

## MOODY'S REVISES OUTLOOK ON STATE OF CONNECTICUT RATING TO NEGATIVE FROM STABLE AND AFFIRMS Aa3 RATING ON APPROXIMATELY \$12B OUTSTANDING GENERAL OBLIGATION BONDS

NEW YORK, October 26, 2009 -- Moody's Investors Service has revised the outlook on the State of Connecticut's general obligation bonds to negative from stable. Concurrently, Moody's has affirmed the Aa3 rating on the state's approximately \$12 billion in outstanding general obligation bonds. The negative outlook reflects the choices made to address the state's biennial 2010-2011 budget gaps as well as the shortfall for fiscal 2009, including a majority of non-recurring solutions and deficit financing, combined with a credit profile that includes significant long-term liabilities. Connecticut plans to issue \$947 million in deficit bonds to resolve the budget shortfall that emerged in fiscal year 2009, and the biennial budget includes \$1.3 billion from a fiscal year 2011 securitization of a yet-to-be-determined revenue stream. In addition, the state has budgeted to deplete its Budget Reserve Fund (BRF) by the end of the biennium and, as in most states, to use one-time federal stimulus funds for ongoing needs. The recently adopted 2010-2011 biennial budget does include recurring actions on both the revenue and spending side. However, Connecticut used one-time solutions to close slightly over half of the shortfall. These solutions create future structural budget gaps and leave the state with significantly reduced flexibility to address additional fiscal pressures that may arise due to a delayed and/or weaker than expected recovery from the worst economic recession since the depression. In addition, the state's GAAP-basis general fund balance sheet will weaken as the BRF is depleted due to the already sizeable unreserved, undesignated fund balance that the state has carried since the early 1990s, largely reflecting an accrued liability that has never been repaid.

Connecticut also compares unfavorably on measures such as debt ratios that are among the highest in the nation, pension funding levels that were among the lowest in the country in 2008 even before the market turmoil is factored, and other post employment benefit (OPEB) liabilities that are larger than the size of the state's annual operating budget. While liquidity remains satisfactory and the state has not had to borrow for cash flow purposes, cash margins would likely be significantly tighter if the state decreased its reliance on debt, addressed the low funding ratios of its retirement systems, and met its annual required contributions for OPEB costs.

The rating level incorporates our expectation that Connecticut's revenue trends should improve as Connecticut emerges from the recession. Even so, as the wealthiest state in the nation Connecticut is more dependent than most states on high income earners. Thus, continued uncertainty in the recovery of the financial markets has an exaggerated impact on the state's personal income tax receipts which account for almost half of the general fund's resources. Once the recovery is underway, we do expect that Connecticut will use its operating surpluses, as it has in the past, for the early retirement of the 2009 economic recovery notes (deficit bonds) and to begin rebuilding the BRF. However, given the magnitude of the recent one-time actions taken to balance the budget, Connecticut will likely struggle more than other states in the near term to achieve structural budget balance, especially once the federal stimulus funds are no longer available.

State credit strengths:

- Application of operating surpluses to BRF, which totaled nearly \$1.4 billion at the end of fiscal years 2007 and 2008.
- Early repayment of economic recovery notes issued and other actions taken to cover operating deficits during the prior recession years, fiscal years 2002 and 2003.
- Wealthiest state in the nation with per capita personal income levels well above national levels.

State credit challenges:

- Use of one-time solutions to close the fiscal 2009 budget gap and balance the 2010-2011 biennial budget reduces financial flexibility and increases out year structural budget gaps.
- Vulnerability to financial market fluctuations due to effect on capital gains for very high wealth residents and employment in the financial services sector.
- Deterioration of already weak GAAP-basis balance sheet due to negative unreserved/undesignated general fund balance and depletion of BRF over near term.
- Debt ratios are among the highest in the nation.
- Very low funding ratios for pension systems (state employees and teachers) and high other post employment (OPEB) liability.

**FISCAL YEAR 2009 BUDGET GAP EMERGED FROM STEEP DECLINE IN TAX REVENUES; DEFICIT FINANCING TO CLOSE YEAR END GAP**

Connecticut's revenues have been hurt by the national economic downturn, as they have been in nearly every other state; Moody's assigned a negative outlook to the U.S. state sector in February 2008 and affirmed that negative outlook in February 2009. As the wealthiest state in the nation, Connecticut is disproportionately reliant on taxes paid by wealthy residents and is particularly vulnerable to fluctuations in tax receipts related to capital gains and the exercise of stock options. After five years of double digit growth, Connecticut's personal income tax receipts plummeted 15% in FY 2009 while sales tax receipts dropped 7.3%. These were well beyond the revenue declines that the state recorded in fiscal 2002 when the state experienced decreases of 10.1% and 4.1% in personal income and sale taxes, respectively, during the last recession.

The state took early action to address the revenue fall off through allotment rescissions of approximately \$178 million in expenses pursuant to executive office rescission authority to reduce agency spending, including social services, by 3% to 5%. In addition, the state's general fund received approximately \$411 million in federal stimulus funds in fiscal year 2009. Still, Connecticut ended fiscal year 2009 with a gap of \$947 million which it plans to fill with the proceeds of deficit bonds to be issued next month. Connecticut has a history of resorting to deficit bonds in times of economic weakness and budget challenges due to the state's tendency to rely on one-time solutions and its inability to achieve structural budget balance. On a positive note, however, the state has used operating surpluses driven by economic rebounds in the past to retire deficit bonds early and more recently to build its rainy day fund.

#### HEAVY RELIANCE ON ONE-TIME SOLUTIONS TO BALANCE 2010-2011 BIENNIAL BUDGET

Connecticut faced a sizeable budget shortfall of approximately \$8.5 billion for the 2010-2011 biennium, representing nearly one-fourth of the state's general fund biennial budget. The gap reflected a significant falloff in revenue (particularly personal income taxes) to a level that could not support current service expenses.

Adopted two months late, the budget for fiscal years 2010 and 2011 includes new recurring revenues and ongoing savings, but relies heavily on one-time measures to resolve slightly over half of the projected shortfall. These solutions include the depletion of the BRF by the end of fiscal year 2011, transfers of various fund balances, a temporary increase in the state's corporate tax surcharge, and, as in most states, the federal stimulus funds. Of significant concern is the expected receipt of \$1.3 billion in fiscal year 2011 from a securitization of a revenue stream that has yet to be identified, effectively another deficit borrowing. These solutions create future structural budget gaps and leave the state with significantly reduced flexibility to address additional fiscal pressures that may arise in the event that the recovery that may be taking hold is delayed and/or weaker than expected as well as to address the anticipated fall off in federal fiscal stimulus funds. These actions will also hurt the state's GAAP-basis general fund balance sheet which is already weak relative to many states. Connecticut has recorded a sizeable (approximately negative \$1.1 billion at the end of fiscal year 2008) in unreserved, undesignated fund balance since the early 1990s, largely reflecting an accrued liability that has never been repaid. On a positive note, the state prepares an annual update to its budget projections in November and this year's update is expected to address the expected fall-off in federal fiscal stimulus funds.

In terms of recurring revenues, the budget includes an increase in the state's personal income tax rate to 6.5% for tax filers earning over \$1 million (or \$500,000 for single filers) which is projected to add \$594 million in fiscal 2010 and \$400 million in fiscal 2011. An increase in the state's cigarette tax is expected to bring in \$95 million in fiscal 2010 and \$112 million the following year. Various fee and license increases are budgeted to add \$110 million and \$106 million in fiscal years 2010 and 2011, respectively.

On the spending side, Connecticut expects significant recurring savings related to contract negotiations. These savings, which total \$855 million for the current biennium, will be achieved through retirement incentives, changes in retiree healthcare insurance, furlough days, healthcare co-pay and premium payments by state employees, and a freeze on salary increases and bonuses. The state also budgeted savings from changes to social services, including a total of \$665 million in reductions for Medicaid costs over the biennium while still meeting the maintenance of effort as required for the federal medical assistance percentages (FMAP) stimulus funds, and approximately \$75 million to \$80 million in annual savings from changes in pharmacy programs.

Connecticut's personal income taxes grew by an average annual rate of 12% over the past five fiscal years (2004 through 2008), but dropped 15% in fiscal year 2009. The budget for the current biennium incorporates relatively conservative personal income tax projections: -2.4% for withholding taxes in fiscal 2010, followed by 1.3% in fiscal 2011, and a 14% decline in estimated and final payments in fiscal 2010, recovering in fiscal 2011 to 10% growth. Since estimates and final payments declined by an estimated 27% in fiscal 2009, these receipts will remain relatively low for Connecticut over the near term. As a very high wealth state, Connecticut is more exposed than many states to financial market volatility which is captured, in part, by estimated and final tax filings. Connecticut tracks these receipts carefully in light of its heightened exposure to fluctuations in the financial markets. Additionally, the state has some exposure to downturns in the high-paying financial activities employment sector as this sector represents 8.4% of total employment for 2008 while the national average is 5.9%. The state's personal income tax revenues declined by 10% in fiscal year 2009 during the last recession. Given the continuing weakness in the financial markets, weak prospects for near-term employment growth, and the magnitude of this recession, Connecticut could face additional budget strain if personal income taxes fail to reach forecasted levels.

#### **BUDGET RESERVE LEVELS ARE SCHEDULED TO BE DEPLETED BY END OF FISCAL YEAR 2011**

Connecticut's BRF balance was \$1.38 billion at fiscal year-end 2008, the same level as the prior year. With strong revenue growth driven primarily by personal income tax receipts, Connecticut recorded operating surpluses in fiscal years 2004 through 2008. Funds were used, in part, to build the state's BRF balance which was a healthy 10% of general fund revenues (excluding federal aid) at the end of fiscal year 2008. However, in terms of GAAP-basis available combined reserves, this amount is offset by an unreserved undesignated general fund balance (UUFb) that was negative \$1.1 billion, reflecting the magnitude of the last recession's impact on the state's finances as well as a large cumulative liability prior to the recession. Still, in fiscal years 2007 and 2008, the state's combined available reserves (UUFb plus BRF) were positive at about 2% of general fund revenues for the first time in well over a decade.

With the budgeted use of the BRF for the current biennium, Connecticut's rainy days funds are expected to drop to approximately \$342 million by the end of fiscal year 2010 and are expected to be depleted entirely by the end of the biennium.

## HIGH WEALTH LEVELS AMPLIFY REVENUE FLUCTUATIONS, UP AND DOWN

As a high wealth state, small swings in Connecticut's income tax performance related to capital gains and the exercise of stock options lead to relatively large revenue fluctuations. Based on 2007 income year data, Connecticut's millionaire residents (earning at least \$1 million or more) made up less than 1% of the state's income tax filers but accounted for about 35% of the state's income tax collections. Market related revenues grew dramatically during the stock market run up of the late 1990s and dropped off precipitously in fiscal year 2002. Like other high wealth states, Connecticut faced the challenge of adjusting revenues and spending to achieve budget balance. In the process, the state was forced to deplete reserves and resort to deficit financing for operations. Similar actions have been incorporated in the 2010-2011 biennial budget.

While the pace of per capita personal income (PCPI) growth slowed during the 2002-2003 recession and in 2008, in line with declines in stock market performance, Connecticut remains the wealthiest state in the nation. The most recent census data show that the state's PCPI far exceeds the nation (by about 40%) and even the relatively wealthy New England region by 14%. Despite gains in other states and below average population growth, Connecticut is likely to maintain its lead as the wealthiest state at least over the near term. As in other high wealth states, Connecticut remains vulnerable to market volatility.

## JOB LOSSES CONTINUE WITH MOST SECTORS DECLINING ALTHOUGH UNEMPLOYMENT RATE IS BELOW THE NATION

Connecticut's non-farm employment was essentially flat year-over-year in 2008, slightly better than the national job decline of 0.4% for the year. However, overall jobs losses began to accelerate in the last quarter of 2008. Jobs lost during the last recession were recovered by 2007 although the state's manufacturing sector continues to decline, as it does nationally. Connecticut is also continuing to experience employment declines in other sectors, especially construction, financial services, and trade. In fact, similar to other states, only the health & education sector has demonstrated any growth. Connecticut's unemployment rate has risen in recent months but at 8.4% in September 2009, it was better than the national rate of 9.8% the same month.

Connecticut's housing market is feeling the effects of the housing downturn, although not to the extent seen in some parts of the country. There are signs that Connecticut's high end home market has been negatively affected by job losses in the financial sector. Foreclosure rates are up significantly in certain weaker demographic parts of the state, notably the Hartford, Bridgeport, and New Haven areas that have higher percentages of sub-prime mortgages. Overall, the state is average in terms of sub-prime loans as a percent of total and loans that are seriously delinquent or in foreclosure.

## SIGNIFICANT LONG-TERM LIABILITIES REFLECT HEAVY DEBT LOAD AND VERY LOW PENSION FUNDING RATIO

Connecticut compares unfavorably with other states on measures such as debt ratios that are among the highest in the nation, pension funding levels that were among the lowest in the country in 2008 even before the market turmoil is factored, and other post employment benefit (OPEB) liabilities that are larger than the size of the state's annual operating budget.

Connecticut is a frequent borrower, and the state's debt per capita and debt-to-personal income ranked first and third among the 50 states for Moody's 2009 debt medians. Net tax-supported debt equaled \$4,490 per capita and 8.2% of total state personal income, well above the 50-state medians of \$865 in debt per capita and 2.5% for debt-to-personal income. These high debt ratios are due, in part, to substantial capital financing for K-12 school building construction that is carried out at the local level in many other states. However, with the sale of \$2 billion in pension obligation bonds (POB) on top of the state's normal sizeable annual debt issuances, Connecticut's debt ratios will likely remain among the highest in the country. The state also has substantial fixed costs for pensions. As of June 30, 2008, the TRF had a funded ratio of 70%, with a \$6.5 billion unfunded actuarial liability following the issuance the pension obligation bonds, up from a funded ratio of 60% prior to the POB issuance. The state employee's retirement fund (SRF) had an unfunded pension obligation of approximately \$9.3 billion, representing a very low 52% funded ratio on an actuarial basis. Unlike the TRF, where contributions were reduced in the earlier part of the decade for budgetary relief, SRF requirements were maintained pursuant to the state's contractual agreement with state employees. However, one of the state's recent budget solutions includes savings from SRF payments that are less than the normal annual required contribution (ARC). As part of the POB issuance, the state made a commitment to fully fund the TRF ARC. As in many states, Connecticut uses a five-year smoothing asset valuation method. The recent turmoil in the stock market will likely have a negative impact on funding levels of both the state employees' and teachers' retirement systems.

Preliminary estimates of Connecticut's other post employment benefits (OPEB) liability could add substantial budget pressures, as is also likely in some other states. The actuarial accrued liability for the SRF and other state retirement systems, excluding the teachers' retirement system, ranges from \$11.4 billion to \$21.7 billion. Annual required contributions (ARC) under various assumptions range from \$1 billion to \$1.6 billion. If the state were to fund this ARC, it would at least double the fixed costs for state employee pensions and health insurance which were budgeted at \$1.78 billion in fiscal year 2008.

While Connecticut's liquidity remains satisfactory and the state has not had to borrow for cash flow purposes, cash margins would likely be significantly tighter if the state decreased its reliance on debt, addressed the low funding ratios of its retirement systems, and met its annual required contributions for OPEB costs.

**VARIABLE RATE DEBT AND SWAP EXPOSURE APPEARS MANAGEABLE**

Out of approximately \$12 billion outstanding general obligation debt, the state has swapped a total notional amount of \$356 million variable rated debt (less than 3% of total outstanding debt) to fixed based on 65% of LIBOR or a percentage point above CPI. The counterparties are all rated Aa3 or higher. Termination payments could be triggered in the unlikely event that the state's rating is downgraded below Baa2 or, by the state, if the counterparty rating falls below A3. There are collateral posting requirements on the part of the counterparties but not for the state. According to recent estimates (September 2009), if all of the state's general obligation swaps were terminated, the state would owe approximately \$26 million to the counterparties. This amount is manageable given the state's current resources and likely ability to issue bonds for the amount if necessary. In accordance with its swap guidelines, the state generally negotiates provisions that permit funding a required termination payment over a period of time to allow time for a refunding. Accordingly, the state would have 270 days to fund a termination payment for its general obligation swaps.

#### MOST RECENT RATING ACTION AND PRINCIPAL METHODOLOGY

The last rating action with respect to the State of Connecticut was on April 20, 2009 when the rating of MIG 1 was assigned to the General Obligation Bond Anticipation Notes (2009 Series A) and General Obligation Bond Anticipation Notes (2009 Series B).

The principal methodology used in reviewing the state's rating was "The State Rating Methodology" published in November 2004 and available on [www.moodys.com](http://www.moodys.com) in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

#### OUTLOOK:

The credit outlook for Connecticut's long-term obligations is negative reflecting Connecticut's significant reliance on one-term measures, including deficit financing to resolve its recent budget gaps together with a credit profile that already exhibits a negative GAAP fund balance, and high long-term liabilities. These reduce the state's flexibility to address future fiscal pressures that may arise and create out year structural budget gaps that will need to be filled. Moody's expectation is that Connecticut will make appropriate adjustments as needed to restore balance in the event that the economic recovery is delayed or more muted than expected resulting in weaker than projected revenue performance.

What could make the state rating move - UP

- Achievement and maintenance of higher GAAP-basis combined available reserve levels.
- Established trend of structural budget balance.

- Evidence of stronger economic performance.
- Reduced debt ratios relative to Moody's 50-state median.
- Significantly improved funding of pension and post-retirement liabilities.

#### What could make the state rating move - DOWN

- Increased use of one-time budget solutions.
- Further revenue weakness driven by delayed economic recovery.
- Further use of deficit financings to resolve budget gaps.
- Cash flow strain stemming from reduced liquidity
- Failure to identify a fiscal plan that will restore structural budget balance, particularly when federal fiscal stimulus dollars are no longer available.

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