

FITCH RATES MARYLAND'S \$490MM GOS 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-19 March 2019: Fitch Ratings has assigned a 'AAA' rating to approximately \$490 million State of Maryland general obligation (GO) bonds, state and local facilities loan of 2019, first series tax exempt bonds (competitive).

The bonds are expected to be offered by competitive sale on or about March 26, 2019.

The Rating Outlook is Stable.

SECURITY

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

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 also significant given Baltimore's prominence. Economic expansion continues and has accelerated in recent years, despite the earlier drag caused 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 individual income tax (IIT) 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 Maryland's resource base. Pensions are the more significant burden; however, 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 MANAGEMENT PRACTICES: The state's IDR 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 IIT making up the majority of the state's 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.

Maryland'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 individual income taxes linked to capital gains.

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

Expenditure Framework

Education and social services represent Maryland's largest spending commitments. K-12 education spending, provided via transfers to counties, remains the most significant expenditure item for the state. 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, Fitch anticipates Maryland's spending will be in line with to marginally above expected revenue growth absent offsetting policy action, driven by social services spending needs. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. Federal action to revise Medicaid's programmatic and financial structure appears less likely in the near term given divided control in Congress.

Maryland's 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 regularly contributes 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 2018 state pension update are above average, measuring 14.2% of 2017 personal income, compared with a statewide median of 6%. 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. The state's 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.

In December, the governor announced a legislative proposal to issue gaming revenue-backed bonds for \$1.9 billion in school construction projects over the next five years. The proposal follows up on a constitutional amendment approved by voters in November that requires the state to use gaming revenues to provide supplemental K-12 funding, rather than as replacement of other dollars. If legislatively approved, Fitch does not anticipate the additional issuance would affect the agency's 'aa' assessment of Maryland's long-term liability burden.

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.

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 7.45% investment return assumption (down from 7.75% in fiscal 2012).

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 state's reported total net OPEB liability as of June 30, 2018 is \$11.4 billion, or 3% 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 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, reaching \$857 million at the end of 2018 and currently projected by the administration to be \$882 million at the end of the current fiscal year (both approximately 5% of general fund revenues).

Current Developments

Fiscal 2018 (ended June 30) general fund revenues were up 4%. IIT receipts were up approximately 5%, while sales and use tax receipts were up roughly 2%. Maryland's sharper growth in IIT receipts in fiscal 2018 could have been attributable to taxpayers accelerating payments into tax year 2017 to avoid the new limitation on state and local tax deductions, or other responses to TCJA. The state also reports that strong 2017 capital markets performance could have been a factor.

In response to the federal tax changes, the state enacted its own tax changes. The state's Board of Revenue Estimates (BRE, its official revenue forecasting body) estimates the combination of TCJA and the state changes will produce nearly \$400 million in new individual income tax revenue for the state in fiscal 2019 and another \$300 million in fiscal 2020. The BRE's March 2019 estimate forecasts robust income tax (individual and corporate) growth in fiscal 2019 of more than 6%, supporting overall general fund revenue growth of 3%.

The March estimate revised down personal and corporate income tax estimates by less than 1%, reflecting weakness in non-withholding personal income tax collections through January. Fitch has noted similar trends in other states through the December and January periods, which could reflect lingering effects of behavioral changes from TCJA, the sharp decline in equity markets in December, or a combination of the two.

BRE projects sales and use tax revenues to be up nearly 5% in fiscal 2019, driven mainly by the board's estimates of the short-term stimulus of TCJA and the 2018 federal bipartisan budget act (BBA) that raised statutory caps on federal discretionary spending through Oct. 30, 2019. BRE also noted benefits of the U.S. Supreme Court's Wayfair decision allowing states to tax remote sellers. Fitch anticipates effects of the recent federal shutdown to be modest on the state's overall fiscal year collections. While federal contractors did not receive back pay from the federal government for the shutdown period, federal employees were fully compensated.

By fiscal 2020, BRE forecasts the benefits of the policy changes noted above will weaken, bringing growth in income tax and sales and use tax to just over 3% and general fund revenues to approximately 3% as well. The governor's fiscal 2020 executive budget builds from this more modest growth expectation and also reflects key policy considerations relating to K-12 spending with a 2% increase in total spending on services and a 5% proposed increase in K-12.

The K-12 increase reflects proposed growth in the state's baseline funding, as well as increased budgetary pressure from the newly-approved constitutional amendment noted earlier and

anticipated recommendations of a commission studying education funding in the state. The education "lockbox" for gaming revenues mandated under the constitutional amendment starts at \$125 million in fiscal 2020, and the state estimates it will rise to more than \$500 million in fiscal 2023. The governor proposes leveraging some portion of those revenues for bonds to finance school construction.

The governor also proposes to maintain a \$200 million reserve (first included in the 2019 budget) for final recommendations 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 state now anticipates the commission's final report will be released in the fall of 2019 for legislative consideration.

One of the largest single line items in the executive budget is a proposed \$675 million appropriation to the RSA bringing it to an estimated \$1.2 billion, or 6.5% of general fund revenues. This would be the highest level since the RSA's 2007 pre-recession peak of \$1.4 billion, or approximately 11% of general fund revenues. The executive budget also includes \$125 million in supplemental pension contributions beyond the ADC, which would continue the state's commitment to accelerating progress on reducing pension liabilities. Maryland's House and Senate are finalizing their own budget bills in the current session, and will begin reconciling differences over the next several weeks to order to finalize a budget.

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

Date of Relevant Rating Committee: July 23, 2018

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

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)
<https://www.fitchratings.com/site/re/10024656>

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. 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 © 2019 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.