

# MOODY'S

## INVESTORS SERVICE

### New Issue: Moody's assigns Aa3 ratings to State of Connecticut G.O. Bonds; outlook is stable

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Global Credit Research - 04 Mar 2014

CONNECTICUT (STATE OF)  
State Governments (including Puerto Rico and US Territories)  
CT

#### Moody's Rating

ISSUE	RATING
General Obligation Bonds (2014 Series A)	Aa3
<b>Sale Amount</b> \$300,000,000	
<b>Expected Sale Date</b> 03/14/14	
<b>Rating Description</b> General Obligation	

General Obligation Bonds (2014 Series B)	Aa3
<b>Sale Amount</b> \$100,000,000	
<b>Expected Sale Date</b> 03/14/14	
<b>Rating Description</b> General Obligation	

**Moody's Outlook** STA

#### Opinion

NEW YORK, March 04, 2014 --Moody's Investors Service has assigned Aa3 ratings to the State of Connecticut \$300 million General Obligation Bonds (2014 Series A) and \$100 million General Obligation Bonds (2014 Series B) - SIFMA Index Bonds. The bonds will be priced the week of March 10. Proceeds will be used for various statewide capital projects.

#### SUMMARY RATING RATIONALE

The Aa3 state rating incorporates Connecticut's high combined fixed costs for debt service, pension, and post employment benefits relative to the state's budget; pension funded ratios that are among the lowest in the country and likely to remain well below average; and minimal reserve levels. The slow pace of the state's economic recovery led to revenue underperformance and persistent budget gaps though the state has recently worked to increase reserves and bring the state budget into fiscal balance.

#### STRENGTHS:

- Legislated support for application of operating surpluses to the Budget Reserve Fund (BRF)
- Commitment to eliminate GAAP negative fund balance
- Wealthiest state in the nation with per capita personal income levels well above national levels

#### CHALLENGES:

- Fixed costs for debt, pension, and other post employment benefits (OPEB) relative to budget are among the highest in the nation
- Very low funding ratios for pension systems

-- Vulnerability to financial market fluctuations due to effect on capital gains for very high wealth residents and employment in the financial services sector

-- General Fund balance sheet will remain negative over near term and rainy day fund modest due to state's slow recovery from the recession

## DETAILED CREDIT DISCUSSION

### \$398 Million Surplus for Fiscal 2013, Higher Than Expected

Connecticut's recovery has been slower than average, but benefitted from improved economic growth in 2013. The state managed to close out fiscal 2013 with a surplus of \$398 million, about \$161 million higher than estimated when the 2014-2015 biennium budget was adopted. The additional surplus is largely related to high wealth one-time revenue. As in many states, Connecticut benefitted from taxes on capital gains and significant gifts recorded in calendar year 2012 (tax year 2013) in anticipation of the expected lapse of tax cuts beginning in calendar year 2013. At the time of the budget adoption, the state estimated that it received one-time revenue of \$200 million in income taxes and \$200 million in gift taxes. For fiscal 2014, the state conservatively reduced these amounts from the base forecast, plus \$50 million on the assumption that it was pulled forward into fiscal 2013. As a result, the base forecast was lowered by a total of \$450 million due to these one-time revenues.

When the 2014-2015 budget was adopted, the expected fiscal 2013 surplus was \$237 million. The majority (\$221 million) was incorporated into the upcoming biennial budget, mostly in fiscal 2014, but \$16 million was to be transferred to the budget reserve fund (BRF). Due to the larger surplus, the state was able to transfer \$177 million to the BRF, bringing the fund balance to \$271 million. Still, Connecticut's rainy day fund balance will remain modest at less than 2% of revenues.

### Adopted 2014-2015 Biennial Budget Addressed Projected Gaps

On a current services basis, Connecticut faced large projected budget gaps relative to most other states. The final adopted budget featured a combination of revenue enhancements, but no new taxes; reduced transfers for municipal aid as well as to the special transportation fund; and spending cuts, largely due to programmatic changes in Medicaid costs. In addition, the state reduced its General Fund current services budget by changing how the state funds its Medicaid expenditures. First, beginning in fiscal 2014, the Affordable Care Act Medicaid expansion program is being funded off budget, since it is funded entirely by the federal government. Second, only the state's share of Medicaid expenditures in the Department of Social Services is appropriated. The net effect of these changes was a reduction of appropriations by \$2.8 billion in fiscal 2014 and by \$3.2 billion in fiscal 2015, with corresponding offsets on the revenue side.

After adopting a structurally balanced budget for the 2012-2013 biennium, Connecticut returned to the use of one-time solutions to balance its budget for the next biennium. One-time resources are lower than they were during the recession, originally representing about 4% (\$728 million) and 2% (\$422 million) of fiscal 2014 and fiscal 2015 revenues, respectively. The largest non-recurring solutions included the use of \$221 million of the fiscal 2013 year end surplus; restructuring the 2009 economic recovery notes by extending the maturity two years to save \$196 million in each of the next two fiscal years; and various fund transfers totaling almost \$250 million over the biennium.

At mid-term, the state is projecting a surplus of approximately \$504 million for fiscal 2014 and has proposed using the surplus to make an additional payment to the state employee retirement system (SERS) (\$100 million), finance a tax refund program (\$155 million) and deposit and additional \$243 million into the BRF. The state has also proposed to the legislature increasing the BRF requirement to 15% of revenues, up from 10% to further build reserves.

### Bond Proceeds Used to Reduce Negative GAAP Balance

In fiscal 2013 the state implemented a plan to begin addressing Connecticut's sizeable \$1.2 billion cumulative GAAP deficit. The state issued \$560 million, which generated \$598.5 million in proceeds, (of the \$750 million total authorized by the legislature) general obligation bonds, amortizing the bonds over 15 years and reducing the accumulated GAAP deficit to \$618.5 million. The remaining portion of the deficit will be amortized over 13 years starting in fiscal 2016, resulting in an annual payment of about \$47.5 million. These amounts will be "deemed appropriated", meaning no further legislative action is needed to make the payments.

The GAAP bond proceeds are not counted as General Fund revenues, and the proceeds cannot be used for any current or future budget appropriations. While the funding strategy enabled the state to begin addressing its

longstanding sizeable GAAP deficit and injects discipline into the plan, the additional debt adds to the state's already high debt levels and fixed costs. Even with the plan, the unassigned General Fund balance will remain negative over the near term.

#### Connecticut's Pension Liability Among the Highest in the Country; Fixed Costs are High Relative to Budget

Based on Connecticut's fiscal 2012 pension data, we have calculated that the SERS adjusted net pension liability (ANPL) was 121% of revenues. The state reported funded ratio for SERS dropped to 42% as of June 30, 2012 from 48% as of June 30, 2011. Moody's SERS adjusted funded ratio as of June 30, 2012 is 22.9%. Moody's TRS adjusted funded ratio as of June 30, 2012 is 31.8%. The actuarial valuation for TRS showed a funded ratio of 55% as of June 30, 2012, down from 61% as of June 30, 2010. SERS revised downward the assumed rate of return, to 8% from 8.25% beginning in fiscal 2014, along with other adjustments to price and wage inflation rates. The assumed rate of return for TRS is 8.5%. For these two plans, the state's combined ANPL for fiscal 2012 was 243.4% of revenues. This amount is notably higher than that of Kentucky, the state with the third largest pension burden, at 211.3% of revenues, but is well below Illinois at 318%. The 50-state median ANPL to revenues is 63.9%, based on 2012 data. Other pension ratios such as ANPL to personal income, GDP, and population are similarly very high for Connecticut.

Full SERS and TRS ARC payments are reflected in the current budget, and the state is required to maintain full funding of the ARC going forward pursuant to a labor agreement for SERS and a bond covenant for the TRS 2008 pension obligation bonds (POB). Some pension and healthcare reforms were achieved in the round of union negotiations prior to the adoption of the fiscal 2012-2013 biennial budget.

Connecticut's unfunded liability for other post employment benefits (OPEB) declined (from \$26.6 billion to \$19.5 billion) due to changes in assumptions and 2011 plan reforms. Still, Connecticut's combined fixed costs for debt service, pension, and OPEB are high and, absent significant further reforms, will continue to consume an increasingly larger portion of the state's budget.

#### High Debt Ratios Reflect Heavy Debt Load

Connecticut is a frequent borrower and the state's debt per capita and debt-to-personal income ranked first and third, respectively, among the 50 states for Moody's 2013 debt medians. Net tax-supported debt equaled \$5,185 per capita and 9.1% of total state personal income, well above the 50-state medians of \$1,074 in debt per capita and 2.8% for debt-to-personal income. These high debt ratios are partly due to substantial capital financing for K-12 school building construction that is carried out at the local level in many other states. However, with the \$2 billion POBs and the sale of \$560 million in GAAP Conversion bonds to address a portion of the state's sizeable cumulative GAAP deficit, on top of the state's normal sizeable annual debt issuances, Connecticut's debt ratios will likely remain among the highest in the country. Connecticut adheres to a 20-year level principal repayment schedule for its general obligation debt, with a declining debt service schedule that provides some flexibility.

State debt includes financing for certain municipal projects (mostly schools) that are funded at the local level in most states. As a result, the state's resources are more leveraged than other states. This results in higher state fixed costs for debt service, even though Connecticut's combined debt loads (state plus local obligations) are more moderate relative to its significant taxable base.

Connecticut's liquidity has improved and remains satisfactory. The state has not had to borrow for cash flow purposes. A standby line of credit for \$300 million for potential cash flow needs in fiscal 2013 was not tapped and expired in December 2013. Cash balances have averaged \$2.1 billion in fiscal 2014 and are currently about \$770 million above the level at the same time last year (as of February 15, 2014). Cash margins would likely be tighter if the state decreased its use of debt, as the state uses bond proceeds as an occasional and temporary source of cash.

#### Modest Amount of Variable Rate Debt and Minimal Swap Exposure

The state has \$1.7 billion in variable rate debt, most of which is indexed to either SIFMA or CPI, or approximately 12% of the state's total G.O. debt. The state has \$10 million in outstanding puttable general obligation variable rate debt with a liquidity facility provided by a standby bond purchase agreement (SBPA) with Bayerische Landesbank. The SBPA expires in May 2014 at which time the bonds mature. A total notional amount of \$336 million variable rate debt is swapped to fixed based on 60% of LIBOR or a percentage point above CPI. Termination payments could be triggered in the unlikely event that the state's rating is downgraded below Baa2, or by the state if the counterparty rating falls below A3. There are collateral posting requirements on the part of the counterparties but not for the state. According to the most recent valuation (December 31, 2013), if all of the state's general

obligation swaps were terminated, the state would owe approximately \$13.6 million to the counterparties. This amount is manageable given the state's current resources and likely ability to issue bonds for the amount if necessary. In accordance with its swap guidelines, the state generally negotiates provisions that permit funding a required termination payment over a period of time to allow time for a refunding. Accordingly, the state would have 270 days to fund a termination payment for its general obligation swaps.

#### Slow Economic Recovery

Connecticut's economy is recovering more slowly than the rest of the country, as indicated by growth rates for GDP, personal income, employment, and single-family housing starts that are below the US average. Several sectors continue to show negative employment trends from a year ago, including manufacturing, information and financial activities. Industry employment was flat in the fourth quarter of 2013 and the state has only recovered about half of the non-farm jobs it lost during the recession. Connecticut's unemployment rate was 7.4% in December 2013, above the national rate of 6.7% the same month. Moody's Analytics expects that Connecticut's employment growth will lag the nation over the forecast horizon.

#### OUTLOOK

The outlook for Connecticut is stable reflecting the positive steps the state has taken to address its long-standing balance sheet weakness and reduce its fixed post employment benefit costs through pension reforms, as well as the adoption of a budget that largely relies on recurring solutions. We expect that Connecticut's revenue trends should improve as its recovery picks up steam. We also expect that the state will maintain its new commitment to replenishing its rainy day fund over time and addressing its remaining negative GAAP basis unassigned General Fund balance. The slow pace of economic recovery will continue to challenge the state's financial position over the near term.

#### What could move the rating up

- Achievement and maintenance of higher GAAP-basis combined available reserve levels
- Established trend of structural budget balance
- Evidence of sustained stronger economic performance
- Reduced debt ratios relative to Moody's 50-state median and lower fixed annual costs.
- Significantly improved funding of pension and post-retirement liabilities

#### What could move the rating down

- Lack of improvement in available reserve levels
- Reversion to significant one-time budget solutions, including deficit financings
- Revenue weakness driven by delayed economic recovery
- Cash flow strain stemming from reduced liquidity
- Significant increase in fixed costs as percent of budget

The principal methodology used in this rating was US States Rating Methodology published in April 2013. Please see the Credit Policy page on [www.moody.com](http://www.moody.com) for a copy of this methodology.

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