TREASURER'S REPORT TO

LEGISLATIVE POLICY COMMITTEE

June 15, 2010

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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 15, 2009. 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 governing boards of the Teachers' and Employees' Supplemental Retirement Plans, the Maryland Health and Higher Education Facilities Authority, the Maryland Small Business Development Financng Authority and of the Maryland Agricultural Land Preservation Foundation. 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 do the two legislative budget committees.

As of May, 2010 the State's fiscal picture seems to be improving, due to the strength and diversity of Maryland's economy. While the State continues to face fiscal challenges, the Office continues to build on staff expertise to assist agencies in improving their business processes. The Office continues to assist State agencies in many ways including expanding the use of innovative banking services such as remote deposit, negotiating reduced insurance premiums while enhancing coverage, and advising on procurements. We have also worked to improve our internal information technology programs to allow the Treasurer's staff to perform their functions more efficiently.

We continue to plan and conduct our bonds sales effectively, while striving to maintain Maryland's coveted AAA bond rating. We monitor the market routinely to take advantage of savings as they become available in refunding our General Obligation Bonds or to issue new types of debt such as Build America Bonds and Qualified School Construction Bonds. Lastly, we continue to invest State funds carefully and conservatively to minimize risk to the Maryland taxpayers.

While we continue to be fiscally constrained, the Office is working hard and achieving real results. The items set forth below detail a number of these achievements and we are always available to provide greater information or answer questions regarding these and other issues.

BOARD OF PUBLIC WORKS

After dealing with $1 billion in budget cuts during the last six months of calendar year 2009, the Board of Public Works (BPW) returned to a more normal schedule of procurement oversight during the end of 2009 and the first five months of calendar year 2010. Critical and often contentious issues still faced the BPW. Meetings drew considerable interest from concerned parties, including proponents, opponents and the media.

Between December 2, 2009 and May 5, 2010, the Board of Public Works acted on 826 agenda items valued at $2,439,960,700. Budget pressure had some impact on the number of transactions, particularly related to Program Open Space projects.

Among the numerous contracts, wetlands licenses, land acquisitions and sales that have come before the BPW in the past six months, the following exemplify the scope of actions overseen by the Maryland Board of Public Works, the only constitutionally mandated organization of its type in the nation:

- $2 million contract for a mandatory disparity study by the Department of Transportation
- $21.5 million contract for a central monitoring and control system for the Video Lottery Terminal (VLT) system
- Approval of a public-private partnership (P3) lease and concession agreement/real property conveyance between the Maryland Port Administration and Ports America Chesapeake, Inc. (P.A.C.) at the cost to P.A.C. of $105 million for a new berth at Seagirt Terminal in Baltimore and roughly $500 million in investment over 50 years
- Approval of declaring surplus 178 acres at the Rosewood Center in Baltimore County
- Approval of an agreement between the Department of Health and Mental Hygiene, the Department of General Services and the Maryland Economic Development Corporation (MEDCO) to build a new Public Health Laboratory at Johns Hopkins' science and technology park in Baltimore
- Approval of a 50-year lease to enable the construction of the National Sailing Hall of Fame & Museum on the waterfront in Annapolis
- $12 million sale of the Washington *Post* printing plant in College Park for use by the University of Maryland, College Park
- $595,315,000 sale of General Obligation bonds, including tax-exempt refunding bonds and taxable Build America Bonds, resulting in a total savings of more than $16 million
- $35 million for student housing at Towson State University
- Extension of the management contract for Rocky Gap Golf Course and Hotel Meeting Center in Allegany County
- Up to $200 million for the purchase of Video Lottery Terminals at Ocean Downs in Berlin in Worcester County and Penn National in Perryville in Cecil County

- Approval of maintaining the present State property tax rate of 11.2 cents per $100 of the full value of real property and 28 cents per $100 of the full assessed value of real property of public utilities
- $695,750 to purchase property for the South River Greenway in Anne Arundel County
- Wetland's license for a marine terminal on the Patapsco River in Baltimore
- Renewal of a $20,419,220 food services contract at Frostburg State University

The Treasurer's Office communicates frequently with legislators about the BPW agenda and items of specific interest to their districts and feedback from legislators is important to the Treasurer. The Treasurer's Office also receives comments and advice from the Department of Legislative Services to ensure that BPW agenda items are consistent with legislative policy.

INVESTMENT DIVISION

The Office's conservative investment policy and practices have protected the State's portfolio through quite volatile times. The par value of the General Fund investment portfolio for April 30, 2010 was $5,707,937,540.76 as compared to April 30, 2009 when it was $6,514,345,886.46. This is a reduction of over $806 million dollars.

On April 30, 2010, the portfolio was earning an average of 2.546%, compared to 3.149% for the same date in 2009. This much lower return reflects the impact of the Federal Open Market Committee maintaining Fed Funds Target rate at .25% or less since December 16, 2008, and the change in portfolio strategy to keep more funds liquid due to unpredictable and volatile cash flows.

The General Fund gross interest earnings received year-to-date for FY 2010 were $113,866,079 as compared with $217,091,454 received for the same time period in FY 2009. The $103 million plus decline in interest received is directly attributable to the fact that FY 2010 had an average $978 million less daily to invest – a reflection of reduced State revenue – in addition to the much lower interest rate environment.

The securities lending program continues to provide additional revenue. The program has earned $119,319.29 so far in FY 2010. This compares with $361,812 for the same period in FY 2009. Much of this reduction is due to the Federal Reserve and Federal Treasury programs designed to add liquidity to the financial markets which drastically reduced borrowers' need for the securities in the State's portfolio.

The Office continues to increase MBE participation in the investment of State funds. Eighteen MBE broker/dealers are on the Office's approved list for FY 2010 and they have handled investments in excess of $527 million so far this year. This compares to FY 2009, when the Office had fourteen approved broker/dealers who handled over $1.027 billion in investments. Due to the change in investment strategy demanded by the economic times the Office has only transacted $3.8 billion in trades this fiscal year as compared to $5.5 billion at this time last year. Therefore, the percentage of MBE trades was 18.8% as of April 2009 and 13.9% as of April 2010.

The Maryland Local Government Investment Pool (MLGIP) has maintained its AAAm rating through all of the turbulence in the money markets. The balance at April 30, 2010 was $2,476,891,571.33 compared with $2,706,148,256.69 for the same date in 2009. This is a decrease of over $200 million dollars due to the decreased revenues collected by all members.

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 Services Division is driven by its mission to provide efficient, accurate, and timely banking services to all State agencies and external customers. The continued enhancement of our processes and controls in response to the ever changing needs of State agencies ensures we maintain our timely, accurate, and completely documented reconciliation of the State's cash accounts. Current highlights of activity include:

- Total cash receipts and disbursements each will exceed $120 billion for FY10.
- The State's bank accounts are reconciled daily to the State's general ledger within two days of receiving all necessary bank data.
- There are no un-reconciled differences. We reconcile the State's cash accounts to the penny every day.

The past six months have been particularly challenging as we have had many unusual working scenarios due to difference in bank and State operating days resulting from State service reduction days and, of course, weather. Our well refined processes and stringent controls allowed us to maintain our mission without incident.

We have also continued our efforts with the Comptroller's Office to convert recurring vendor check payments to electronic payments. At one point, we were converting over 150 vendors a week, increasing efficiencies in the disbursement process. In addition, our Deposit Products team has been working with individual agencies to ensure that the general ledger posting of the electronic receipt of funds is automated to the extent possible.

We actively work with agencies to develop and strengthen their internal processes and to promote efficient banking services. The Maryland Military Department became the second agency to use our depository bank's remote deposit service. The University of Maryland Dental School and the Maryland Institute for Emergency Medical Services Systems have set up lockbox accounts to create efficiencies in their check collection processes. We also recently completed set up of an account structure for the Department of Health and Mental Hygiene's Pharmacy Rebate Program. The new account structure will enhance DHMH's tracking and reporting of an estimated $145 million in annual pharmacy rebates from drug manufacturers.

Finally, as noted in past reports, we are continually working on standardizing our tracking, processing, and reconciliation of bank related transactions for the State's cash accounts in order to enhance our ability to change banks if required by market conditions or the procurement process.

INSURANCE DIVISION

The Insurance Division is responsible for administering the State's Insurance Program which is comprised of 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 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.

The Insurance Division is comprised of three units: Loss Prevention, Underwriting and Claims. The Division's goal is to provide statewide risk management through loss protection (Underwriting), loss control (Loss Prevention), and loss restoration (Claims).

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:

Members of the Underwriting Unit met with four State agencies in January, March, and April 2010: the Maryland Aviation Administration (MAA) to discuss their operations, upcoming insurance renewal, and open claims; the University of Maryland, Baltimore County (UMBC) to discuss owned and non-owned fine art coverage; the

Maryland Transportation Authority (MdTA) to discuss updating the values of their bridges and tunnels; and the Department of Human Resources (DHR) and the Department of Juvenile Services (DJS) to discuss Foster Parent liability coverage and claims procedures with the newly-awarded carrier.

The Underwriting Unit frequently addresses agencies' questions about commercial insurance coverage. In FY 2010, for example, the Underwriting Manager consulted with Maryland Public Television (MPT) about their insurance coverage; with Archives to discuss claims and further protection of their assets; and with the Maryland Transit Administration (MTA) to conduct a comprehensive review of their commercial insurance program. The most significant consultation however, occurred with the Maryland Port Administration (MPA) over several months in advance of the Ports America Chesapeake, Inc. contract award to operate Seagirt Marine Terminal, effective January 12, 2010. The Underwriting Manager worked closely with the MPA to determine the impact of the award on the commercial coverages procured for their operations and property. The resulting policy endorsements for both the crane and automobile policies generated pro-rated return premiums of over $57,000. As part of this process, the Underwriting Manager reviewed the written agreement between MPA and PAC to evaluate the resulting revenue streams for the January 31, 2010 insurance renewal. As a result of this liability insurance analysis, the Unit **achieved an additional premium savings of over $56,000.**

In March, the Underwriting Manager and the Director had a rare opportunity to meet with representatives of four insurance companies operating out of Bermuda. It was important to meet with these representatives as they are among the few carriers in the world that are willing to participate in railroad insurance at the levels of coverage required by the State. This offered the State an opportunity to highlight the State in advance of the July 2010 renewal for the Maryland Transit Administration.

The FY 2010 Excess Property coverage renewed on April 1, 2010. Four State-owned high hazard dams were added to the State's property inventory this year. Despite a value increase of 9%, the policy's **renewal rate (cost per $100 of value) decreased by 9.5%, for a premium savings of $46,052.**

The UMB Dental School professional liability coverage renewed in FY 2010 without an increase in rate. The premium went up solely because of the increase in the number of "visits" the school estimates for this year, partially stemming from the opening of a new 26- chair second location in June of 2009.

Loss Prevention

The aim of loss prevention is to help State agencies implement specific action plans and safety practices to mitigate their most frequent or severe preventable losses. To do this, on an annual basis, the Loss Prevention Manager conducts a review of numerous State agencies' claims and loss histories to identify problem areas and to help those with high severity claims and/or frequency take corrective measures. After the Manager identifies agencies with above-average claims frequency and severity, the Manager meets with agency risk managers to discuss the findings and recommendations.

This year, the Loss Prevention Manager and Director met with the Maryland State Police (MSP) following a series of settlements of significant automobile property and liability claims emanating from the Eastern Shore. The Manager shared trend and loss data and received information about the action plans implemented by MSP to curtail the frequency and severity of these automobile losses. Currently, the Loss Prevention Manager is conducting a loss and trend analysis of claims for the State Highway Administration (SHA). The Manager and Director plan to meet with the risk managers of SHA this fiscal year to discuss these findings and to recommend action plans to reduce the causes of their most frequent and severe losses.

The Loss Prevention Manager also identifies, coordinates and oversees risk control service hours provided by our insurance brokers to the State agencies. This fiscal year's outreach activities have resulted in a dramatic increase in requests for loss control services. Thus far, State agencies and universities have requested services for infrared thermographic imaging, aerial infrared testing, and property inspections. Due to their popularity, the Loss Prevention Manager has prioritized the receipt of risk control services on the basis of the type and the severity of the exposure.

The infrared inspections, noted above, provide valuable information on the condition of equipment and roofing systems in State agency facilities. Thermographic imaging identifies loose connections that create heat that can be imaged to show the exact location of a defect. An infrared inspection of an electrical distribution system is designed to identify potential equipment failures before they happen so that appropriate action can be taken before costly repairs and downtime are incurred.

The University of Maryland Baltimore County, Maryland Stadium Authority (Oriole Stadium Park), Maryland Food Center Authority (Wholesale Produce Market), and Department of Health and Mental Hygiene (Eastern Shore Hospital), and Department of Labor, Licensing, and Regulation (Headquarters) are currently slated for testing this fiscal year.

The purpose of aerial infrared testing is to identify the location of moisture penetration of roofing systems before there are visible signs, structural damage or business interruption. With the results of this analysis, State agencies and Universities can significantly extend the life of roofing structures while reducing maintenance expenditures and potential property-related claims. Pending the availability of hours, aerial infrared testing may be coordinated for the University of Maryland College Park and Baltimore County, and the Department of Health and Mental Hygiene (Springfield Hospital Center).

In January 2010, an additional loss control service was offered and coordinated by the Loss Prevention Manager to assist the Maryland State Police Aviation Command

(MSPAC) to develop a Letter of Compliance to meet federal requirements. Previously, MSPAC had utilized loss control services to perform a comprehensive operational gap analysis and safety assessment of the MSPAC. These services were offered to assist the Aviation Command Unit to address some of the safety recommendations made by the National Transportation Safety Board.

In March 2010, the Loss Prevention Manager arranged for a property valuation (appraisal) of the Maryland State House in Annapolis. Given the design and construction of an historic building, it inevitably is vulnerable to damage, especially by fire, and more expensive to repair after damage has occurred. The valuation service is being conducted to assist the State in determining the historic replacement cost of the building. Once that has occurred, the Underwriting Unit in conjunction with our insurance brokers will work to ensure that appropriate levels of coverage and protection are provided for that significant historic asset.

Claims

The Insurance Division's Claims Unit investigates and resolves liability claims arising from services provided by the State under the Maryland Tort Claims Act, Md State Government Code Ann. §§12-101 *et seq.* The unit also handles claims for damage to State-owned property arising from sudden and accidental perils such as collision and comprehensive loss to autos, and from a number of other perils such as fire, hail, lightning, wind, etc. which causes damage to State structures, equipment, and contents.

Snowstorm claims

On average, the Claims Unit handles 4,000 claims annually. This year, the Claims Unit had to contend with a significant increase in road hazard and auto liability claims arising from the historic snowfall. For example, between the period January 1, 2009, through April 30, 2009, approximately 105 road hazard claims had been filed with the Treasurer's Office. During the same period in 2010 however, approximately 247 claims were filed. The change represents a 135% increase in claims filed. The Unit's road hazard team also responded to liability claims filed for property damage, particularly mailboxes, fences, and other appurtenant structures damaged by snow removal operations. The State Highway Administration's assistant attorneys general provided the claims adjusters with specific standards for handling mailbox claims. These standards, which are unique compared to the standards of other jurisdictions, enabled the adjusters to fairly and consistently adjust these claims.

In order to better serve the public during this period, a special letter of acknowledgement was sent to claimants filing road hazard and snow operations claims. The letter asked the claimants for their understanding and patience while the adjusters worked with State Highway Administration personnel who understandably had less time to devote to claim inquiries because of continuing snow removal and road repair operations. Despite the significant increase in claims, the majority of claimants received a response within three weeks. This tremendous accomplishment is a result of the determination and dedication of the road hazard team, the support of the Unit's other claims adjusters, and the extraordinary support and customer service skills of the Division's administrative clerk.

Many State-owned structures were also damaged during the snowstorms. Fortunately, most State-owned structures were less vulnerable to the storms than structures in other areas in Maryland. The cost to the State and the affect on the State Insurance Trust Fund for State-owned property is not expected to reach the catastrophic levels seen in past natural disasters such as Hurricane Isabel in 2002.

Medicare Reporting

In August, 2009, the Division began developing protocols to comply with the legislation enacted by Congress in 2007, which required all insurers, including self-insurers, to report to the Centers of Medicare and Medicaid Services (CMS) all bodily injury settlements and judgments paid to Medicare beneficiaries. Because of the challenge faced by CMS to fully implement the reporting process, the deadline for reporting of January 1, 2010, has been postponed to January 1, 2011. The postponement has not prevented the Division's efforts to complete the development and implementation of its reporting procedures. The adjusters handling bodily injury claims have received training on how to enter Medicare data into the Insurance Services Office's (ISO's) database. ISO is the Division's reporting agent to CMS. The adjusters have also been trained on the Division's internal reporting procedures. The Division will provide the attorneys in the Office of the Attorney General with information and forms necessary to comply with the law for claims paid from funds other than the State Insurance Trust Fund.

Insurance Fraud Prevention

Two claims adjusters identified and referred three claims that had indications of fraudulent activity to the Insurance Fraud Division of the Maryland Insurance Administration. These adjusters recognized irregularities in invoices that the claimants had submitted for payment. At this time, one of the three has resulted in felony charges against the claimant.

The Claims Unit has expanded its fraud recognition training by partnering with the Maryland Automobile Insurance Fund which will share its training resources with the adjusters in areas such as forensics, medical providers and fraud rings. The training will provide the adjusters with a wider variety of methods and sources of information to detect and combat fraud.

DBM partnership

In March, 2006, the Department of Budget and Management (DBM), awarded a vehicle fleet maintenance contract to Automotive Resources International, Inc. (ARI). In addition to maintaining the State's fleet of passenger vehicles, trucks, and other heavy duty automobiles and equipment, ARI established the State's first Accident Management program. The program was primarily designed to receive auto accident reports from State drivers, to manage the vehicle's repair, and to track and contain repair costs. As an added benefit, however, ARI has provided the raw data generated from these activities to the Division's Loss Control Manager who uses the information to conduct trend analyses of the State agencies' accident frequency and severity.

The State Treasurer's Office is fully vested as a stakeholder in the program. The Office met to discuss the Division's continued participation in the development of the Request for Proposal's Accident Management component of the State's Fleet Maintenance contract. DBM officials welcomed the Insurance Division's participation and both agencies look forward to working together to improve the outcome of future proposals.

Tort Litigation

The Litigation Manager works closely with the Office of the Attorney General to proactively resolve these matters by investigating and evaluating cases, providing settlement authority or when necessary, by briefing the Insurance Review Committee on high dollar value settlements, and by attending settlement conferences and other court mandated activities. The Litigation Manager also works closely with the claims adjusters to provide feedback on investigations conducted by the adjuster. The Litigation Manager may also brief an adjuster on the status of certain litigation claims of interest.

Since FY06, the State Treasurer received 526 notices of suit. Of the cases closed, approximately 30% were settled; 55% were dismissed; judgments and defense verdicts accounted for 7% each.

	Case Disposition					**Total Served**
Fiscal Year Case Served	**Settled**	**Dismissed**	**Judgment**	**Defense Verdict**	**Open**	
FY06	28	67	10	8	3	116
FY07	21	68	6	7	4	106
FY08	33	51	6	9	16	115
FY09	31	29	7	4	29	100
FY10	10	8	1	1	69	89
Total Served as of May 11, 2010	123	223	30	29	121	526

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INFORMATION TECHNOLOGY DIVISION

The Information Technology Division (IT) provides a platform of integrated systems to support the State Treasurer's Office's operations. Over the past six months, the IT Division worked with the STO Divisions and our State agency clients to support many changes and upgrades.

The IT Division made numerous enhancements to the client screens and reporting. We worked with the Administration Division and expanded controls for Transmittal List number assignments, Insurance Subrogation Reserve and Accounts Receivable tracking. In addition, we consolidated multiple data entry screens to a single screen that now includes Unpresented and Undeliverable check data. These enhancements provided immediate benefit to Administration staff and were done in preparation for future R*STARS enhancements to include original check numbers when displaying the detail of checks reissued from the Undeliverable and Unpresented funds. The improvements for the Insurance Division included a modification to the Claim Entry system that requires Insurance to forward the claim to A/R whenever a subrogation reserve amount is entered. A related modification was made to Claim Entry system to provide a flag to serve as a placeholder for Pending Subrogations. The "Claims by Tickler Date" report was modified to include Tickler Comments that are related to the pending subrogations. These changes allow for better management of anticipated subrogation collections from third parties.

One of our many projects involved the IT Division, Banking Services Division and the General Accounting Division teaming up to streamline the setup of ACH vendor payments. The team recognized that it is efficient to make vendor payments via ACH to those vendors which would otherwise receive a high volume of check based payments. The Office programmed a new process to extract vendor data from GAD's daily vendor interface file and auto populate that data into the Banking ACH Authorization table on the STO i5 System. This new process eliminated the coping of GAD X-10 forms and the manual exchange of these paper records. The new process saves the banking staff data entry time, reduces data entry errors, saves paper and shortens the turnaround time, all of which results in less cost to the State.

The Division continued to process disbursements for Child Support, Retirement and Central Payroll. All three are making changes to their systems that take effect on July 1st. The IT Division has participated in numerous pre-conversion tests of files. All tests to date have been a success.

As part of our ongoing assistance to the Office we supported audit requests, website changes, software updates and firewall management. The Division provided documentation, procedures, answered questions regarding workflow and ran numerous queries and file extracts for the STO audit. We also updated the Bond Sale website for Debt Management's 2009 Third Series bond sale, and the Office PC's to Internet

Explorer 8 for better security and implemented new procedures related to application patching, to protect against new spyware/virus infection attacks. The Division expanded the firewall and its host-based Intrusion Detection and Prevention software, successfully upgraded the VPN software and implemented better formal log review process for VPN (remote access).

The IT Division is responsible for GAD, Child Support, Cares, Retirement, RAD and Central Payroll disbursements as well as hosting numerous applications that are critical to the Treasurer's Office. The Office recognizes the important role we serve and the importance to perform that service every day without interruption. Our goal is to be prepared for a disaster. To prepare for such an event the IT Division completed a Disaster Recovery (DR) Test on March 17th. The Office was able to replicate our existing system on the DR Vendor's System The ADC was able to transmit the GAD Check and ACH files from March 12th to the DR System using secure FTP software. We successfully processed all the files and the totals matched the Friday, March 12th reports. We created the ACH file that is sent to M&T and printed a limited number of checks on our DR MICR printer that was stored at DR Vendor site. The test was a great success and will be executed annually.

DEBT MANAGEMENT DIVISION

Financing Activities - Ratings

In the last few months, Moody's and Fitch have recalibrated their municipal ratings to a global rating scale so that municipal ratings are aligned with the scales that assess the creditworthiness of other types of issuers. The original municipal scale represented a ranking of municipal credit quality based on "distance to distress" rather than default probability. This generally meant municipalities were stuck with lower ratings than corporate issuers despite what in many cases were stronger histories of repayment.

As a result of the recalibration, all issuers are assessed on the same criteria, and a rating means the same thing regardless of whether the issuer is a city, a sovereign nation, or a retail chain. Because of the recalibration to a global rating scale, Fitch and Moody's have moved up some municipal issuers one to two notches. Standard and Poor's has reported that they have been using a global rating scale over the past few years and, consequently, they have not participated in this recalibration although they are proposing to update their methodology and assumptions for rating state governments.

Even with these rating changes, only one additional state (Iowa) has joined Maryland and the six others that had AAA ratings from all three rating agencies prior to the recalibration. The states now are: Maryland, Delaware, Virginia, North Carolina, Georgia, Missouri, Utah and Iowa.

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 on February 9, 2010 just prior to the sale of 2010 First Series General Obligation Bonds. Participating in the most recent conference call were the Treasurer, Comptroller, Secretary of Budget and Management, Director of the Bureau of Revenue Estimates and the Director of Policy Analysis for the General Assembly.

The rating agencies are generally uniform 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 recession, including State revenue shortfalls, outstanding liabilities such as the public pension and retiree benefit obligation, and increased demand for public services. They are particularly concerned about how states (including Maryland) will manage in FY 2012 and 2013 without federal stimulus funds and about Maryland's significant structural budget deficit.

Standard and Poor's noted two of these challenges, the structural imbalance and the pension liability, in its February 18, 2010 report. Regarding the budget, they stated in their report, "Expectations are that Maryland will continue to face a structural imbalance for the next several years, and will have to find ways to balance operations while the economy recovers". They also note that "The state's unfunded pension liability has grown significantly in the past two fiscal years due to a combination of investment losses and the lack of fully funding the annual required contribution. In our view, if not addressed this would likely result in the continued weakening of the state's pension system, which at one point (before the recession) was considered adequately funded."

Questions arose during the 2010 Legislative Session on the prudence of using Rainy Day funds to bridge the budget gap. There have been ratings downgrades of governments who have used reserves without a plan to replenish the account and without a plan to resolve future structural deficits. It appears that until the State can project revenue growth, it is wise to maintain the reserve balance at 5% of revenues. Until then, the reserve balance is a hedge against any future revenue shortfalls during this recession. Again, Standard and Poor's clearly states, "Maryland has made a steady commitment to funding reserves, which we believe enhances its flexibility in the current economic environment."

The next conference call with the rating agencies is expected on June 29, 2010, prior to the sale of the 2010 Second Series General Obligation Bonds. In the meantime, the STO has provided the 90 Day Report and monthly revenue performance to the rating agencies.

Financings - General Obligation Bonds

Since our last report, there has been one general obligation bond sale on February 28, 2010. This sale had two series: $400 million in taxable Build America Bonds (BABs) in the 2010 First Series A and $195.3 million in the 2010 First Series B (Refunding Tax-Exempt bonds). The $400 million of Build America Bonds generated $11.2 million in present value interest savings in the 2019-2025 maturities compared to traditional tax-exempt bonds. Because of the scheduled expiration of the Build America program in December 2010 and the potential end-of-year rush to market by many issuers trying to get the 35% subsidy, the STO decided to issue BABs early in the calendar year. To achieve the maximum financial benefit, the 2010 First Series A has longer maturities. Debt service will be leveled out with a predominant issue of tax-exempt bonds in the shorter maturities in July 2010. The 2010 First Series Bonds were sold competitively.

At this time, the STO is structuring the July 2010 issue. Tentatively, the sizing will be approximately $500 million comprised of $45 million of Qualified School Construction Bonds (QSCBs), $4.5 million of Qualified Zone Academy bonds (QZABs), $6.5 million of Qualified Energy Conservation Bonds (QECBs), $110 million of Build America Bonds and $334 million of tax-exempt bonds. The QSCB, QZAB will be taxable bonds with a 100% direct interest subsidy from the US Treasury. The subsidy will be 70% and 35% respectively for QECBs and BABs. The STO is also planning a retail component with first priority to Maryland citizens in this sale.

The STO encourages legislators and all interested persons to attend the competitive sales and/or the pricing calls for the negotiated sales. When the dates are set, the STO will notify the Legislature.

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 15, 2009 and May 15, 2010, $7,197,683 in capital equipment was leased by State agencies through the State Treasurer’s Office.

The Treasurer’s Office also finances Energy Performance leases in cooperation with the Department of General Services (DGS), providing funding for energy conservation at State facilities. The program finances significant up-front investments in conservation projects and the lease is paid for using the savings in operating costs. Energy leases in the amount of $8,313,816 were financed between December 15, 2009 and May 15, 2010.

Status of the Annuity Bond Fund

Debt service on General Obligation Bonds is paid from the Annuity Bond Fund (ABF) and the primary source of revenue for this fund is real property tax receipts. In Fiscal Year 2011, it is projected that there are sufficient property tax receipts, surplus transfers from 2010 and bond premium to cover debt service without any general fund subsidies. However, if the real property tax rate continues at the current level of 11.2¢ per $100 of assessed valuation and future debt is issued at the rates projected in the 2009 CDAC Report, subsidies of general funds will be necessary to support the debt service on General Obligation (GO) Bonds beginning as early as 2012 unless bond premium is able to close the gap.

CDAC Affordability Criteria

The Capital Debt Affordability Committee recommended a $990 million conditional authorization of general obligation bonds in September 2009. At this meeting, the committee planned to reconvene in late December 2009 to reexamine the authorization after considering the following:

1. Board of Revenue Estimate's December revenue estimates.
2. Options to provide operating budget relief by transferring appropriate expenditures to the capital budget.
3. Debt service projections subsequent to the projected refunding and new money bond issuance this fall.
4. Possible extension of federal authorizations incorporated in the ARRA, such as school construction bonds and Build America Bonds.
5. Any other appropriate issues.

The Committee did meet on December 18, 2009 to consider these issues and circumstances. A recommendation was made to increase the original authorization, $150 million for a revised total of $1,140 million limit for new general obligation authorizations by the 2010 General Assembly to support the 2011 capital program.

The Committee discussion reflected its clear intent that the increased 2010 authorization and future year recommendations continue to be within the adopted affordability benchmarks of 8% debt service to revenues and 4% debt outstanding to personal income. The Committee recognizes that there are multiple 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 projections for future authorizations will reflect updated revenue and personal income projections and authorization levels to adhere to these affordability benchmarks.

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.