STANDARD & POOR'S

FULL ANALYSIS

US$718.455 mil GO bnds state & loc facs ln of 2011, second series

Long Term Rating
AAA/Stable
New

Maryland

Long Term Rating
AAA/Stable
Affirmed

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Maryland

Rationale

Standard & Poor's Ratings Services assigned its 'AAA' long-term rating, and stable outlook, to Maryland's million general obligation (GO) bonds, state and local facilities loan of 20***11, second seri***es. At the same time, Standard & Poor's affirmed its 'AAA' long-term rating on Maryland's parity GO debt outstanding. The outlook is stable.

The rating reflects what we view as the state's:

- Diverse, broad-based economy, which has historically outperformed the national economy;
- Strong wealth and income levels, coupled with unemployment that remains below the national average through economic cycles;
- Long history of prudent fiscal management, including making difficult decisions to restore structural budget balance; and
- Moderate debt burden; enhancing this are a clearly defined debt-affordability model limiting annual issuance and the maintenance of ratios within reasonable limits, including a constitutional 15-year debt maturity schedule.

While Maryland has what we consider a strong diversified economic base, its economy has been negatively affected by the national recession although not as hard as the nation. In 2009, the state sustained its highest job declines during the recession, losing 3.1% of total nonfarm employment. State employment fell 0.4% in 2010, contributing to a negative employment growth rate of 0.3% in the past five years, which is half the nation's decline. The hardest hit sectors were construction and the manufacturing, finance, and information sectors. The only major industries to add jobs in this period were education and health services, and government.

The state's unemployment rate in this period, while rising each year, has steadily been below the national average. In 2010, Maryland recorded an unemployment rate of 7.5% compared with the nation's 9.6%. Its economic forecast, upon which the fiscal 2012 budget is based, projects an employment growth rate of 1.3% in 2011, 1.6% in 2012, and 1.9% in 2013. The state expects that these estimates will be lowered in September when the Board of Revenue Estimates meets. Recent forecasts (July 2011) from IHS Global Insight Inc. project employment to rise by only 0.2% in 2011, followed by an increase of 1.4% in 2012, and 1.7% in 2013. Similar to the state projections in December 2010, Global Insight was projecting stronger growth patterns. Home prices rose in the third quarter of 2010 for the first time in more than three years, and foreclosure rates appear to have peaked.

Maryland's adopted $13.14 billion fiscal 2011 general fund budget was based on state revenue growth of only 2.6% and spending declining by 2.0%. The budget did not rely on the use of the rainy-day fund, but instead continued to use transfers from other state funds to support general fund spending, federal stimulus monies, and significantly reduced pay-as-you-go capital funding.

Based on the latest state revenue estimates (March 2011), general fund revenues are expected to increase in fiscal 2011 for the first time in three years. All major revenue sources except the corporate income tax will increase. For fiscal 2011, Maryland is now projecting an increase in total general fund revenues of $184 million against the original budget, with income tax increasing by $145 million and sales taxes rising by $41 million, offset slightly by decreases in other categories. State officials estimate the adopted budget for fiscal 2011, on a budgetary basis, to close with a general fund balance of $646.1 million and the revenues stabilization account of the state reserve fund to be $624.3 million. On a combined basis, that represents 9.7% of expenditures, which Standard & Poor's considers to be strong.

The fiscal 2012 adopted budget is based on total revenue sources of $14.81 billion, including ongoing revenues of about $13.9 billion, $249.0 million in transfers from various other funds, and the use of Maryland's estimated fiscal 2011 general fund balance. Ongoing general fund state spending increases to about $14.75 billion, inclusive of $32.4 million of agency reversions. The proposed budget increases the revenue stabilization account of the state reserve fund to $681.5 million but reduces the general fund balance to $56.4 million. On a combined basis, these funds represent 5.4% of spending, which Standard & Poor's considers to be good.

The state is now projecting an $87.3 million drop in the $214.8 million budgeted for fiscal 2012 from video lottery revenues to support education, due to a delay in the opening of one of the casinos. However, Maryland now anticipates that general fund revenues in fiscal 2011 will exceed estimates by an amount sufficient to offset this shortfall and believes it will not affect the estimated fiscal general fund balance as previously described.

The state continues to project shortfalls through fiscal 2015; however, the adopted budget reduces the annual gap in the future.

We consider Maryland's management practices "strong" under Standard & Poor's Financial Management Assessment (FMA) methodology. In our framework, an FMA of strong indicates that practices are strong, well embedded, and likely sustainable.

At the close of fiscal 2010, we viewed state debt ratios as moderate on both a per capita basis and as a percent of personal income. Annual debt service is moderately high, in our opinion, but remains below debt-affordability targets. We believe debt amortization remains rapid, with all GO bonds to be retired in the next 15 years, as the Maryland constitution requires.

In the past three fiscal years, the state's unfunded pension liability has grown significantly, in our view, due to a combination of investment losses and the lack of fully funding the annual required contribution (ARC). The fiscal 2012 budget implemented reforms to Maryland's pension system, which will allow the fund to reach full funding by 2031.

Based on the analytic factors evaluated for Maryland, on a scale of '1.0' as the strongest to '4.0' as the weakest, Standard & Poor's has assigned a composite score of '1.5' to the state.

Outlook

The stable outlook reflects what we view as Maryland's economic strength and historically strong financial and debt management policies. We believe the state has proactively responded to recent structural budget imbalance and we would expect it to continue to 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. Downside risk for the rating includes our view of the potential for significant reductions in federal funding that currently flows to the state. We believe that, absent a timely resolution to the ongoing debt limit negotiations at the federal level, the risks to the state associated with a decline in federal funding could accelerate.

Government Framework

Maryland's constitution requires the state to approve balanced budgets each fiscal year and for its budgets to remain in balance. To help manage its budget and maintain adequate fund balances despite revenue drops, the governor is empowered by statute to adjust spending as needed if the Maryland Board of Revenue Estimates, which meets three times per year, reduces its initial revenue estimate upon which the budget is formulated. Such adjustments might only be made after first providing adequate provision for the payment of the principal and interest on state bonds and notes according to their terms. Maryland has considerable revenue-raising ability and can raise its income and sales tax rates and approve new revenues without voter approval. It also has a fair amount of budgetary flexibility regarding its expenditures. By law the governor has the power, with the approval of the Board of Public Works, to reduce by not more than 25%, any appropriation that he might deem unnecessary, except appropriations for the payment of interest and the retirement of state debt, the legislature, the public schools, the judiciary, and the salaries of both public officers and permanent employees. When needed, the state has adjusted agency spending accordingly. Education aid is Maryland's largest expenditure item and accounts for about 50% of general fund expenditures in 2011.

Standard & Poor's assigned a score of `1.4' out of `4.0' to Maryland's government framework, where `1.0' is the strongest score and `4.0' the weakest.

Financial Management: 'Strong'

We consider Maryland's management practices "strong" under Standard & Poor's Financial Management Assessment (FMA) methodology. In our framework, an FMA of strong indicates that practices are strong, well embedded, and likely sustainable. Based on a review of several key financial practices, Maryland has made continuing efforts to institutionalize sound financial management practices. In reviewing its practices and policies, it was very apparent to us that the state's use of a five-year financial plan, which is updated annually with the adopted budget, provides the basis for future fiscal decisions and recognizes future fiscal year gaps. Monthly monitoring and reporting of key revenues allows the state to make midyear financial adjustments, if necessary, to maintain balance. Maryland has consistently maintained its statutory rainy-day fund at or above its legal minimum of

5% of revenues. Under current law it can be increased to 7.5%. The state has a formal debt-management policy based on defined measurements, including debt as a percent of personal income and debt service to revenues, along with a statutory debt amortization schedule. Maryland produces a five-year capital improvement plan that outlines expected capital requirements and identifies funding sources. Its investment practices are conservative and actively adhered to.

Once the budget is approved, the state monitors both revenue and expenditure performance on a regular basis and reports results in addition to an economic update. Budget adjustments have historically been implemented regularly on a timely basis. The governor has the authority to make adjustments to the budget and has a track record of doing so. Deficits can't be carried forward into the next fiscal year.

On a scale ranging of '1.0' (strongest) to '4.0' (weakest), Standard & Poor's assigned a '1.0' to Maryland's financial management.

Economy

Maryland's economy enjoys several fundamental strengths in Standard & Poor's view, including a diversified base that historically has expanded at a healthy pace. Although the state has been affected by the recession, we believe the basic underpinnings of the economy will provide for adequate growth prospects into the future. Maryland has exhibited stable population growth trends that have been in line with the national growth average in the past five years. Its population stood at 5.7 million in 2010; up 6.8% since 2001. Other features of the state's economy are a relatively low age-dependency ratio (56.0%), an above-average per capita gross state product (108% of the nation), and a per capita income that is what we consider a strong 122% of the U.S.

The professional, business, education, and health services sectors, combined, make up the single largest job segment, with 31.4% of the state's total nonfarm employment in 2010. The government sector makes up 19.7% of employment followed by trade, transportation, and utilities (17.3%); leisure and hospitality (9.5%); and construction (5.9%). Manufacturing makes up only 4.5% of the employment base, which is well below the national average of 8.9%. Maryland's employment base has sustained significant construction job losses in the past three years, bringing it more in line with the national average in this area. In 2010, the state saw a leveling off in this sector. Through the recession only education, health services, and the federal government consistently added jobs. These major sectors increased employment 8.1% (education and health services, combined) and 9.7% (federal government), respectively, since the start of the recession, adding almost 43,000 jobs. The state has historically enjoyed an unemployment rate that is consistently below the national average.

Maryland promotes economic development with state programs that encourage job growth as do local governments through their individual efforts. For some time, the presence of the federal government in the state has served to stabilize the economy and provide a permanent boost in terms of both jobs and income as the Base Closure and Realignment Commission (BRAC) process continues. The state estimates that more than 21,400 military and civilian jobs will be moving into Maryland, with the bulk of those jobs coming within the first nine months of 2011. While this will have a positive effect on employment, it will have a proportionately higher impact on wage growth because these jobs are predominantly high education and high technology jobs with an average salary approaching or exceeding $90,000 annually. Adding to this is the continued expansion by the National Security Agency at Fort Meade, including the newly created U.S. Cyber Command.

The outlook for economic growth is favorable, in our opinion, and the state expects to regain positive employment growth beginning in 2011.

On a scale ranging of '1.0' (strongest) to '4.0' (weakest), Standard & Poor's assigned a score of '1.1' to Maryland's economy.

Budgetary Performance

By the close of fiscal 2008, Maryland's general fund unreserved balance stood at a $1.50 billion with its reserve fund balance at slightly more than $720 million. On a combined basis, these reserves totaled $2.22 billion. Fiscal 2009 ended with a $1.3 billion general fund operating deficit, reducing the total general fund balance to $1.5 billion on an audited basis. The state's general fund unreserved balance declined significantly, in our opinion, to $146.9 million in fiscal 2009. However, Maryland's reserve fund balance stood at nearly $702 million in that fiscal year. On a combined basis, these reserves totaled $848.7 million. We believe that, while these reserves were dramatically reduced, they were still an adequate 3.6% of expenditures. The state recorded a further decline in total fund balance to $1.25 billion in fiscal 2010 as the general fund recorded a $260.8 million operating deficit. The unreserved general fund balance turned negative $341 million and Maryland's state reserve fund balance decreased to $614.6 million. On a combined basis, these reserves dropped slightly more than $575 million to $273.6 million. However, in our view, combined available reserves remained adequate.

On a budgetary basis, the fiscal 2010 general fund balance closed at $344 million and the revenues stabilization account of the state reserve fund was $611.6 million, which is 5% of estimated general fund revenues. On a combined basis, Maryland's budgetary reserves totaled nearly $956 million or 7.8% of general fund revenues, which we consider good.

Fiscal 2011 adopted budget

The state's adopted fiscal 2011 general fund budget is based on total revenue sources of $13.35 billion, including ongoing revenues of nearly $12.7 billion, $367 million in net revenue adjustments, the largest increase of $363 million in gas and motor vehicle account receipts, and $153 million in transfers from various other funds. Included in those transfers is $112 million proposed to come from capital-related accounts, including $45 million from the Bay Restoration Fund and $54 million in transfer tax.

Ongoing spending will decline to about $13.14 billion in 2011, a decrease of $286 million (2%) from fiscal 2010. This budget would be the second consecutive one to provide for a negative spending affordability growth rate. To achieve a balanced budget, Maryland instituted certain cost-saving measures including:

- $82.2 million in personnel actions;
- $156 million from funding intercounty connector payments with bond proceeds;
- $23 million from level funding aid to community colleges;
- $19 million from level funding police aid;
- $17 million from increasing nursing facility assessments, and
- $14 million from reducing aid to private colleges and universities.

The fiscal 2011 adopted budget, on a budgetary basis, is currently estimated to close with a $646.1 million general fund balance and a $624.3 million revenue stabilization account of the state reserve fund, which is 4.7% of estimated general fund revenues. On a combined basis, Maryland's usable reserves would total $1.27 billion, or 9.7% of general fund revenues.

Fiscal 2012 adopted budget

On April 8, 2011, the state enacted the budget for fiscal 2012. The adopted budget closed a $1.4 billion general fund budget gap and reduced the structural deficit to $1.1 billion from $2.0 billion. The adopted budget reduced the gap by several measures, including cutting state agency spending by $516 million, pre-funding education aid ($124 million), implementing $124 million in retirement and health benefit reforms, and redirecting $319 million in existing revenues.

The adopted budget is based on revenue sources of $14.81 billion, including total revenues of about $13.9 billion, and $249 million in transfers from various other funds, which was well below the prior-year level. Included in those transfers is $191.3 million from capital-related accounts. Ongoing general fund state spending increases to about $14.75 billion, including $32.4 million of reductions. State general fund spending increases by 11.2% above fiscal 2011 levels; however, when federal funds that were used in fiscal 2011 and no longer available to support general fund spending are considered, the growth rate is slightly more than 2.0%. The proposed budget increases the revenue stabilization account of the state reserve fund to $681.5 million but reduces the general fund balance to $56.4 million. On a combined basis, these funds represent 5.4% of spending, which we consider to be good.

The Board of Revenue Estimates projected revenues are budgeted to increase $435.1 million above anticipated fiscal 2011 levels to nearly $13.6 billion; an increase of 3.3%. Total revenues are budgeted at $13.9 billion, about $687 million above fiscal 2011 levels. Income taxes, the largest revenue item (52.5% of total revenues), are estimated to increase nearly 5.2% to $7.31 billion. The sales tax, inclusive of redistributions, is estimated to be 12.3% higher than projected fiscal 2011 levels. Franchise, excises, licenses, and fees are budgeted to decline by 6.5%, while lottery receipts ($503.5 million) are estimated to be $11.0 million better than the previous year's receipts.

Public education, the leading expenditure category, is budgeted at $7.22 billion, making up nearly 49% of expenditures. Public health, which amounts to about $4.02 billion in fiscal 2012, accounts for 27.3% of state fiscal 2012 spending. Public safety is budgeted to increase 5.4% from fiscal 2011 levels.

Standard & Poor's assigned a score of '1.2' out of '4.0' to Maryland's budgetary performance, where `1.0' is the strongest and `4.0' the weakest.

Debt And Liability Profile

The state's tax-supported debt was about $9.4 billion at the close of fiscal 2010, an increase of 44.7% from fiscal 2006. In our view, the tax-supported debt burden is moderate by all measures at $1,616 per capita, 3.3% of personal income, and 3.6% of gross state product. Debt service represents about 6.9% of state revenues, which we consider moderately high. However, tax-supported debt is amortized rapidly, with all GO bonds to be retired in the next 15 years, as required by the Maryland constitution. The Capital Debt Affordability Committee recommended to the governor and legislature a debt authorization of $925 million in fiscal 2012, down from $1.14 billion authorized in fiscal 2011. State-supported debt levels are projected to remain within the limitations established for debt to personal income (4%). The limit for debt service as a percent of revenue remains at 8% or lower.

As of June 2010, the state pension system was 64.1% funded, which we consider to be below average. The system has experienced a reduced funded ratio annually in the past five years. At June 2006, the funded ratio was 82.8%. Like many pension funds, the investment of the retirement and pension system has been affected by the stock market decline. As of June 2010, the actuarial value of the assets was $34.7 billion, down from $39.5 billion in fiscal 2008.

While still meeting the requirements of state law, Maryland has failed to fully fund its ARC rate in each of the past three fiscal years. In fiscal 2010, the state funded 84.5% of its ARC but its fiscal 2011 adopted budget reduces the ARC funding to 72.6%. The adopted fiscal 2012 budget increased the funding level but it still remains below required levels. In our view, both the state's ratio of unfunded pension liabilities per capita and personal income are below average at $3,403 and 7%, respectively.

The adopted 2012 budget plan includes reforms to the Teachers' and Employees' Pension System. The approved reforms affect both current and new employees. For both current member as of June 30, 2011, and new hires after that date, the contribution rate will increase to 7.00% from 5.00% and the cost of living adjustments will be capped at 2.50% if the assumed rate of return (7.75%) for investments in the previous year is achieved and 1.00% if it is not met.

For new employees, the annual benefit multiplier will be 1.5% and average final compensation will be calculated using the highest five consecutive years. An employee must have 10 years of service required before being vested. Normal service retirement age will be raised to age 65 from 62; however, members could retire if the sum of age and eligibility service equals 90 and receive full benefits. Early retirement age will be raised to age 60 and 15 years of eligibility service from 55.

The enacted reforms are expected to raise the state funded ratio to 80% by 2023, three years sooner than currently projected. The actuary also projects the system will reach nearly full funding by fiscal 2031.

As of June 30, 2010, the actuarial accrued other postemployment benefits (OPEB) unfunded liability was $16 billion. The ARC was estimated at nearly $1.2 billion in fiscal 2010. Maryland's general fund has historically provided for 60% of the annual pay-as-you-go costs of OPEB. Chapter 355 of the Laws of 2007 created the Postretirement Health Benefits Trust Fund (trust fund) as an irrevocable trust. In fiscal 2010, $3.4 million in state funds was transferred to the trust fund. The amount held in trust for OPEB as of June 30, 2010, was $167.9 million.

The adopted 2012 budget implemented changes to employee and retiree prescription drug and health benefits that are estimated to decrease the state's OPEB liability to $9.2 billion. The new program increased employee and retiree prescription drug copayments and increased retiree premium payments and out-of-pocket maximums. New employees will require 10 years of service to be eligible for retiree health benefits and 25 years of service to receive a full state subsidy. Retirees will be required to enroll in Medicare Part D effective July 1, 2020, after the Part D coverage gap is phased out.

Standard & Poor's assigned a score of '2.8' out of '4.0' to Maryland's debt and liability profile, where `1.0' is the strongest and `4.0' the weakest.

Related Research

USPF Criteria: State Ratings Methodology, Jan. 3, 2011