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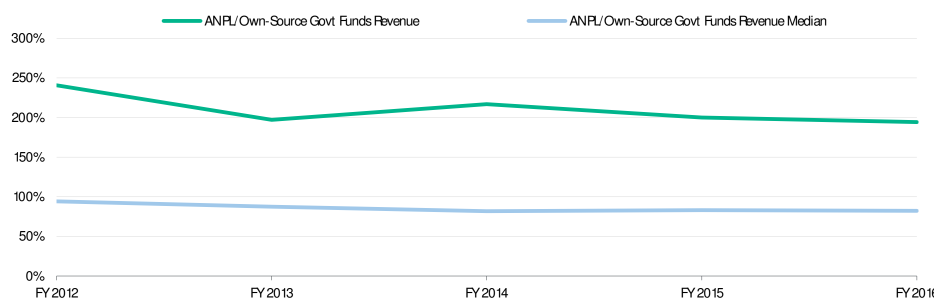
Maryland (State of)

Update to credit analysis

Summary

Maryland (Aaa stable) benefits from a significant federal presence that provides well-paid civilian and national defense jobs and has generally led to a stable economic environment. The state has strong budgetary and financial management practices and a history of proactive initiatives in response to economic cycles. A relatively high debt and pension burden leads to high fixed costs compared to peers and will continue to test the state's commitment to reducing its long term liabilities while providing the level of services expected by its residents.

Exhibit 1
Maryland's ANPL elevated by state payment of unfunded teacher pension liabilities



Source: Moody's Investors Service

Credit strengths

» Proactive financial management

» Stable economy with high personal income levels

» Adequate budgetary reserves and strong liquidity

Credit challenges

» High net pension liabilities and above average debt burden relative to Maryland's Aaa peers, leading to high fixed costs

» Vulnerability to swings in federal spending priorities

» Addressing prospective structural imbalance

Rating outlook

The outlook for Maryland's general obligation debt is stable. The state's proactive fiscal management enables it to make midcourse corrections and weather economic cycles. It has also taken often difficult actions to strengthen the foundation for long term fiscal sustainability. Even so, growth in fixed costs for pensions, debt service and retiree health benefits will continue to be a challenge.

Factors that could lead to a downgrade

» Economic and financial deterioration that results in deficits, fund transfers and reserve draws without a plan for near-term replenishment and structural balance

» Failure to adhere to policies to redress large unfunded pension liabilities

» Downgrade of the US government

Key indicators

Exhibit 2

Maryland	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Operating Fund Revenues (000s)	17,861,360	18,809,434	18,954,432	19,769,076	20,471,039
Balances as % of Operating Fund Revenues	0.0%	0.5%	-0.8%	0.1%	1.6%
Net Tax-Supported Debt (000s)	10,585,600	10,617,996	11,290,500	11,577,387	12,764,867
Net Tax-Supported Debt/Personal Income	3.6%	3.4%	3.5%	3.5%	3.8%
Net Tax-Supported Debt/Personal Income 50 State Median	2.8%	2.6%	2.5%	2.5%	2.5%
Debt/Own-Source Governmental Funds Revenue	52.4%	49.4%	51.7%	50.5%	53.6%
Debt/Own-Source Governmental Funds Revenue Median	37.4%	36.1%	35.8%	34.4%	32.7%
ANPL/Own-Source Govt Funds Revenue	240.6%	197.0%	216.9%	199.8%	194.2%
ANPL/Own-Source Govt Funds Revenue Median	94.2%	87.6%	81.8%	83.0%	82.2%
Total Non-Farm Employment Change (CY)	1.2%	1.0%	0.9%	1.6%	1.4%
Per Capita Income as a % of US (CY)	120.5%	118.4%	116.5%	116.4%	116.9%

Source: Moody's Investors Service; Maryland audited financial statements

Profile

Maryland is located on the east coast of the United States and has 3,190 miles of shoreline, according to the National Oceanic and Atmospheric Administration. Its population of 6 million places it 19th among the 50 states. Its state gross domestic product is 15th largest. The state has above average wealth, with per-capita personal income equal to 118% of the US level in 2017.

Detailed credit considerations

Economy

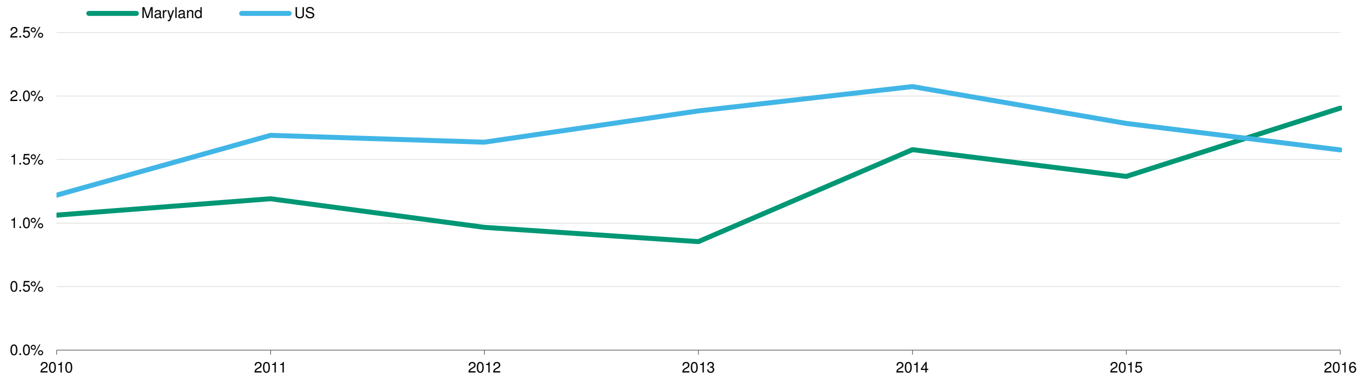
Maryland's highly-educated workforce and proximity to the nation's capital will continue to support steady economic growth. About 39% of the population age 25 and over have at least a bachelor's degree, compared to nearly 31% nationwide. The state's economy is more concentrated than the nation's in business and professional services, education and health services, and government.

While historically a source of stability, the large federal presence in Maryland has in recent years been a mixed blessing. Federal jobs account for more than 5% of Maryland employment, compared to about 2% nationally. Federal sequestration slowed overall job growth in 2013 followed by a rebound. In 2017, the state's total job count grew 1.9% compared to a slightly lower 1.6% nationwide, based on preliminary BLS estimates.

Exhibit 3

Maryland employment growth has picked up since the federal sequester

% change in annual employment



Source: Moody's Analytics; US BLS

The state's Board of Revenue Estimates forecasts slowing employment growth over the next several years, reflecting demographic trends. However, personal income growth is expected to achieve relatively stable growth of about 3.5% as wages and other components of income grow.

Given the highly skilled workforce and concentration in government and related employment, Maryland's unemployment rate is typically below the US. In December, Maryland's unemployment rate was 4% compared to 4.1% in the nation.

Finances and Liquidity

Despite the state's economic rebound from the federal sequester, it will continue to be challenged by recurring structural imbalances. These projected imbalances reflect revenue growth that is slow relative to historical norms and increasing costs for major expense areas such as Medicaid.

Governor Hogan's proposed fiscal 2019 budget would increase spending about 2% after keeping appropriations relatively flat in fiscal 2017 and fiscal 2018. The budget includes a projected fiscal 2019 surplus of about $100 million, after budgetary surpluses of $258 million in fiscal 2017 and $207 million expected in fiscal 2018. The declining surpluses reflect the state's continued need to draw on reserves to maintain balance. However, the projections do not take into account the likely fiscal benefit to the state from the federal tax reform bill or potential actions the legislature might take to return some of that benefit to taxpayers.

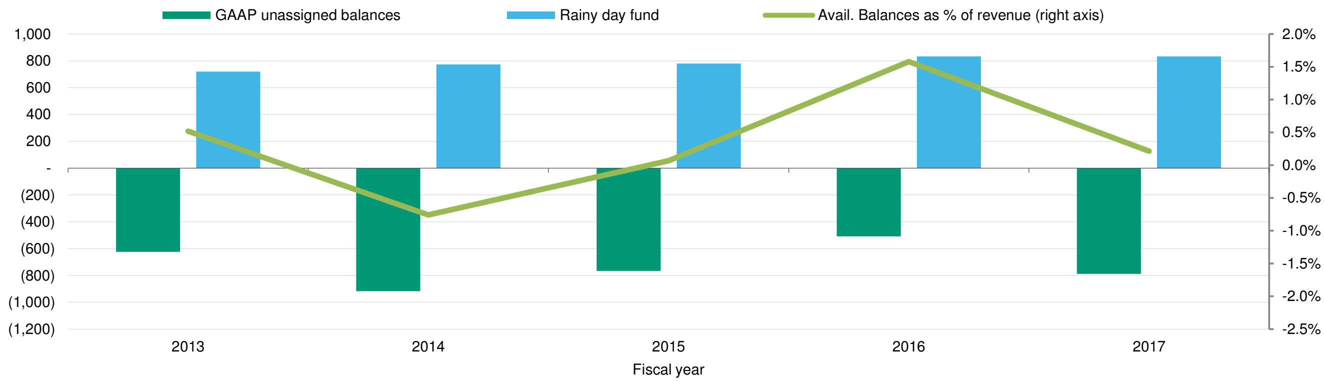
Although the state struggles with structural gaps, it is also quick to address mid-year shortfalls. Early in the current fiscal year, the Board of Public Works, which has extensive authority to adjust budgets, made $67 million in general fund agency reductions to address an identified shortfall. The state also maintains its rainy day fund at or near 5% of revenues since balances were replenished after the recession.

On an audited GAAP basis, the state's available balances (unassigned balances plus the rainy day fund balance) have been low but positive since fiscal 2015. The state's unassigned fund balance—those funds that are not otherwise restricted or committed—has been negative partly due to the state carrying a liability stemming from the transfer of funds from a local income tax reserve fund during the 2010-2015 period. Unassigned balances were -$788 million at the end of fiscal 2017, slightly offset by a $832 million balance in the revenue stabilization account (RSA) (see Exhibit). At less than 1% of operating revenues, available balances remain below those of the state's Aaa peers. During the previous decade the state built its GAAP-basis available balances to nearly $2.3 billion in 2007, a cushion of more than 15% of revenues.

Exhibit 4

Maryland's rainy day reserves offset by negative unassigned balances

Billions of dollars



Source: Moody's Investors Service; Maryland audited financial statements

In 2017, the state enacted House Bill 503, which is designed to reduce the impact of volatility on state budgeting, including conservative treatment of revenues from personal income tax non-withholding collections and allocation of positive revenue variances to reduce long-term liabilities such as pensions and retiree health insurance or bolstering the state's rainy day reserves. If the state abides by the guidelines, the measures should strengthen the state's overall credit profile in the long run by bolstering reserves and reducing leverage.

LIQUIDITY

Maryland's liquidity is strong, bolstered by unfettered access to the state's short-term investment pool. As of January 31, 2018, the market value was about $8.5 billion

Debt and Pensions

Maryland's debt levels relative to 50-state medians are high. Moody's 2017 state debt medians ranks Maryland 15th for debt as a percent of personal income and 11th on a per capita basis. The state's debt burden has historically remained within the recommendations of its Capital Debt Affordability Committee, which advises limiting total debt to within 4% of personal income and debt service to within 8% of revenues.

DEBT STRUCTURE

The state's tax-supported debt is about $12 billion. The state's debt consists primarily of general obligation bonds (75%) and consolidated transportation revenue bonds (18%). The remaining debt consists of GARVEEs, lease commitments and bay restoration bonds. Maryland has about $50 million of outstanding variable rate debt that was issued by the Maryland Stadium Authority for baseball stadium improvements.

Maryland's constitution requires a rapid 15-year amortization of tax-supported debt. This policy increases debt service as a percentage of revenues, but also quickly replenishes the state's debt capacity and helps restrain growth in the outstanding balance. The state ranked 9th in debt service as a percent of own-source governmental funds revenue adjusted for net transfers in our 2017 State Debt Medians report.

Maryland has a single series of variable rate demand bonds outstanding, issued through the Maryland Stadium Authority. Liquidity support for tenders is provided through an SBPA provided by Sumitomo Mitsui Banking Corporation (counterparty risk assessment A1(cr)/P-1(cr)) that expires in 2019. The state also has about $77.3 million in privately placed loans under the Qualified Zone Academy Bond program as of July 1.

DEBT-RELATED DERIVATIVES

There is a swap with notional value of $71 million in conjunction with the Maryland Stadium Authority's variable rate debt. The mark-to-market value of the swap was about -$9.6 million as of June 30, 2017.

PENSIONS AND OPEB

The state's pension costs will continue to grow in coming years, reflecting the poor investment performance of fiscal years 2015 and 2016. The financial condition of Maryland's retirement system represents the state's most significant credit challenge. The state's weak pension position stems from the combined effects of asset losses associated with the financial crisis and the enactment in 2002 of a corridor funding method that resulted in contributions less than actuarially required when the pension system had a funded ratio of less than 90%.

The state's reported net pension liability for fiscal 2017 is $22.173 billion for the Maryland State Retirement and Pension System (MSRPS), representing 94% of the plan's total net pension liability, and $969 million for the Maryland Transit Administration Pension Plan. In fiscal 2016, the state's three-year average Moody's adjusted net pension liability (ANPL) ranked sixth-highest among the states at 195% of own-source governmental revenues, more than twice the median of 78%. Our adjustments to reported state pension data include a market-based discount rate to value the liabilities rather than the long-term investment return used in reported figures, and are designed to improve comparability among state pension metrics.

Demonstrating its proactive management approach, the state has taken a number of steps to manage its pension burden that have included reductions in its liabilities and efforts to improve funding. It has enacted reforms to both pension and retiree health (OPEB) legislation and has shifted the responsibility for paying the normal cost of teacher pension to local governments. The state has phased out its corridor funding method and starting with fiscal 2017 makes contributions based on full payment of actuarially determined contribution (ADC) amounts. In addition, the state has committed to adding $75 million to its contributions to amortize its liabilities more rapidly than the baseline actuarial schedule and to contribute additional amounts depending on year-end general fund surpluses. Even with these additional payments, improvements in the pension plan's net position relative to its liability have stalled, with this ratio as reported by the pension system at 72% in fiscal 2014 and 69.4% in fiscal 2017.

The additional contributions bring the state's contribution level nearer than would otherwise be the case to the “tread water” amount that would prevent the state's pension liabilities from growing by covering interest on the beginning of year net pension liability and annual service cost. In fiscal 2017, the state actuarially determined contribution of $1.924 billion was 89% of this threshold, but more than 92% when factoring in the additional payment.

The state's OPEB (retiree health insurance) annual required contribution (ARC) rose to an estimated $779 million in fiscal 2017, an increase from $574 million in 2015. The state made actual payments of $526 million, representing the pay-go cost of retiree health benefits. While the state established a trust fund to accumulate assets to offset accrued OPEB liabilities, it does not regularly contribute to it. As of July 1, 2017, the fund held $307 million in assets to offset $11.4 billion in liabilities, resulting in a net OPEB obligation (reported in accordance with new accounting guidelines) of $11.085 billion. The state implemented OPEB reforms in 2011 that increased eligibility requirements to contain long-term growth in OPEB liabilities.

Governance

Maryland's financial practices and flexibility are very strong. For example, the state has a binding consensus revenue forecast, multiyear financial planning, and its Board of Public Works, consisting of the Governor, the Comptroller and the Treasurer, is able to respond swiftly to mid-year budget challenges. The state also has no tax and spending limitations or supermajority requirements limiting its flexibility.

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