FITCH RATES CONNECTICUT GO BONDS 'A +' AND CHESLA BONDS 'A'; OUTLOOK STABLE

Fitch Ratings-New York-06 December 2017: Fitch Ratings has assigned ratings to the following bond issues linked to the state of Connecticut:

--$450 million taxable general obligation (GO) bonds (2017 Series A) at 'A+';
--$400 million GO bond anticipation notes (BANs) (2017 Series A) at 'F1+';
--$11.3 million Connecticut Higher Education Supplemental Loan Authority (CHESLA) state-supported revenue bonds (CHESLA Loan Program) 2017 Series C at 'A.'

The GO issues and the CHESLA bonds are being offered under separate official statements. The GO bonds and BANs are expected to be sold via competitive bid on Dec. 11, 2017. The CHESLA bonds are expected to be sold via negotiation on Dec. 14, 2017.

In addition, Fitch has affirmed the state's Issuer Default (IDR) and outstanding GO bond ratings at 'A+' and the ratings on bonds supported by state appropriations or capped at the state IDR as listed at the end of this release.

The Rating Outlook is Stable.

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

CHESLA state-supported revenue bonds issued under the 1990 resolution are special obligations of the authority secured by education loan repayments and a special capital reserve fund (SCRF) equal to maximum annual debt service. In the event of a draw on the fund, the state deems appropriated from its general fund an amount necessary to replenish the SCRF.

ANALYTICAL CONCLUSION

Connecticut's 'A+' IDR and related ratings reflect expectations for relatively flat economic and revenue performance that will continue to challenge the state in matching revenues to expenditures, together with the state's broad economic resource base and the continued fiscal flexibility inherent in a state's budget autonomy. The state's long-term liabilities are expected to remain well above the U.S. state average, an elevated although still moderate burden on the wealthy resource base and one that limits expenditure flexibility compared to that of most states. The state's operating performance has suffered from the need to address chronic economic and fiscal challenges throughout the current prolonged period of national economic expansion, with the significant delay in enacting a budget for the current biennium highlighting the narrowed options for closing a substantial $5 billion (15% of general fund biennial revenues) forecast budget gap. The gap was largely closed through recurring actions on the part of the state, including achieving sizable budgetary savings from a renegotiated labor contract, but implementation risks remain. The rating assumes that the state will continue to proactively manage its challenged financial operations.

The 'F1+' rating on the BANs incorporates the state's strong market access despite its financial challenges. The 'A' rating on the CHESLA bonds, one notch below the state's IDR, reflects the state's deemed appropriations from the general fund to replenish the SCRF as necessary.

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 impact of the Great Recession in Connecticut was severe and the economic and revenue recovery has been very slow compared to previous economic cycles. Over 2012-2016, employment in the state rose at roughly half of the pace enjoyed by the nation, and current employment remains below the pre-recession 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 and key finance and manufacturing sectors are experiencing only modest growth after the retrenchment of recent years.

KEY RATING DRIVERS

Revenue Framework: 'a'
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 has been marginal, requiring tax policy changes to boost revenues, and modest future economic growth will continue to constrain resources. The state has unlimited legal ability to levy taxes.

Expenditure Framework: 'aa'
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 comparatively 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'
The burden of debt and unfunded pension liabilities in relation to resources is elevated and among the highest for a U.S. state but still considered moderate. 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'
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 has continued to increase taxes and cut spending throughout the expansion, reducing its means to tackle future cyclical budgetary challenges. Expenditure adjustments in the recently enacted budget demonstrate the state's commitment to balance operations but out-year budget gaps remain an issue to be addressed. 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 flat to modestly declining population trends 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. The state projects positive medium-term economic growth but at rates below the nation's.

Employment gains through much of the recovery have been well below national averages and slower than past recoveries; through October 2017, the state regained 73% of jobs lost in the Great Recession compared to a national average of 199%. Rates of recovery have also varied across the state's larger metropolitan regions - from 111% of jobs regained in the New Haven region to 35% in Waterbury. 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. These areas have now almost fully recovered employment lost in the recession.

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 opening of a state-approved third tribal casino, which could stem revenue losses to venues outside the state, is not expected for at least 18 months. The state's unemployment rate has historically run below the U.S. rate, but has exceeded the nation since 2012. Personal income per capita ranks highest among the states, at 141% of the national level, and aggregate personal income growth continues, albeit at rates below the nation.

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, and below inflation, 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. Based on the state's November 2017 consensus revenue estimate (CRE), tax policy changes in the enacted budget contribute to a revised 4.6% boost in revenue growth in fiscal 2018 from fiscal 2017 with 2.1% growth now needed to meet the forecast used to enact the budget in fiscal 2019. These increases are followed by a sharp 5.9% forecast drop in fiscal 2020 as nonrecurring revenue actions fall off, the hospital tax is automatically reduced, and sales tax revenue sharing through the municipal revenue sharing account is restored; these current law measures could be reversed by future legislatures to maintain general fund revenues at the higher level.

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 statutorily dedicated for transportation needs, have been subject in the past to frequent diversion for general operations. Positive support for a measure that will appear on the November 2018 ballot would amend the state constitution to restrict the state transportation fund solely to transportation purposes.

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 normally handled 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 previously shared sales tax revenue was suspended in the enacted biennial budget. Municipal aid will instead be funded through a number of targeted grants coming directly from the general fund, including to the financially troubled city of Hartford.

Fitch expects that spending growth, absent policy actions, will be ahead of comparatively weak natural revenue growth, and require regular budget adjustments to ensure ongoing balance.

The state retains solid ability to cut spending despite successive budgetary adjustments during the current and last biennia. 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. The state partly addressed a $5 billion (15% of 2018-2019 baseline revenue) forecast budget gap with savings from a renegotiated contract with the state's employee bargaining agent coalition (SEBAC), providing one of the largest recurring actions. The renegotiated contract included three years of wage freezes followed by two years of increases, healthcare plan revisions, increased state employee retirement system (SERS) pension contributions from employees, a revised cost of living formula for retirees, and a new hybrid defined benefit/defined contribution retirement tier for all new SERS employees. The state estimates savings of $700 million beginning in fiscal 2018, escalating over time.

The annual savings somewhat reduce the state's operating flexibility, as the new agreement extends the length of the existing SEBAC agreement for pension and healthcare benefits from fiscal 2022 to fiscal 2027 and provides layoff protection through June 30, 2021 for existing employees. The wage agreement remains in effect through fiscal 2021. As a result, Fitch believes that absent new revenue initiatives through fiscal 2021, actions to address an unforeseen economic or financial downturn could be limited to programmatic reductions or shifts in municipal aid.

The state's relatively high carrying costs of over 19% in fiscal 2016, compared to a U.S. state median of 5%, continues to constrain policy options. The metric includes debt service for GO bonds issued for school construction, past deficit borrowing, and conversion to GAAP budgeting, as well as full actuarial contributions toward paying down its unfunded pensions. While not included in the enacted budget, the governor's proposal for municipal contributions toward the employer share of teachers' pension costs points to one potential area for future offset to carrying costs. Expected positive impact on the carrying cost metric in future years from pension and employee and retiree health care savings provided in the new SEBAC agreement is partly offset by the state's new commitment to match the 3% employee contribution to the state's OPEB trust fund; this contribution totals $120 million in fiscal 2018.

Spending for Medicaid remains a key fiscal challenge for Connecticut, one that 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. In other major areas of spending such as education, CT is able to more easily adjust the trajectory of growth. Federal action to revise Medicaid's programmatic and financial structure, including a basic restructuring of federal Medicaid funding to a capped amount, remains a possibility. 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.

Long-Term Liability Burden
As of Nov. 1, 2017, Connecticut's long-term liability burden for debt and pensions adjusted to a 6% return assumption on pensions, at 26.7% of 2016 personal income, is amongst the highest for a U.S. state. It remains an elevated but still moderate burden on resources and the state continues to contribute full actuarial contributions to its pensions. Net tax-supported debt alone totals $23.7 billion, or 9.5% of 2016 personal income. Over 70% 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 in 2008 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 determined contributions for many years, the TRF under a covenant linked to the GO pension bonds. A December 2016 memorandum of understanding for SERS shifted to the more conservative entry-age cost method for calculating contributions, extended the state's closed amortization period, and lowered the return assumption to 6.9%. These actions, which produced budgetary savings, resulted in raising the liability to reflect a far more realistic return assumption while lowering the risk that future investment loss could lead to a spike in contributions.

The recently approved SEBAC agreement increases employee pension contributions for all existing SERS members, revises the COLA formula and timing for post-2022 SERS retirees, and creates a new hybrid defined benefit/defined contribution retirement tier for all new SERS employees. In conjunction with agreed-to wage freezes, the modifications provide for a modest improvement in SERS's funded ratio. The agreement also provides for significant savings through revisions to the healthcare plan design and premium cost sharing arrangement for current employees. The state's healthcare actuary estimates a reduction in the OPEB liability from $20.9 billion projected as of June 30, 2017 to $15.6 billion as a result of the agreement, a reduction of 25%.

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), equal to 1.2% of fiscal 2017 net revenues. Tax rate increases adopted in recent biennial budgets, together with the likely passage of federal tax policy changes, could 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.

Recent budgetary challenges have been driven by revenue underperformance, particularly in the non-withholding component of PIT collections, although the state took extensive administrative and legislative actions first to narrow the gaps before relying on reserves. Draws on the BRF balance were used to close ending deficits of $113 million in fiscal 2015, $170 million in fiscal 2016, and $23 million in fiscal 2017. The draw in fiscal 2017 was much less than forecast as the state implemented across-the-board personnel savings, reduced municipal and education funding, and reduced sales and use tax transfers to locals to address a May 2017 forecast budget gap of $390 million. The current $213 million BRF balance is well below the nearly $1.4 billion peak in fiscal 2009 and prospects for significant additions are uncertain despite recent legislative action to bolster future balances.

Included in the enacted budget for the 2018-2019 biennium is a provision to deposit all revenue from estimated and final PIT payments in excess of $3.15 billion to the BRF; the state received $3.16 billion in fiscal 2017. If the BRF reaches a balance of 15% of net general fund appropriations, no additional deposits are required. Notwithstanding this provision, funds continue to be available from the BRF 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. Fitch recognizes the intent of the state to bolster balances in the BRF and remove some of the cyclicality of PIT collections from the general fund although the timing of additional deposits is uncertain.

Despite the challenges posed by its slow recovery from the Great Recession, the state's fiscal management has generally improved in recent biennia, with a greater reliance on structural solutions and continued full actuarial pension contributions. Nonetheless, the state was challenged to close the budget gap projected for the current biennium and discord between the governor and legislature resulted in a lengthy stalemate, with a final budget enacted four months into fiscal 2018. The gap was largely closed through recurring actions but leaves the state with several issues to be addressed in subsequent budgets. Expirations on taxes, the restoration of sales tax municipal revenue sharing and the continued deferral of contractually agreed upon appropriations to correct a longstanding GAAP deficit will weigh on the state in future years. Appropriations to amortize the GAAP deficit were pledged in a 2014 bond issue whereby the state covenanted to amortize this deficit, now at $680 million, by fiscal 2028.

Along with relatively high fixed costs, the state has carried 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, providing closure to this obligation.

Current Financial Operations

The enacted 2018-2019 general fund biennial budget provides for $18.7 billion in appropriations for fiscal 2018 and $18.8 billion for fiscal 2019. The fiscal 2018 budget funds growth of 5.4% from fiscal 2017. Notable policy actions in the enacted budget include personnel savings under the new SEBAC agreement for wages, pension, healthcare and OPEB, a suspension of sales tax revenue sharing with municipalities which is replaced by direct grants from the general fund, an increase in cigarette taxes, and an increase in the hospital provider tax to leverage additional federal Medicaid reimbursement that requires the pending assent of the federal government.

The enacted budget was based on a revenue growth forecast of 5.9% in fiscal 2018 and 0.9% in fiscal 2019 that incorporates the policy actions. The state's November 2017 CRE forecast lowered anticipated revenues by $227 million to incorporate PIT and sales tax reallocations and shortfalls and a large decline in federal grants. Incorporating prior state balances and updated expenditures, the state now forecasts a $203 million (just over 1%) operating deficit for the current fiscal year and will propose a deficit mitigation plan to eliminate the deficit in the near future.

Nonrecurring actions in the enacted budget combined with the automatic restoration of municipal sales tax revenue sharing and an automatic reduction in the hospital provider tax contribute to the legislative Office of Fiscal Analysis' projection for out-year general fund budget gaps in fiscal years 2020 through 2022 of $1.9 billion, $2.7 billion, and $3.2 billion, respectively. While noting that some of the automatic actions embedded in current law may prove less controversial to adjust, Fitch believes the state will find it challenging to provide solutions to these gaps.

Related Ratings

Fitch has affirmed the following ratings that are supported by state appropriations or otherwise capped at the state IDR, as follows:

--Approximately $5 billion in outstanding special tax obligation bonds issued for transportation purposes, both senior and subordinate lien, at 'A+';
--University of Connecticut state debt service commitment bonds, subject to annual appropriation, at 'A';
--CHESLA state supported revenue bonds payable from special capital reserve funds, subject to annual appropriation, at 'A';
--Capital City Economic Development Authority appropriation-backed parking and energy fee revenue bonds, series 2004B and 2008D at 'A';

--Connecticut Development Authority and Connecticut Innovations appropriation-backed general fund obligation bonds, series 2004A, 2006A and 2014A at 'A';
--Connecticut Development Authority appropriation-backed general obligation bonds, series 2004B, at 'A-'.

Contact:

Primary Analyst
Marcy Block
Senior Director
+1-212-908-0239
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Douglas Offerman
Senior Director
+1-212-908-0889

Committee Chairperson
Laura Porter
Managing Director
+1-212-908-0575

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

Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email: sandro.scenga@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
U.S. Public Finance Short-Term Debt Rating Criteria (pub. 01 Nov 2017)
https://www.fitchratings.com/site/re/905637
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)
https://www.fitchratings.com/site/re/898466