:

- **State of Connecticut General Obligation Bonds, Series 2017**
- **U.S. State General Obligation Rating Methodology**