FITCH RATES MARYLAND'S $1.2B GOS 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-19 February 2015: Fitch Ratings assigns an 'AAA' rating to the following state of Maryland (the state) general obligation (GO) bonds, state and local facilities loan of 2015, first series, consisting of:

--$518,000,000 first series A tax-exempt bonds (competitive);
--$750,000,000 first series B tax-exempt refunding bonds (competitive).

The par amount of the refunding bonds is subject to change. The sale will take place on March 4.

The Rating Outlook is Stable.

SECURITY

The bonds are general obligations to which the state's full faith and credit are pledged.

KEY RATING DRIVERS

CONSERVATIVE FINANCIAL OPERATIONS: Financial operations are conservative, and the state maintains a well-funded rainy day fund. The state took repeated action during the course of the last recession to address projected budget gaps, including raising tax revenues, cutting spending, and using rainy day and other balances.

STRONG DEBT MANAGEMENT: Debt oversight is strong and centralized, and the debt burden is moderate. The state has policies to maintain debt affordability, and the constitution requires GO and transportation bonds to amortize within 15 years.

PENSION FUNDING REFORMS: Pension funding levels have deteriorated, although the state has undertaken extensive reforms to pensions and other post-employment benefits to improve funding levels.

BROAD ECONOMY: The state has a diverse, wealthy economy, benefiting from its proximity to the nation's capital.

RATING SENSITIVITIES

CONTINUATION OF CURRENT PRACTICES: Sound fiscal management practices and the consistent maintenance of fiscal flexibility (including budgetary reserves) provide the state with significant ability to respond to near-term economic or fiscal conditions, such as federal budget reductions, in a manner consistent with the 'AAA' rating.

CREDIT PROFILE

The 'AAA' rating on Maryland's GO bonds reflects its sound financial operations, a wealthy, diversified economy and strong management of debt. The state's economy has long benefited from proximity to the nation's capital, although the prospect of federal budget austerity poses a degree of uncertainty for the state given its large federal agency presence and associated private contracting.

Despite this risk and the generally slow pace of economic recovery, the state's diverse and wealthy service-oriented economy remains a source of credit strength.

The state's approach to fiscal management has been consistently conservative both through the last recession and during the recovery, with the state relying on spending cuts, revenue increases and the use of non-recurring resources to maintain balance. Maryland retains ample fiscal flexibility, including a well-funded rainy day fund. Although pension funded ratios are weak, the state has undertaken multiple reforms to return to full funding over time.

WEALTHY, DIVERSE ECONOMY

Maryland's economy is wealthy and diverse, and continued to expand in recent years despite the drag posed by federal austerity, which remains an ongoing risk to state economic performance. December 2014 employment rose 0.8% year-over-year, compared to 2.3% nationally.

Job gains in December were spread across multiple sectors, including in education and health, professional and business services, and financial activities. Total government employment continues to decline, with recent growth in federal employment breaking a two-year trend of declines, even as state and local employment continues to fall. The state's unemployment rate, at 5.5% in December 2014, was just below the 5.6% national average for the same period. Measured on a per capita basis, Maryland's 2013 personal income ranks fifth among the states, at 120% of the U.S. level. Personal income growth has strengthened in the last three quarters after weakness in late 2013; third quarter 2014 personal income grew 3.7% in Maryland, nearly matching the 3.9% rate for the U.S. overall.

The state's December 2014 economic outlook appears conservative, with modest estimated gains in 2014 after a much weaker 2013 performance. Forecast gains accelerate in 2015 and beyond but remain slow in part due to the ongoing effects of federal austerity. In 2015, employment is forecast to rise 1.1% and personal income 3.8%, ahead of the corresponding estimates for 2014 at 0.7% for employment and 3.3% for personal income.

CONSERVATIVE FINANCIAL OPERATIONS

Financial operations are conservatively maintained, with the state consistently demonstrating a strong commitment to budgetary balance through the downturn and the slow recovery that has followed. The state has maintained flexibility in the form of its rainy day fund (RDF), which remained funded at or near 5% of general fund revenues through the downturn, as well as its practice of responding quickly to changing budgetary circumstances through repeated spending cuts, fund balance transfers and revenue increases.

As of June 30, 2014 (the end of fiscal 2014), the general fund ending balance was $147.5 million (1% of general fund revenues), and the RDF balance was $763.5 million (5.1%). The state's fiscal 2015 fiscal performance has been weaker than anticipated at the start of the fiscal year, but consistent with longstanding practice the state has taken quick balancing actions and the governor's executive budget for fiscal 2016 outlines additional actions to maintain balance through the current year.

The board of public works (BPW), which consists of the governor, treasurer and comptroller, and has broad powers including to cut spending mid-year, implemented $83 million in reductions at the start of the fiscal year. Since then, forecast revenues were lowered a cumulative $300 million in the September and December 2014 forecasts, and appropriation deficiencies of $310 million have emerged, most notably due to higher Medicaid costs associated with federal health care expansion and prescription drug costs.

The governor's executive budget identifies a fiscal 2015 baseline gap of $423 million, with proposed solutions totaling $459 million largely consisting of cuts to agency spending and targeted cuts in

Medicaid, as well as a $100 million loan from the local income tax reserve to be repaid at the start of fiscal 2016. The BPW already implemented $198 million of the cuts in early January, with remaining actions subject to legislative agreement. The state currently forecasts fiscal 2015 ending with a narrowly positive general fund balance of $36.7 million (0.2% of general fund revenues), while the RDF remains fully funded at $786.1 million (5% of revenues).

The state's executive budget for fiscal 2016 is currently under legislative deliberation. As of the December 2014 forecast, general fund revenues are expected to rise 3.5%, to $16.2 billion, with income taxes rising 5.7%. The governor identified a baseline gap of $802 million in his executive plan, which includes revenue revisions and the continuing impact of the Medicaid spending trends noted earlier. Proposed solutions total $842 million. As with fiscal 2015 mid-year actions, the governor's proposal focuses primarily on baseline spending cuts, notably to Medicaid, local education aid and employee compensation. The plan forecasts fiscal 2016 ending with a narrow balance of $47.3 million (0.3% of revenues) and a fully funded RDF at $814.1 million (5% of revenues).

STRONG DEBT MANAGEMENT

The burden of Maryland's total tax-supported debt is moderate, and its strong and centralized debt management remains a credit strength. Fitch calculates net tax-supported debt as of Dec. 31, 2014 of approximately $11.9 billion, or 3.7% of 2013 personal income; these figures include the new money portion of the current sale. About three-fourths of tax-supported debt is GO bonds. GO and transportation bonds are constitutionally required to mature within 15 years, ensuring rapid amortization. Debt affordability guidelines include holding tax-supported debt at or below 4% of personal income.

On a combined basis, net tax-supported debt and pension liabilities attributable to the state as of Fitch's May 2014 state pension update report were estimated at about 10.7% of 2013 personal income, above the states' median of 6.1%.

PENSION FUNDING LOW BUT IMPROVING

The funding for the state's largest pension obligations - covering state employees and teachers - has begun to improve after a decade of weakening that resulted from an actuarial contribution methodology now being phased out and market losses in the last downturn. On an actuarial basis, funded ratios as of June 30, 2014 rose to 61.9% for state employees and 70.7% for teachers; the corresponding funding was 59.7% and 65.4% as of June 30, 2010.

Under new GASB pension accounting requirements the state is reporting higher ratios of assets to liabilities. As of June 30, 2014, assets to liabilities measured 69.5% for the employees' system (including certain local employees) and 73.7% for teachers. Using Fitch's more conservative 7% discount rate assumption (compared to the 7.65% used by the system in 2014), the employees and teachers plans would be funded at 64.9% and 62.3%, respectively.

Despite pensions being a comparative credit weakness, the state has taken multiple steps to reduce their burden and improve sustainability over time. These include lowering benefit accruals, requiring higher state contributions to accelerate funded ratio improvement, shifting the normal cost of teacher pensions to local government, and gradually lowering the system discount rate. Reforms include the phase out of the previous contribution methodology referenced above, which began in 2015. Additionally, changes in 2011 to other post-employment benefits are estimated to have reduced the state's OPEB liability to $9.2 billion, from $15.9 billion as of June 30, 2011; the total unfunded OPEB liability as of June 30, 2014 is $8.7 billion.

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In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from IHS Global Insight.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria', dated Aug. 14, 2012;
--'U.S. State Government Tax-Supported Rating Criteria', dated Aug. 14, 2012.

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Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. State Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033