

# **FITCH RATES MARYLAND'S \$510MM GOS 'AAA'; OUTLOOK STABLE**

Fitch Ratings-New York-24 July 2018: Fitch Ratings has assigned a 'AAA' rating to approximately \$510 million State of Maryland general obligation (GO) bonds, state and local facilities loan of 2018, second series.

The bonds are expected to be offered by competitive sale on or about Aug. 1, 2018.

Additionally, Fitch has affirmed the Long-term Issuer Default Rating (IDR) of the State of Maryland at 'AAA' and the following ratings on securities that are linked to the IDR:

- \$9.3 billion in outstanding state GO bonds at 'AAA';
- \$50 million in outstanding bonds issued by the Maryland Department of Transportation and the Maryland Transportation Authority supported by annual state general and transportation appropriations at 'AA+';
- \$104 million in Maryland Stadium Authority lease revenue bonds at 'AA+'.

The Rating Outlook is Stable.

## **SECURITY**

The bonds being issued are general obligations for which the state's full faith and credit are pledged.

Appropriation-backed debt issued by the Maryland Transportation Authority, the Maryland Department of Transportation, and the Maryland Stadium Authority are rated one notch below the state's IDR, reflecting repayment from annual state appropriations.

## **ANALYTICAL CONCLUSION**

Maryland's 'AAA' IDR reflects its broad, diverse and wealthy economy, extensive budget controls and sound financial operations, and strong management of debt. The state's economy has long benefited from proximity to the nation's capital, although exposure to federal budget cuts poses a greater uncertainty for Maryland than for most states given its large federal agency presence and associated private contracting. Fiscal management is very strong, with consensus-oriented long-term planning and multiple sources of flexibility including a consistently solid budgetary reserve and a demonstrated ability to adjust spending to address changing circumstances. Although liabilities are elevated for a state, they are moderate relative to resources and carefully managed.

### **Economic Resource Base**

Maryland's economy is wealthy, diverse and service-oriented. The federal government's presence has long served as an important anchor to Maryland's economy, with numerous federal agencies, military facilities and contractors supporting the state's solid economic performance. Trade and port activity are likewise significant given Baltimore's prominence. Economic expansion continues and has accelerated in recent years, despite the earlier drag posed by federal sequestration.

## **KEY RATING DRIVERS**

Revenue Framework: 'aaa'

Maryland's revenue growth is expected to be in line with or above the level of U.S. economic growth, given the state's solid economic base. Maryland retains unlimited legal authority to raise

operating revenues. Cyclical revenue performance is a risk given both the prominence of personal income tax (PIT) in overall state revenues and the state's exposure to changes in federal spending. However, overall growth prospects for revenues remain strong.

#### Expenditure Framework: 'aaa'

Maryland has a strong ability to change its spending commitments in response to shifting economic and revenue circumstances. Education and Medicaid remain the largest components of spending. Carrying costs for liabilities are above the median for states, partly given the state's extensive role in funding education needs, including for capital and accrued pension liabilities.

#### Long-Term Liability Burden: 'aa'

The burden of direct debt and unfunded pensions is elevated for a state but only a moderate burden in relation to the state's resource base. Pensions are the more significant burden, but the state has implemented multiple changes to benefits and contribution policies to improve pension sustainability and accelerate funded ratio improvement over time.

#### Operating Performance: 'aaa'

Financial resilience is exceptionally strong, with a well-funded budgetary reserve and a willingness to trim spending commitments and increase revenues in response to changing circumstances. Multi-year forecasting and planning are disciplined, including measuring actual performance against structural targets. Consensus-oriented practices ensure steady management of budgetary conditions and liabilities.

### RATING SENSITIVITIES

**CONTINUATION OF CURRENT PRACTICES:** The rating is sensitive to continued sound fiscal management practices and maintenance of fiscal flexibility, providing the state with the ability to respond to economic or fiscal uncertainties in a manner consistent with the 'AAA' rating.

### CREDIT PROFILE

#### Revenue Framework

Maryland's revenue framework includes a broad range of tax revenues, with PIT making up more than half of the state's \$17 to \$18 billion in annual general fund revenues. Sales and use taxes are also significant, at approximately one-fourth of general fund revenue. Gaming revenues (approximately \$500 million) provide an important source of support for K-12 education spending, and flow through the state's Education Trust Fund. Transportation receipts, most significantly motor fuel taxes, have been reallocated by the legislature at times for general spending, but recent changes tightened the dedication of these revenues for transportation needs. The state also levies a small statewide property tax to support general obligation debt that flows through the annuity bond fund.

The state's wealthy, service-oriented economy is the basis for a revenue growth profile that, while subject to economic cyclicity and federal policy actions, is likely to grow ahead of, or in line with, national economic growth over time. Economic sensitivity is most notable in the component of personal income taxes linked to capital gains.

The state has an unlimited legal ability to raise revenues through rate increases or base broadenings.

#### Expenditure Framework

Spending commitments are dominated by education and social services. Education spending for K-12, provided via transfers to counties, remains the most significant expenditure item for Maryland. Education spending also includes amortization contributions for local teacher retirement

liabilities, capital support, and a large network of higher education institutions. Social services, primarily for Medicaid, are also a substantial and growing component of the state's budget.

Consistent with most states, spending is expected to be in line with to marginally above expected revenue growth absent offsetting policy action, driven by social services spending needs. Federal action to revise Medicaid's programmatic and financial structure remains a possibility given recent federal legislative and administrative efforts. Most proposals to date include a basic restructuring of federal Medicaid funding to a capped amount. Whether any future change in federal Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increase liability burdens could negatively affect both the expenditure framework assessment and the IDR.

Carrying costs for liabilities are higher than the median for states but remain manageable relative to resources. Debt service is elevated given a constitutional requirement to amortize most tax-supported borrowing within 15 years. Carrying costs also include those for accrued pension liabilities of local teachers, although newly-earned benefits are the responsibility of local governments. The state has established a practice of contributing additional resources to pensions to accelerate funding progress, including both an annual supplemental contribution and a "sweeper" provision to divert a portion of unappropriated surpluses. The sweeper provision was originally scheduled to sunset in 2021. The state waived the sweeper provision for the fiscal 2018 and 2019 budgets but also lifted the 2021 sunset and extended the sweeper indefinitely; when the pension system reaches 85% funding, the statute triggers an analysis of the necessity of maintaining the sweeper provision. These changes also split the sweeper between supplemental pension and OPEB payments beginning in 2021.

#### Long-Term Liability Burden

On a combined basis, debt and net pension liabilities attributable to the state as of Fitch's 2017 state pension update are above average for a state, measuring 13% of 2016 personal income, compared to a statewide median of 6%. Based on the most recently available data, Fitch calculates a long-term liability burden of 15% of 2017 personal income. Fitch's calculation incorporates project debt associated with the Purple Line availability payment-based public private partnership (P3) entered into by the state's department of transportation (total \$1.2 billion, of which \$875 million is an untapped construction loan from the federal government), and Maryland Stadium Authority bonds issued for Baltimore City Public Schools (approximately \$750 million) that partially benefit from state revenue support. Inclusive of these commitments, Fitch calculates debt at \$15 billion, or 4% of 2017 personal income. Centralized debt planning and issuance are additional credit strengths. Debt affordability guidelines include holding tax-supported debt as defined by the state (which excludes the P3 and Baltimore school obligations noted above) at or below 4% of personal income.

Pensions are a comparative credit weakness in Maryland, although the state has taken repeated action since 2011 to revise benefits and contribution practices. Specific measures include lower benefit accruals, longer service requirements, a phased-in decline in the discount rate, ending a contribution methodology that had consistently left actual contributions below actuarial calculations and replacing it with full actuarial contributions, and appropriating supplemental contributions.

On an accounting basis, reported pension assets cover 65% of pension liabilities as of the state's fiscal 2017 financial statements. As adjusted by Fitch to reflect a 6% return assumption (based on Fitch's U.S. Public Finance Tax-Supported Rating Criteria), pension assets cover 54% of pension liabilities. Most of the state's net pension liability (NPL) consists of obligations for state employees and local teachers in the State Retirement and Pension System, which calculates its liabilities based

on a 7.5% investment return assumption (down from 7.75% in fiscal 2012 and expected to decline further to 7.45% this fiscal year).

Changes in 2011 to other post-employment benefits (OPEB) are estimated to have reduced the state's liability by approximately 40% as measured at the time. The total unfunded OPEB liability as of June 30, 2017 is \$13 billion, or 4% of personal income.

### Operating Performance

Maryland's financial resilience is exceptionally strong. Historically the state has relied on spending cuts, revenue increases and the use of non-recurring resources, including drawdowns of general fund balance and from the revenue stabilization account (RSA; the state's primary rainy day account) when confronted with budgetary weakness. Legislation enacted in the 2017 legislative session is intended to address revenue volatility and build up reserve balances to provide additional financial resilience. Beginning in fiscal 2020, personal income tax revenues from non-withholding components that exceed a 10-year average will be diverted from routine spending and instead be directed to address general fund revenue shortfalls, build the total rainy day fund up to 10% of general fund revenues, and cover pay-go project needs for K-12 and higher education.

Maryland has disciplined consensus revenue forecasting and monitoring that identify material changes in the direction of state economic and revenue performance in a timely manner. The Board of Public Works (BPW), which includes the governor, comptroller and treasurer, has the power to trim governmental spending during the year in response to budgetary weakness, and demonstrated this ability repeatedly during the last downturn.

The state routinely budgets to maintain flexibility both in the form of a general fund unencumbered balance and the separate RSA balance, the latter of which has been consistently funded at 5% of general fund revenues, including through most of the last downturn. The RSA balance has risen in step with the budget in recent years, and is forecast to be at \$858.5 million (5% of general fund revenues) in fiscal 2018.

### Current Developments

Taxpayer responses to federal tax changes in December 2017 (H.R. 1) have introduced some uncertainty to the state's revenue forecast. As in several other states with individual income taxes, Maryland's sharp growth in tax receipts since passage of H.R. 1 could be partially attributable to taxpayers accelerating payments into tax year 2017 to avoid the new limitation on state and local tax deductions, or other responses to H.R. 1. The state also reports that strong 2017 capital markets performance could be a factor. Sales and use tax collections continued their tepid growth with gains near 2% in fiscal 2017 and 2018.

Preliminary results for fiscal 2018 (ended June 30) indicate overall general fund revenues were up approximately 4%, ahead of the 2.2% March estimate from the state's consensus Board of Revenue Estimate (BRE), but growth is likely colored by the federal tax changes. Personal income tax receipts were up 5.4% (versus a 3% estimate), sales and use tax receipts were up just 2.1% versus the 1.6% estimate.

Maryland's fiscal 2019 budget includes modest spending growth and no major tax policy changes, but the fiscal 2020 budget adoption process could be more eventful due mainly to possible changes on education funding. Projected tax revenue growth is up sharply in fiscal 2019 by 6%, driven mainly by the effects of recent federal tax changes. Medicaid spending on a total state funds basis is up 4%, with provider rate increases driving most of the growth. K-12 state spending growth of \$170 million, or 3%, is tied mainly to a statutory formula. To achieve balance, the budget includes several cuts to otherwise planned spending, including lowering the contribution to the state's rainy day fund by roughly \$150 million (the fund would still receive sufficient funding to leave the RSA funded at 5% of general fund revenues) and eliminating the planned \$50 million supplemental

pension sweeper contribution. However, the actuarially determined contribution and the separate \$75 million supplemental contribution remain in the proposal.

The legislature gave initial approval to a constitutional amendment that would require further increased K-12 state spending by revising provisions around gaming revenues. The amendment would require the state to use gaming revenues to provide supplemental K-12 funding, rather than replacement of other dollars. If approved by voters in November's general election, the state estimates required increases would start at \$125 million in fiscal 2020 and escalate to more than \$500 million in fiscal 2023. Additional budgetary pressure on K-12 spending could come from the final report of the Commission on Innovation and Excellence (also known as the Kirwan Commission), which was statutorily-empaneled to make recommendations on education policy and funding. The commission's final report is due Dec. 31, 2018. As a preliminary step, the fiscal 2019 budget designates \$200 million of the projected tax revenue growth from federal tax changes to a special fund to address commission recommendations.

In response to the federal tax changes, the state enacted some changes to state tax code provisions but rejected broader legislation proposed by the governor to more fully offset anticipated increases in state and local income tax receipts. BRE's initial analysis of H.R. 1 focused on the individual income tax and estimated that because of linkages between the state and federal income tax codes, state and local governments in Maryland would see a combined \$572 million in additional income tax receipts in fiscal 2019, with \$361 million for the state alone. Following the 2018 legislative session, the BRE now estimates the state's direct gains from federal tax changes will be between \$300 million-\$400 million annually over the next several years.

Contact:

Primary Analyst  
Eric Kim  
Director  
+1-212-908-0241  
Fitch Ratings, Inc.  
33 Whitehall Street  
New York, NY 10004

Secondary Analyst  
Douglas Offerman  
Senior Director  
+1-212-908-0889

Committee Chairperson  
Marcy Block  
Senior Director  
+1-212-908-0239

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: [sandro.scenga@fitchratings.com](mailto:sandro.scenga@fitchratings.com).

Additional information is available on [www.fitchratings.com](http://www.fitchratings.com)

Applicable Criteria  
U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](https://www.fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT [WWW.FITCHRATINGS.COM](http://WWW.FITCHRATINGS.COM). PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT [HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY](https://www.fitchratings.com/site/regulatory). FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2018 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see <https://www.fitchratings.com/site/regulatory>), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.