FITCH DOWNGRADES STATE OF CONNECTICUT RATING TO 'A+'; OUTLOOK STABLE

Fitch Ratings-New York-12 May 2017: Fitch Ratings has downgraded the Issuer Default Rating (IDR) of the state of Connecticut to 'A+' from 'AA-'. In addition, the following ratings that are linked to the state's IDR have been downgraded by one notch:

--Approximately $16.6 billion in outstanding general obligation (GO) bonds to 'A+' from 'AA-';
--Approximately $5.3 billion in outstanding special tax obligation bonds issued for transportation purposes, both senior and subordinate lien, to 'A+' from 'AA-';
--University of Connecticut state debt service commitment bonds to 'A' from 'A+';
--Connecticut Higher Education Supplemental Loan Authority state supported revenue bonds payable from special capital reserve funds to 'A' from 'A+';
--Capital City Economic Development Authority parking and energy fee revenue bonds, series 2004B and 2008D to 'A' from 'A+';
--Connecticut Development Authority and Connecticut Innovations general fund obligation bonds, series 2004A, 2006A and 2014A to 'A' from 'A+';
--Connecticut Development Authority general obligation bonds, series 2004B to 'A-' from 'A';
--Connecticut Health and Educational Facilities Authority (CHEFA) revenue bonds (child care facilities program) series G to 'A-' from 'A'.

The Rating Outlook is Stable.

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

KEY RATING DRIVERS

The downgrade of Connecticut's IDR and related ratings is based on reduced expectations for economic and revenue performance over the medium term and the deterioration in Fitch's assessment of the state's through-the-cycle fiscal flexibility, which has suffered from the need to address chronic economic and fiscal challenges during a prolonged period of national economic expansion. Despite a demonstrated commitment to identifying structural solutions to budget shortfalls, the state's ability to manage is constrained by a comparatively high liability burden that reduces its scope of flexibility. The state remains pressured by revenue collections that are failing to keep pace with rising expenditures, as evidenced in the recent downward revision to its revenue forecast for the current and future fiscal years. After addressing the newly forecast budget gap for the current year, the state will be left with no reserve cushion and more limited tools to address already projected budget shortfalls for coming years and the expected effects of future economic downturns.

The Stable Outlook recognizes the state's broad economic resource base and the significant budget autonomy that is inherent in a state's powers as well as Fitch's expectation that the state will continue to proactively manage its challenged financial operations.

Economic Resource Base
Connecticut has a wealthy, mature and diverse economy anchored by a large finance sector and important manufacturing and education and health sectors. The last downturn in Connecticut was severe and the recovery has been very slow compared to previous economic cycles. Over

the 2012 - 2016 period, employment in the state rose at roughly half of the pace enjoyed by the nation, and current employment remains below the prerecession peak. The state forecast is for fairly weak employment growth over the next several years. 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: 'a' factor assessment
Tax revenues are diverse, although the largest tax revenue source, personal income tax (PIT), is subject to considerable cyclicality. Sales, corporate income, transportation and gaming taxes serve to further diversify the tax base. Baseline growth of taxes is expected to be marginal given the state's mature economy and structural changes in key economic sectors. The state has unlimited legal ability to levy taxes.

Expenditure Framework: 'aa' factor assessment
Connecticut's natural pace of spending growth is expected to be higher than that of revenues given projections for weak growth in revenues. The state has consistently demonstrated the ability to cover its high fixed costs, including making full actuarial contributions to pensions, and benefits from the large degree of budget autonomy common to states.

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 are more significant, with recent reforms providing budgetary savings but raising the unfunded liability.

Operating Performance: 'a' factor assessment
Gap-closing capacity remains strong but its robustness has been reduced by the state's modest economic growth during the current national economic expansion and the resulting repeated need for gap-closing actions. In contrast to prior recoveries, the state has been unable to 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 and expected depletion of the state's modest budget reserve fund limit the state's scope of action. Frequent revenue reforecasting allows the state to identify revenue underperformance and quickly implement corrective actions.

RATING SENSITIVITIES
MAINTAINING FISCAL RESILIENCE: The rating is sensitive to the state's ability to rebalance financial operations to its current economic profile in a manner consistent with the current rating level.

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 expansions, the state's performance in the current expansion has been unusually slow and uncertain. Employment gains through much of the recovery have been well below national averages and slower than past recoveries. The finance sector, with important banking and investment activity in the southwestern part of the state 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 anchors the

sector and may bring future gains. Tourism has grown in importance over time, but prospects for the state's gaming resorts are more uncertain given rising competition in neighboring states. The state's unemployment rate has historically run below the U.S. rate, but has exceeded the nation's since 2012. Personal income per capita ranks highest among the states, at 143% 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 their volatility has had a negative impact on the state's financial position. The separate transportation fund receives a range of transportation-related receipts as well as resources from the general fund.

Historical growth in the state's revenues, after adjusting for the estimated impact of tax policy changes, has been well below the pace of national GDP growth due to contractions in the important financial services sector as well as the maturity of the state's economy that includes an older, more slowly-growing demographic profile. The state's May 2017 revenue forecast projects declines in general fund revenue in fiscal years 2017 and 2018 followed by very slow growth through fiscal 2020.

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, though 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, Connecticut's scope of spending is very broad, with the state responsible for delivering or funding numerous services at the local level. 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-funded expansion included in the adopted fiscal 2015 budget was partly reversed given budgetary weakness. The governor's proposed biennial budget for fiscal years 2018-2019 recommends a shift in funding for teacher pension contributions from the state to municipalities, although to date the legislature has not provided support to this proposal. Medicaid and other social services are the largest spending commitments.

Fitch expects that spending growth, absent policy actions, will be ahead of natural revenue growth which continues to fall below national growth metrics, and require regular budget adjustments to ensure ongoing balance.

The state retains solid ability to cut spending despite several rounds of budgetary adjustment during the current and last biennia. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules that limit the states' options in managing the pace of spending growth. Federal action to revise Medicaid's programmatic and financial structure remains a possibility given recent House passage of the American Health Care Act (AHCA) which includes a fundamental restructuring of Medicaid's funding structure to a capped amount. The bill's prospects in the Senate are unclear. States generally have significant flexibility to deal with fiscal challenges, including shifts in federal funding, while maintaining fundamental credit quality. As Medicaid represents a sizable share of all states' budgets, significant changes could challenge that flexibility. Whether a change in Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increased liability burdens could negatively affect both the expenditure framework assessment and the IDR.

Statutes require 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. The belatedness of the recently identified fiscal 2017 budget gap is largely expected to be resolved through one-time actions including applying the state's $235.6 million budget stabilization fund and various fund sweeps, in addition to a small amount of agency savings. 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
Per Fitch's October 2016 State Pension Update report, Connecticut's long-term liability burden for debt and pensions, at 21.4% of 2015 personal income, is among 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 $23.6 billion as of February 2017, or 8.9% of 2015 personal income. Seventy percent 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 (SERS) and teachers, have relatively low funded ratios driven by weak contribution practices in the past; both plans have now received full annual actuarial contributions (ARC) for years, the TRF under a covenant linked to the GO pension bonds. A recently approved MOU for SERS shifts to the more conservative entry-age cost method for calculating contributions, extends the state's closed amortization period, and lowers the return assumption to 6.9%. These actions, while producing budgetary savings, will raise the liability to reflect a far more realistic return assumption and lower the risk that future investment losses could lead to a spike in contributions.

Operating Performance
Fitch views Connecticut as having still strong gap-closing capacity, but this capacity has been reduced in recent biennia due to the state's comparatively weak economic and revenue performance. 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), which is expected to be depleted to close the newly identified budget shortfall in the current fiscal year, and tax rate increases adopted in recent biennial budgets that make further increases more challenging. Financial resilience is supported by multiple revenue monitoring mechanisms, including consensus forecasting, and disciplined mechanisms to respond to identified budgetary weakness.

Draws on the BRF balance were used to close ending deficits of $113 million in fiscal 2015 and $170 million in fiscal 2016. These draws left the BRF balance at $236 million, or 1.3% of fiscal 2017 net revenues, below the $519 million balance it held in fiscal 2014 and well under the nearly $1.4 billion peak in fiscal 2009. Recent budgetary challenges have been driven by revenue underperformance, particularly in the non-withholding component of personal income tax collections, although in both fiscal years the state took extensive administrative and legislative actions first to narrow the gaps before relying on reserves.

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. The outstanding deficit notes are scheduled to be fully repaid on Jan. 1, 2018 and the state has articulated a goal of not issuing additional notes to solve for the current revenue shortfall. Despite 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 Financial Operations

The state's January 2017 consensus revenue estimate (CRE) forecast general fund revenue performance just above the fiscal 2017 budget target while the state's budget office estimated expenditures slightly below adjusted appropriations. The May 2017 CRE updated these expectations and incorporated PIT collections that are down $450.7 million due to lower than expected receipts in April. Overall, the May forecast lowered anticipated revenues by $413.3 million (2.4% of total general fund revenue) from January expectations. Incorporating prior state balances and an update to anticipated expenditures, the state is forecasting a $390 million operating deficit for the current fiscal year ending June 30. To close the deficit, the state has instituted a hiring freeze and is pursuing state agency savings in addition to plans to apply the remaining BRF balance and sweep available fund balances.

The May CRE also updated the general fund baseline revenue forecast for fiscals 2018 to 2020, incorporating the revenue revision for fiscal 2017 as well as forecasting lower growth prospects for revenues through fiscal 2020. The state estimates a 2.3% decline in baseline revenue between fiscal years 2017 and 2018, from $17.48 billion to $17.1 billion, which incorporates more general fund resources being diverted to the special transportation fund as well as the municipal revenue sharing fund, while revenue growth to fiscal 2019 is essentially flat at $17.17 billion. Revenue growth is expected to improve to a still slow 1.3% in fiscal 2020.

The governor initially proposed a 2018-2019 biennial budget that addressed a projected budget gap of almost $1.7 billion in fiscal 2018 through modest revenue enhancements and more significant expenditure reductions; that baseline gap has now grown to $2.28 billion as a result of the updated revenue forecast. Similarly, an earlier projected budget gap for fiscal 2019 of $1.9 billion has grown to $2.78 billion. Initially proposed expenditure changes included $700 million in savings through revisions to collective bargaining agreements, $408 million in savings linked to municipal contributions toward teachers' pension costs, and $256 million in other spending changes. With the recent updates to the forecast, the governor plans to recommend a revised budget proposal to the legislature on May 12 which the legislature is expected to consider in the current session.

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Applicable Criteria
U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)
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