FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Connecticut's $800 Million GO Bonds 'AA-'; Outlook Stable

Thu 09 Dec, 2021 - 5:26 PM ET

Fitch Ratings - San Francisco - 09 Dec 2021: Fitch Ratings has assigned a 'AA-' rating to $800 million in state of Connecticut general obligation (GO) bonds, consisting of:

--$500,000,000 General Obligation Bonds (2022 Series A);

--$300,000,000 General Obligation Bonds (2022 Series B) (Social Bonds).

Par amounts are subject to change pending final sale.

The bonds are expected to be offered by negotiated sale the week of Dec. 13, 2021.

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

The Rating Outlook is Stable.

SECURITY

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

IDR ANALYTICAL CONCLUSION

Connecticut's 'AA-' IDR reflects its superior gap-closing capacity, as well as its wealthy and diverse, yet slow-growing economic profile. The rating also incorporates the state's liability burden, carrying costs and expenditure growth trends that are likely to remain comparatively high over time. In recent years, enhancements to the state's fiscal management practices materially increased the state's resilience to absorb economic and revenue cyclicality.

(SEE BELOW FOR DEDICATED TAX ANALYSIS)

Economic Summary

Connecticut has a diverse and mature economic base anchored by a large finance sector and important manufacturing and education and health sectors. Pre-coronavirus pandemic economic expansion cushions the state as its recovery trails the nation's. Connecticut has the highest per capita personal income of any state, though income growth has slowed in the prior decade.

IDR 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 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 relative to personal income. 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. Other post-employment benefits (OPEB) is also a significant liability, although one the state has been able to modify.

Operating Performance: 'aa'

Resilience is bolstered by strong mechanisms that are set aside in the budget reserve fund (BRF) volatile revenue collections over specific thresholds and a required excess margin of revenues over budgeted 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.

RATING SENSITIVITIES

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

--Consistent economic and revenue growth in line with long-term national inflation or stronger 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

Connecticut Budgetary Update

Strong budgetary performance has lifted the state's financial position. Connecticut's financial performance has also been supported by relatively recent mechanisms that accelerate deposits to the BRF. These include a volatility cap that shifts non-withholding PIT and pass-through entities tax receipts above a threshold to the BRF, and a revenue cap mechanism that requires a revenue cushion in adopted budgets.

The state ended fiscal 2021 with a $1.7 billion transfer to the BRF surplus, around 8% of fiscal 2021 general fund appropriations. After an initial steep decline at the pandemic's onset, collections almost immediately began to rebound. Thus far, most major tax revenues outpaced forecasts through November 2021. The state currently expects to add $200 million to the BRF balance in fiscal 2022, net of $1.6 billion in excess transfers to lower the state's pension liabilities. Higher baseline spending for debt service, pensions and health care, among other needs, are partly offset by extended FMAP support through March 2022, and administrative efficiencies from an anticipated wave of state employee retirements.

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 health care providers and other recipients, the majority in the form of various loan programs such as the Paycheck Protection Program.

The state received $1.38 billion from the Coronavirus Relief Fund (CRF) provisions included in the Coronavirus Aid, Relief and Economic Security (CARES) Act. 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), Connecticut is receiving $16.9 billion, including governments. The package is expected to provide $2.8 billion in direct federal aid to the state itself. While the enacted budget and outyear forecasts incorporate use of federal stimulus aid for operating needs, they also anticipate budget surpluses and sizable one-time spending, thereby lessening the risk of a fiscal cliff as federal aid rolls off.

Connecticut Economic Update

Connecticut's economy was affected by the pandemic and related public health measures in early 2020, and recovery has been uneven. While the state's 13% decline in nonfarm payrolls from February through April 2020 was somewhat less than the national decline of 15%, Connecticut's rebound in nonfarm payrolls has lagged the nation's. Through October 2021, 73% of lost state jobs have been recovered compared to the U.S. states' median of 76%.

Connecticut's unemployment rate has nonetheless improved. The monthly unemployment rate for October 2021 was 6.4% versus the 4.6% national rate. Fitch calculates an adjusted unemployment rate to capture the large number of labor force departures since the pandemic began. Fitch's adjusted unemployment rate for Connecticut was an elevated 11.5% for October, well above Fitch's 6.3% average adjusted rate for U.S. states.

ECONOMIC RESOURCE BASE

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. 2020 census data points to a modest, 0.9% uptick since the 2010 census, stronger than recent annual estimates although below neighboring states.

IDR CREDIT PROFILE

Revenue Framework

Tax revenues for general fund needs are diverse, with PIT, corporate income tax 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.

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 to carrying teacher pension liabilities 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 adopted fiscal 2022 and 2023 biennium budget partially funds this, but delays full implementation 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 compounded annual growth rate (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 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 expenditure growth rates. SEBAC's current contract extended the agreement on pension and health care benefits from fiscal years 2022 to 2027 and provided layoff protection through June 30, 2021 for existing employees.

The state has 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 state 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 teachers' retirement system (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 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.

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 26.5% of personal income as of Fitch's 2021 State Pension Update report, a burden which Fitch views as elevated. Based on more recent data, Fitch estimates long-term debt at $27 billion, or 9.6% of personal income.

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) issued in 2008 to improve the funded ratio of the TRS and $431 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.

The state's net OPEB liability as reported in the fiscal 2021 state audit (based on a June 30, 2019 measurement date) totals $23.3 billion (8.3% of personal income). This is up notably from $19.9 billion in fiscal 2019, reflecting 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, 2021.

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 new volatility cap and revenue cap mechanisms enabled it to move excess revenues 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 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 in fiscal 2020 (15.3% of net general fund appropriations, above the 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 $5 billion at the end of fiscal 2022, net of $969 million in deposits from the volatility cap, $895 million in projected surplus, and $1.6 billion in transfers to SERS/TRS 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.

Related Ratings

In conjunction with the affirmation of the state's IDR, Fitch has affirmed 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, at 'A+';

--Connecticut Higher Education Supplemental Loan Authority state supported revenue bonds at '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 at 'A+';

--Connecticut Development Authority general fund obligation bonds series 2004A at 'A+';

--Connecticut Innovations general fund obligation bonds series 2014A at 'A+'.

The 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.

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Connecticut, State of (CT) [General Government]	LT IDR Affirmed	AA- Rating Outlook Stable	AA- Rating Outlook Stable

Connecticut, State of (CT) /General Obligation - Unlimited Tax/1 LT	LT	AA- Rating Outlook Stable	Affirmed	AA- Rating Outlook Stable
Connecticut, State of (CT) /Special Capital Reserve Fund/1 LT	LT	A+ Rating Outlook Stable	Affirmed	A+ Rating Outlook Stable
Connecticut, State of (CT) /State Appropriation/1 LT	LT	A+ Rating Outlook Stable	Affirmed	A+ Rating Outlook Stable
Connecticut, State of (CT) /State Contract/1 LT	LT	A+ Rating Outlook Stable	Affirmed	A+ Rating Outlook Stable
Connecticut, State of (CT) /UConn State Debt Service Commitment/1 LT	LT	A+ Rating Outlook Stable	Affirmed	A+ Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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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

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Connecticut, State of (CT) EU Endorsed, UK Endorsed

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