

FITCH RATES \$525MM MARYLAND GOS 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-23 February 2018: Fitch Ratings has assigned a 'AAA' rating to approximately \$525 million in State of Maryland general obligation (GO) bonds, state and local facilities loan of 2018, first series, consisting of:

- \$475,000,000 first series A tax-exempt bonds (competitive);
- \$50,000,000 first series B taxable bonds (competitive).

The bonds are expected to be offered by competitive sale on or about March 7, 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 whose ratings 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 IDR, reflecting available state appropriations support.

ANALYTICAL CONCLUSION

Maryland's 'AAA' Issuer Default Rating (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 presence of the federal government in the neighboring District of Columbia 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 net tax-supported 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 individual income taxes 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 Maryland. Education spending also includes amortization contributions for local teacher retirement liabilities, capital support, and a large and growing network of higher education institutions. Social services, primarily for Medicaid, are also a large 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 latter provision was suspended legislatively in fiscal 2018 and the governor's executive budget recommends doing the same for fiscal 2019.

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 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 (\$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 benefit partially from state revenue support. Inclusive of these commitments, Fitch calculates debt at \$15 billion, or 4% of 2016 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 would 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. Changes included in the 2017 legislative session are intended to address revenue volatility and build up reserve balances to provide additional financial resilience. Beginning in fiscal 2020 individual 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 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.

Taxpayer responses to the recent federal tax changes (H.R. 1) have introduced some uncertainty to the state's revenue forecast as individual income receipts were up sharply in December and January. 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 due 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 continue their tepid growth with gains near 2% in fiscal 2017 and estimated for the current year.

Year to date through January, overall general fund revenues are up nearly 4%, ahead of the 2.2% December estimate from the state's consensus-driven Board of Revenue Estimate (BRE), but growth is likely colored by the federal tax changes. While individual income tax receipts are up nearly 6% (versus a 3% estimate), sales and use tax receipts are up just 1.2% versus the 1.8% estimate.

BRE has made two modest negative adjustments to the fiscal 2018 revenue forecast since budget enactment last spring, leading the BPW to approve commensurate spending reductions. In his fiscal 2019 executive budget proposal, the governor also included supplementary fiscal 2018 spending needs of just over \$100 million, to be offset by \$55 million in health insurance reductions, as well as \$78 million in appropriated spending that he projects will not be needed. Overall, the administration estimates ending the year with \$208 million in general fund balance, down from the \$259 million at the end of fiscal 2017.

The fiscal 2019 executive budget represents a 2% total increase over the revised fiscal 2018 spending plan, with 3.4% growth in general fund spending. K-12 education aid would increase approximately 2% while Medicaid spending from the general fund would increase 6% with growth coming mainly from provider rate increases and a statutory step-up in the state's share of costs for the Medicaid expansion population under the Affordable Care Act. The budget also includes proposed state tax changes with a fiscal 2019 effect of negative \$20 million (on a \$17.7 billion proposed general fund budget), growing to \$150 million by 2023. To achieve balance, the budget proposes several cuts to otherwise planned spending, including lowering the contribution to the state's rainy day fund by \$193 million (the fund would still receive \$24 million leaving 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.

In response to H.R. 1, the governor has also proposed legislation to 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. The legislature has begun consideration of this and other proposals related to H.R. 1.

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