FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Maryland's $858MM GOs 'AAA'; Outlook Stable

Mon 02 Aug, 2021 - 4:35 PM ET

Fitch Ratings - New York - 02 Aug 2021: Fitch Ratings has assigned a 'AAA' rating to the following State of Maryland general obligation (GO) bonds, state and local facilities loan of 2021, second series:

--$540 million second series A, tax-exempt bonds (competitive);

--$75 million second series B, taxable bonds (competitive);

--$116 million second series C, tax-exempt refunding bonds (negotiated, forward delivery);

--$126 million second series D, tax-exempt refunding bonds (negotiated, forward delivery).

The second series A and second series B bonds are expected to be offered by competitive sale on or about Aug. 11, 2021.

The second series C and second series D bonds are anticipated to be offered through forward delivery purchase contracts.

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

--GO bonds at 'AAA';

--Certificates of participation (COPs) issued by the Maryland Department of Transportation supported by annual state general and transportation appropriations at 'AA+';

--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 Department of Transportation and the Maryland Stadium Authority is 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, strong and forward-looking fiscal management, and broad budgetary flexibility. Liabilities are elevated for a state, but carefully managed and moderate relative to available resources. The state's economy benefits from proximity to the nation's capital, although exposure to federal budget changes poses a greater uncertainty for Maryland than for most states given its large federal agency presence and associated private contracting.

ECONOMIC RESOURCE BASE

Maryland's economy is relatively wealthy, diverse and service-oriented. Fitch's D-Trend indicates a robust economic profile, coupled with mid-range growth trends relative to other U.S. states. In addition to world-class trade centered around the Port of Baltimore, the federal government's presence is an anchor and long-term economic stabilizer to Maryland's economy. The state houses numerous federal agencies, military facilities and contractors.

KEY RATING DRIVERS

Revenue Framework: 'aaa'

Maryland retains unlimited legal authority to raise operating revenues on its solid economic base. Revenue growth prospects are expected to be strong and comparable to overall U.S. economic growth. Risk from reliance on personal income tax is mitigated by a robust federal presence.

Expenditure Framework: 'aaa'

Maryland has a strong ability to adjust its spending commitments, of which education and Medicaid remain the largest components. Carrying costs for liabilities remain moderately low but above states' median.

Long-Term Liability Burden: 'aa'

Maryland's debt and net pension liabilities are elevated for a state but moderate relative to its resource base. Pensions are the more significant burden, which the state is addressing through benefit and contribution policy changes.

Operating Performance: 'aaa'

Financial resilience is extremely strong, with well-funded budgetary reserves, consensus-oriented decision-making with a willingness to trim spending and increase revenues, and disciplined multiyear forecasting and planning.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

--Not applicable for a 'AAA' rating.

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

--Inability to effectively manage rising spending demands, notably from expanding education funding commitments, which weaken Fitch's assessments of either its expenditure framework or operating performance.

--A material increase in long-term liabilities, particularly those associated with retiree benefits, which are not mitigated by policy or budgetary actions.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CURRENT DEVELOPMENTS

Federal Relief Provides Critical Support

Federal aid measures enacted in 2020 and 2021 have provided direct fiscal support and boosted economic activity in Maryland, and throughout the country. Direct fiscal aid included a 6.2 percentage point (pp) increase in the Federal Medical Assistance Percentage (FMAP) for Medicaid worth an estimated $140 million-$150 million per quarter according to the state, and $1.7 billion from the Coronavirus Relief Fund included in the Coronavirus Aid, Relief and Economic Security (CARES) Act.

The state's Bureau of Revenue Estimates reports that Maryland's residents, business, and healthcare providers received more than $38 billion in total federal funding from the pandemic relief through May 2021 with as much as $55 billion in total support anticipated, equal to roughly 11% of the state's entire 2019 GDP. This significant influx of federal funding played a key role in supporting a rebound in economic activity.

Under the March 2021 American Rescue Plan Act (ARPA), Maryland's state and municipal governments expect to receive $11.8 billion in direct aid from the Coronavirus State and Local Fiscal Recovery Fund, of which the state's portion is $3.7 billion. An additional $2.5 billion is allocated for education statewide. The governor and legislature have agreed to allocate its ARPA funds largely for one-time uses, including $1.1 billion to the state's Unemployment Insurance Trust Fund, $800 million to existing statewide pandemic relief efforts, $600 million to the safe opening of schools, $500 million to transportation and infrastructure, and $300 million to broadband expansion.

Employment Still Trails Pre-Pandemic Levels

Fitch's June 2021 analysis of BLS data indicates the state had recovered nearly two-thirds of the 14% pandemic-driven decline in non-farm payrolls. Maryland's performance has been in line with national medians.

The state's official unemployment rate in June of 6.2% was above the national 5.9% rate and the states' median 5.0% rate for that month. Maryland's notably higher Fitch-adjusted unemployment rate (counting labor force declines since February 2020 as unemployed), at 11.0% compared to the national state median of 6.7%, indicates that its service-sector labor markets weakened more than most other states despite relative strength in government and related business services. Fitch notes similar trends across states, as labor market conditions remain materially weaker than pre-pandemic levels, reflecting the deep and sustained economic dislocation. For additional information on labor market analysis, please see Fitch's U.S. States Labor Markets Tracker. (https://app.fitchconnect.com/search/research/article/RPT_10170505)

Revenue Outlook Improved

Maryland's current revenue and economic forecast anticipates growth well ahead of early pandemic estimates, but still short of pre-pandemic expectations. Maryland's Board of Revenue Estimates, the official revenue forecasting body for the state, has revised its forecast four times since March 2020. Each forecast incorporated actual revenue collections and an updated economic outlook. Importantly, the Board's March 2021 estimate projects fiscal 2021 revenue of $19.2 billion, less than 1% below its last pre-pandemic estimate, a striking projection given the depth of the pandemic's economic dislocation.

The state's fiscal 2022 revenue estimate anticipates broad-based general fund revenue growth of 6.1%, to $20.4 billion, led by over $580 million from individual income tax growth. Fitch notes that, as in all states, economic and revenue performance remains subject to potential volatility should public health conditions materially weaken.

Reserves on Track to Remain Adequately Funded

The state ended fiscal 2020 with $1.2 billion in various reserve funds, mostly its Revenue Stabilization Account (RSA), or 6.6% of fiscal 2020 general fund revenues. The combined reserve funds (collectively, the state reserve account) and general fund balance at fiscal year-end 2020 was $1.6 billion, or nearly 9% of general fund revenues. The state estimates ending fiscal 2021 with a $583 million balance in the state reserve account (3% of fiscal 2021 estimated general fund revenues) and $2.0 billion when combined with the general fund ending balance (10.6%). For fiscal 2022, the state estimates ending the year with $1.1 billion in the state reserve account (6% of fiscal 2022 general fund revenues) and $1.8 billion when combined with the general fund ending balance (9%). Fitch considers these levels adequate to support Maryland's robust financial resilience.

The spring 2021 legislative session included a series of meaningful fiscal and policy actions, including enactment of the fiscal 2022 budget and the $1.1 billion RELIEF Act, which provides economic stimulus and tax cuts for businesses and individuals to counteract the pandemic's economic effects.

Blueprint Fund Sets New Course for Education Funding

In February, the legislature overrode gubernatorial vetoes to enact House Bill 1300 (HB1300) and HB732. HB1300 implemented and provided initial funding for key recommendations of the Commission on Innovation and Excellence (also known as the Kirwan Commission), which was empaneled to address education policy and funding. The enacted plan gradually increases state and local education aid by $4 billion by 2030 (see details below).

Importantly, HB732 established the nation's first taxes on digital goods and downloads, including advertising; these provisions were amended slightly in May under Senate Bill 787. Up to $119 million in annual receipts will flow outside the general fund to the Blueprint for

Maryland's Future Fund, pending resolution of litigation preventing implementation. HB732 also established additional tobacco taxes that are estimated to generate $100 million for the general fund in its first year, and $81 million-$92 million annually thereafter.

REVENUE FRAMEWORK

Maryland's revenue framework includes a broad range of tax revenues, with personal income taxes (PIT) 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 statutory changes tightened the dedication for transportation needs. The state also levies a small statewide property tax to support GO 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 cyclicality and federal policy actions, is likely to grow at least in line with national economic growth over time.

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.

Kirwan Commission Implementation Will be Key Budget Driver

Education funding demands will escalate over the next several years based on enactment of HB1300, and Fitch anticipates the state will consider alternative revenue measures or adjustments to planned spending to minimize general fund support. Under the current estimates, education spending for the Blueprint will reach $4 billion annually by 2030: $2.8 billion from the state and $1.2 billion from local governments. In 2019, the state established the Blueprint for Maryland's Future Fund as a tool to manage and track related funding needs. The legislature also directed to the Blueprint Fund annual gaming revenues going to the education trust fund (estimated at $500 million-$600 million), as well as annual sales and use tax revenues over $100 million from remote sellers and marketplace facilitators (estimated at $400 million-$500 million).

The enactment of HB1300 and HB732 noted earlier provide significant additional revenues to address Kirwan Commission needs. The state's Department of Legislative Services now estimates the Blueprint Fund could fully fund Kirwan Commission costs through at least fiscal 2026 before potentially requiring general fund support.

Consistent with most states, Maryland's spending will likely be in line with to marginally above expected revenue growth, absent offsetting policy action, driven by both education and Medicaid. 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 fundamental programmatic and financial structure does not appear to be a near-term priority of the current federal administration or Congressional leadership. As with all federal programs, Medicaid remains subject to regulatory changes that could affect various aspects.

Maryland's carrying costs for liabilities are double the median state level (10.3% vs. 5.1% in fiscal 2019 and 10.2% for fiscal 2020) but remain well within the state's ability to control given its fiscal and economic resource base. Debt service is elevated due partially to 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 supplemental contributions. A "sweeper" provision to divert a portion of unappropriated surpluses 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, tied to pension system funding levels, and split the sweeper between pension and other post-employment benefits (OPEB) payments. Since these contributions are beyond the actuarially determined contributions, Fitch does not incorporate them into the carrying cost metric. The fiscal 2021 budget waived the sweeper provisions ($25 million each), but maintained $75 million in supplemental pension system contributions, and $100 million is budgeted for fiscal 2022.

LONG-TERM LIABILITY BURDEN

On a combined basis, debt and net pension liabilities attributable to the state as of Fitch's 2020 state pension update are above average, measuring 12.6% of 2019 personal income, compared with the U.S. states median of 5%. Based on a state debt statement as of June 30, 2021 and pension data from the state's fiscal 2020 annual financial report, Fitch anticipates the long-term liability burden remains largely unchanged.

Fitch's calculations incorporate project debt associated with the Purple Line availability payment-based PPP 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 $1 billion) 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 PPP and Baltimore school obligations) at or below 4% of personal income.

The veto override of HB1300 also made effective the Built to Learn Act. The Built to Learn Act authorizes the Maryland Stadium Authority (MSA) to issue up to $2.2 billion in gaming revenue-backed bonds for school construction projects. Fitch's analysis indicates the additional issuance would not change the 'aa' assessment of Maryland's long-term liability burden, nor the 'aaa' assessment of the state's expenditure framework, even if issued immediately in a single tranche. Fitch anticipates issuance would likely be spread over multiple issuances and years.

Pensions are a comparative credit weakness in Maryland, although the state has taken repeated action since 2011 to revise benefits and contribution practices to improve sustainability. Specific measures include lower benefit accruals, longer service requirements, a phased-in decline in the discount rate, revising the contribution methodology to achieve 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 7.4% investment return assumption. Fitch calculates the consolidated ratio of the state's pension assets to liabilities as reported in its comprehensive annual financial report is approximately 70%. The Fitch-adjusted ratio, based on the standard 6% investment return assumption we apply to all U.S. public sector pension systems, is approximately 60%.

OPEB Litigation and Related Legislation Shifts Liability Estimate

OPEB liabilities are sizable, but not exceptionally large, roughly equivalent to Fitch's estimate of the state's debt liabilities. Maryland's reported total net OPEB liability as of June 30, 2020 is $17.6 billion, or 4.4% of personal income. This is up from $12 billion in 2018 reflecting the effects of litigation originally challenging a 2011 law reducing OPEB prescription drug benefits, and legislation (SB 946 of 2019) enacted following filing of the litigation. The 2011 changes reduced the state's OPEB liability by approximately 40% as measured at the time.

The OPEB liability could shift further as the litigation progresses. An unexpectedly large increase in the OPEB liability, to make it much closer to the level of net pension liabilities (Fitch-adjusted $32.8 billion at June 30, 2020) and indications that the state's capacity to make benefit changes is significantly limited, could lead Fitch to consider the OPEB liability as a asymmetric rating factor consideration.

OPERATING PERFORMANCE

Maryland's financial resilience is extremely 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 RSA when confronted with budgetary weakness.

Legislation in 2017 addressed revenue volatility and 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 were to be diverted from routine spending and instead be directed first to address any deficit in general fund revenues versus the last estimate, and then to build the RSA up to 10% of general fund revenues and cover pay-go project needs for K-12 and higher education. Pandemic-driven declines led to a revenue deficit of $243 million in fiscal 2020 for revenues other than non-withholding components, greater than the excess non-withholding revenues of $141 million and eliminating any RSA contribution.

Maryland's disciplined approach to budget management during expansions leaves it well-positioned to address downturns. Regular consensus revenue forecasting identifies material changes in economic and revenue performance. The state's Board of Public Works (BPW) regularly exercises its ability to reduce spending to manage projected revenue shortfalls, including at the onset of the pandemic. Under statute, the BPW can reduce appropriations up to 25% without legislative approval.

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. Recent improvements to the state's budgetary management practices include the transition to full actuarial funding of pensions, implementation of the revenue volatility cap and a planned restoration of a 2021 draw on the RSA.

Maryland Stadium Authority Details

Lease revenue bonds of the MSA are secured by leases between the MSA and the State of Maryland, with lease payments subject to annual legislative appropriation. The 'AA+' long-term rating of the bonds is thus linked to the credit quality of the State of Maryland. The MSA has funded several sports, cultural and convention venues statewide using a master lease structure, and MSA borrowing is part of state debt oversight.

Please see "Fitch Rates Maryland Stadium Auth's $21M Lease Rev Bds 'AA+'; Outlook Stable," published on Oct. 16, 2019 for additional information on the MSA revenue bonds.

Maryland Department of Transportation (MDOT) COPs Details

MDOT's COPs are payable solely from purchase installments from MDOT pursuant to purchase agreements, subject to appropriation in each year by the Maryland General Assembly. MDOT intends to make payments from the department's Transportation Trust Fund, but the state's full resources are available for appropriation.

Please see "Fitch Rates Maryland DOT's $30MM COPs 'AA+'; Outlook Stable," published on Feb. 20, 2019 for additional information on the MDOT COPs.

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Maryland, State of (MD) [General Government]	LT IDR	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable

ENTITY/DEBT	RATING			PRIOR
• Maryland, State of (MD) /General Obligation - Unlimited Tax/1 LT	LT	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable
• Maryland, State of (MD) /Stadium Revenues/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 04 May 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Maryland Stadium Authority (MD)	EU Endorsed, UK Endorsed

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