Maryland STATE TREASURER

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STATE TREASURER'S OFFICE

UPDATE ON DEBT ISSUANCE, RATING AGENCY and CDAC RECOMMENDATIONS

FOR THE

JOINT COMMITTEE ON THE MANAGEMENT OF PUBLIC FUNDS

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State Treasurer

Ratings

In conjunction with the sale of Maryland’s General Obligation Bonds State and Local Facilities Loan of 2017, Second Series, Moody’s Investors Service, S&P’s Global Ratings and Fitch Ratings all affirmed their AAA ratings for Maryland’s General Obligation debt in August of 2017. Maryland is one of only eleven states to hold the coveted AAA rating, the highest possible rating, from all three major rating agencies. S&P’s Global Ratings has rated the bonds AAA since 1961. Moody’s has assigned the bonds a rating of Aaa since 1973, and Fitch Ratings has rated the bonds AAA since 1993. The other ten states that hold AAA ratings from all three rating agencies are Delaware, Georgia, Iowa, Missouri, North Carolina, South Dakota, Tennessee, Texas, Utah and Virginia.

Meetings with Rating Agencies

As of the date of this report, there have been no further rating actions. The Treasurer’s Office has provided the rating agencies with regular updates on the financial condition of the State. The next conference call with the rating agencies is expected prior to the sale of the 2018 First Series General Obligation Bonds in March 2018.

Why Is Maryland Considered A “Triple AAA” State?

In their reports, the three rating agencies generally agree on the credit strengths and challenges that lead each to rate the State so highly. Moody’s, S&P, and Fitch all agree that the State’s highly educated workforce, diverse economy (including the federal government), proactive financial management, and debt management policies are significant credit positives. The rating agencies also agree that the State’s challenges include a continued slow recovery from the Great Recession, moderate debt burden, and pension costs, as well as the current climate of uncertainty in the federal government.

A Highly Educated, Highly Paid Workforce

All three rating agencies note Maryland’s highly educated and well compensated workforce in their analyses. Moody’s notes that the State’s 2017 per capita personal income is “nearly 117% of the national average,” and that 39% of the population over age 25 possess a bachelor’s degree, compared to only 31% nationwide. Fitch states that the impact of the last recession on the State was less severe than in other parts of the country, in part because of the State’s “solid labor market characteristics.” Likewise, S&P Global Ratings highlights Maryland’s “strong wealth and income levels relative to those of the nation” as a key reason for the State’s AAA rating.

A Broad, Diverse Economy

In assigning its ‘AAA’ long-term rating and stable outlook, S&P Global Ratings said: “The rating reflects what we view as the state’s “broad and diverse economy,” and “continued strong wealth and income levels.” S&P’s further states: “The stable outlook reflects Maryland's continued focus on structural budget alignment and maintenance of minimum state reserve levels.” Fitch observed that Maryland’s economy “has long benefited from proximity to the nation's capital" and notes that the State's dominant sector is services, including "professional and business services, education, health, and government", with Baltimore's trade and port activity also factoring in as a significant part of its economic base. Fitch also mentions a recent uptick in economic growth in the State which has brought Maryland's personal income and employment growth to a level "matching or exceeding national levels in recent months."

Each rating agency cites ties to the federal government as both benefits and risks to Maryland's economy, with Moody's calling the large federal presence in Maryland a "mixed blessing." S&P Global Ratings notes the State's economy "continues to recover slowly after weakness in recent years due to federal budget uncertainty and sequestration" while also stating that the government sector and federal agencies are economic strengths. Fitch writes that despite the "drag posed by federal sequestration," the federal government continues to be an "important anchor… supporting the State's solid economic performance."

A History of Proactive Financial Management

All three rating agencies point to the State's history of strong, sound financial management as a credit strength, with Moody's saying the State has a "history of proactive financial management." All three commend the Board of Revenue Estimates' binding, consensus-based revenue forecast and the Board of Public Works' ability to adjust spending mid-year when necessary, with S&P Global Ratings mentioning the State has a "long history of… frequent and timely budget adjustments to align revenues and expenditures and long-term financial planning." Fitch Ratings notes that its rating reflects Maryland's "exceptionally strong" financial resilience and its unlimited ability to increase revenues, as well as its strong reserve levels. Moody's likewise highlights the State's liquidity, which it states is "bolstered by unfettered access to the State's short-term investment pool," which totaled $6.5 billion at the end of fiscal year 2017.

Debt Policies and Debt Burden

In the case of all three rating agencies, the State's Capital Debt Affordability Committee process and constitutionally imposed fifteen-year amortization of debt are considered credit strengths and help to offset concerns the rating agencies have regarding the State's debt burden, which S&P Global Ratings calls "moderate." Fitch notes that "centralized debt planning and issuance" managed by the State Treasurer's Office is an additional credit strength. Moody's states that the fifteen-year amortization requirement "quickly replenishes the State's debt capacity and helps restrain growth in outstanding balance." S&P echoes this assessment, noting our "well-developed debt management practices with a moderate debt burden for most measures and rapid amortization."

Pension and other liabilities

Fitch Ratings calls pensions a "significant burden," but notes that the state has taken multiple steps to reduce their burden and improve sustainability over time. Moody's indicated it considers the State's retirement system its "most significant credit challenge," but goes on to recognize that "the state has taken a number of steps to manage its pension burden," which demonstrates its "proactive management approach." S&P's indicates "failure to demonstrate a consistent commitment to fully funding its pensions could also pressure [Maryland's] rating."

The State Treasurer's Office provides information about the State's ratings reports for each bond sale to all members of the General Assembly. Current reports are also available on the Treasurer's website at www.treasurer.state.md.us.

General Obligation Bonds

Since our last report to this committee, the State has conducted three General Obligation bond sales.

Qualified Zone Academy Bonds (QZAB) totaling $4.68 million were issued on December 15, 2016. The bonds earn federal tax credits at the rate of 4.67% per annum for Capital One Public Funding until maturity on December 15, 2031;

The 2017 General Obligation Bond, First Series was sold on March 8, 2017 and totaled $1,140,685,000. The proceeds were used to finance new projects and refund existing bonds. The sale closed on March 22, 2017 and had three series:

Series A: $575.0 million in Tax-Exempt Bonds sold in a competitive sale primarily to institutions
Series B: $100.0 million in Taxable Bonds sold in a competitive sale primarily to institutions
Series C: $465.7 million in Tax-Exempt Refunding Bonds

The Series A bonds provided $575.0 million, at a TIC (True Interest Cost) of 2.83%, to finance investments in capital projects critical to our State. The Series B bonds provided $100.0 million, at a TIC (True Interest Cost) of 2.03%, to finance loan programs and other capital projects with the potential to benefit non-governmental entities. The Series C refunding bonds saved taxpayers $24.2 million in debt service costs. In addition, the State received a premium of $93,189,554 to offset fiscal year 2018 debt service costs.

The 2017 Second Series was sold on August 16, 2017 and totaled $1,335,340,000. The proceeds were used to finance new projects and refund existing bonds. The sale closed on August 30, 2017 and had two series:

Series A: $550 million in Tax-Exempt Bonds sold in a competitive sale primarily to institutions
Series B: $785.3 million of Tax-Exempt Refunding Bonds

The Series A bonds provided $550.0 million, at a TIC (True Interest Cost) of 2.29%, to finance investments in capital projects critical to our State. The Series B refunding bonds saved taxpayers $75.8 million in debt service costs. In addition, the State received a premium of $93,874,850 to offset debt service costs.

Leases

The Capital Lease-Financing Program allows State agencies to acquire equipment and pay for those items over a three, five, or ten year time frame. Between November 16 2016 and November 15, 2017, $1,940,532 in capital equipment was leased by State agencies through the State Treasurer's Office. A total of $26.9 million remains of the $33.1 million authorized by the Legislative Policy Committee through June 30, 2018.

The Treasurer's Office also finances Energy Performance Leases in cooperation with the Department of General Services, providing funding for energy conservation improvements at State facilities. The program finances significant up-front investments in conservation projects; the lease is paid using the savings in operating costs. The State closed on a $4,682,772 energy lease on December 22, 2016 to finance improvements at The Department of Health and the Motor Vehicle Administration. The State closed on a $9,459,123 energy lease on August 9, 2017 to finance improvements at the Department of Health. A total of $65.9 million remains of the $80.0 million authorized by the Legislative Policy Committee through June 30, 2018.

Upcoming Financing Plans

The next General Obligation tax-exempt financing, projected to total approximately $475 million, is planned for March 2018. The State Treasurer's Office will consider whether a retail component will be offered in light of market conditions. Throughout the year, the Office monitors interest rates to gauge refunding opportunities that meet present value savings criteria in debt policy. If these benchmarks are met, refunding bonds could also be issued in March.

Status of the Annuity Bond Fund

Debt service on General Obligation Bonds is paid from the Annuity Bond Fund, and the primary source of revenue for this Fund is the State's real property tax receipts. Over the years, however, the debt service has also been supported on occasion by appropriations from the General Fund, as well. The Commission on State Debt met and released its annual report on April 24, 2017. In fiscal year 2018, $259.6 million is appropriated from the General Fund to support debt service. Assuming current property tax rates are maintained and other assumptions remain as currently estimated, a continued General Fund subsidy is projected for fiscal years 2018 - 2021. The complete Commission on State Debt report is available on the Treasurer's website at: http://www.treasurer.state.md.us/debtmanagement/csd-reports.aspx

Annuity Bond Fund Forecast, FY 2016 – 2022 ($ thousands)

	2016 Act.	2017 Act.	2018 Est.	2019 Est.	2020 Est.	2021 Est.	2022 Est.
Beginning Balance	**$132,164**	**$202,278**	**$162,522**	**$5,582**	**$2,000**	**$2,000**	**$2,000**
Total Property Tax Collections	747,033	779,752	809,987	829,991	850,687	871,899	893,642
General Fund Appropriation	252,400	259,395	259,649	453,649	487,389	477,428	500,425
Bond Sale Premium	171,212	91,187	0	0	0	0	0
Federal Subsidy for ARRA Bonds	11,511	11,532	11,527	11,527	10,843	10,123	9,364
Transfer Tax	6,422	6,575	6,735	7,059	6,851	6,884	6,917
Other Cash Receipts	2,530	2,530	2,530	2,530	2,530	2,530	2,530
Debt Service	(1,120,995)	(1,190,728)	(1,247,367)	(1,308,339)	(1,358,300)	(1,368,864)	(1,412,878)
Ending Balance	**$202,278**	**$162,522**	**$5,582**	**$2,000**	**$2,000**	**$2,000**	**$2,000**

Capital Debt Affordability Committee (CDAC)

General Obligation Recommendation

At its final meeting on September 29, 2017, the Committee reviewed its assumptions on revenues, personal income, interest rates, debt issuance, debt service and bond authorizations. The Committee believes that these variables have been estimated prudently. The personal income and revenue estimates reflect the most recent forecast by the Board of Revenue Estimates in September 2017. A motion was made by the Secretary of the Department of Budget and Management, asking the Committee to approve a recommendation of $995 million for new general obligation authorizations to support the FY 2019 capital program. The motion passed 4-1, with the Treasurer voting against.

In addition to determining and recommending a prudent affordable debt authorization level for the coming year, the Committee also sets out planning assumptions for the State to use in its capital program planning process. Again, a motion was made by the Secretary of Budget and Management, asking the committee to vote in support of maintaining the authorization at $995 million in future fiscal years. The motion passed 4-1, with the Treasurer voting against.

CDAC Affordability Ratios, FY 2018 – 2027 (projected)

$995M Annual Authorization		
Fiscal Year	4% Debt Outstanding to Personal Income	8% Debt Outstanding to Revenues
2018	3.57%	7.75%
2019	3.56%	7.83%
2020	3.51%	7.67%
2021	3.40%	7.67%
2022	3.30%	7.83%
2023	3.19%	7.84%
2024	3.11%	7.58%
2025	3.04%	7.54%
2026	2.92%	7.35%
2027	2.80%	7.39%

The Committee recognizes that there are multiple annual authorization levels and patterns that would result in adherence to the benchmarks, depending on future levels of personal income and State revenue. The Committee's planning assumptions for future authorizations will be reviewed in preparation for the 2018 report in light of updated revenue and personal income projections, and authorization levels may be adjusted to adhere to these affordability benchmarks.

Academic Facilities Bonds Recommendation

Based on its review of the condition of State debt in light of the debt affordability guidelines, the Committee recommended a limit of $24.0 million for new academic facilities bonds for the University System of Maryland for fiscal year 2019. The Committee did not receive any requests for new issuances for Morgan State University, St. Mary's College of Maryland or Baltimore City Community College and therefore made no recommendations for these institutions.

The 2017 meeting materials are available on the State Treasurer's website at: http://www.treasurer.state.md.us/debtmanagement/cdac-reports.aspx