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STATE  
TREASURER

Investing for Maryland's future.

**TREASURER'S REPORT TO  
LEGISLATIVE POLICY COMMITTEE**

**May 26, 2009**

**Nancy K. Kopp**

*State Treasurer*

**Section 5-104 of the State Government Article of the Annotated Code of Maryland provides that, “*The Treasurer shall address the Legislative Policy Committee of the General Assembly on a semi-annual basis and as necessary on issues of legislative importance, including the activities of the Board of Public Works, bond sales, and investment and procurement initiatives.*” This Report is in fulfillment of that law and covers the period since the report of December 16, 2008. I invite and welcome further discussion with the Committee at your convenience.**

The State Treasurer’s activities and responsibilities are of particular concern to the Legislature. One of five statewide Constitutional officers, and the only one elected by the General Assembly, the State Treasurer’s duties are multifaceted and extend throughout State government and higher education. The Treasurer’s duties include membership on the Board of Public Works and Board of Revenue Estimates and Chairmanship of the Capital Debt Affordability Committee. The Treasurer presently also serves as Chair of the Board of Trustees of the College Savings Plans of Maryland and the Board of Trustees of the State Retirement and Pension System. She is a member of the Teachers’ and Employees’ Supplemental Retirement Plans, the Maryland Health and Higher Education Facilities Authority, the Maryland Small Business Development Financial Authority and of the Maryland Agricultural Land Preservation Board. Several of these Boards work under the general oversight of legislative oversight committees which are in periodic receipt of reports and communications from the Office, as are the two legislative budget committees.

As we continue to face challenging fiscal times, the Office is working diligently to efficiently and effectively assist State and local agencies and the citizens of Maryland with State Treasury-related issues. The Office continues to be both a partner and reliable resource for State agencies and local government. The Office continues its work with State agencies to develop action plans and safety practices to mitigate insurance losses and reduce insurance costs, to improve banking and cash management procedures, and to advise on procurement issues.

As fiscal steward for the State, the State Treasurer’s Office approaches its responsibilities in a prudent, deliberate way. At this time of world-wide financial stress, such caution and deliberation is more critical than ever, as has been reflected in each of the Divisions of the State Treasurer’s Office. As market conditions have worsened, we have taken great care to invest State funds carefully and conservatively to minimize risk to the Maryland taxpayers. We have, through negotiation, reduced insurance premium rates. We continue to plan and conduct our bond sales efficiently and effectively, while striving to maintain Maryland’s coveted AAA bond rating. We are pleased to announce that, for the first time in March, 2009, we offered State bonds in a negotiated sale limited to retail investors. The sale was highly successful and allowed our citizens, for the first time, the opportunity to directly purchase the State’s highly rated General Obligation Bonds, investing directly in their State. The State Treasurer’s Office, experiencing furloughs and resource reductions like the rest of State government, has achieved more with less.

While our agenda is full and challenging; the Office is working hard and achieving real results even during these difficult fiscal times. The items set forth below detail a number of these achievements and we are available to provide greater information or answer questions regarding these and other issues.

## **BOARD OF PUBLIC WORKS**

The State Treasurer represents the General Assembly and citizens of Maryland on the Board of Public Works (BPW). Multi-year, high-dollar contracts representing the whole spectrum of Maryland State government require serious, thorough and open examination to ensure that the procurement process is fair, open and competitive. In these times, more than ever, priorities must be set and proposals scrutinized; projects or procurements that are highly desirable but not essential, not immediately revenue producing or subject to timing demands must be considered for deferral. At the same time, projects that will stimulate the economy and maintain employment, both with and without the assistance of federal funds, must be undertaken, overseen and held to high standards of accountability. Similarly, proposals for land acquisitions and wetlands licenses demand and receive extensive scrutiny by the Treasurer and other BPW members, the Governor and the Comptroller.

Between December 3, 2008 and May 6, 2009, the BPW acted on 826 transactions totaling \$7,278,527,506.14.

Some of the more visible issues that have come before the BPW during the past six months are:

- Conclusion of the State House renovation
- Lease modification between the Maryland Stadium Authority and the Babe Ruth Birthplace and Sports Legends Museum in Baltimore
- Ground lease restructuring at Rocky Gap Hotel in Allegany County
- Comprehensive inspection of both Bay Bridge span cables
- Fox Creek dredging/wetlands license in Anne Arundel County
- New integrated tax accounting system for the Comptroller's Office
- Purchase of the Foster property in Worcester County
- Purchase of the Jesuit properties in Southern Maryland and Cecil County
- Public School Construction Program appeals hearing
- Acquisition of a five-acre parking lot in Salisbury and subsequent design of bio-retention system to support parks and recreation
- General Fund budget cuts of \$81.6 million
- Architectural/engineering contract for construction of the new University of Baltimore Law School
- Construction of Oyster Cultivation Facilities at Horn Point Lab in Cambridge
- \$4 Billion-plus multi-year Health Benefit Contracts for State Employees

In her review of BPW agenda items, the Treasurer seeks and appreciates comments and advice of the Department of Legislative Services (DLS) outstanding staff and their scrutiny to ensure that BPW agenda items are consistent with legislative policy. The Treasurer uses these comments to pose additional questions to State agencies and to inform her decisions.

The Treasurer's Office continues to operate its constituent outreach system to inform legislators about the agenda and the Board's actions on items of specific interest to their districts. Feedback from legislators allows this Office to inform the Governor and Comptroller about legislative interest in specific issues. Sometimes the issues are contentious, in which case legislative input becomes even more important.

In preparation for Board of Public Works meetings, the staffs of the Governor, Treasurer and Comptroller, along with the Secretary of the Board of Public Works, conduct pre-board meetings, attend numerous briefings and participate in site visits. Briefings by State agencies are particularly helpful in providing in-depth analyses of often complicated, sometimes contentious contracts. These briefings are invaluable not only to BPW staffers, but also to the agencies, which receive insight into concerns that they may not have anticipated.

Transparency and accountability are critical components of the BPW process. While providing essential oversight to the State's procurement process, the Board of Public Works shines light on contracts, wetlands licenses, land acquisitions, legal settlements and other transactions that might otherwise avoid public visibility.

## **School Construction**

One of the major responsibilities of the Board of Public Works is to approve the allocations of the State's share of public school construction funds based on recommendations made by the Interagency Committee on School Construction (IAC).

School construction funding totals \$251.6 million in the Public School Construction Program for FY 2006; \$322.6 million for FY 2007; \$401.8 million for FY 2008; \$333.4 million for FY 2009 and \$260.0 million for FY 2010 in the capital budget. The combined total of over \$1.5 billion in five fiscal years is significant, exceeding the highest levels of school construction funding ever provided by the State and representing important steps towards achieving the goal established in the Public School Facilities Act of 2004 of bringing schools up to minimum standards.

The Public School Facilities Act of 2004 also required the Rules, Regulations, and Procedures of the Public School Construction Program (RR&P) be developed as regulations. The regulations were formally adopted by the BPW in 2007. Amendments to the regulations based on new legislative requirements as well as progressive policy initiatives are now under review and should be effective as of June 2009. The

amendments concern project eligibility requirements, project categories, high performance schools, the State-local cost share formula, and the revised Minority Business Enterprise (MBE) program. A new regulatory chapter concerning relocatable classrooms is now under review by affected agencies.

In response to concerns raised by the Board of Public Works, the IAC revised its MBE procedures, with the goal of substantially increasing MBE participation in State-funded school construction projects and reducing the number of waivers granted by the LEAs. The change from a reporting to a compliance role on the part of the PSCP has entailed not only revision of the MBE procedures that each LEA must adopt but also changes to internal procedures and an extensive outreach effort. The PSCP, in collaboration with the Governor's Office of Minority Affairs, provides extensive support to local school systems and the construction community in meeting these new requirements.

Consonant with the concerns and priorities of the Board, the IAC has also taken an increasingly active role in promoting school facilities as models of environmental stewardship through a number of practices and policies. Every January, a report is provided to the BPW detailing the current practices of the school districts in high performance school design and construction. Beginning with the FY 2010 CIP, the IAC has included additional State funding for new school projects that attain high performance certification in project allocations. In accordance with the High Performance Buildings Act of 2008, the IAC will enforce a requirement for new State-funded schools to achieve high performance certification in the FY 2011 and subsequent CIPs.

In response to BPW Advisory No. 2009-2 (March 18, 2009), the IAC reported on May 6, 2009 on the storm water management and sustainable environmental features of the projects that were recommended for approval in the FY 2010 Capital Improvement Plan. The IAC, which is represented on the Maryland Green Building Council, will be actively involved in assisting school systems to meet the new State storm water requirements that will be in effect in early 2010.

## **INVESTMENT DIVISION**

Turbulent financial times have punctuated the last six months. Once again, the Office's conservative investment policy and practices have served the State's portfolio well. Since June 20, 2008, the Federal Reserve Open Market Committee has lowered the Federal Funds Target Rate from 2.00% to a range of 0-.25%. The Federal Government has instituted 29 different programs to shore up the economy. With the Federal Government cash infusions and guarantees, the Agency Debt securities in the portfolio are even more secure than last year at this time and all debt securities held have improved in market value. The book value of the General Fund investment portfolio for April 30, 2009 was \$6,514,225,145. While this is well over a billion dollars less than the book

value of \$7,609,917,748 for April 30, 2008, it is approximately \$930 million more than the previous quarter end of \$5,584,322,577 at March 31, 2009.

On April 30, 2009, the portfolio was earning an average of 3.149%, compared to 4.629% for the same date in 2008. This return was realized at the same time that the Federal Open Market Committee, as noted above, had reduced the Fed Funds Target rate .25% or less, rather than the 2% target of June, 2008.

The General Fund interest earnings received year-to-date for FY 2009 were \$93,721,7378 as compared with \$112,703,388 received for the same time period in FY 2008. The almost \$19 million decline in interest received was directly attributable to the fact that FY 2009 had an average \$555 million less daily to invest – a reflection of reduced State revenue – as well as the much lower interest rates.

The securities lending program continues to be successful. The program has earned \$361,812 so far in FY 2009. This compares with \$1,860,095 for the same period in FY 2008. Much of this reduction is due to the Federal Reserve's expansion of acceptable collateral combined with the Treasury's TARP program, actions which drastically reduced borrowers' need for the securities in the portfolio. This is combined with shrinking broker/dealer balance sheets. Interestingly, for comparison purposes, the amount earned for the same period in FY 2007 was \$325,818. This abrupt and temporary spike was apparently another reflection of the volatility and instability of the 2008 market.

The Office continues to increase MBE participation in the investment of State funds. Fourteen MBE broker/dealers are on the Office's approved list for FY 2009 and they have handled investments of \$971,723,873 so far this year. This compares to FY 2008, when the Office had 8 approved broker/dealers who handled \$206,858,971 in investments. The Approved Broker Dealer List will be updated this month for FY 2010.

The Office continues to invest according to the officially adopted State Treasurer's Investment Policy, which sets out investment goals, priorities and constraints. The overriding goal is to assure sufficient liquidity to maintain uninterrupted funding of State government and legislated payments. As revenues shrink and become less predictable, the strategy has been adjusted to ensure liquidity. The STO continues to review and compare our cash management and investment policies and practices with those of peer AAA-rated states to ensure best practices.

## **BANKING SERVICES DIVISION**

The Banking Division's mission of providing efficient, accurate and timely banking services to all State agencies and external customers is vital in the current economic environment. Constant changes in banking products and services offered, direct us to continually explore new financial products and improved data delivery

methods that will provide efficient cost-saving banking services while anticipating the State's future banking needs. The Division must maintain the capacity to contain costs while accommodating for the growth, diversity, and complexity of banking transactions.

The Division's continual processing and reconciliation advancements allow the Treasurer's Office to be proactive in identifying and solving agency banking issues. These processes and controls ensure the timely, accurate, and completely documented reconciliation of the State's cash accounts. Current highlights of the results of the Division's efforts include:

- Total cash receipts and disbursements each are on pace to reach almost \$115 billion for FY 2009
- The State's bank accounts are reconciled daily to the State's general ledger within 4 days,
- There continue to be no un-reconciled differences.

Despite the recent turnover of two of the three employees in the deposit reconciliation group, the Division has been steadfast in ensuring that agencies' deposit posting processes remain timely and accurate. It is the responsibility of the Division to ensure bank deposits equal recorded general ledger deposits. Accurate outstanding deposits totals are vital to precise cash reconciliation.

We continue to be actively involved in enhancing the revenue collection process in many agencies, including working with DHMH Board of Optometry to collect license fees through the internet, and enabling the Maryland Port Administration to accept credit cards for parking at the cruise ship terminals. We also expect agency use of remote deposit products to begin during this summer. We are committed to actively working with agencies to develop and strengthen their internal processes. The Office is working jointly with DHR's Child Support Enforcement Unit on procurement for banking services that, over a period of time, will replace check issuance with stored value cards. In addition to the monetary savings, the cards will reduce the inefficiencies inherent with check issuance and, more importantly, provide child support recipients with a quick, secure and convenient method to access their funds.

We are continuing with the development of a more automated environment that will enhance the current tracking, processing and reconciling of all bank related transactions for the State's cash accounts. In the current tenuous financial environment, the Division priority must be to enhance the ability to recover in the event of a disaster and to change banks if required by market conditions or the procurement process.

## INSURANCE

The Insurance Division is responsible for administering the State's Insurance Program, which includes both commercial and self-insurance. Commercial insurance policies are procured to cover catastrophic property and liability losses, and other obligations derived from State contracts, statutes and regulations. Among the several exposures covered by commercial policies are: State maintained toll bridges and tunnels, rail operations, assorted professional liability exposures and student athlete accidents. The State also self-insures a significant portion of its exposures and maintains the State Insurance Trust Fund (SITF) to pay claims and the costs associated with handling those claims. Self-insurance coverage includes State owned real and personal property, vehicles and liability claims covered under the Maryland Tort Claims Act.

In December 2008, we advised the Legislative Policy Committee that because of our proactive underwriting management and loss prevention efforts there would be a surplus in the SITF. This continues to be the case even after factoring in the transfer of \$10 million scheduled to take place on before June 30, 2009, under the Budget Reconciliation and Financing Act of 2009.

The revised FY 2008 and 2009 projected balances are stated below:

### **Current Status of SITF**

- Balance of SITF as of June 30, 2008 - \$ 35.9 million
- Actuarial recommended fund balance - \$27.4 million
- *Estimated* balance on June 30, 2009 - \$30.3 million. This estimated balance has factored in the transfer of \$10 million, under the Budget Reconciliation and Financing Act of 2009.

### **Underwriting**

The Insurance Division procures broker services for the purchase of commercial insurance to protect the State Insurance Trust Fund from catastrophic loss, to meet statutory or regulatory requirements and for compliance with agency contractual agreements. Underwriting highlights for the past six months include the following:

- The Underwriting Unit met with three State agencies in FY 09, including the MAA, UMB Dental School and DHCD. The MAA meeting is an annual meeting held to discuss the airport liability coverage, claims, and any anticipated operational changes. The meeting also allows the airport

staff to make loss control requests of the insurance carrier for the upcoming year. The meeting with the Dental School was held to introduce a new broker and insurance carrier representatives and allowed us to clarify operations for the insurance carrier. The meeting with DHCD was held at the request of the insurance carrier which sought clarification of DHCD's procedures related to Section 8 (Federal Low Income Housing) exposures. These meetings were very well received and helped build a solid relationship with the agencies and their carriers.

- The State Treasurer's Office awarded three insurance broker services contracts since the last Report. These awards are for broker services for the State's Inland/Ocean Marine, Auto, and Athletic/Travel Accident exposures which include coverage for risks such as the MPA cranes, State-owned watercraft, physical damage for MTA buses, and athletic participants coverage for many of our State universities. **The annual broker fees for these three contracts decreased by \$3,200 from the prior awards in 2003, and will apply for four years going forward.**
- The Underwriting Unit met with the new broker and insurance carrier for the MPA liability coverage. They addressed the MPA's needs for claims settlement under the deductible, stevedoring coverage, and the MPA's request to select a local marine attorney and surveyor for future claims. The new carrier will be touring the Port facilities and operations in the near future.
- The MPA's liability policy was successfully renewed in FY 2009. Although the MPA receipts were up 4%, **the rate decreased 39% for an annual premium savings of approximately \$431,900.**
- The UMB Dental School liability policy renewed in FY 2009. Although the number of patients had increased by 23%, **the rate decreased by 35% for an annual premium savings for UMB of \$44,117.**
- The Excess Property coverage for State-owned buildings, contents and data processing equipment renewed in FY 2009. In a market where pricing is hardening, rate increases are typically 0-12%, but the State renewed with a rate reduction of 7.5%. Our reported values were up over 4% as well. **Including the broker fee, the State saved \$111,036 on this renewal.**
- The Foster Parent liability coverage for DHR and DJS renewed in FY 2009. **The State renewed with a 21% rate reduction for savings of \$2,825.**

## Loss Prevention

The aim of loss prevention is to help State agencies develop specific action plans and safety practices to mitigate or eliminate State agencies' most frequent or severe sources of preventable losses.

In FY 2009, the loss prevention manager began tracking the potential loss exposures (the estimated maximum dollar value that could be lost in the event of an incident), the cost of preventive maintenance repairs, and the actual savings to the State. The aim is to document the cost effectiveness and savings resulting from the implementation of loss preventive measures recommended by the State's commercial insurance broker's property inspectors. In FY 2009, State agencies invested approximately \$185,000 to implement repair and improvement recommendations identified in the insurance broker's boiler and machinery survey reports. This investment reduced the potential loss exposures from \$1,632,900 to \$60,000; a cost savings of \$1,572,900.

As a member of the Mitigation Advisory Committee, the loss prevention manager participated in the ranking of mitigation project and planning applications submitted under the Federal Emergency Management Agency (FEMA) 2009 Unified Hazard Mitigation Grant Program. Subsequently, the manager was invited by FEMA to participate in the Hazard Mitigation Assistance (HMA) National Review of Fiscal Year (FY) 2009 applications. Mitigation specialists representing 40 States, Tribal Governments, six Territories, 26 local jurisdictions, and FEMA personnel evaluated over 400 Pre-Disaster Mitigation (PDM) grant subapplications. The grant program is designed to help States, Tribes, Territories and Communities implement a sustained pre-disaster natural hazard mitigation program to reduce overall risk to the population and structures, while also reducing reliance on federal funding from actual disaster declarations.

Further loss prevention initiatives include the following:

- A contingency plan to address the operations of the Insurance Division is currently under development. The objective is to provide a coordinated response for each critical business process within the Insurance Division in the event of a catastrophic loss or major event.
- In response to the Maryland State Police helicopter crash in September 2008, the loss prevention manager facilitated the provision of risk control services through the commercial insurance broker for an audit and gap analysis of the MSP's Safety Program.
- The loss prevention manager and the commercial insurance broker met with the MAA to discuss the rollout of the federally mandated Safety Management System (SMS) and the use of risk management services to implement the program.

- State agencies have been identified and selected to participate in the property inspection and infrared thermographic imaging of select buildings with high voltage electrical systems. The facilities were chosen based upon information obtained from the recent property survey reports, such as the value of the buildings, contents, fine arts, occupancy, and the date of construction/renovation. Preference was given to properties that present a potential fire/life safety issue or underwriting concern.
- The State Chief Fire Protection Engineer and the loss prevention manager met to discuss and obtain information about which jurisdictions have local fire marshals performing fire code enforcement duties. The loss prevention manager provided the Chief Engineer with an inventory of State-owned property obtained from the Insurance Division's annual property survey report. The report included the dates of purchase/acquisition, construction/renovation, in addition to the insurance inspection dates of the buildings, boilers and machinery, and high voltage electrical systems. Collaborative efforts combined with the sharing of information should serve as a valuable tool to assist the Office of the State Fire Marshal and the State Treasurer in the protection of life and State owned property from fire and explosion.

## **INFORMATION TECHNOLOGY DIVISION**

The Information Technology (IT) Division provides an integrated platform of systems and programming to support the Office's daily cash receipts, disbursements, accounting, reconciliations and insurance claim management. IT ensures that appropriate hardware and up-to-date software is provided to the agency staff to ensure timely and accurate disbursements, record keeping and account reconciliation for over seven million payments totaling almost \$110 billion of State funds over a fiscal year.

IT also manages local area networking, internet access, email, application development, website management, software evaluation, alternative data communications, training, technical assistance, and other technology services to all divisions in the State Treasurer's Office. IT provides electronic funds transfer, check printing, positive pay and ARP services for the Comptroller's Office's General Accounting Division, Revenue Division, Central Payroll Bureau as well as DHR's Child Support & CARES, and the State Retirement Agency.

### **Deposit Processing & Posting**

IT receives daily ACH deposit transactions from the State's depository bank and posts those general ledger entries of electronic and printed check payments to the State's accounting system. IT offers the choice of an automated fax or data file to be

transmitted to each agency for use by their proprietary systems for reconciliation processing.

### **Payment Processing**

The IT Division services include the retrieval of warranted check disbursement files that feed a high speed customized check printing process for the General Accounting Division, Revenue Division, Central Payroll Bureau as well as DHR's Child Support & CARES and the State Retirement Agency. For each of these agencies IT provides for a unique check design, signature, MICR encoding and the delivery of an electronic positive pay file to the State disbursement bank.

The Office has developed a payment processing system that is flexible enough to allow the Treasurer to make payments for any agency in the State. The use of blank secure paper stock precludes the need to maintain preprinted checks for each account. The paper is also protected with several security features to eliminate or detect forgery or fraud. The checks are printed in a presorted zip code order to comply with the State's presort vendor requirements that lower postage expense.

### **Electronic Funds Transfer (EFT)**

The State Treasurer is ultimately responsible for all disbursements made by the State. The IT Division supports the State's initiative to move away from paper checks over to electronic funds transfer. Electronic payments or direct deposits are run through a conversion program that transforms the agency's payment information into a CCD+, CTX or Electronic Data Interchange format (EDI). Payments are sent in these formats to the State disbursement bank which then forwards them to the Federal Reserve's Automated Clearing House (ACH). The payment can then be deposited to any payee's bank account in the country.

### **Receipt Processing**

The State Treasurer's Office's receipt processing system complements the payment processing system by allowing any State agency to receive electronic payments from taxpayers, credit card processors and federal programs. Currently, most of the taxes collected by the State, all credit card receipts, lockbox (used for high-volume, mail-in collections) and all federal funds come in through the "Depository Plus" process. Agencies without direct access to the State's depository bank use the FDGS phone transfer system to allow them to transfer their deposits made at local banks that are affiliated with the State's depository bank. Funds are electronically transferred from the local bank over to the State's main account at the depository bank.

## IT Accomplishments for 2<sup>nd</sup> Half of FY 2009

- The IT Division worked with the Insurance Division to clean-up the Claim Management database in preparation for forthcoming enhancements to the system.
- The IT Division made program enhancements to the Insurance Claim Management system's Claim Entry screen. The additional features include the ability to update obsolete agency accounting strings, add new automated notes to the claim file and add new status messaging for Recovery Reimbursement.
- The IT Division worked with the Banking Division to streamline the Wire Entry system. The new program reduces the Banking Division staff's data entry and research time.
- The IT Division has been working with the Administration Division and the GAD programmers to have R\*Stars screens include the original check numbers when displaying the detail of checks reissued from the Undeliverable and Unpresented funds.
- The IT Division has nearly completed migration away from a legacy SNA/SDLC connection to the Annapolis Data Center. This connection was used for file transfer, client emulation sessions, printing, and job control. All functionality is now accomplished via TCP/IP connections through firewalls and over SwGI. This migration has resulted in better security, faster performance, and elimination of legacy technology.
- The IT Division successfully supported the 2009 First Series bond sale which included a retail component for the first time. Working with a design firm, the IT Division implemented a new Bond Sale website. The IT Division also improved our capabilities to monitor and respond to heavy web traffic, ensuring that we would be able to keep the Bond Sale website operating even if the website suddenly received a large amount of traffic. Lessons learned from the web design and the web traffic preparations will be used in a planned redesign of the regular State Treasurer's website.

## DEBT MANAGEMENT DIVISION

### Financing Activities - Ratings

Since 1961, Maryland has had a continuous rating of AAA from Moody's Investors Service. Similarly, Standard and Poor's has continuously rated Maryland AAA since 1973 and Fitch since 1993. Only 6 other states currently have ratings that are equivalent to our State.

The State Treasurer's Office maintains frequent contact with the rating agencies and schedules conference calls with each of them prior to every bond sale as we did prior to the bond sale on March 4, 2009. Participating in the most recent conference call were the Treasurer, Comptroller, Secretary of Budget and Management, Director of the Bureau of Revenue Estimates, the Director of Policy Analysis for the General Assembly and their staffs.

The Rating Agencies are very consistent in their assessment of Maryland's credit. They cite Maryland's history of prudent, moderate debt and budget management, its protected Rainy Day Fund and other reserves, its Capital Debt Affordability and Spending Affordability processes, its 15-year G.O. bond terms, and other strong evidence of prudent stewardship. However, they also note the serious financial challenges posed or exacerbated by the on-going world-wide economic crisis, including State revenue shortfalls, outstanding liabilities such as the public pension and retiree benefit obligations, and increased demand for public services.

In its most recent report on Maryland General Obligation Bonds dated February 19, 2009, Moody's stated, *"While the state has taken significant action to address budget deficits, there remain serious challenges for the fiscal 2009 and 2010 budgets and out-year budgets. An ongoing trend of economic and financial weakening will continue to stress state finances. Revenue estimates for fiscal years 2009 and 2010 are likely to be further revised downward in March. Beyond fiscal 2009, budget balance is dependent on video lottery fee revenues, with \$90 million in receipts expected in fiscal 2010 and larger collections projected in fiscal years 2012 and 2013 (more than \$400 million). These revenue performance expectations may be overly optimistic in light of the economic downturn and early indications of lower than expected bid requests on video lottery licenses. Maryland has a good history of managing its finances through periods of fiscal stress. Moody's expects that, like other Aaa-rated states, and in keeping with Maryland's historically conservative financial management and aggressive approach to dealing with budget shortfalls, the state will soon stabilize its finance."*

Recently the rating agencies have contacted the State Treasurer's Office with inquiries regarding revenue estimates (particularly the April tax receipts), retirement funding levels and projected budget deficits in future years. The next conference call with the rating agencies is scheduled for July 13, 2009, prior to the sale of the 2009 Second Series General Obligation Bonds.

## **Financings - General Obligation Bonds**

The State's first bond sale for calendar year 2009 was quite noteworthy for three reasons – the method of sale, refunding higher rate debt to achieve lower debt service, and low interest rates.

This sale was the first time in modern history that the State gave first priority to Maryland citizens for the purchase of the State's general obligation bonds. On February 27 and March 2, the State sold \$291.6 million of general obligation bonds to retail customers using the negotiated method of sale. A competitive sale of \$199.2 million was held at the Board of Public Works meeting on March 4, 2009. Of the total par amount of \$490.8 million, \$65.8 million were refunding bonds and the State saved approximately \$2.9 million in future debt service as a result of this refunding. The remaining \$425 million of bonds financed new projects. These bonds generated a premium of approximately \$30.7 million which was deposited to the Annuity Bond Fund and the 3.52% TIC on these bonds was the lowest in at least 20 years.

The negotiated sale to retail investors accomplished two goals. In prior competitive sales, retail investors generally could only purchase the State's bonds in the secondary market because essentially all of the bonds were purchased by institutional investors in the competitive sale. The 2009 First Series sale satisfied the strong interest by the citizens of Maryland to purchase the State's highly rated General Obligation Bonds. Furthermore, with recent market disruptions, retail investors have been large purchasers of highly rated municipal debt and this sale took advantage of that momentum. To generate as much interest as possible in the retail sale, the State Treasurer's Office created a website, [www.buymarylandbonds.com](http://www.buymarylandbonds.com), and used print advertising in the Baltimore Sun and Washington Post.

The American Recovery and Reinvestment Act (ARRA) of 2009 created several new financing opportunities for the State and local authorities. The Treasurer is reviewing each of these separate instruments to assess their benefit to the State and their requirements and implications. Among these, the Qualified School Construction Bonds appear to have the most financial benefit to Maryland. These are federal tax credit bonds which should provide significant interest savings by subsidizing 100% of the interest cost. For instance, instead of issuing tax-exempt G.O. bonds for school construction, the State could issue Qualified School Construction Bonds, reducing potential annual State debt service payments. The State's allocation is approximately \$101 million over the next two years. In addition, allocations have been made directly by the Federal Government to Baltimore City, Prince George's County and Baltimore County Public Schools. The Office will continue to analyze and consult with its advisors on other bonds authorized by ARRA to determine the potential financial benefits to the State and how the State could assist the three local jurisdictions in the use of their allocations.

The next tax-exempt General Obligation bond sale is scheduled this summer. The Treasurer is planning to again offer first priority to Maryland citizens in a retail sale

that is expected to begin on July 31 and continue on August 3. The competitive sale would be on August 5 at the Board of Public Works meeting. The total amount of the 2009 Second Series tax-exempt bonds is \$435 million. The Qualified School Construction Bonds could total approximately \$50 million; however, the date has not been set for the sale of the Qualified School Construction Bonds.

### **Leasing**

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 December 17, 2008 and April 30, 2009, \$2.4 million in capital equipment was leased by State agencies through the State Treasurer's Office with approximately \$98.5 million remaining to draw down under the current contracts as of the end of April.

The Treasurer's Office also finances Energy Performance leases in cooperation with the Department of General Services (DGS), providing funding for energy conservation improvements at State facilities. The program finances significant up-front investments in conservation projects with lease payments coming from savings in budgeted operating cost allocations. Energy leases in the amount of \$48.3 million were financed between December 17, 2009 and April 30, 2009. The current energy contract has a remaining balance of \$9.6 million.

### **Status of the Annuity Bond Fund**

Debt service on General Obligation Bonds is paid out of the Annuity Bond Fund (ABF): the primary source of revenue for the Fund is real property tax receipts. It is projected that there will be sufficient property tax receipts to cover debt service for fiscal year 2010 without any general fund subsidy. However, assuming the real property tax rate continues at the current level of 11.2¢ per \$100 of assessed valuation, future debt is issued at the rates projected in the 2008 CDAC Report, and no further premiums are deposited to the Annuity Bond Fund after FY 2009, subsidies of general funds will be necessary to support the debt service on General Obligation (GO) Bonds in future years. As projected in the 2009 Commission on State Debt Report, for the 4 year period beginning in FY 2011 through FY 2014, \$421.0 million of general funds will need to be appropriated to the Annuity Bond Fund for the payment of debt service on GO Bonds.

### **CDAC Affordability Criteria**

The Capital Debt Affordability Committee (CDA) has adopted two complementary affordability criteria: 1) Debt outstanding should not exceed 4% of personal income; and 2) Annual debt service should not exceed 8% of appropriate revenues. Using preliminary financial data as of April 2009, the ratio of debt outstanding to personal income will peak at approximately 3.4% in 2012 and fall below 3% by 2019. However, the ratio of annual debt service to revenues is projected to increase from 6.14% in fiscal year 2009 to about 8% in 2017. It is critical to note that all projections rely on

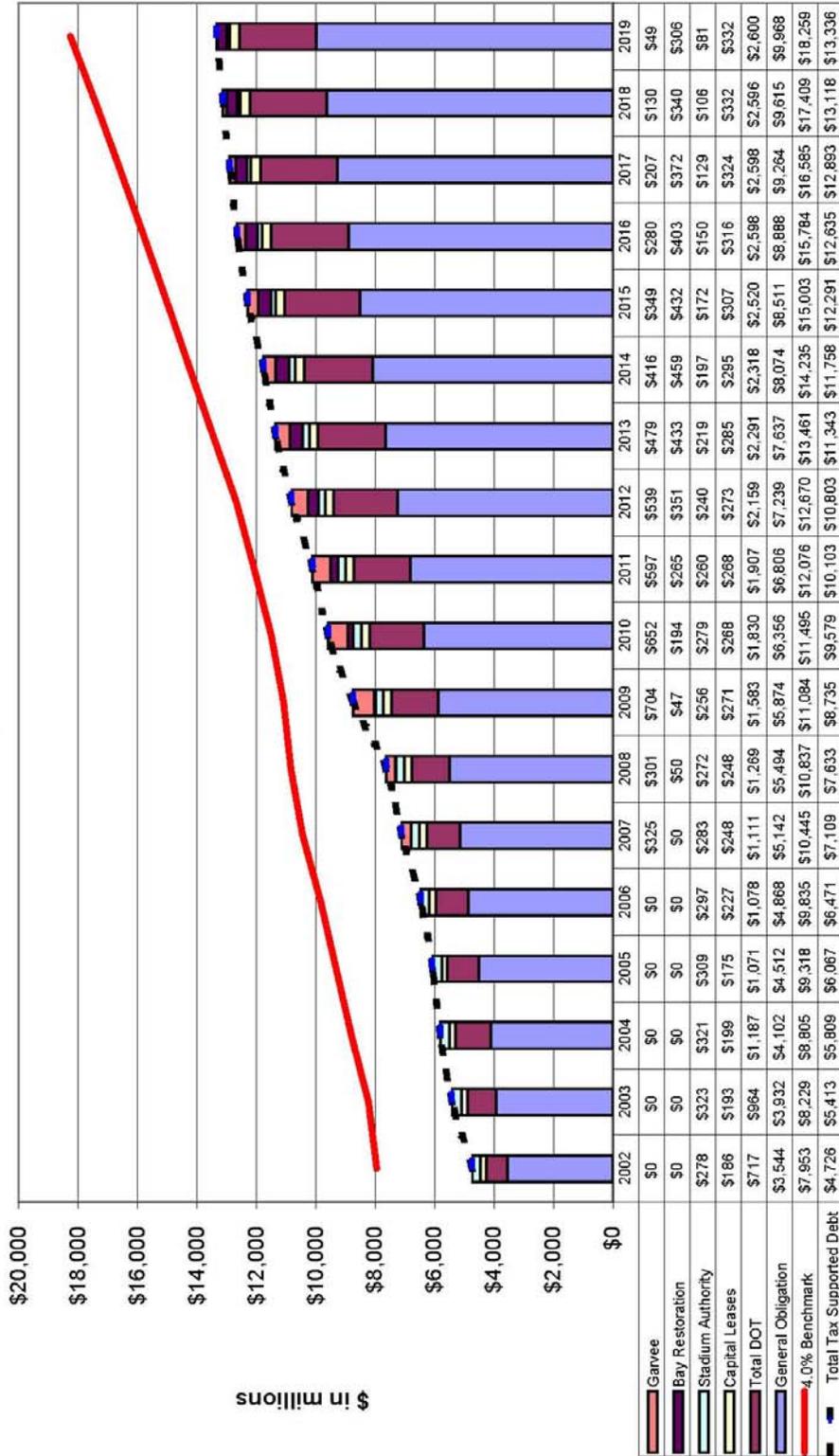
assumptions concerning both revenue and personal income several years in the future. See the charts at the end of this section for detailed information on debt outstanding and debt service.

Updates to the status of these affordability criteria will be available as CDAC meets in the summer of 2009. Meetings are scheduled for May 26, July 14, August 5 and the final recommendation will be made on September 3. Relevant topics that will be discussed throughout the summer include capital and operating leases, Public Private Partnerships, and the types of bonds that were authorized in ARRA.

The Treasurer anticipates continued change in the affordability measurements as a result of current financial conditions and market volatility, both of which impact State revenue and spending in many ways. For instance, declining transportation revenues have limited the issuance of Consolidated Transportation Bonds thereby reducing the total tax supported debt outstanding and consequently, the debt outstanding to personal income ratio. Conversely, the decline in general fund revenues have increased the debt service to revenues ratios compared to the ratios reported in the September 2008 CDAC Report.

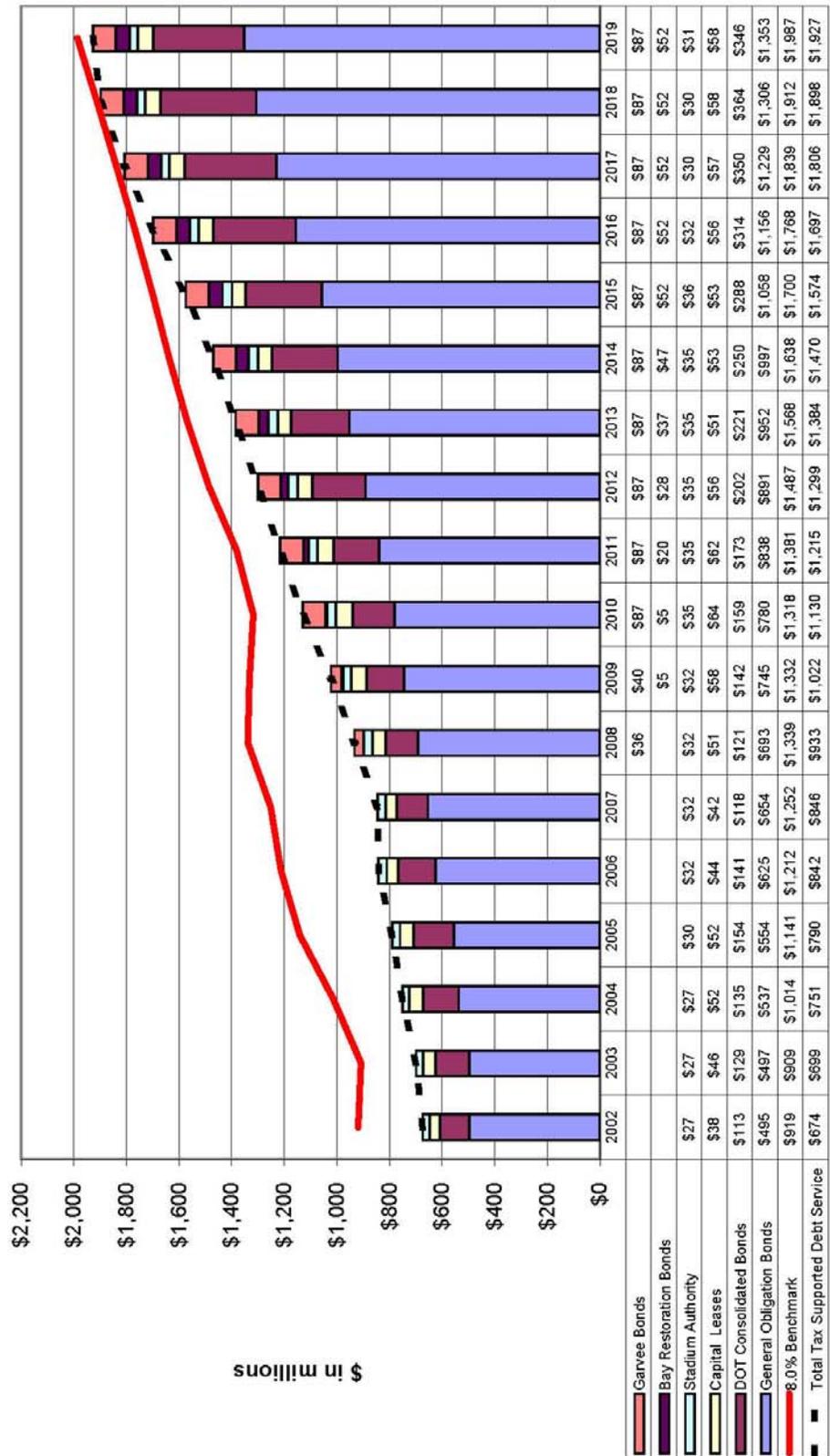
## Tax Supported Debt Outstanding to Personal Income May 2009

Preliminary, Subject to Change



Source: CDAC Table 1 as of May 2009

**Tax Supported Debt Service to Revenues**  
**May 2009**  
 Preliminary, Subject to Change



Source: CDAC Table 2A as of May 2009

*As noted in the opening section of this Report, present revenue and market conditions continue to impact the operations and achievements of the State Treasurer's Office in many ways. The Treasurer appreciates the opportunity to provide this report to the Legislative Policy Committee on a regular schedule. If the Committee or its members would care to pursue further these or other STO developments, or any other aspects of the Treasurer's activities, please call the Treasurer at (410) 260-7160 or Chief Deputy Treasurer Bernadette T. Benik at (410)260-7390.*