RATING ACTION COMMENTARY

Fitch Upgrades Connecticut's IDR to 'AA-', Rates $1 Billion GO Bonds 'AA-'; Outlook Stable

Fri 14 May, 2021 - 2:26 PM ET

Fitch Ratings - New York - 14 May 2021: Fitch Ratings has assigned an 'AA-' rating to $1 billion in State of Connecticut general obligation (GO) bonds, consisting of:

--$300,000,000 GO bonds (2021 series B) (social bonds);

--$175,000,000 GO refunding bonds (2021 series C);

--$225,000,000 GO refunding bonds (2021 series D) (forward delivery) (social bonds);

--$300,000,000 taxable GO bonds (2021 series A).

Par amounts are subject to change pending final sale.

The bonds are expected to be offered by negotiated sale the week of May 17, 2021.

In addition, Fitch has upgraded the state's Issuer Default Rating (IDR) and outstanding GO bonds to 'AA-', from 'A+', and upgraded the ratings on bonds linked to the IDR as listed at the end of this release.

The Rating Outlook is Stable.

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SECURITY

The GO bonds are supported by the full faith and credit of the state pledged to payment of principal and interest.

ANALYTICAL CONCLUSION

The upgrade of Connecticut's IDR to 'AA-', from 'A+', reflects enhancements to the state's fiscal management practices in recent years that are materially increasing the state's resilience to absorb economic and revenue cyclicality. Connecticut's credit rating otherwise continues to reflect its wealthy, diverse and slow-growing economic profile. These attributes remain balanced by a liability burden, carrying costs and expenditure growth trends that are likely to remain comparatively high over time.

ECONOMIC RESOURCE BASE

Connecticut has a diverse and mature economic base anchored by a large finance sector and important manufacturing and education and health sectors. Through much of the economic expansion that preceded the coronavirus pandemic, the economic rebound in Connecticut had trailed both the U.S. rebound and the state's own experience during earlier economic expansions. Personal income gains trailed U.S. gains for a decade through 2020, although Connecticut remains the wealthiest state in the U.S. as measured by per capita personal income.

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KEY RATING DRIVERS

Revenue Framework: 'a'

The state's largest tax revenue source, personal income tax (PIT), is subject to considerable cyclicality, although the state has instituted measures to shield the general fund from its volatility. Sales, corporate income, transportation and gaming taxes further diversify the revenue base. Absent tax policy changes, underlying revenues are expected to grow only modestly over time, consistent with the state's wealthy and diverse but slow-growing economic profile. The state has unlimited legal ability to levy taxes.

Expenditure Framework: 'aa'

Connecticut's natural pace of spending growth is expected to outpace revenues, requiring ongoing budget controls. The state has consistently demonstrated the ability to cover its comparatively high fixed costs, including making full actuarial contributions to pensions for more than a decade, and it benefits from the large degree of budget autonomy common to states.

Long-Term Liability Burden: 'a'

The state's long-term liability burden is elevated and among the highest for U.S. states, but still considered moderate. Long-term debt consists primarily of GO and transportation borrowings, with much of GO borrowing undertaken on behalf of local schools. Net pension liabilities are a more significant burden, with the state carrying obligations for state retirees as well as for local school teachers. OPEB is also a significant liability, although one the state has been able to modify.

Operating Performance: 'aa'

Resilience has improved given strengthened mechanisms that set aside in the BRF volatile revenue collections over specific thresholds and a required excess margin of revenues over spending, enabling rapid accumulation of balances. Budget management powers and strong fiscal monitoring, including frequent revenue and budget forecasting, allow the state to identify budget under-performance and address emerging gaps.

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RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Consistently stronger economic and revenue growth over the medium term, raising Fitch's assessment for revenue growth prospects;

--Material and sustained success in gradually lowering its elevated liability burden to less than 10% of personal income, while managing comparatively high fixed cost burden.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Erosion of existing budget management practices, including taking actions during the current period of fiscal uncertainty that further elevate the state's liability burden or materially enlarge structural challenges.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CURRENT DEVELOPMENTS

Federal Relief Provides Critical Support

Multiple federal stimulus and relief measures since the start of the coronavirus pandemic have boosted economic activity in Connecticut and throughout the country. Federal legislation passed during 2020 alone are estimated by the Committee for a Responsible Federal Budget (CRFB) to have provided over $30.7 billion to Connecticut governments, residents, businesses, and healthcare providers and other recipients, the majority in the form of various loan programs such as the Paycheck Protection Program.

Direct fiscal aid has included a 6.2% increase in the Federal Medical Assistance Percentage (FMAP) for Medicaid for each quarter in which the federally-declared public health emergency is in place. This provision is currently expected to remain in place through the

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end of calendar year 2021 based on guidance from the federal government. Over this period, Connecticut anticipates the provision will generate $805 million in revenues for Medicaid. The state also received $1.38 billion from the Coronavirus Relief Fund (CRF) provisions included in the Coronavirus Aid, Relief and Economic Security (CARES) Act early last year, and separate provisions supporting schools further reduced potential fiscal demands on the state. The state allocated its CRF funds for a range of pandemic response costs including medical equipment, hospital needs and targeted social services.

Under the $1.9 trillion American Rescue Plan Act of 2021 (ARPA), the CRFB estimates that recipients in Connecticut will receive $16.9 billion, including governments. The package is expected to provide $2.65 billion in direct federal aid to the state itself. Separate provisions will provide additional funds to local governments, schools and universities, further reducing contingent risks to the state. The U.S. Treasury has only recently provided guidance on eligible uses for ARPA funds, although the governor has introduced a plan already that would apply the funds over three fiscal years to replace lost revenues, as well as to a range of pandemic response, economic development, education and social service needs.

Connecticut Economic Update

Economic implications of the pandemic and related public health measures have been significant for Connecticut as in all states. The labor market shock early in the crisis was more severe in Connecticut than for the nation as a whole, and despite solid progress since then, Connecticut has not yet recouped earlier job declines. Non-farm payrolls fell 17% at the start of the pandemic (from February to April 2020), more severe than the national decline (15%). Since April 2020, the state's jobs recovery (60% of jobs regained through March 2021) has been only slightly behind the national recovery (62%). Connecticut's official monthly unemployment rate of 8.3% in March 2021 remains above the 6% national rate. Fitch notes that unemployment data for Connecticut, like many smaller states, has been volatile and subject to change. Beyond the labor market, recent metrics including real estate conveyance tax collections, housing market data and other migration data point to a notable uptick of new residents over the last year, mostly from New York State. While a near-term positive shift for Connecticut, it remains uncertain whether this reflects a short-term response to the pandemic or a more durable change of trend.

Connecticut Budgetary Update

Since the initially severe fiscal shock caused by the pandemic and public health countermeasures, Connecticut has experienced a steady and consistent fiscal rebound,

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supported by robust revenues and federal pandemic assistance. Performance has also been supported by relatively recent mechanisms that accelerate deposits to the budget reserve fund (BRF). These include a volatility cap that shifts non-withholding personal income tax (PIT) and pass-through entities tax receipts above a threshold to the BRF, and a revenue cap mechanism that shifts a required excess of budgeted revenues over spending to the BRF.

At enactment of the biennial budget for fiscal 2020-2021, the state had forecast fiscal 2020 ending with a $141 million surplus. After an initial steep decline at the pandemic's onset, collections almost immediately began to rebound, with revenues net of BRF deposits ending the year only 1.4% below forecast and with the surplus standing at $39 million. Most major tax revenues ended the year below target with the exception of the pass-through entities tax. Revenue weakness was offset in part by enhanced FMAP receipts, the early receipt of federal grant funds that had been budgeted in fiscal 2021, and other state actions. Following the fiscal 2020 closeout, the BRF balance expanded by a net $507 million given the volatility cap mechanism, to just over $3 billion, at the statutory maximum of 15% of net general fund appropriations.

Fiscal 2021 has followed a similar trajectory, with the state's budget office projecting a $250 million surplus as of April 30, a marked improvement from the Comptroller's estimate of a $2.1 billion deficit in August. The revenue outlook remains $375 million below the pre-pandemic adopted budget, although spending has been $459 million below the adopted budget, reflecting deficiencies for fixed costs offset by favorable Medicaid enrollment and rescissions, among other changes. The state currently expects the BRF balance to rise $893 million due to the volatility cap, to just under $4 billion, and well over the statutory 15% maximum noted earlier. Most of the excess deposit would be subject to transfer to lower the state's pension liabilities.

Strong budgetary performance during the fiscal 2020-2021 biennium has lifted the state's outlook for the fiscal 2022-2023 biennium budget, which is now under deliberation in the legislature. The governor's proposed budget, adjusted for the April consensus revenue forecast and including the impact of the revenue cap, anticipates surpluses of $590 million in fiscal 2022 and $334 million in fiscal 2023. The state will have recouped the vast majority of projected revenue losses as it recovers from the pandemic, although projected ending balances reflect inclusion of $775 million and $975 million in stimulus funds or BRF draws in fiscal 2022 and fiscal 2023, respectively. The proposal also extends revenue provisions put in place during the current biennium, such as delaying municipal revenue sharing and maintaining a 10% corporate tax surcharge. There are only limited new revenue sources in the plan, such as for cannabis and online gaming. Higher baseline spending for debt service,

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pensions and healthcare, among other needs, are partly offset by extended FMAP support, administrative efficiencies from an anticipated wave of state employee retirements, continuation of fiscal 2021 rescissions and other measures.

CREDIT PROFILE

Connecticut has a diverse and wealthy economic base, anchored by a sophisticated, defense-related manufacturing sector, important finance and insurance sectors in Fairfield County and Hartford, respectively, health and education institutions, and tourism linked in part to Native American gaming in the southeast. Population growth in Connecticut, like much of the northeast, has been well below the U.S. average in recent decades. Initial 2020 census data points to a modest, 0.9% uptick since the 2010 census, stronger than recent annual estimates although below neighboring states.

REVENUE FRAMEWORK

Tax revenues for general fund needs are diverse, with PIT, CIT and sales taxes serving as the primary tax sources. PIT receipts are particularly important, but the component derived from non-withholding is volatile, although the volatility cap partially shields the general fund. The separate state transportation fund (STF) receives a range of transportation-related receipts as well as resources from the general fund.

Historical growth in revenues, after adjusting for the estimated effect of tax policy changes, has been below the national pace of inflation, due to contractions in the important financial services sector as well as the slow-growing nature of the state's economy.

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The state has an unlimited legal ability to raise tax revenues. Tax rate competitiveness is more of a factor in Connecticut than in some other states due to the nature of its taxpayer base, its relatively small size, and its proximity to neighboring states' urban employment centers. Passage of the federal Tax Cut and Jobs Act (TCJA) heightened this concern, as the limit on the deduction for state and local taxes increased residents' effective tax burden. In 2018, the state enacted legislation to mitigate the effects of TCJA on state taxpayers by

creating a revenue-neutral tax on pass-through entities, offset by a personal income tax credit.

Transportation revenues, while statutorily dedicated for transportation needs, have been subject in the past to frequent diversion for general operations. To reduce diversions, voters approved a constitutional amendment in November 2018 that restricts moneys collected in the STF to transportation purposes. Despite this, the state has modified the timing of changes in transfers to support the STF, scaling back the deposit of motor vehicle sales taxes to the STF until fiscal 2022.

EXPENDITURE FRAMEWORK

As with many smaller states, Connecticut's scope of spending is very broad, with the state responsible for delivering or funding numerous services routinely handled at the local level in other states. Formula funding for local schools and subsidies for higher education highlight the state's role in education, which extends as well to making teacher pension contributions and funding school capital. Municipal aid is also significant, although a sales tax revenue-sharing provision passed in 2015 was delayed through fiscal year 2021 and replaced through targeted general fund grants. The governor's budget for the fiscal 2022 and 2023 biennium further delays this provision beyond the next biennium.

The state's constitutional cap on expenditure growth, excluding appropriations for certain fixed or federal requirements, limits increases in annual appropriations to the CAGR of personal income over the past five calendar years or of the annual growth in the U.S. consumer price index less food and energy, whichever is greater. This cap, in concert with comparatively slow forecast revenue growth, requires particularly active expenditure growth management.

As with most states, carrying costs for liabilities and Medicaid spending will be key drivers of overall spending growth, that in the absence of policy actions is expected to be in line with to marginally above expected revenue growth. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. Federal action to revise Medicaid's fundamental programmatic and financial structure does not appear to be a near-term priority of the current federal administration or Congressional leadership. As

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with all federal initiatives, Medicaid remains subject to regulatory changes that could affect various aspects of the program.

The state retains solid ability to cut spending despite successive budgetary adjustments during recent biennia, though high carrying costs do constrain policy options. 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 believes agreements with its collective bargaining units, particularly with the state employee bargaining agent coalition (SEBAC), have successfully lowered growth in annual expenditures. SEBAC's current contract extended the agreement on pension and healthcare benefits from fiscal 2022 to fiscal 2027 and provided layoff protection through June 30, 2021 for existing employees. The wage agreement remains in effect through fiscal 2021.

The state's relatively high carrying costs for debt service, actuarial pension contributions, and other post-employment benefits (OPEB), totaling 21.9% of governmental expenditures in fiscal 2020, well above the level for most states.

Prior to the pandemic, the fiscal 2020-2021 budget achieved annual savings in pension contributions beginning in fiscal 2020 through revisions to the SEBAC agreement which re-amortizes a portion of the outstanding unfunded pension liability for the state employee retirement system (SERS) and through reforms to TRS that also extend the amortization period (discussed in greater detail below.) Pension changes also included phasing in a level dollar amortization method, a more conservative approach than the level percentage of payroll method in place previously in Connecticut and commonly used by most major state plans. Carrying costs in fiscal 2021 include the state's commitment to match the 3% employee contribution to the state's OPEB trust fund, while benefits continue to be paid on a pay-go basis, supporting rapid accumulation of fiduciary assets.

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LONG-TERM LIABILITY BURDEN

Connecticut's long-term liability burden for debt and net pension liabilities adjusted to Fitch's standard 6.0% return assumption is amongst the highest for a U.S. state at 25.9% of 2019 personal income as of Fitch's 2020 State Pension Update report, a burden which Fitch views as elevated. Based on more recent data as of Feb. 28, Fitch estimates long-term debt $26 billion, or 9.6% of 2020 personal income, which includes the new money components

both of the current GO sale and a recent special tax obligation bond sale; the state's total adjusted liability burden approximates 26.5%.

Two-thirds of outstanding direct debt is GO, including a large share issued for local school capital needs. GO borrowing includes $2.4 billion in pension bonds (POBs), including accrued interest on capital appreciation bonds, issued in 2008 to improve the funded ratio of the TRS, and $453 million of remaining GO bonds issued by Hartford as part of the contract assistance agreement between the state and the city. Under a bond cap in place since fiscal 2018, annual new debt issuance is limited to $1.9 billion per year, which rises with inflation; the bond cap excludes UCONN and Connecticut State Colleges and University 2020 higher education borrowing, as well as borrowing for refunding purposes.

Both of the state's two major pension systems have relatively low funded ratios driven by past weak contribution practices. The state has implemented changes in recent years that position them better to make funding progress going forward, assuming plan assumptions are met. Both plans have received nearly full actuarial contributions for over a decade, the TRS under a covenant linked to the GO pension bonds. As part of the 2020-2021 biennial budget, the state re-amortized the TRS unfunded liability, lowering the actuarially determined contribution (ADC) by $183 million and $188 million during the biennium and by similar amounts going forward. In conjunction with the TRS re-amortization, the investment return assumption was lowered to 6.9% from 8.0%, below the level of most major plans.

The 2019 budget act also extended SERS' amortization period to 27.9 years from 22.8 years. The extension follows multiple other revisions for SERS which extended the state's closed amortization period, lowered the return assumption to 6.9%, revised benefits, increased employee pension contributions for all existing members, revised the COLA formula and timing for post-2022 retirees, and created a new hybrid defined benefit/defined contribution tier for all new employees.

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The state's net OPEB liability as reported in the fiscal 2020 state audit (based on a June 30, 2019 measurement date) totals $23.3 billion (8.2% of 2020 personal income). This is up notably from $19.9 billion in the prior year, reflecting recent changes to collective bargaining agreements and healthcare benefit assumptions. The state is pursuing a range of policy changes to lower this liability. The OPEB trust was valued at $1.3 billion as of June 30, 2020.

OPERATING PERFORMANCE

Connecticut's financial resilience is built on very strong powers to address budgetary weakness, including administrative and legislative actions to reduce spending, a willingness to raise revenues, and more recently through mechanisms that strengthen reserve funding and buffer the impact of revenue volatility on the general fund. Budget performance is carefully managed, including through consensus forecasting, monthly revenue monitoring, and disciplined mechanisms to respond to identified budgetary weakness.

Budgetary challenges have been historically driven by economic and revenue underperformance in the context of fixed costs that consume a large share of budgetary resources. Comparatively weak economic and revenue performance during much of the long economic expansion of the last decade had limited the state's ability to swiftly rebuild its BRF balance, leaving expenditure cuts and revenue increases as the state's primary sources of financial resilience. This situation changed beginning in the fiscal 2018-2019 biennium, when the new volatility cap and revenue cap mechanisms enabled it to shift revenue over-performance into the BRF.

The volatility cap directs non-withholding revenue (estimates and final component of the PIT and a pass-through entity tax) above the cap to the BRF, partly shielding the general fund from volatility. The volatility cap threshold is adjusted annually by a formula of compound annual growth in personal income over the prior five-year period, gradually increasing the threshold for BRF deposits. The threshold amount may also be modified by a three-fifths majority of the General Assembly in response to changes in state or federal tax law or significant adjustments to economic growth or tax collections.

A separate revenue cap limits budgeted appropriations to a level below budgeted revenue, creating an additional budgetary buffer; the excess is also directed to the BRF. The cap on appropriations relative to revenues is being phased in to 98% by 2026, and stands at 99% and 98.75% in fiscal 2022 and fiscal 2023, respectively.

If the BRF reaches a balance of 15% of the next year's projected net general fund appropriations, no additional deposits are required and the excess is redirected to reducing state liabilities. The BRF may be drawn upon to cure a prior fiscal year deficit or if estimated general fund revenues decline by 1% or more from the forecast used to enact the budget. Future legislation can also assign surplus balances to other uses.

The BRF grew from $213 million in fiscal 2017 (1.1% of net general fund appropriations) to $2.5 billion in fiscal 2019 (13.0% of net general fund appropriations), and to almost $3.1 billion (unaudited) in fiscal 2020 (15.3% of net general fund appropriations, above the

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15.0% statutory maximum). This triggered a $62 million deposit to reduce pension liabilities, which the treasurer deposited to SERS in excess of the ADC. The state is expecting the BRF to stand at nearly $4 billion at the end of fiscal 2021, following deposits of $705 million from the volatility cap and $250 million in the currently projected surplus, a level that would result in a further $890 deposit to reduce pension liabilities.

Fitch Analytical Stress Test

The Fitch Analytical Stress Test (FAST) scenario analysis tool relates historical tax revenue volatility to GDP to support the assessment of operating performance under Fitch's criteria. FAST is not a forecast, but represents Fitch's estimate of possible revenue behavior in a downturn based on historical revenue performance. Actual revenue declines will vary from FAST results, which provide a relative sense of the risk exposure of a particular state compared to other states. Despite its comparatively higher exposure to revenue declines shown by FAST, Connecticut has very strong financial resilience that would enable it to manage through fiscal stress, in particular the BRF replenishment mechanism that enhances its fiscal cushion in the event of revenue volatility.

Despite the challenges posed by its slow recovery from the Great Recession, the state's budget management had improved in the biennia prior to the pandemic, with a greater reliance on structural solutions and the stronger reserve funding mechanisms noted above. Full actuarial pension contributions had been in place for more than a decade. Other budgetary management improvements included establishing mechanisms to bolster balances in the BRF, protect the general fund from PIT cyclicality, and moderate annual growth in expenditures and debt issuance through statute in addition to bond covenants that impose limitations through June 30, 2023.

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Related Ratings

In conjunction with the upgrade of the state's IDR, Fitch has upgraded the ratings on bonds that are notched off of the IDR based on various appropriation structures:

--University of Connecticut state debt service commitment bonds, subject to annual appropriation, to 'A+', from 'A';

--Connecticut Higher Education Supplemental Loan Authority state supported revenue bonds to 'A+', from 'A';

--Capital Region Development Authority (formerly known as the Capital City Economic Development Authority) appropriation-backed parking and energy fee revenue bonds, 2004 series B and series 2018 refunding bonds to 'A+', from 'A';

--Connecticut Development Authority general fund obligation bonds series 2004A to 'A+', from 'A';

--Connecticut Innovations general fund obligation bonds series 2014A to 'A+', from 'A'.

The Rating Outlook is Stable.

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 04 May 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

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Endorsement Policy

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