MARYLAND STATE TREASURER

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State of Maryland
Debt Management Policy

1.0 Introduction and Applicability

1.1 Introduction

This Debt Management Policy (the "Policy") is prepared by the Maryland State Treasurer's Office and provides guidance for the prudent use of debt to finance the State's Capital Improvement Program ("CIP").

Through the adoption of this Policy, the State will strive to attain and maintain the highest credit ratings, manage financial risk and be guided by governmental best practices while taking proactive steps to maximize value for the citizens of Maryland.

1.2 Applicability

This Policy is applicable to the issuance and management of the State's general obligation bonds.

2.0 Policy Objectives

The primary objectives of this Policy are to:

- <u>Minimize the Cost of Capital</u> – Achieve the lowest long-term cost of capital for the State;

- <u>Preserve Credit Ratings and Inspire Investor Confidence</u> – Manage debt levels and financial practices to maintain the highest credit ratings for the State and inspire investor confidence.

- <u>Ensure Compliance with Legal Requirements and Covenants</u> – Establish procedures to ensure compliance with applicable laws, regulations and governmental best practices as well as covenants made in connection with the issuance of general obligation bonds.

3.0 Constitutional and Statutory Authority

Actions described in this Policy are authorized under the following, which are referred to herein as the "Authorizing Laws":

- Article III, Section 34 of the Maryland Constitution;
- Title 8 of the State Finance and Procurement Article of the Annotated Code of Maryland ("SF&P"); and
- General obligation bond enabling acts of the General Assembly, as enacted and amended from time to time.

In the event of a conflict between this Policy and the Authorizing Laws, the provisions of the Authorizing Laws shall take precedence.

4.0 Authorizations Required to Incur Debt

4.1 General Assembly Authorization and Delegation to BPW

The General Assembly annually approves general obligation bond enabling acts authorizing the issuance of bonds for various capital projects and programs. The General Assembly has delegated to the Board of Public Works ("BPW") responsibility for general supervision of State debt including the authority to provide, by resolution, for the terms, conditions, security, issuance, sale, delivery, replacement, and payment of State general obligation bonds authorized by one or more enabling acts and consolidated for purposes of a bond sale.

The BPW has delegated primary responsibility for the preparation and conduct of bond sales to the Treasurer. (See Item 21 on the Secretary's Action Agenda at the July 2, 2014 meeting of the BPW).

4.2 Recommendation for Structuring of Bond Issue by State Treasurer's Office

Prior to each issuance of bonds, the Debt Management Division in the State Treasurer's Office will brief the Treasurer and Chief Deputy Treasurer on the anticipated need for the issuance of bonds and provide a financial analysis of projected debt service and the status of refunding opportunities that meet the requirements of Section 6.3 of this Policy. The Debt Management Division Director shall recommend the amount of each bond sale using projections from the most recent Capital Debt Affordability Report and by monitoring the rates of bond expenditures and the balance of bond proceeds in the State and Local Facilities Loan Fund.

4.3 Initial BPW Bond Sale Authorization

Upon the recommendation of the Treasurer, the BPW, by resolution adopted approximately 30 days in advance of a bond sale, authorizes the consolidation of various general obligation bond enabling act authorizations, and approves, among other things, the date and place of sale, the amount and form of the bonds, the manner of sale and the payment dates of the bond issue. (SF&P §8-118 to §8-124).

4.4 Final BPW Bond Sale Authorization

On the date of the bond sale, held during a regularly scheduled BPW meeting, and upon the recommendation of the Treasurer, the BPW approves the sale of Maryland State General Obligation Bonds by resolution accepting bids or proposals and approving bond maturities and interest rates.

4.5 Expenditure of Bond Proceeds

The expenditure of bond proceeds is accounted for on a "cash flow" basis rather than on a "project" basis. Proceeds from the sale of general obligation bonds are deposited in the State and Local Facilities Loan Fund and expended as needed on any project authorized by a general obligation bond enabling act. "Project" accounting is maintained by the Comptroller of the Treasury to assure that individual project expenditures will not exceed individual project authorizations (SF&P §8-125,127).

5.0 Debt Guidelines

When evaluating debt and other debt-related structures, the State will consider three primary factors: cost of capital, capital structure/balance sheet management, and interest rate risk management.

5.1 Cost of Capital

The State will evaluate the risk-adjusted cost of capital inherent in any financing or capital funding strategy. This evaluation will consider the risks associated with the strategy and, to the extent applicable, shall include an interest rate sensitivity analysis to estimate the probable and potential cost of the strategy. The evaluation will also require the development of a rationale for the funding strategy that considers not only the economics and risks of the strategy, but also its probable and potential budgetary impact. More particularly:

- Except as set forth below, the State should use tax-exempt debt whenever it produces an economic benefit;
- The State should compare the cost of capital of any federally authorized bonds that have subsidies or tax credits with traditional tax-exempt bonds;
- If the expected use of a to-be-financed facility precludes the use of tax-exempt debt under federal tax law, the State may issue taxable debt; and
- The State will continue to finance multiple CIP projects within a given bond issuance to reduce issuance costs by consolidating various enabling act authorizations into periodic bond sales using the cash flow method described in Section 4.5.
- The use of taxable debt shall be reviewed by the Office of the Attorney General and, if necessary, Bond Counsel prior to issuance.

5.2 Capital Structure / Balance Sheet Management

The Maryland Constitution limits the term of general obligation bonds to 15 years. Generally, new money general obligation debt will amortize assuming level debt service, with principal amortization beginning three years after issuance. The State may structure principal and interest payments to achieve debt service objectives, such as:

- Vary the term of bonds provided the maturity is less than 15 years;
- Structure principal amortization to achieve policy goals. In alignment with the 15-year final maturity limit, the State remains committed to rapid debt repayment;

  Structure the bonds either as serial or serial and term bonds after considering the marketability of serial and term bonds and the cost benefit of either structure.

5.3 Risk Management

The State will manage its financial risks by considering:

- Liquidity risks and exposures;
- Available CIP funds on hand; and
- Current market interest rates and interest rate sensitivities.

6.0 Fixed Rate Debt

The State will evaluate the issuance of fixed rate debt to fund the CIP in light of the Debt Guidelines described in Section 5 of this Policy. Because fixed rate debt transfers most financial risks to bondholders, fixed rate debt will always be considered a viable financing alternative for all long-term capital projects when practicable and economically viable.

6.1 Permitted Types of Fixed Rate Debt

The State may consider the use of all alternative structures and types of fixed rate debt to the extent permitted by law including serial bonds and term bonds. If term bonds are used, they should normally be retired with annual sinking fund payments.

6.2 Permitted Features for Fixed Rate Debt

The State may consider the use of alternative structural features for fixed-rate debt to the extent such features are reasonably expected to produce a lower cost of capital for the State. In evaluating the relative value of alternative coupon structures, the State will consider the expected impact such alternative coupons may have on the refinancing optionality of its debt portfolio. These features include, but are not limited to:

- The bonds can be sold at par or as premium or discount bonds.
  - If bonds are sold with a premium, the premium shall be deposited to a Premium and Expense Account and used to pay bond issuance costs. Any remainder shall

be transferred to the Annuity Bond Fund to fund up to three years of interest on the bonds generating the premium or deposited in the State and Local Facilities Loan Fund and expended on a cash flow basis on any project authorized by a general obligation bond enabling act.

- The State will consider and evaluate the cost of capital of alternative call options over the life of the bonds as part of the financing process.

- The State may consider using credit enhancement, such as municipal bond insurance, if using such credit enhancement will lower the cost of capital over the life of the bond series. Any insurance premiums will be considered a cost of capital.

- Reserve accounts for debt service will not be maintained unless determined necessary to market the bonds on favorable terms.

- Capital Appreciation Bonds as described in SF&P §8-123.1 may be issued at a negotiated sale to provide greater access to resident Maryland investors.

- Small Denomination Bonds as described in SF&P §8-123.2 may be issued at a negotiated sale for reasons of efficiency or economy, or to provide greater access to resident Maryland investors.

- The State may issue any federally authorized or subsidized bond such as tax credit bonds or taxable bonds with a federal subsidy if issuance is anticipated to produce a lower cost of capital for the State.

6.3 Refunding Opportunities

The State will monitor its fixed rate debt portfolio on an ongoing basis to identify possible refunding opportunities. The State Treasurer's Office will follow refunding criteria based on a review of then current interest rates and State fiscal needs. The following criteria provide general goals for refundings that will be adjusted as needed on a case-by-case basis. The State Treasurer's Office may execute refinancings that differ from the below guidelines.

The State Treasurer's Office and the State's Financial Advisor, under contract to the State Treasurer's Office, will monitor the markets and the State's debt portfolio for opportunities to refund existing fixed rate debt for savings (SF&P §8-131). When considering the refunding or refinancing of State debt, the State shall calculate the net present value (NPV) savings for the refunding transaction as a whole and on a maturity-by-maturity basis.

The State may consider issuing refunding bonds for savings purposes if debt service savings calculated on a present value basis, net of financing costs, meet the following guidelines (the "Refunding Guidelines"):

- Net present value ("NPV") savings greater than 3% of the aggregate refunded par amount.

- Positive NPV savings for each candidate being currently refunded on a maturity-by-maturity basis.

- For a refunding substantially in advance of a refunding candidate's call date, such as a forward refunding, advance refunding, taxable refunding or tender transaction, the candidate's NPV savings should be at least 1% on a maturity-by-maturity basis.

- For each candidate to be refunded substantially in advance of its call date, a breakeven analysis should be performed. A breakeven analysis calculates how much interest rates would have to change by the refunded candidate's current call date to produce a current refunding with savings matching those achieved with the proposed refinancing. If the calculation results in a large interest rate increase, consideration should be given to delaying the proposed refinancing.

- For each candidate to be refunded, negative arbitrage should not exceed the present value savings.

- There should be no dissavings in any year unless there is an overriding policy objective for the refunding.

- In no event shall a refunding occur where the maturity of a refunding bond exceeds 15 years from the date of issuance of the bond refunded by such refunding bond.

- In addition, the State may refund individual bond maturities if the bond is otherwise unlikely to be refunded by its call date and such a delay in refunding the maturity may lead to a reduction in savings.

The State may deviate from the Refunding Guidelines if it is in the State's overall best financial interest. Approval of the sale of the refunding bonds by the BPW shall be conclusive as to a finding that a refunding is in the State's overall best financial interest.

7.0 Other Types of Debt

Although the State has the authority to make short-term borrowings in anticipation of taxes and bond proceeds up to a maximum of $100 million, the State has not issued short-term revenue anticipation notes or made any other similar short-term borrowings for cash flow purposes. While this policy does not address procedures for the issuance of such short-term debt, short-term borrowing may be utilized in accordance with law for the temporary funding of CIP cash flow deficits in lieu of internal borrowing if it is determined to be cost-effective. This policy does not address derivatives or variable rate debt. The State has not historically issued general obligation secured derivatives or variable rate debt and does not anticipate doing so.

8.0 Method of Sale

In accordance with SF&P §8-124, a public, competitive sale is the State's preferred method of sale of general obligation bonds. Competitive sales are generally used for fixed rate bond issues that are typically sold to investment bank syndicates. The State currently uses the electronic closed auction method for competitive sales. However, the State Treasurer's Office will stay abreast of industry developments to recommend the most efficient and cost-effective competitive sale method.

Negotiated sales may be appropriate under certain circumstances. However, except as discussed below, the BPW may only offer general obligation bonds pursuant to a negotiated sale if the BPW determines that: (1) extraordinary credit market conditions exist that warrant the use of a private, negotiated sale instead of a competitive sale; and (2) the terms and conditions for the sale of general obligation bonds of the State, including price, interest rates, and payment dates, achieved through a private, negotiated sale are more advantageous to the State than the terms and conditions for the sale that can be achieved by a public, competitive sale. See SF&P §8-124.

The State may also choose to use a negotiated sale for either fixed rate small denomination bonds (as defined in SF&P §8-123.2) or capital appreciation bonds (as defined in SF&P §8-123.1). The negotiated sale could either be separate or in conjunction with a competitive sale.

The State may sell small denomination bonds in a retail only order period. A retail only order period may occur a few days before a competitive sale and would offer underwriters to sell only to retail accounts, thereby giving Maryland citizens an opportunity to directly purchase and own Maryland general obligation bonds. After the retail only order period, the amount of the competitive sale would be adjusted by the amount of bonds that were sold to retail investors. The selection of underwriters will follow procurement guidelines identified in Section 9.0.

9.0 Procurement

All procurement activity will be in accordance with state procurement laws and regulations. Underwriters, liquidity providers, printers, financial advisors, rebate consultants, and swap advisors will be procured using the competitive proposal method of selection. The evaluation of firms and the awarding of contracts related to the issuance of State debt is the responsibility of the State Treasurer's Office.

Underwriters for negotiated sales will be selected by a Request for Proposal (RFP) process. The RFP should include the reason the State has determined that a negotiated sale is appropriate. Criteria for evaluating proposals should be transparent.

10.0 Ongoing Management and Reporting

After each fixed rate bond sale, the Debt Management Division in the State Treasurer's Office and the State's financial advisor will compare the Maryland yields achieved at the bond sale with Municipal Market Data yields and with similar bond issues sold at about the same time and report their findings to the State Treasurer.

11.0 Disclosure

The State Treasurer's Office will comply with all Securities and Exchange Commission requirements for disclosure by providing annual financial information and notices of material events as outlined in the Continuing Disclosure Agreement executed for each series of bonds. In addition, the State Treasurer's Office will also comply with disclosure requirements for all other bonds that require disclosure of the State's financial information. Finally, the State Treasurer's Office will facilitate disclosure for all interested parties by maintaining links to Official Statements on the Treasurer's website and the State's investor relations webpage, www.stateofmarylandbonds.com.

12.0 Bond Ratings and Rating Agency Relations

The State will seek to maintain the highest credit ratings:

- The State will consider published ratings guidelines in developing its capital funding and debt strategy.

- The State will compare its credit ratings and financial performance versus those of its peer groups as a measure of absolute and relative performance.

- To this end, the State Treasurer's Office will regularly monitor a series of appropriate financial ratios and operating measures based on audited financial statements and other readily available data.

- If the State's credit ratings are downgraded below the highest credit ratings, the capital funding and debt strategy will be reviewed for opportunities to avoid additional downgrades and to restore the highest credit ratings.

- The State Treasurer's Office is responsible for the communication of information to the rating agencies and keeping them informed of significant developments throughout the year. The State Treasurer's Office will schedule rating agency calls and/or visits prior to the issuance of general obligation bonds, as appropriate. The State Treasurer's Office will also schedule all other meetings with the rating agencies and coordinate these meetings with other State officials.

13.0 Legal and Tax Compliance

The State will comply with:

- All debt covenants. Such covenants will be monitored by the State Treasurer's Office and external auditors with advice, as needed, from the Office of the Attorney General;

- Federal tax law to establish and maintain the exclusion from gross income the interest on State bonds issued on a tax-exempt basis. The State Treasurer's Office will ensure compliance with all applicable tax law during the debt issuance process, and on an ongoing basis thereafter, including compliance with:

- Private use rules for all financed facilities; and
- Arbitrage rules, including monitoring the State's arbitrage rebate position and any attendant rebate liability, as defined in §148 of the Internal Revenue Code of 1986, as amended.

In determining the timing and structure of tax-exempt bond sales, the State Treasurer's Office shall consult with independent bond counsel and consider all possible relief and benefits articulated in tax law and regulations, including, without limitation, consideration of the "spending exceptions" to the arbitrage and rebate rules.

14.0 Waiver; Exceptions to Policy

This Policy is intended to provide a framework for responsible debt issuance and management. However, under exceptional circumstances, a waiver or exception may be granted by the Treasurer, if the Treasurer determines that the waiver or exception is in the best interest of the State and does not conflict with the Authorizing Laws or any other applicable laws or regulations. Exceptions should be rare, documented, and evaluated on a case-by-case basis to maintain the integrity of this Policy.

15.0 Policy Review and Revision

Staff within the Debt Management Division of the State Treasurer's Office will meet at least annually to consider changes and updates to the Policy and to consider any necessary or desirable statutory changes.

The review shall focus on:

- Assuring that the Policy meets all regulatory and disclosure requirements and guidelines; and
- Ensuring the Policy meets the State's fundamental objectives of capital structure development, financial risk management, and credit rating targets.

Any amendments shall be approved in writing by the State Treasurer.

Dereck E. Davis

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Treasurer

Date: March 11, 2025