STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

RatingsDirect®

Maryland; General Obligation

Primary Credit Analyst:
Sussan S Corson, New York (1) 212-438-2014; sussan.corson@standardandpoors.com

Secondary Contact:
Robin L Prunty, New York (1) 212-438-2081; robin.prunty@standardandpoors.com

Table Of Contents

Maryland; General Obligation

Credit Profile		
US$750.0 mil go bnds state & local Facs loan (Tax-exempt Refunding Bonds (competitive)) ser 2015B due 08/01/2026		
Long Term Rating	AAA/Stable	New
US$518.0 mil go bnds state & local Facs loan (Tax-exempt Bonds (competitive)) ser 2015A due 03/01/2030		
Long Term Rating	AAA/Stable	New
Maryland GO		
Long Term Rating	AAA/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'AAA' long-term rating, and stable outlook, to Maryland's $1.3 billion general obligation (GO) bonds, state and local facilities loan of 2015, consisting of first series A tax-exempt bonds and first series B tax-exempt refunding bonds.

Standard & Poor's also 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:

- Broad and diverse economy, which has experienced tepid overall growth in 2013 and 2014 due to sequestration and federal budget uncertainty;
- Strong wealth and income levels;
- Long history of proactive financial and budget management, including implementation of frequent and timely budget adjustments to align revenues and expenditures;
- Well-developed financial and debt management policies including long-term financial planning that should be helpful in addressing future budget challenges; and
- Still-moderate debt burden across all measures, despite increasing issuance. Although some growth in debt levels is likely based on planned issuance and the potential for public-private partnership (P3) projects, we expect the debt burden will remain moderate for most measures due to a clearly defined debt affordability process that limits annual issuance, coupled with a rapid 15-year debt maturity schedule as required by the Maryland Constitution.

Maryland's full faith and credit secures the GO bonds.

Although we believe the state's pension-funded ratios are below average and other postemployment benefit (OPEB) liabilities are significant, we believe pension funded ratios should improve following pension and OPEB reform initiatives passed in the previous four years, albeit at a slower pace given recent budgeted reductions to pension funding contributions from previously approved levels.

Maryland faces increasing fiscal pressure in fiscal 2016 due to a slower-than-anticipated pace of economic growth and continued structural budgetary imbalance with some use of reserves in fiscal 2014. Economic reliance on federal spending could also remain a source of budgetary pressure. After the Maryland Board of Revenue Estimates (BRE) revised revenue estimates downward in September by $177 million for fiscal 2015, it lowered its revenue estimates again in December by another $123 million due primarily to lower-than-anticipated personal income tax collections from slower job growth and federal spending cuts. Although the BRE's December general fund revenue forecast for fiscal 2016 reflects an amount $148 million lower than the September estimate, it reflects a projected 3.5% year-over-year growth in overall revenue to $16.2 billion, which we believe is reasonable given economic forecasts.

Given slower-than-anticipated revenue as well as higher-than-anticipated Medicaid enrollment and costs in fiscal 2015, the state faces a $423 million shortfall for fiscal 2015 and an $802 million estimated budget gap for fiscal 2016, or about 5% of budget. Governor Hogan's executive budget proposes solving the fiscal 2015 shortfall primarily with $300 million in budget reductions and a $143 million transfer from other funds, including $100 million from the local income tax reserve fund, which Maryland will need to pay back in fiscal 2016. The executive budget also proposes a fiscal 2016 total general fund budget of $16.3 billion, which reflects 1.5% growth in spending from the previous year after excluding proposed one-time deposits to reserves. The budget proposal aims to restore structural balance in the budget by reducing certain mandated spending through adjusting certain aspects of the kindergarten to grade 12 education funding formula and eliminating a required repayment to the open space fund. The recommended budget also controls spending as it reduces previous employee cost-of-living allowance (COLA) compensation increases, reduces provider rates, and continues state agency reductions. The budget is based on the BRE recurring revenue forecast and also relies on transfer tax revenue and one-time transfers from the revenue stabilization account (RSA) and tax credit reserves. However, the recommended budget also appropriates sufficient amounts to maintain a combined general fund and RSA equal to $861 million, or 5.3% of revenue, which we still consider good.

We expect that Maryland's economic recovery will continue and could accelerate as uncertainties relating to federal fiscal issues moderate. The BRE's current economic forecast projects 1.3% employment growth and 4.1% personal income growth in fiscal 2016. Wage and salary forecasts reflect 4.2% growth. We believe the state's forecast is reasonable based on recent economic trends and generally in line with IHS Global Insight Inc. forecasts that project 1.6% employment growth and 4.3% personal income growth in calendar 2015. Risks to the state forecast include continued uncertainty related to the federal budget or a national economic slowdown. Although federal fiscal policy remains a challenge to the state's budget and long-term financial plan, we believe that Maryland has demonstrated strong revenue and budget monitoring practices with a track record of making expenditure adjustments midyear when required.

We consider the state'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.

The state's debt burden remains moderate on both a per capita basis and relative to personal income and we expect ratios to remain moderate for most measures, given current plans for debt issuance and P3 projects and the annual debt-affordability process. Annual debt service relative to the budget is moderate at 5.3% of governmental expenditures (less federal revenue). The state levies a property tax with receipts credited to a special fund used to help support GO debt service. The state's Board of Public Works fixes the property tax rate each year, which has been set at 11.2 cents per $100 of assessed value since 2007 and generates 81% of the revenues available for GO debt service.

Debt amortization remains rapid, with all GO bonds to be retired in the next 15 years, as the Maryland Constitution requires.

For most of the past 10 years, the state's unfunded pension liability has grown significantly, in our view, due to a combination of investment losses and less than full funding of the annual required contribution (ARC). Various pension reform measures were implemented during the 2011 legislative session that included increased employee contributions and decreased COLA adjustments. In addition, certain benefits were reduced and vesting periods for new employees increased to 10 years from five to improve funding levels. The 2011 reform also required an annual supplemental pension contribution to improve funded ratios until the system is at least 85% funded; however, budgetary pressures in fiscal years 2013, 2014, and 2015 led the state to temporarily reduce these supplemental contributions. Due to these reforms, as well as strong investment returns, the combined pension funded ratios for the state pool improved slightly in fiscal 2014 to 67.7% from 64.6% in fiscal 2013.

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 on Maryland reflects our view of the state's proactive midyear adjustments to align the budget with slower-than-anticipated revenue growth and a proposed fiscal 2016 budget that maintains current reserve levels and limits reliance on one-time measures for budgetary balance. Structural budget alignment and the pace of economic recovery will remain important credit factors over the two-year outlook time horizon given Maryland's above-average economic dependence on federal government employment and spending. Should the state continue to experience economic and revenue trends that fail to meet budget expectations with a reliance on reserves and other one-time sources to cover budget gaps, we could lower the rating. Despite implementation of various reforms and some improvement in funded ratios, the state's below-average pension funded ratios and annual contributions that do not meet the full ARC also continue to represent downside risk to the rating.

Government Framework

Maryland Constitution requires the state to approve balanced budgets each fiscal year and for its budgets to remain balanced. To help manage its budget and maintain adequate fund balances despite revenue decline, the governor is empowered by statute to adjust spending as needed if the Maryland BRE, which meets three times per year, reduces its initial revenue estimate upon which the budget is formulated. Such adjustments can 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 increase 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, although this does not extend to all program areas. 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 public officers. When needed, the state has adjusted agency spending accordingly. Public education is Maryland's largest expenditure item and accounted for about 48% of general fund expenditures in fiscal 2014.

Standard & Poor's assigned a score of '1.4' 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 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 institute sound financial management practices. 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 RSA 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 as a percent of 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. The treasurer provides monthly investment inventory reports on its website and is required to report general fund investments to the general assembly in January of each year.

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 score of '1.0' to Maryland's financial management.

Economy

Maryland's economy enjoys several fundamental strengths in Standard & Poor's view, including strong wealth and income indicators and a diversified base that historically has expanded at a healthy pace. Maryland has exhibited stable population growth that has been in line with the national growth average in the past five years. Its population stood at 5.9 million in 2013, a 0.75% increase compared with 2012. Wealth and income levels have consistently been strong, in our view, with 2013 per capita personal income at 122% of the U.S. levels. We believe the basic underpinnings of the economy will provide for adequate growth prospects into the future but the importance of the federal government to the overall economy and uncertainty related to future federal contracts for certain private-sector employers in the context of the federal budget will likely to continue to affect the pace of growth in the near term. Annual employment growth slowed in 2013 and 2014 to 0.9% and 0.6%, respectively, as a result of federal sequestration and the loss of government jobs, although steady slow growth in private sector employment helped to offset this loss. Slight gains in employment contributed to a decline in the state unemployment rate to 5.5% in December 2014, slightly below the national 5.6% level. Based on IHS Global Insight projections, annual employment growth will pick up in the next two years to about 1.6%, although it will slightly lag national growth forecasts. Maryland's gross state product has also posted less than 1% average annual growth in the previous two years as federal spending has historically comprised a relatively high proportion of output. Predicted annual gross state product growth in 2015 and 2016 improves significantly to 2.7% and 2.3%, respectively; however, state levels are still projected to slightly lag national gross domestic product growth.

The professional, business, education, and health services sectors, combined, continue to make up the single largest job segment, accounting for about one-third of Maryland's total nonfarm employment in 2013. The government sector makes up 19.4% of employment. While a majority is state and local government employment, federal government employment represents 5.6% compared with about 2.0% for the U.S. Trade, transportation, and utilities (17%) as well as and leisure and hospitality (9.8%) are the other major sectors. Manufacturing makes up a minimal 4.1% of the employment base, which is well below the national average of 8.8%. Construction jobs represented 5.7% of state employment in 2013 compared with 7.0% of employment in 2004. The housing market has shown some recovery after the recession as reflected in improving home prices and housing starts in 2013 and 2014.

An established higher education and research presence, favorable location, and a well-educated workforce are among the state's strengths in attracting future economic development. Maryland has offered incentives such as tax credits and venture fund investments to further attract biotechnology companies. Federal research agencies in the state as well as Johns Hopkins University and the University of Maryland also position the state for economic and technology development. State officials also expect the widening of the Panama Canal, once completed in 2016, could be a significant source of future growth for the state.

On a scale ranging of '1.0' (strongest) to '4.0' (weakest), Standard & Poor's assigned a score of '1.4' to Maryland's economy.

Budgetary Performance

Although Maryland has experienced slower-than-expected revenue growth in the past few years, it has adopted a balanced approach to address budget shortfalls, including revenue enhancement, spending reductions, cost shifting to local governments, and use of reserves. The RSA has been consistently budgeted at 5% of revenues and state law requires appropriations to the account depending on fund balance levels and unappropriated general fund surpluses until it reaches up to 7.5% of revenue. In addition to the RSA, the state reserve fund holds balances across three other funds: the dedicated purpose account for multi-year expenditures and contingency requirements, the economic development opportunities account, and the catastrophic event account. On a combined basis, with the RSA and $8.9 million in these other funds, the state reserve fund represented 5.1% of general fund revenue at the end of fiscal 2014. The state has had sufficient cash and has not historically needed to issue short-term notes for cash flow needs. Maryland's BRE regularly forecasts state revenue across a diverse revenue base, with 52% of general fund budgetary revenue coming from personal income and 27% from sales tax revenue. The state has a history of adjusting certain tax rates since 2008 to enhance revenue collections and help accommodate expenditure growth.

Fiscal 2014 GAAP results

On a generally accepted accounting principles (GAAP) basis, Maryland ended fiscal 2014 with a slight $220 million general fund deficit equal to 0.8% of expenditures. Although the total general fund balance of $1.1 billion represented 4.1% of expenditures, the unassigned balance was a negative $916 million, or 3.3% of expenditures. The combined unassigned and committed balance, which includes the state reserve fund, represented $637 million, or 2.3% of expenditures. The total fund balance has steadily declined since peak levels recorded in fiscal 2007 ($3.3 billion).

Fiscal 2015

Estimated general fund revenues in fiscal 2015, based on the December forecast by the BRE and including transfer tax revenue, total $15.7 billion, or 4% higher than fiscal 2014 actuals. Despite year-over-year revenue growth, estimated fiscal 2015 revenues are $300 million lower than originally estimated. The Board of Public Works previously approved budget adjustments to offset a portion of the revenue shortfall; however, the state faces an estimated $423 million budget shortfall driven by more than $300 million in projected budget deficiencies. The majority of the deficiencies are in the Medicaid budget with $200 million of the shortfall due to higher-than-budgeted enrollment as the state expands under the Affordable Care Act, higher-than-expected drug costs driven by a new Hepatitis C drug, and revenue shortfalls in the cigarette restitution fund. Deficiencies in other areas, including public education, total about $110 million. Governor Hogan's budget maintains a previously recommended and approved 2% reduction in agency budgets representing $113 million in savings and proposes using $45 million in special funds to support Medicaid as well as other reductions including to provider rates. A proposed $100 million transfer from the local income tax reserve fund, to be repaid in fiscal 2016, comprises the bulk of the remaining proposed budget solutions for fiscal 2015.

Maryland ended fiscal 2014 with $147.5 million in the general fund balance on a budgetary basis. When combined with $772.5 million in the state reserve fund, the combined $920 million ending balance represents 5.9% of fiscal 2014 appropriations (down from $1.22 billion or about 8.0% of fiscal 2013 appropriations). In fiscal 2015, an additional draw on the fund balance brings the projected ending general fund balance to $37 million, or a combined $827 million, with total estimated state reserve funds equal to 5% of appropriations. We believe that the aggregate reserves still provide the state with the flexibility to manage future budget volatility but we note this flexibility has been diminished following the use of the general fund balance to address a structural budget gap and offset revenue weakness related to sequestration and tax policy uncertainty at the federal level.

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

Debt And Liability Profile

In our view, the tax-supported debt burden at the end of fiscal 2014 is moderate by all measures at $1,881 per capita based on the state's 2013 population, 3.5% of personal income, and 3.3% of gross state product. Debt service represents about 5.3% of state revenues, which we consider moderate; however, we calculate that total tax-supported debt is amortized rapidly, with more than 80% or principal retired in the next 10 years including all GO bonds retired in the next 15 years as required by the Maryland Constitution. The state's net tax-supported debt following this issuance is estimated at about $11.8 billion and we calculate the tax-supported debt burden by all measures will remain moderate. The governor's proposed capital improvement program for fiscal years 2016 through 2020 totals $20.6 billion including $13.3 billion identified for transportation projects and $7.3 billion for general capital. Although the Capital Debt Affordability Committee recommended to the governor and legislature a GO debt authorization of $1.17 billion for fiscal 2016, the proposed budget recommends less than $1 billion in GO debt for fiscal 2016. In addition to planned GO debt, the 2013 legislature approved increasing the statutory debt authorization for transportation bonds to $4.5 billion from $2.6 billion funded with enhanced revenue from annual CPI-adjusted gas tax rates and sales tax equivalent rate increases over a multiyear period. In early 2015, the governor introduced bills to repeal the planned rate adjustments and increases, which if passed, could reduce the capacity for planned transportation projects. However, assuming projected debt issuance includes the $4.5 billion of transportation bonds, the committee projects state-supported debt levels will remain within the committee's affordability criteria, which limits state tax-supported debt to 4% of state personal income and debt service to 8% of revenue.

The Maryland Stadium Authority entered into direct purchase financings for $17.5 million of lease debt outstanding supported by rental payments from sports lottery revenue. Although we believe the terms of the document include contingent liquidity risk related to immediate acceleration of principal, we believe these risks are mitigated by the relatively minimal amount of principal outstanding compared with the state's cash position. In addition, Maryland estimates it has $125 million outstanding in energy performance contract lease financing agreements with various banks for various agencies and universities as of June 30, 2014, which are self-supporting from guaranteed energy savings. Upon our review of representative documents provided, although the agreement provides for the acceleration of the current fiscal year lease payment, there are no provisions that require immediate acceleration of full principal outstanding.

The Maryland State Retirement and Pension System recorded an unfunded actuarial accrued liability (UAAL) of $18.75 billion as of June 30, 2014. After deteriorating for several years, the fiscal 2014 pension funded ratio for the state pool improved slightly to 67.7% compared with 64.6% in fiscal 2013, although we still consider funded levels below average. The liability assumes a rate of return of 7.65%, which is not aligned with the system's 10-year average (6.46%) and 20-year average (7.4%) investment returns, although the average annual return over the previous 25 years was slightly higher at 7.85%. In fiscal 2014, investment performance was strong with a 14.4% one-year rate of return. In 2013, the pension board authorized a phased reduction of the earnings estimate to 7.55% from 7.75% and this is being phased in over four years beginning with fiscal 2013.

Maryland has also historically contributed less than the combined ARC across pension plans for the past five years based on the current statutory funding requirement. In fiscal 2014, the state funded only 73.3% of its combined ARC. The general assembly passed pension reform in 2011 that increased contribution rates, capped COLAs, and increased vesting periods and retirement ages. The reforms provided for supplemental contributions to each system and the general assembly subsequently approved legislation that phased out the current corridor funding method for the teachers and employees systems over 10 years and replaced it with a 25-year closed-end amortization. However, supplemental contributions were reduced in fiscal years 2013, 2014, and 2015. The fiscal 2015 budget reduced the supplemental contribution to $100 million from $300 million in fiscal years 2014 and 2015, with planned $50 million increases to the supplemental contribution in each year beginning in fiscal 2016 until it reaches $300 million in fiscal

2019. Based on the earlier reforms and adjusted for these recent legislative changes, the state's actuary now projects that the system will be 80% funded by 2021 and fully funded by 2039.

As of June 30, 2014, the state employee and retiree health and welfare benefits program unfunded actuarial accrued other postemployment benefits (OPEB liability was $8.7 billion compared with $8.1 billion in fiscal 2013. Although we consider the state's $1,370 per capita liability above-average, Maryland has significantly reduced the overall liability through reforms in 2011 and established an irrevocable trust. In fiscal 2014, the state contributed an annual pay-as-you-go payment representing 69% of the total $580.5 million annual OPEB cost. The updated liability estimate is well below the $15.9 billion UAAL recorded before the health care benefit reforms approved by the general assembly in 2011. The reforms included increased premium payments and prescription drug copayments. The amount held in trust for OPEB as of June 30, 2014, was $250 million.

Standard & Poor's assigned a score of '2.7' to Maryland's debt and liability profile, where '1.0' is the strongest and '4.0' the weakest.

Related Criteria And Research

Related Criteria

- Ratings Above The Sovereign: Corporate And Government Ratings—Methodology And Assumptions, Nov. 19, 2013
- USPF Criteria: Contingent Liquidity Risks, March 5, 2012
- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Financial Management Assessment, June 27, 2006

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Dec. 10, 2014

Ratings Detail (As Of February 19, 2015)		
Maryland go bnds st & local facs loan of 2014 2nd ser B tax-ex bnds due 08/01/2029		
Long Term Rating	AAA/Stable	Affirmed
Maryland go rfdg bnds st & local facs loan of 2014 2nd ser C tax-ex bnds due 08/01/2023		
Long Term Rating	AAA/Stable	Affirmed