

MOODY'S

INVESTORS SERVICE

New Issue: Moody's assigns Aaa to Maryland's \$475M GO bonds; outlook negative

Global Credit Research - 11 Jul 2013

\$10.7 billion of net tax-supported debt outstanding

MARYLAND (STATE OF)
State Governments (including Puerto Rico and US Territories)
MD

Moody's Rating

ISSUE	RATING
General Obligation Bonds State & Local Facilities Loan of 2013, Second Series B	Aaa
Sale Amount	\$40,000,000
Expected Sale Date	07/24/13
Rating Description	General Obligation

General Obligation Bonds State & Local Facilities Loan of 2013, Second Series A	Aaa
Sale Amount	\$435,000,000
Expected Sale Date	07/24/13
Rating Description	General Obligation

Moody's Outlook

Opinion

NEW YORK, July 11, 2013 --Moody's Investors Service has assigned a Aaa rating to the State of Maryland's General Obligation State and Local Facilities Loan of 2013, Second Series. The borrowing consists of \$435 million in tax-exempt bonds (Second Series A) and \$40 million in taxable bonds (Second Series B) to finance various capital projects. The bonds are expected to be sold competitively on July 24.

SUMMARY RATING RATIONALE

The highest quality rating reflects Maryland's strong financial management policies and stable economy with high personal income levels. The rating also acknowledges the state's above average debt burden and large unfunded pension liabilities relative to the size of its economy. The negative outlook reflects the state's indirect linkages to the weakened credit profile of the US government.

STRENGTHS

- History of strong financial management
- Strong economy with high personal income levels
- Adequate reserve levels despite recent draws

CHALLENGES

- Continuing budget pressure
- Low retirement system funded levels

-Above average debt burden

-Reliance on federal jobs in era of retrenchment

DETAILED CREDIT DISCUSSION

SPENDING GROWTH EXCEED REVENUE GROWTH IN FISCAL 2014

The fiscal 2014 enacted budget increases general fund spending 3.7%, from \$15.1 billion to about \$15.7 billion. The increase primarily reflects additional appropriations for higher education, employee salaries and fringe benefits, local education aid and capital spending.

Partly offsetting additional spending for these initiatives, the state adopted a 2.5% cap on the growth of most human service provider reimbursement rates. The budget also reflects savings from slowed Medicaid enrollment trends, the implementation of the Affordable Care Act and miscellaneous savings on state operations.

The March Board of Revenue estimate projected fiscal 2014 revenue to slow to 2.4% from the 4.9% pace set in fiscal 2013, lagging spending growth. The slower growth rate is partly due to the acceleration of capital gains that occurred late in calendar year 2012 as taxpayers responded to an anticipated increase in federal income taxes. As a result, capital gains realizations and other activity were shifted from future years into fiscal 2013, artificially increasing state tax revenue collections for that year and decreasing revenue projections in subsequent years. In addition, the enactment of a personal income tax increase boosted the 2013 growth rate.

The slower growth also echoes the moderation of economic growth in calendar year 2013 resulting from the impacts of federal fiscal tightening. Personal income is expected to grow 2.8% in 2013, compared to 4.1% in 2012 and projected growth of 4.9% in 2014. Similarly, the state's forecast for employment growth dips from 1.2% in 2012 to 0.9% in 2013, then resumes a faster pace in 2014. These factors have contributed to sluggish sales tax collections.

The gap between spending and revenue growth is made up by a number of recurring and non-recurring actions, including redirection of \$411 million of transfer tax revenues to the general fund over five years, with \$89 million projected for fiscal 2014. The state also has postponed or cancelled \$100 million in repayments from the general fund to other state funds to later fiscal years and will draw down its cash balance from \$558 million at the end of fiscal 2013 to \$294 million at the end of fiscal 2014.

Over the longer term, the state expects the pace of revenue growth to pick up and spending growth to moderate. The Executive Budget projected annual average total general fund revenue growth of 4.1% and spending growth of 3.5% from fiscal 2014 to fiscal 2018. The state is benefiting from favorable trends in health care costs, including more moderate growth of the Medicaid program, which state cost-containment efforts, enrollment and utilization trends have helped to trim.

SMALLER STRUCTURAL IMBALANCE WILL LINGER UNTIL 2017

By its calculations, the state has reduced the structural imbalance to \$172 million in fiscal 2014, a significant decrease from \$1.264 billion in 2011. A personal income tax increase on high-income individuals, the transfer of certain teacher pension costs to local governments and assorted reductions to state operating costs are recurring actions that have contributed to the decrease in the structural gap. The gap emerged about a decade ago when the state enhanced education aid without putting offsetting revenues in place and continued as the state struggled with the impacts of the recession. Under current projections, the gap will not be eliminated until fiscal 2017.

REVENUE HIT EXPECTED FROM FEDERAL CUTS

Maryland has a high concentration of federal employment and is susceptible to the impacts of federal budget reductions. The enacted state budget incorporates assumed a negative impact of \$194.5 million for fiscal 2013 and 2014. However, this captures the impacts of a partial sequestration, while Congress has not so far mitigated the impacts of full sequestration. Indeed, earlier this week the Department of Defense began to implement furloughs of its civilian workforce, which in Maryland reflects 1.4% of the state's total employment, according to department figures. Those employees will average 11 nonpaid furlough days before the end of the federal fiscal year, and their decreased disposable income will negatively affect the state's sales tax collections. As a cushion against additional impacts of federal actions, the legislature has deposited \$97 million in a dedicated purpose account that can be used with legislative review only to support programs affected by sequestration. Most of this amount has been diverted from \$300 million in extra pension payments that are meant to accelerate the reduction of the state's unfunded accrual pension liabilities. To the extent that pension funds are not required to offset sequestration

impacts, the governor may transfer the funds to the pension system.

STATE'S RESERVES OFFSET BY NEGATIVE FUND BALANCE

Maryland ended fiscal 2012 with a rainy day fund balance of \$672 million, nearing a target 5% of general fund revenues. The Revenue Stabilization Fund (RSA) account is anticipated to be \$701 million as of the close of fiscal 2013. The governor's budget had allocated funds to bring the RSA balance to \$921 million, or 6% of revenues, at the end of fiscal 2014 but the enacted budget brings the account to \$768 million, maintaining a 5% reserve. If the state achieves its projected year-end cash balance of \$294 million it will end fiscal 2014 with just more than \$1 billion in budgetary reserves.

On an audited basis, however, the state's available balances have dwindled. The state's unassigned fund balance - those funds that are not otherwise restricted or committed - has been negative in the two years that the state has reported under new reporting standards required by the Governmental Accounting Standard Board's (GASB) Statement no. 54. Unassigned balances deteriorated from -\$292 million at the end of fiscal 2011 to -\$681 million at the end of fiscal 2012. This amount is just offset by the amount in the RSA, leaving the state's GAAP-basis net available funds at zero at the close of fiscal 2012. Negative balances for uncommitted funds are atypical of Aaa-rated states except during recession. We anticipate that Maryland's reduction of its structural deficit and adjustment to the loss of ARRA funds will reverse the negative trend.

MARYLAND ECONOMIC RECOVERY FACING FEDERAL HEADWIND

Maryland's economic recovery continues to lag behind the nation, but the gap is closing in 2013. In 2012, national employment growth averaged 1.7% compared to Maryland's 1.3% pace and the state's per capita personal income growth of 2.6% fell just short of the nation's 2.7% gain. May 2013 data indicates employment growth for Maryland and the nation at 1.4% and 1.6%, respectively, versus the same period last year. The state's unemployment picture is better than the nation's, with the rate registering 6.7% in May 2013, compared to 7.6% nationwide.

In the past year, the state's job gains have been concentrated in business and professional services, health and education, leisure and hospitality and financial activities. Employment in both manufacturing and the information sectors has declined. federal employment growth has stalled.

Based on the large federal presence in Maryland, the state's economy is exposed to federal deficit reduction measures. Federal jobs account for more than 5% of Maryland employment, compared to just more than 2% nationally, and account for 9.9% of total wages. After gaining federal jobs over several years because of the relocation of military personnel under the Base Realignment and Closure process, which consolidated certain defense operations in Maryland, federal job levels peaked in September 2011 and have since dropped 2.4%. Additionally, defense and non-defense federal procurement reflects nearly 8.9% of Maryland's gross domestic product compared to the national average of 3.4%.

With a population of just 5.9 million, Maryland's 2012 per capita personal income of \$51,971 is significantly higher than the national average of \$42,693. The gap between the state's personal income per capita and the nation's widened significantly since 2000. In addition to a large percentage of well-paid residents employed by the federal government, Maryland has an economic concentration in industries such as information and business and professional services, where college and advanced degrees are more frequently required than in some other sectors.

STATE HAS HIGH DEBT BURDEN BUT RAPID AMORTIZATION

Maryland's debt levels relative to 50-state medians are high. Moody's 2013 State Debt Medians ranks Maryland eighteenth for debt as a percent of personal income and fourteenth on a per capita basis. The state's debt burden has historically remained within the recommendations of its Capital Debt Affordability Committee, which advises limiting total debt to within 4.0% of personal income and debt service to within 8% of revenues.

Somewhat offsetting the credit impacts of its high debt burden, Maryland's constitution requires a rapid 15-year amortization of tax-supported debt. This policy increases debt service as a percentage of revenues, but also quickly replenishes the state's debt capacity and helps restrain growth in the outstanding balance.

MARYLAND GRADUALLY REDUCES PENSION BURDEN

The financial condition of Maryland's retirement system represents a credit challenge for the state. Based on the state's fiscal 2011 pension data, we have calculated that its adjusted net pension liability (ANPL) was 99% of revenues. This amount is more than double the 2011 50-state median ratio of ANPL to revenues of 45.1% and

places Maryland's ANPL to revenues tenth highest of the states. Another measure of pension burden is the state's annual amortization amount, as calculated under our adjustments, over a 20-year period. As a share of revenues, Maryland's annual pension amortization amount is 8%, compared with a 50-state median of 3.6%. Our adjustments to reported state pension data include the common 20-year amortization period, as well as an assumed 13-year duration of plan liabilities and a market-based discount rate to value the liabilities, rather than the long-term investment return used in reported figures. Our adjusted liability amounts currently exclude the state's two smaller plans, for legislators and judges

Contributing to the state's large net pension liability are asset losses associated with the financial crisis and the enactment in 2002 of a corridor funding method that results in contributions that are less than actuarially required when the pension system has a funded ratio of less than 90%.

The state has taken a number of measures to reduce its pension burden. Reforms in 2011 to both pension and retiree health (OPEB) plans reduced the pension liability by more than \$400 million and halved the OPEB liability. The pension reform was coupled with statutory requirements to allocate a portion of the resulting annual savings to make additional payments to the plan. (As noted above, a portion of these savings are instead being reserved in 2014 to address impacts of federal sequestration.) In 2012, the state enacted legislation to shift over four years the responsibility for paying the normal cost of teacher pension to local governments, saving roughly \$100 million in the first year of implementation.

In the 2013 legislative session, the General Assembly enacted a bill to phase out the corridor funding method over a 10-year period by increasing the rate at which contributions increase. To offset the additional annual cost, the legislation combines the various amortization schedules associated with previous years' incremental unfunded liabilities into one schedule that will amortize over a single 25 year period. This stretches the existing unfunded liabilities considerably and will result in overall additional interest costs to the state. However, this outcome is mitigated by the return to the practice of fully funding the state's required contribution which will result in a more soundly funded pension system in the long run.

OUTLOOK

Moody's negative outlook on Maryland's Aaa rating is due to its indirect linkages to the weakened credit profile of the U.S. government. The negative outlook relates to Moody's August 2, 2011 decision to confirm the Aaa government bond rating of the United States and assign a negative outlook, and to our most recent February 5, 2013 assessment of the state's exposure to indirect linkages to the federal government. Moody's has determined that issuers with indirect linkages, such as Maryland, have some combination of economies that are highly dependent on federal employment and spending, a significant healthcare presence in their economies, have direct healthcare operations, and/or high levels of short-term and puttable debt. After calculating these quantitative metrics, Moody's determined that Maryland had above-average exposure to federal employment and spending. Please see the special comment from February 5, 2013 entitled "Update: Ratings of Aaa Municipal Credits Indirectly Linked to the US Government" for more information.

WHAT COULD MAKE THE RATING GO DOWN

- Economic and financial deterioration that results in deficits and continued draw downs of reserves without a plan for near-term replenishment
- Failure to adhere to the state's tradition of conservative fiscal management, including taking actions to reverse its negative fund balance
- A state economy that does not rebound in tandem with the rest of the country
- Failure to adhere to plans to address low pension funded ratios
- Downgrade of the US government

RATING METHODOLOGY

The principal methodology used in this rating was US States Rating Methodology published in April 2013. Please see the Credit Policy page on www.moody's.com for a copy of this methodology.

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