FitchRatings

FITCH RATES CONNECTICUT'S $510MM GO BONDS 'AA'; OUTLOOK REMAINS NEGATIVE

Fitch Ratings-New York-29 July 2014: Fitch Ratings assigns an 'AA' rating to approximately $510 million in state of Connecticut general obligation (GO) bonds, consisting of the following:

--$300,000,000 GO bonds (2014 series E);
--$200,000,000 taxable GO bonds (2014 series A);
--$10,590,000 taxable GO refunding bonds (2014 series B).

The bonds are expected to sell via competitive sale on Aug. 6.

In addition, Fitch affirms the following outstanding ratings:

--Approximately $14.9 billion outstanding GO bonds and notes at 'AA'.

The Rating Outlook remains Negative.

SECURITY

GO bonds to which the full faith and credit of the state will be pledged for payment of principal and interest.

KEY RATING DRIVERS

NEGATIVE OUTLOOK BASED ON BUDGET VULNERABILITY: The Negative Outlook reflects the state's reduced fiscal flexibility at a time of lingering economic and revenue uncertainty. The adopted budget for the current biennium relied on one-time items and anticipated little near-term progress in rebuilding fiscal flexibility. Personal income tax (PIT) revenues were volatile in the first year of the biennium, with the state taking proactive action to ensure a modest fiscal 2014 budgetary surplus to be deposited to the rainy day fund.

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, and the state's large and important finance sector continues to weaken.

CYCLICAL REVENUES AND SPENDING PRESSURE: State revenue performance is cyclical, while high fixed costs limit its ability to respond during revenue downturns.

HISTORICAL WILLINGNESS TO BUILD BALANCES: During past economic recoveries the state has demonstrated a willingness and ability to rapidly repay deficit borrowing and rebuild its rainy day balance. The current slow recovery has hampered rebuilding of reserves in the current biennium.

HIGH DEBT: Tax-supported debt is high for a U.S. state. Most GO bonds, excluding GO bonds issued to fund the teachers' retirement system, amortize rapidly.

SIGNIFICANT PENSION OBLIGATIONS: Unfunded liabilities for employees are significant, including for state employee and teacher pensions. The state fully funds actuarially calculated pension contributions and maintains fixed amortization dates. Additionally, the state has taken steps to reform retirement pension and health liabilities.

RATING SENSITIVITIES

VULNERABILITY TO ECONOMIC AND REVENUE CHALLENGES: An inability to meet or exceed budgeted forecast expectations could lead to a downgrade.

SUCCESS IN RAISING RESERVE BALANCES: Improved fiscal flexibility provided by higher than forecast revenues and material progress in rebuilding reserves could stabilize the state's credit outlook.

CREDIT PROFILE

Connecticut's GO rating, at 'AA,' reflects its vast wealth and income resources, tempered by a comparatively high burden of debt, retirement liabilities and other fixed costs. The Negative Outlook is based on the state's inability in its adopted fiscal 2014-2015 budget to return to more structurally sustainable budgeting and rebuild flexibility at a time of unusually slow economic and revenue recovery. The budget was balanced only through a number of non-recurring resources, including refinancing the outstanding economic recovery notes (ERNs) that were used to fund deficits in the last recession.

Revenues in the first half of fiscal 2014 surged, with solid year-over-year gains in personal income tax (PIT) collections prompting the state to elevate its forecast expectations. Following disappointing spring 2014 PIT collections, the state reversed course, lowering forecast revenue growth down to just below originally budgeted levels and adopting a modest package of mid-biennium budget adjustments to ensure a small deposit to the budget reserve fund (BRF), the state's rainy day fund.

ECONOMY

Connecticut has a wealthy, 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. Employment rose 0.9% annually in both 2012 and 2013, below the 1.7% national growth rates for both years. Job weakness continues, with June 2014 up only 0.5% year-over-year, compared to 1.9% nationally, and with an unemployment rate of 6.7%, above the 6.1% national rate. Growth in financial services, an important source of the state's wealth, has been weak, with financial activities employment falling 1.4% in June year-over-year.

The state remains the wealthiest as measured by personal income per capita, at 137% of the national average in 2013. Personal income growth in recent quarters continues at levels below the national average; first-quarter 2014 growth was 2.7% year-over-year in Connecticut, compared to 3.5% nationally.

The state's revised economic outlook through fiscal 2018 appears reasonable, in Fitch's view. It foresees improving performance after recent sluggish growth; gross state product gradually accelerates in 2014 and 2015 generally in line with national forecast expectations. Employment growth continues at a below-average level through the period, rising 0.8% annually in 2014 in the state compared to 1.7% nationally.

RECENT FISCAL PERFORMANCE

Connecticut has a cyclical revenue system, and strong growth in some years historically has enabled the state to build large balances in the BRF. During recessionary periods, the state relies on the BRF to cover revenue declines, and bonding in the form of economic recovery notes (ERNs) to cover year-end deficits. Prior to the 2008-2009 recession, an unusually severe one in the state, the BRF balance had risen to $1.38 billion in fiscal 2007, equal to 8.5% of appropriations; the statutory maximum is 10%. The lingering slow recovery has stymied a full recovery from the last recession.

To close persistent budgetary gaps in the fiscal 2008-2009 and 2010-2011 biennia, the state relied on spending cuts, tax rate changes and non-recurring resources, including federal stimulus funds and $916 million in ERNs. The BRF was depleted in fiscal 2010 and fiscal 2011. In fiscal 2012, continued revenue underperformance and higher spending needs eroded forecast surpluses despite mid-year cuts and other balancing actions. A fiscal year-end deficit of $143.5 million was closed using remaining fiscal 2011 surplus originally intended for early repayment of ERNS. Uncertainty continued in fiscal 2013, with revenue under-performance early in the fiscal year followed by a strong revenue turnaround, driven by PIT receipts linked to 2013 federal tax law changes. The state was able to make a sizable deposit to the BRF in fiscal 2013, bringing its balance to $271 million (1.4% of fiscal 2013 general fund revenues).

The fiscal 2014-2015 biennium adopted budget 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 $221 million in fiscal 2013 surplus into the new biennium, restructuring the ERNs for $276 million in savings, fund shifts with the transportation fund to benefit the general fund, and a delayed start to amortizing the state's GAAP deficit. General fund revenues were forecast to grow 2.9% in fiscal 2014 and 3.7% in fiscal 2015. Tax law changes included extending a corporate tax surcharge that had been scheduled to expire. GO bonds to restructure the 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.

After initially raising forecast fiscal 2014 revenue expectations largely due to strong PIT collections early in the fiscal year, spring 2014 PIT collections under-performed significantly, reflecting the continued impact on tax filings of 2013 federal tax rate changes. In response, the April consensus forecast reduced expected general fund revenues by $462 million, carrying forward lower collection trends into fiscal 2015 and beyond, and the state quickly adopted a modest mid-biennium budget revision, including a range of limited revenue and expenditure adjustments, maintaining a small, $43.4 million fiscal 2014 surplus for deposit to the BRF, and balanced fiscal 2015 operations.

As of its June 2014 update, the state budget office is now forecasting a modest fiscal 2014 operating surplus of $121.3 million, which would bring the BRF balance to $392 million, or 2.3% of general fund revenues. The comptroller will certify final fiscal 2014 results in September.

DEBT AND OTHER LIABILITIES

Connecticut's burden of debt and other liabilities is high compared to other states. Net tax-supported debt as of July 2014 totals $19.8 billion, or 9% of 2013 personal income, excluding the current bonds. Three-quarters of net tax-supported debt is GO, a large share of which has been issued for local school capital needs. Borrowing also includes $581 million in ERNs.

Funding levels for the state's major pension systems remain a source of concern. As of June 30, 2013, the state employees' retirement system (SERS) was funded at 41.2% on a reported basis, and the teachers retirement fund (TRF) was funded at 55.2%, the latter having benefited from the 2008 issuance of pension bonds. Using Fitch's more conservative 7% investment return assumption (instead of the 8% rate assumed by SERS and the 8.5% rate assumed by TRF) reduces funded ratios to 37.1% and 47.4%, respectively. On a combined basis, the burden of net tax-supported debt and adjusted unfunded pension obligations equals 23.9% of 2013 personal income, among the highest for U.S. states and well above the 6.1% median.

Connecticut has continued to demonstrate the ability and willingness to absorb the comparatively high fixed costs posed by its liabilities. The state fully funds an actuarially calculated annual required contribution (ARC) to the TRF under a covenant linked to the pension bonds, and the SERS ARC is likewise fully funded. Several rounds of pension reforms have been implemented which in some cases elevated near-term contributions to accelerate funded ratio improvement over time. Moreover, both plans have maintained fixed amortization periods over which the unfunded liability is expected to be paid down.

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In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from IHS Global Insight.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. State Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033
Tax-Supported Rating Criteria
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