



**TREASURER'S REPORT TO  
LEGISLATIVE POLICY COMMITTEE**

**December 15, 2009**

**Nancy K. Kopp**

*State Treasurer*

**Section 5-104 of the State Government Article of the Annotated Code of Maryland provides that, “*The Treasurer shall address the Legislative Policy Committee of the General Assembly on a semi-annual basis and as necessary on issues of legislative importance, including the activities of the Board of Public Works, bond sales, and investment and procurement initiatives.*” This Report is in fulfillment of that law and covers the period since the report of May 26, 2009. I invite and welcome further discussion with the Committee at your convenience.**

The State Treasurer’s activities and responsibilities are of particular concern to the Legislature. One of five statewide Constitutional officers, and the only one elected by the General Assembly, the State Treasurer’s duties are multifaceted and extend throughout State government and higher education. The Treasurer’s duties include service on the Board of Public Works and Board of Revenue Estimates and Chairmanship of the Capital Debt Affordability Committee. The Treasurer presently also serves as Chair of the Board of Trustees of the College Savings Plans of Maryland and the Board of Trustees of the State Retirement and Pension System. She is a member of the Boards of Trustees of the Teachers’ and Employees’ Supplemental Retirement Plans, Maryland Health and Higher Education Facilities Authority, Maryland Small Business Development Financial Authority and the Maryland Agricultural Land Preservation Board. Several of these Boards work under the general oversight of legislative oversight committees which are in periodic receipt of reports and communications from the Office, as are the two legislative budget committees.

As the State continues to face the most challenging fiscal times in decades, the Office has continued to do its part to help keep the budget in balance. While the Treasurer’s Office was comprised of 64 staff members at the beginning of FY 2009, that number has been reduced to 61 as of December, 2009. In addition to the abolishment of three positions, the Office has seen operating budget reductions of approximately \$800,000 and fund balance transfers of approximately \$17 million since the beginning of FY 2009. While these reductions have been difficult, we continue to be both a partner and reliable resource to State agencies and local governments. We continue to assist State agencies in many ways including providing innovative banking services such as remote deposit, negotiating reduced insurance premiums which enhancing coverage and advising on procurements.

We continue to plan and conduct our bonds sales efficiently and effectively, while striving to maintain Maryland’s coveted AAA bond rating. We monitor the market routinely to take advantage of savings as they become available in refunding our General Obligation (GO) bonds or to issue new types of debt such as Build America Bonds and Qualified School Construction Bonds. Lastly, we continue to invest State funds carefully and conservatively to assure appropriate liquidity and minimize risk to the Maryland taxpayers.

While we continue to do more with less, the Office is working hard and achieving real results. The items set forth below detail a number of these achievements and we are

always available to provide greater information or answer questions regarding these and other issues.

## **BOARD OF PUBLIC WORKS**

During the past six months, three rounds of budget cuts totaling more than \$1 billion have dominated the Board of Public Works (BPW). These cuts were necessary to balance the fiscal year 2010 budget. As the reductions have increased in frequency, their impact on services and programs has deepened, generating intense public interest.

While dealing with significant budget reductions at three different meetings in July, August and November, the Board has continued its oversight of State procurement, ensuring that the process of awarding contracts is open, fair and competitive. Between May 26, 2009 and November 18, 2009, the Board of Public Works acted on 1,113 agenda items valued at \$3,757,771,976.99.

Among the numerous contracts, wetlands licenses, land acquisitions and sales that have come before the Board in the past six months, the following exemplify the scope of actions overseen by the Board of Public Works, the only constitutionally mandated body of its type in the nation:

- \$485 million bond sale in August, including the sale of \$235 million sold mostly to Marylanders as part of a direct retail bond sale.
- A 20-year license for operation of a solar energy “farm” at the University of Maryland Eastern Shore.
- The approval of \$266.7 million in public school construction.
- The Renovation of Pocomoke and St. Martin resident halls at Salisbury University.
- Approval of a new Administrative Services Organization Contract for the State’s Mental Health Administration.
- Approval of a new health benefits contract for Maryland Transit Administration employees.
- Approval of \$10 million in improvements to Oriole Park at Camden Yards and M&T Stadium.
- The acquisition of 1,000-plus acres in Dorchester County.
- The demolition of Union Dam in Patapsco State Park.

The Treasurer's Office continues to communicate frequently with legislators about the Board agenda and items of specific interest to their districts. Feedback from legislators is important to the Treasurer, who represents the legislature on the Board of Public Works. The Treasurer's Office also receives comments and advice from the Department of Legislative Services to ensure that BPW agenda items are consistent with legislative policy.

## INVESTMENT DIVISION

Continued unpredictable volatility has continued to severely impact the financial markets during the last six months since our last Report. The Office's conservative investment policy and practices have protected the State's portfolio. Since December 16, 2008, the Federal Reserve Open Market Committee has targeted the Federal Funds Rate to a range of 0 - .25%. The Federal Government programs implemented to prevent a complete financial meltdown have been successful. The par value of the General Fund investment portfolio for October 31, 2009 was \$6,071,575,936. While this is almost \$1.5 billion less than the par value of \$7,531,091,634 for October 31, 2008, it is approximately \$440 million more than the previous quarter end of \$5,630,516,296 at September 30, 2009.

On October 31, 2009, the portfolio was earning an average of 1.633%, compared to 3.841% for the same date in 2008. This much lower return reflects the impact of the Federal Open Market Committee maintaining Fed Funds Target rate at .25% or less, and the change in strategy to keep more funds liquid due to unpredictable volatile cash flows.

The General Fund interest earnings received year-to-date for FY 2010 was \$71,668,881 as compared with \$97,836,574 received for the same time period in FY 2009. The \$26 million decline in interest received is directly attributable to the fact that FY 2010 had an average \$1.5 billion less daily to invest – a reflection of reduced State revenue – in addition to the much lower interest rate environment.

The Maryland Local Government Investment Pool (MLGIP), a fund which is used as a cash flow depository by local governments and agencies, as well as limited State deposits, is managed externally under the oversight of the Investment Division. Once again the MLGIP was awarded an AAAM rating by Standard and Poor's, an outstanding recognition of prudent management.

The securities lending program continues to be successful. The program has earned \$60,048 so far in FY 2010. This compares with \$181,050 for the same period in FY 2009. Much of this reduction is due to the Federal Reserve and Federal Treasury programs to aid liquidity in the financial markets which drastically reduced borrowers' need for the securities in the State's portfolio.

The Office continues to increase Minority Business (MBE) participation in the investment of State funds. Fifteen MBE broker/dealers are on the Office's approved list for FY 2010 and they have handled investments in excess of \$200 million as of October 31, 2009. This compares to the same period in FY 2009, when the Office had fourteen approved broker/dealers who handled over \$318 million in investments. The absolute numbers do not

tell the entire story. Due to the change in investment strategy required by the economic times, the Office has only transacted a little over one billion in trades this fiscal year as compared to over two billion at this time last year. Therefore, the percentage of MBE trades was 15.21% as of October 2008 but 17.10% as of October 2009.

The Office continues to invest according to the officially adopted State Treasurer's Investment Policy, which sets out investment goals, priorities and constraints. The overriding goal is to assure sufficient liquidity to maintain uninterrupted funding of State government and legislated payments. As revenues shrink and become less predictable, the strategy has been adjusted to ensure liquidity. The STO continues to review and compare our cash management and investment policies and practices with those of peer AAA-rated states to ensure best practices.

### **BANKING SERVICES DIVISION**

The Banking Services Division remains committed to providing State agencies and external customers efficient, accurate and timely banking services. The Division continually explores new financial products and enhanced data delivery methods to ensure the capacity to contain costs while accommodating for increasingly diverse and complex banking transactions.

The Division's timely, accurate, and completely documented reconciliation of the State's cash, results in the Treasurer's Office's ability to promptly identify and solve agency banking issues. Current highlights of the results of the Division's efforts include:

- Total cash receipts and disbursements reached almost \$116 billion for FY 2009.
- The State's bank accounts are reconciled daily to the State's general ledger within two days of receiving all necessary bank data.
- And; most importantly, there continue to be no un-reconciled differences.

We are continually developing a more automated environment that will enhance the current tracking, processing and reconciling of all bank related transactions for the State's cash accounts. One of the Division's primary concerns must be to enhance the ability to recover in the event of a disaster and to change banks if required by market conditions or the procurement process.

Banking Services has begun the development of a new master bank account database to replace the current Banking Account Information System maintained by the General Accounting Division. The new system will allow for a more efficient set-up and approval process for agency bank accounts. This system will also enhance and further automate the management and control of the State's bank accounts, including the collateralization of State funds.

We continue to be actively involved in enhancing the revenue collection process in many agencies, including working with the Maryland Department of Disabilities to enable them to draw funds from a federal Medicaid Infrastructure Grant. We worked closely with the University of Maryland Baltimore in their conversion of almost 80% of tuition refunds from checks to electronic payments. We also assisted the Maryland Transit Administration with their launch of credit card acceptance on the Metro and Lightrail systems and have also been working together with the Comptroller's Office to convert recurring vendor check payments to electronic payments.

Department of Labor Licensing and Regulation's accounting office has recently begun the use of our depository bank's remote deposit product, which will result in significant cost savings through the elimination of their armored courier service. We are enthusiastic to be actively working with agencies to develop and strengthen their internal processes and to promote efficient and cost effective banking services.

## **INSURANCE DIVISION**

The Insurance Division is responsible for administering the State's Insurance Program, which is comprised of both commercial and self-insurance. Commercial insurance policies are procured to cover catastrophic property and liability losses, and other obligations derived from State contracts, statutes and regulations. Among the exposures covered by commercial policies are State maintained toll bridges and tunnels, rail operations, assorted professional liability exposures and student athlete accidents. The State also self-insures a significant portion of its exposures and maintains the State Insurance Trust Fund to pay claims and the costs associated with handling those claims. Self-insurance coverage includes State-owned real and personal property, vehicles, and liability claims covered under the Maryland Tort Claims Act.

The Insurance Division is comprised of three units: Loss Prevention, Underwriting and Claims. The Division's goal is to provide statewide risk management through loss control (Loss Prevention), loss protection (Underwriting) and loss restoration (Claims).

### **Loss Prevention**

The aim of loss prevention is to help State agencies develop specific action plans and safety practices to mitigate or eliminate their most frequent or severe sources of preventable losses.

Annually, the Loss Prevention Manager conducts a comprehensive review of numerous State agencies' loss histories to identify problem areas and to help those with high severity claims and/or high frequency of claims take corrective measures to significantly reduce the losses to State-owned buildings and contents. Upon identifying agencies with above average claims frequency and severity, the Manager meets with State agency risk managers to discuss the analysis performed and possible improvements.

This year, the Loss Prevention Manager met with the University of Maryland College Park to discuss their five-year trends and the action plans implemented by the University to curtail frequency and severity of losses. Initiatives for loss prevention were developed to further reduce the incidence of losses and ways to improve the tracking of incidents. Brief discussions were also held with Bowie State University about ways to improve claim reporting and incident tracking. The Manager also discussed loss history and trends with the risk manager for the Maryland Port Administration.

The Loss Prevention Manager plans to meet with Maryland State Police and the State Highway Administration this fiscal year to discuss their agencies' loss experience and action plans to reduce the frequency and severity of losses.

Implementation of a more robust portfolio of loss control services offered by our commercial insurance broker partners is underway to maximize the use of loss control services available for State agencies. Through our outreach activities, Coppin State University received an Aerial Infrared Testing of its roofing system. In that case, an aerial inspection of their roofing systems was performed to accurately pinpoint where moisture was penetrating their structures. The purpose of this testing was to indicate roofing failures before there are visible signs, structural damage or business interruption. With the results of this analysis, the University can significantly extend the life of its roofing structures while reducing maintenance expenditures and potential property-related claims.

Recently loss control services were offered to the Maryland State Police Aviation Command (MSPAC) to develop standard operating procedures and guidelines to manage helicopter dispatch. The loss control services were offered to assist the Aviation Command Unit to address some of the safety recommendations made by the National Transportation Safety Board as a result of the tragic crash on September 27, 2008, involving Trooper 2. Previously, MSPAC obtained services to have a gap analysis and assessment conducted on its safety management program.

In FY 09, State agencies **invested \$155,485** to implement preventive maintenance recommendations noted in Boiler and Machinery Survey Reports, **which reduced the potential loss exposure from \$2,566,400 to \$60,200**. Since FY 10, State agencies have **invested \$126,080 to reduce the potential loss exposures from \$1,019,000 to \$35,000**.

## **Underwriting**

The Insurance Division procures broker services for the purchase of commercial insurance to protect the State Insurance Trust Fund from catastrophic loss, to meet statutory or regulatory requirements and for compliance with agency contractual agreements. Underwriting highlights for the past six months include the following:

- Members of the Underwriting Unit conducted three meetings with State agencies in October and November 2009. The first October meeting was with the Aviation Department at University of Maryland Eastern Shore

- The Maryland Transit Administration (MTA) rail car coverage was renewed in FY 2010, with a **34% rate reduction and savings of \$214,253**. The expiring coverage excluded terrorism and flood in Zone A. This **renewal added coverage for domestic and foreign terrorism** and also included flood in Zone A with a \$10,000,000 sub limit. There were significant premiums savings with these coverage improvements.
- The Maryland Aviation Administration's (MAA) airport liability policy was **renewed in FY 2010, with the premium remaining basically flat**. The aviation market was seeking rate increases on most coverages this year, so holding the line on the renewal premium is a reflection of the carrier's positive opinion of MAA's loss prevention efforts.
- The FY 2010 Boiler and Machinery policy was **renewed with no increase in rate**. The insurance carrier continued to include 15 days of infrared testing.
- The FY 2010 renewal premium for the MTA policy covering physical damage on the bus fleet reflected a **rate decrease of 10%** even with increased values of 10.7%.
- The athletic participant's FY 2010 basic coverage for ten schools was down in overall cost by about 8% this year. Eight of the ten schools covered by the policy had a premium decrease, and two had a premium increase due to claim experience. The **8% reduction resulted in approximately \$33,680 in savings**.
- The Allied Health coverage purchased to provide professional liability for student interns in FY 2010 was **\$4,945 less than the expiring policy**. This is good pricing in light of the \$552,880 in losses over the past six years.

## **Claims**

The Insurance Division's Claims unit investigates and resolves liability claims arising from services provided by the State under the Maryland Tort Claims Act, Md. State Gov't Code Ann. §§12-101 *et seq.* The unit also handles claims for damage to State-owned property arising from sudden and accidental perils such as collision and comprehensive loss to autos and a number of other perils such as fire, hail, lightning, wind, etc. which causes damage to State structures, equipment, and contents. The unit handles an annual average of approximately 4,000 claims.

### **Production goals achieved**

Our year-to-date results for FY 2010 show that the Claims unit has received 1449 claims and has resolved 1455 claims including carry-over from previous fiscal years. This result exceeded the unit's production goal of a 1:1 closing ratio.

### **Medicare legislation impacts the unit**

Congress has passed legislation which requires all insurers, including self-insurers, to report to the Centers for Medicare and Medicaid Services (CMS) all bodily injury settlements and judgments paid to Medicare beneficiaries. The reporting process is aimed at ensuring that Medicare is always the secondary payer for benefits.

The Treasurer's Office has been designated as the Responsible Reporting Entity (RRE) for settlements and judgments paid out of the State Insurance Trust Fund. If CMS determines that the RRE failed to report a Medicare beneficiary, it may impose a \$1,000 penalty for each day the beneficiary goes unreported. Therefore, it is critical that the Treasurer's Office accurately report settlements and judgments paid to Medicare beneficiaries. To that end, CMS has developed a letter using "safe-harbor" language to assist insurers in gathering data from claimants and to provide immunity from penalty should a claimant provide inaccurate information about his or her Medicare status or prove to be uncooperative.

The Insurance Division in conjunction with the Office of the Attorney General is coordinating its efforts to establish protocols for identifying and reporting Medicare beneficiaries. The testing period for reporting claims to CMS begins January 1, 2010.

### **Tort Litigation**

The Litigation Manager is responsible for developing and implementing a comprehensive litigation plan for all tort claims in litigation. The Litigation Manager works closely with the Office of the Attorney General to proactively resolve these matters by investigating and evaluating cases, providing settlement authority or when necessary, by briefing the Insurance Review Committee on high dollar value settlements, and by attending settlement conferences and other court mandated activities. The Litigation Manager also works closely with the claims adjusters to provide feedback on

investigations conducted by the adjuster. The Litigation Manager may also brief an adjuster on the status of certain litigation claims of interest.

On average, the Litigation Unit receives 108 suits each year. Since FY 2006, the State Treasurer received 430 notices of suit. Of the cases closed, 28 % were settled; 60% were dismissed; judgments and defense verdicts accounted for 6% each.

Fiscal Year Case Served	Case Disposition					Total Served
	Settled	Dismissed	Judgment	Defense Verdict	Open	
FY06	25	63	9	10	9	116
FY07	21	67	7	4	7	106
FY08	31	48	3	5	28	115
FY09	13	15	0	1	64	93
<b>Total Served as of 6.30.09</b>	<b>90</b>	<b>193</b>	<b>19</b>	<b>20</b>	<b>108</b>	<b>430</b>

### INFORMATION TECHNOLOGY DIVISION

The Information Technology Division (IT) provides a platform of integrated systems to support the State Treasurer’s Office’s (STO) operations.

Over the past six months, the IT Division worked with other Divisions of the Office to support many changes and upgrades. Working with our Banking Services Division, we designed a new daily report that captures checks paid by the bank prior to their issue date, which helped to streamline the Banking Division’s check reconciliation process. We also worked with the Insurance Division to design a new weekly Claim Inventory Report. The report tracks the number of claims opened and closed by adjuster each week. The additional information helps management allocate assignments and track the overall progress of the Insurance Division. We have also worked with the Administration Division to have R\*STARS screens include the original check numbers when displaying the detail of checks reissued from the Undeliverable and Unpresented funds. We are deploying programming that streamlines the Administration Division’s data entry and also supports additional fields for the R\*STARS interface. The Division successfully supported Debt Management’s 2009 Second Series bond sale. The sale included a retail component for the second time. The IT Division, together with Debt Management, implemented an updated Bond Sale website.

The Division introduced new programming to support Service Reduction Days’ affect on our IBM i5 production schedule. The program ensures that the first STO production day for the month is calculated correctly in all scenarios. We also reconfigured two IT printers to support the printing of Expedited Checks on single sheet

check stock. The printers will also be available for limited use during a Disaster Recovery situation. The new programming for single sheet checks printing is completed. Sample checks are in the process of being forwarded to our disbursement bank for quality assurance testing. The new single sheet expedite checks will save over 4,000 pages of check stock per year and eliminate the labor associated with voiding and shredding leader stock.

The IT Division conducted extensive testing with our disbursement bank's upgrade of their VPN service. The IT Division uses this service to transmit Direct Deposit, Vendor ACH, Paid Check and ARP files to and from the bank. The upgrade was a success and should offer the IT Division additional transmission services in the future. We also enhanced our security reporting on the IBM i5 system to now track any data entry via the data file utility program. This option is already secured to only permit specific users. The new reporting does a better job of tracking those users for follow-up by the Security Officer.

The IT Division introduced a new report to show if our ACH files exceed the predetermined amounts that are set by our disbursement bank. For a limited number of times per year the ACH files for Vendor, Payroll and Retirement exceed the bank's limit. The report alerts the IT Division of these situations so that we may notify the bank and get the limit raised for that day. This ensures that proper settlement does occur. We also upgraded our Spam Filtering software and introduced new Spam fighting techniques.

We have also worked with the General Accounting Division to stop printing advices for the majority of their ACH vendor payments. The advices were being printed onto our check stock paper. This change will save the State Treasurer's Office from printing 300,000 advices per year.

## **PROCUREMENT**

In May 2009, an award was made to provide investment and administrative services for the Maryland Local Government Investment Pool (MLGIP) participants. The MLGIP is under the administrative control of the Maryland State Treasurer, and is supervised by the Director of Investments. The MLGIP consists of funds deposited by local governments and agencies that are placed in the custody of the State, as well as any funds of the State that are placed in the MLGIP by the Treasurer, for investment and reinvestment.

On July 1, 2009 the State Treasurer's Office made an award on behalf of the Department of Human Resources, Child Support Enforcement Administration, to provide general banking services to process and disburse monies collected on behalf of individuals who receive child support. The services include accounts for the deposit and disbursement of child support funds, and investment services for account balances. The disbursement services include the use of an electronic payment card product.

The Office made an award to three underwriting firms to provide assistance to the Office and its financing team in negotiating the sale and issuance of tax credit bonds, consisting of Qualified School Construction Bonds, Qualified Zone Academy Bonds, and Qualified Energy Conservation Bonds in September 2009.

## **DEBT MANAGEMENT DIVISION**

### **Financing Activities - Ratings**

Since 1961, Maryland has had a continuous rating of AAA from Moody's Investors Service. Similarly, Standard & Poor's has continuously rated Maryland AAA since 1973 and Fitch since 1993. Only seven states currently have AAA ratings from all three rating agencies.

The State Treasurer's Office (STO) maintains frequent contact with the rating agencies and schedules conference calls with each of them prior to every bond sale, as we did on October 6, 2009, prior to the sale of the 2009 Third Series General Obligation (GO) Bonds. Participating in the most recent conference call were the Treasurer, Comptroller, Secretary of Budget and Management, Director of the Bureau of Revenue Estimates and the Director of Policy Analysis for the General Assembly and staff.

The Rating Agencies are generally uniform in their assessment of Maryland's credit. They cite Maryland's history of prudent, moderate debt and budget management, its protected Rainy Day Fund and other reserves, its Capital Debt Affordability and Spending Affordability processes, its 15-year GO bond terms and other strong evidence of prudent stewardship. However, they also note the serious financial challenges posed or exacerbated by the on-going world-wide economic crisis, including State revenue shortfalls, outstanding liabilities such as the public pension and retiree health benefit obligations, and increased demand for public services. They are particularly concerned about how states (including Maryland) will manage without federal stimulus funds and about Maryland's significant structural budget deficit.

In its most recent report on Maryland General Obligation Bonds dated October 14, 2009, Standard & Poor's stated, "*The stable outlook reflects Standard & Poor's view of Maryland's economic strength and historically strong financial and debt management policies. We believe the state has pro-actively responded to recent structural budget imbalance. Standard & Poor's would expect continued focus on achieving structural budget balance. Maryland has made a steady commitment to funding reserves, which we believe enhances its flexibility in the current economic environment.*"

The next conference call with the rating agencies is expected in February 2010, prior to the sale of the 2010 First Series General Obligation Bonds.

## Financings - General Obligation Bonds

There have been two General Obligation Bond sales since our last report – \$485 million in 2009 Second Series (August) and \$200 million in 2009 Third Series A and B (October). Interest rates on both sales were particularly noteworthy since each sale had an overall rate that was lower than rates in the last 20 years. To illustrate, there is an attached chart of True Interest Cost (TIC) for each sale since 1988. Specifically, the overall TIC for the 2009 First Series in March 2009 was 3.52% and 3.06% and 2.93% for the Second Series and Third Series respectively. To achieve these remarkable rates, the State benefited from a strong municipal market rally, demand for highly rated Maryland bonds, an expansion to the taxable market with the issuance of Build America Bonds (BABs), the diminished tax-exempt supply of new bonds because of the issuance of taxable Build America Bonds, the deep federal subsidy to the State of 35% of the interest on BABs, and the establishment of the retail market for Maryland bonds.

The 2009 Second Series in August 2009 also continued the State's use of the negotiated sale method to target retail customers. Of the total \$485 million, the sale gave first priority to Maryland citizens for the purchase of \$235 million of the State's bonds in a retail only order period on July 31 and August 3. To generate interest in the retail sale, the State Treasurer's Office used its specifically created website, [www.buymarylandbonds.com](http://www.buymarylandbonds.com), and print advertising in the Baltimore Sun and Washington Post. There were frequent press releases that generated press coverage and the Treasurer also did a radio interview for brokers to educate them about Maryland bonds.

A competitive sale followed on August 5 for \$200 million of tax-exempt bonds and \$50 million of Build America Bonds. This was the State's first issue of Build America Bonds, a program authorized in American Recovery and Reinvestment Act (ARRA) in February 2009 which expires on December 31, 2010. These bonds generated \$4.25 million in interest savings compared to a traditional tax-exempt bond in the 2024 maturity. Overall, the tax-exempt bonds generated premium of approximately \$30.2 million which was deposited to the Annuity Bond Fund. The Build America Bonds sold at a slight discount of approximately \$.4 million. Efforts are being made to extend federal authorization for new BABs beyond the 2010 cut-off.

In late summer and early fall of 2009, the municipal market continued to rally and interest rates were dropping further. To take advantage of these circumstances, the STO decided in late August to issue new money bonds and to refund bonds issued at higher rates. In a refunding, bond proceeds are invested in US Treasuries until the optional redemption date. Unfortunately, because municipal interest rates climbed from their low and Treasury rates declined, the refunding did not meet the criteria established in the debt policy. As a result, the refunding sale was cancelled on October 20 which was the day prior to the competitive sale. The STO continues to monitor the market and, if there is improvement and the refunding criteria set in debt policy are met, a refunding could occur. Sensitivity analysis indicates that we could achieve a large refunding with a drop in interest rates of .25%.

While the October refunding was deferred, the State did proceed with a \$200 million issue (2009 Third Series) to fund capital projects and benefited, as described above, from low interest rates. Of the total \$200 million, there were \$58.2 million of Build America Bonds that generated \$2.6 million in interest savings in the 2022, 2023 and 2024 maturities compared to traditional tax-exempt bonds. Series A (tax-exempt bonds) generated \$21.2 million in premium that was deposited to the Annuity Bond Fund. The Build America Bonds sold at a slight discount of \$.3 million.

At this time, the STO is working on two additional financings in 2009, in addition to a potential refunding issue. Qualified School Construction Bonds (QSCBs) are a new financing opportunity for the State as a result of ARRA. These are federal tax credit bonds which, compared to traditional tax-exempt bonds, should provide significant interest savings due to federal subsidy of up to 100% of the interest cost. The State's allocation is approximately \$50 million in each of the next two years. In addition to the State's allocation, allocations have been made to Baltimore City, Prince George's County and Baltimore County Public Schools.

The State's 2009 QSCB issue is expected to be sold to an underwriter who has guaranteed to purchase the bonds at par. This is an extremely aggressive price because, since September, QSCB bonds have sold with either a supplemental coupon (i.e., at more than 0% interest) or at a discount. In fact, to achieve 0% interest, Baltimore County's general obligation \$19.4 million QSCB was issued at a price of 89.68% in early November. If the State's 2009 issue sold at a similar discount, the State would issue \$50.3 million in bonds but receive only \$45.1 in proceeds, albeit with no interest expense.

The other financing in progress is \$5.5 million of Qualified Zone Academy Bonds (QZAB). These bonds are also tax credit bonds and the State has issued them since 2001. These bonds will probably price with either a supplemental coupon or a discount. Closing for both 2009 QZAB and 2009 QSCB is expected before year end.

The next tax-exempt General Obligation Bond sale will be scheduled for February or March 2010. The financing plan is expected to offer first priority to Maryland citizens in a retail sale and the remainder of the tax-exempt bonds in a competitive sale. The STO will also recommend the issuance of BABs in as many maturities as financially feasible.

## **Leasing**

The capital lease-financing program allows State agencies to acquire equipment and pay for those items over a three, five, or ten year time frame. Between May 26, 2009 and November 30, 2009, \$10,983,819 in capital equipment was leased by State agencies through the State Treasurer's Office.

The Treasurer's Office also finances Energy Performance leases in cooperation with the Department of General Services, providing funding for energy conservation at State facilities. The program finances significant up-front investments in conservation

projects and the lease is paid for using the savings in operating costs. Energy leases in the amount of \$7,759,134 were financed between May 26, 2009 and November 30, 2010.

### **Status of the Annuity Bond Fund**

Debt service on General Obligation Bonds is paid from the Annuity Bond Fund (ABF) and the primary source of revenue for this fund is real property tax receipts. However, the projected amounts of future property tax receipts are not sufficient to pay debt service on the State's General Obligation Bonds without the use of general funds or bond premium. In fiscal year 2011, it is projected that there are sufficient property tax receipts, surplus transfers from 2010 and bond premium to cover debt service without any general fund subsidies. However, if the real property tax rate continues at the current level of 11.2¢ per \$100 of assessed valuation and future debt is issued at the rates projected in the 2009 Capital Debt Affordability Committee (CDAC) Report, subsidies of general funds will be necessary to support the debt service on General Obligation Bonds beginning as early as 2012 unless bond premium is able to close the gap.

### **CDAC Affordability Criteria**

To develop its 2011 recommendations for authorizations of general obligation and higher education debt, the CDAC met on May 26, July 14, August 5 and September 3, 2009. At the July 14 meeting, the Committee reviewed the size, condition and projected issuances of tax-supported debt including General Obligation Bonds, Consolidated Transportation Bonds, Grant Anticipation Revenue Vehicle (GARVEE) Bonds, Maryland Stadium Authority Bonds and Bay Restoration Fund Revenue Bonds (Bay Restoration Bonds). The Committee conducted a similar annual review of the debt of higher education institutions at the August 5 meeting. Also at the August meeting, the Committee reviewed the State of Maryland Capital Program and school construction needs during the next five fiscal years.

The Committee also included two special topics on its 2009 agenda. On May 26, they reviewed the bonds authorized by the American Recovery and Reinvestment Act of 2009. The discussion focused on the characteristics of the bonds, allocations, the financial benefits, projected issuance and the potential effect on affordability ratios. On July 14, in response to the Joint Chairmen's 2009 Report, CDAC reviewed the proposed financing alternatives for a new public health lab that were presented by the Department of Health and Mental Hygiene (DHMH). Section VII of the 2009 CDAC Report describes the DHMH financing alternatives and the implications to the affordability ratios.

At the September 3 meeting, the Committee unanimously recommended a \$990 million limit for new general obligation authorizations by the 2010 General Assembly to support the 2011 capital program. Future projections assume increases of 3% annually in 2012 through 2019.

However, due to extraordinary and rapidly changing fiscal conditions, the Committee also agreed to reconvene on December 18, 2009 to reexamine the recommended authorization level. Among the issues and circumstances which the Committee will review and consider at that time and which might impact this recommendation are the following:

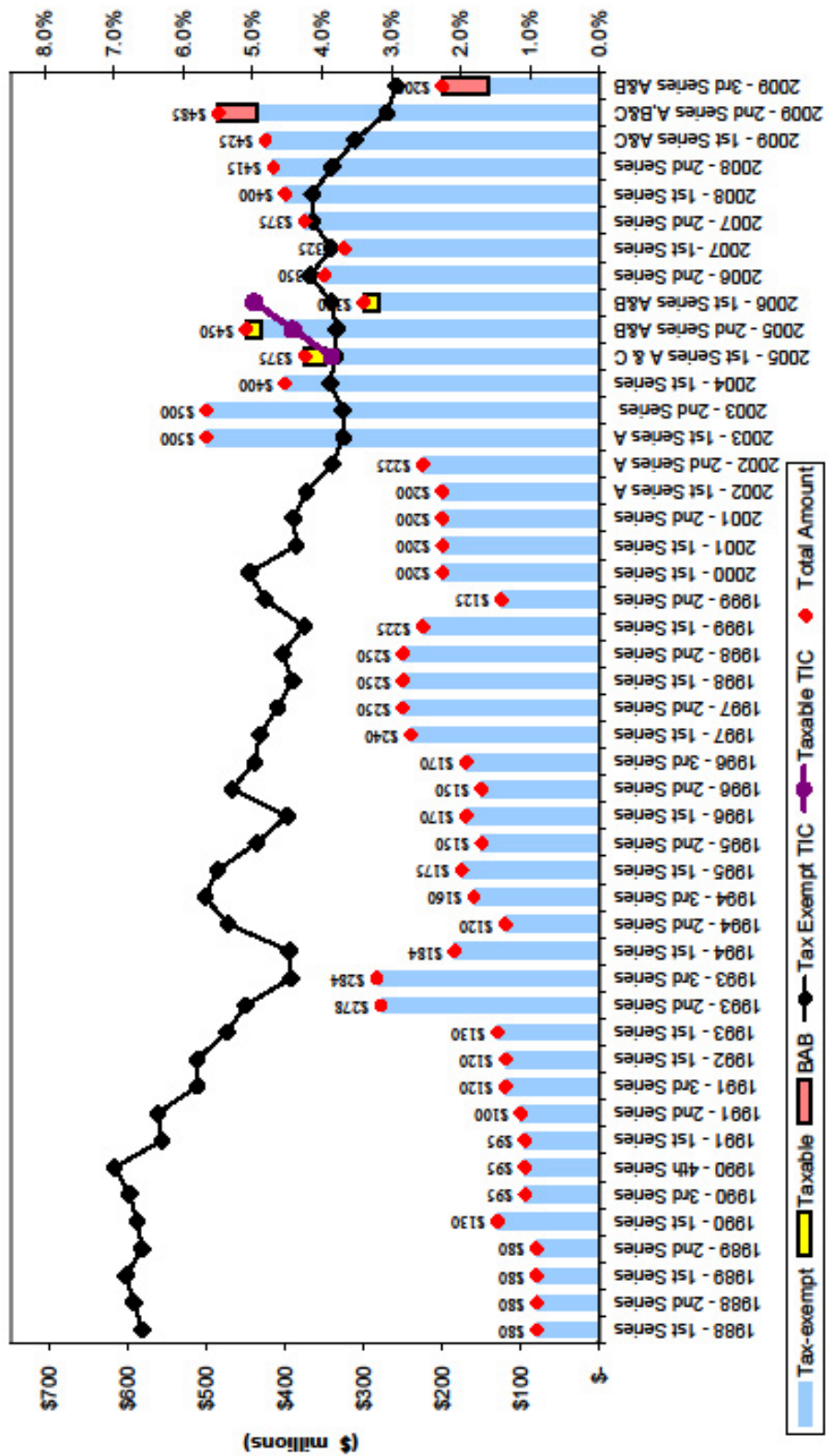
1. The Board of Revenue Estimate's December revenue estimates.
2. Developing options to provide operating budget relief by transferring appropriate expenditures to the capital budget.
3. Debt service projections subsequent to the projected refunding and new money bond issuance this fall.
4. Possible extension of federal authorizations incorporated in the ARRA, such as school construction bonds and Build America Bonds.
5. Any other appropriate issues.

The affordability analysis presented at the September 3 meeting indicates that the Committee's projection of General Obligation Bond authorizations is currently affordable. The personal income criterion peaks at 3.49% in 2012 and is at 2.96% in 2019. The debt service criterion increases annually to 8.02% in 2018 but declines to 7.82% in 2019. Attached are graphs of these ratios.

The risks of exceeding the affordability criteria in future years (debt outstanding should not exceed 4.0% and debt service should not exceed 8.0%) are probably greater than at any other time in the last 20 years. The Committee reviewed its interest rate, revenue, personal income, issuance and authorization assumptions and subjected its recommendation to sensitivity analysis. The personal income and revenue estimates reflect the most recent projections by the Bureau of Revenue Estimates in August 2009. The Committee believes that all of these variables have been estimated conservatively but the volatile financial conditions in the last year have resulted in frequent revisions to estimates. Furthermore, as noted in the charts for the affordability analysis of debt service to revenues, there is little remaining capacity for further adjustments to revenues. As noted above, in response to the rapidly changing fiscal conditions, the Committee will reconvene in December 2009 to reexamine the recommended authorization.

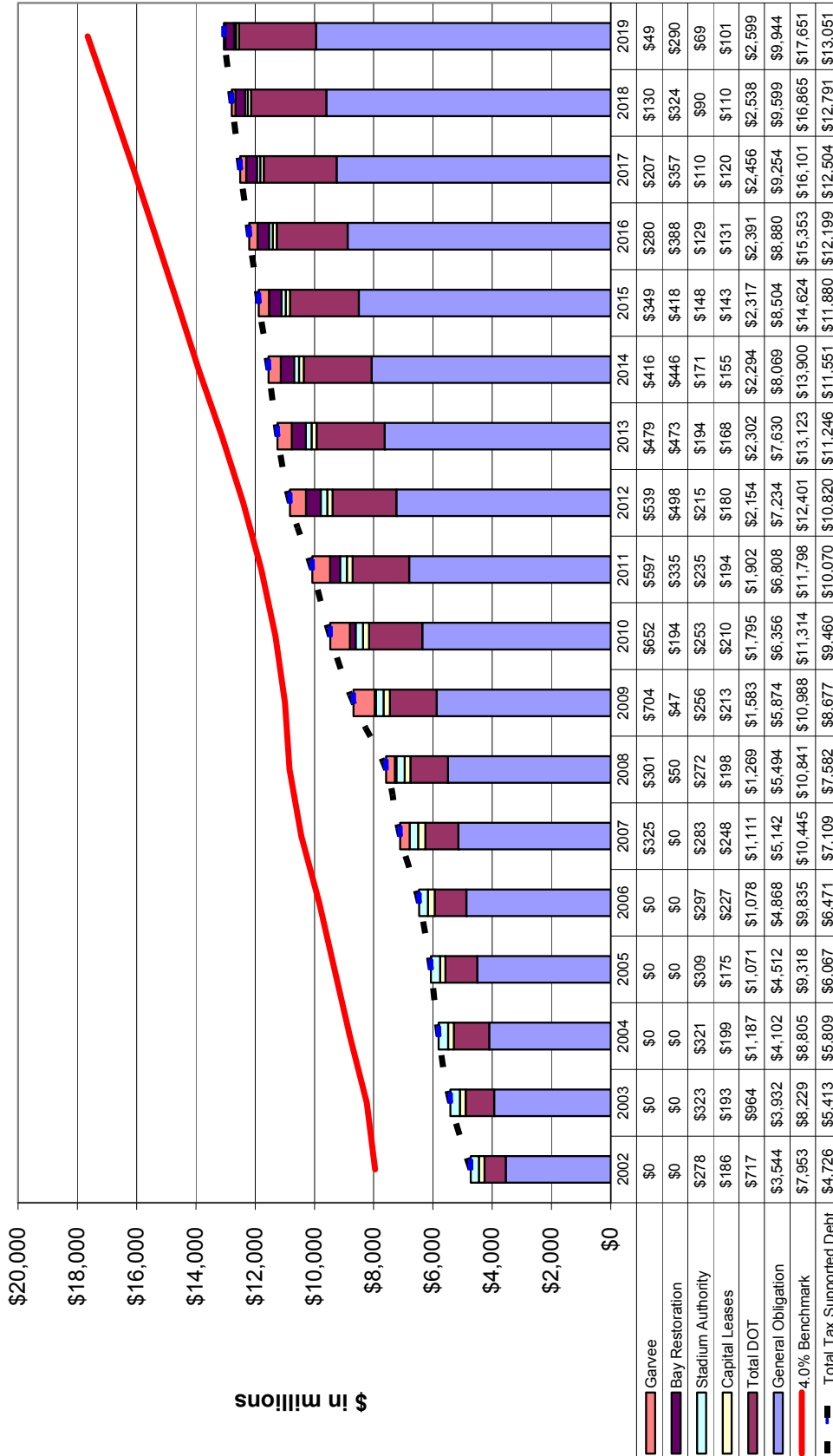
Based on its review of the condition of State debt in light of the debt affordability guidelines, the Committee unanimously recommended a limit of \$27 million for new academic facilities bonds for the University System of Maryland for fiscal year 2011.

### Issuance Amounts and TICs of General Obligation Bonds 1988-2009



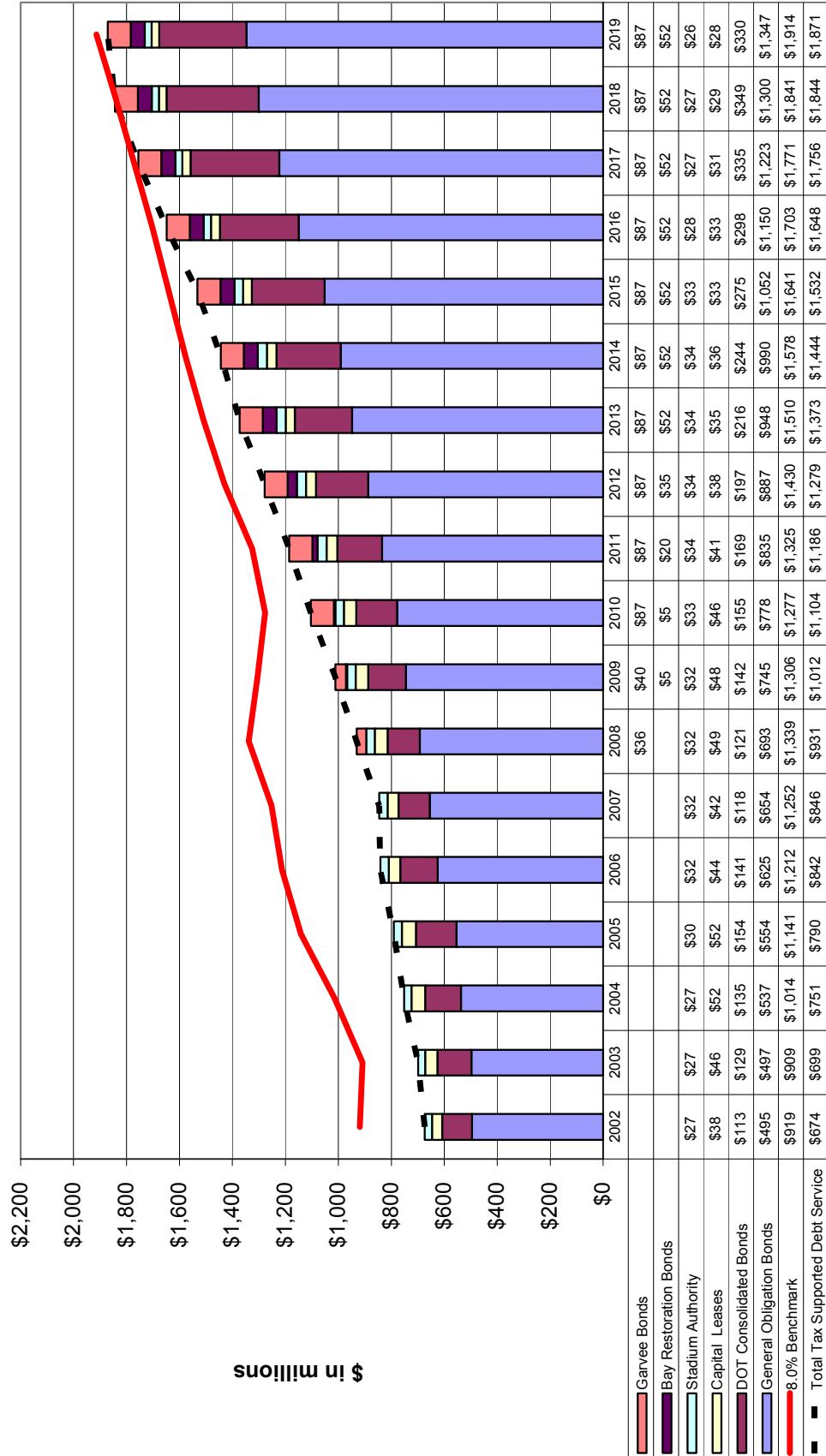
TIC - True Interest Cost

## Tax Supported Debt Outstanding to Personal Income August 2009



Source: Table 1 as of August 2009

### Tax Supported Debt Service to Revenues August 2009



Source: Table 2A as of August 2009

*As noted in the opening section of this Report, present revenue and market conditions continue to impact the operations and achievements of the State Treasurer's Office in many ways. The Treasurer appreciates the opportunity to provide this report to the Legislative Policy Committee on a regular schedule. If the Committee or its members would care to pursue further these or other STO developments, or any other aspects of the Treasurer's activities, please call the Treasurer at (410) 260-7160 or Chief Deputy Treasurer Bernadette T. Benik at (410) 260-7390.*