

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

Fitch Ratings-New York-24 February 2017: Fitch Ratings has assigned a 'AAA' rating to approximately \$1.2 billion in State of Maryland general obligation (GO) bonds, state and local facilities loan of 2017, first series, consisting of:

- \$575,000,000 first series A tax-exempt bonds (competitive);
- \$100,000,000 first series B taxable bonds (competitive);
- \$524,470,000 first series C tax-exempt refunding bonds (competitive).

The par amount of the refunding series is subject to change pending final sale.

The bonds are expected to be offered via competitive sale on or about March 8, 2017.

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

Maryland's 'AAA' rating reflects its broad, diverse and wealthy economy, extensive budget controls and sound financial operations, and strong management of debt. The state's economy has long benefited from proximity to the nation's capital, although exposure to federal budget cuts poses a greater uncertainty for Maryland given its large federal agency presence and associated private contracting. Fiscal management is very strong, with consensus-oriented long-term planning and multiple sources of flexibility including a consistently solid budgetary reserve and a demonstrated ability to adjust spending to address changing circumstances. Although liabilities are elevated for a state, they are moderate and carefully managed.

Economic Resource Base

Maryland's economy is wealthy, diverse and service oriented. The presence of the federal government in the neighboring District of Columbia has long served as an important anchor to Maryland's economy, with numerous federal agencies, military facilities and contractors supporting the state's solid economic performance. Trade and port activity are likewise significant given the prominence of Baltimore. Economic expansion continues and in fact accelerated in recent years, despite the earlier drag posed by federal sequestration.

Revenue Framework: 'aaa' factor assessment

Maryland's revenue growth is expected to be in line with or above the level of U.S. economic growth, given the state's solid economic base, service-oriented economy and broad tax resources. The state retains unlimited authority to raise operating revenues. Cyclical revenue performance is a risk given both the prominence of personal income tax (PIT) in overall state revenues and the state's exposure to changes in federal spending. However, overall growth prospects for revenues remain strong.

Expenditure Framework: 'aaa' factor assessment

Maryland has a solid ability to change its spending commitments in response to shifting economic and revenue circumstances. Spending pressures from education and Medicaid, among other needs,

have been notable in recent years. Carrying costs for liabilities are above the median for states, partly given the state's extensive role in funding education, including capital and accrued pension liabilities.

Long-Term Liability Burden: 'aa' factor assessment

The burden of net tax-supported debt and unfunded pensions is elevated for a state, but only a moderate burden in relation to the state's resource base. Debt is comprehensively managed. Pensions have been a more significant burden, but the state has implemented multiple reforms to benefits and contribution policies to improve pension sustainability and accelerate funded ratio improvement over time.

Operating Performance: 'aaa' factor assessment

Financial resilience is very strong, with a well-funded budgetary reserve and a willingness to trim spending commitments and increase revenues in response to changing circumstances. Multi-year forecasting and planning are disciplined, including measuring actual performance against structural targets. Consensus-oriented practices ensure steady management of budgetary conditions and liabilities.

RATING SENSITIVITIES

CONTINUATION OF CURRENT PRACTICES: Sound fiscal management practices and the consistent maintenance of fiscal flexibility (including through maintaining budgetary reserves) are expected to provide the state with the ability to respond to near-term economic or fiscal uncertainties in a manner consistent with the 'AAA' rating.

CREDIT PROFILE

Maryland benefits from a diverse, wealthy economy centered on the Baltimore-Washington, D.C. metropolitan area. Services are the dominant sector, including professional and business services, education and health, and government. Trade and transportation are also significant, with notable port activity centered on Baltimore. The state's large federal workforce includes multiple agencies, research institutions and military facilities, and its importance has grown with several rounds of military consolidation undertaken in recent decades. Private-sector activity associated with federal contracting likewise augments the state's service-sector strength.

The state has generally enjoyed high personal income and solid labor market characteristics, including an unemployment rate consistently below the nation's. The state was not spared from the impact of the last recession; however, the drop-off was less severe and the initial recovery was faster in Maryland compared to the nation. State performance during much of the recovery, however, has been slower than national averages, driven in part by federal sequestration and its impact on the federal workforce and on federal contracts. Recent economic gains continue, with quarterly personal income in the third quarter of 2016 exceeding the nation's, although job gains remain slower than those for the nation as a whole.

Revenue Framework

Maryland's revenue framework is very diverse. Personal income is the largest source of general revenues, with sales and corporate income taxes also significant. Transportation receipts are similarly diverse and dedicated to transportation needs. The state also levies a statewide property tax to support general obligation debt.

The state's wealthy, service oriented economy is the basis for a revenue growth profile that while subject to economic cyclicity and federal policy actions, is likely to grow faster than state medians over time. Economic sensitivity is most notable in the component of personal income taxes linked to capital gains.

The state has an unlimited legal ability to raise revenues. It has shown a willingness to change tax policy, including implementing rate increases, in response to changing budgetary circumstances.

Expenditure Framework

Spending commitments are dominated by education and social services. Education spending for K-12, provided via transfers to counties, expanded significantly a decade ago as the state sought to address concerns regarding school funding adequacy. Education spending also includes amortization contributions for local teacher retirement liabilities, capital support, and a large and growing network of higher education institutions. Social services, including for Medicaid, are also a large and growing component of the state's budget.

Consistent with most states, spending is expected to be in line with to marginally above expected revenue growth, driven by social services spending needs. Federal action to revise Medicaid's programmatic and financial structure appears likely, although the magnitude and timing of changes for state budgets remains unknown. Both the new presidential administration and congressional leadership support significant Medicaid policy shifts. As one of the largest parts of state budgets and by far the biggest source of federal funding to the states, federal decisions could have significant implications for states' ability to manage this key budget item.

The state has a solid ability to cut spending. Carrying costs for liabilities, including debt service and pension contributions, are higher than the median for states but remain moderate.

Long-Term Liability Burden

On a combined basis, net tax-supported debt and pension liabilities attributable to the state as of Fitch's 2016 state pension update are above average for a state, measuring 10.1% of personal income, compared to a statewide median of 5.1%. Tax-supported debt, which Fitch calculates at \$13.1 billion, including new bond proceeds, measures 3.9% of personal income. Most debt is constitutionally required to amortize in 15 years, and centralized debt planning and issuance are additional credit strengths. Debt affordability guidelines include holding tax-supported debt at or below 4% of personal income.

Pensions are a comparative credit weakness in Maryland, although the state has taken repeated action since 2011 to reform benefits and made contributions to strengthen funding. Reforms have included lower benefit accruals, higher service requirements, a phased-in decline in the discount rate, ending a contribution methodology that had consistently left actual contributions below actuarial calculations and replacing it with full actuarial contributions, and appropriating supplemental contributions.

Fitch calculates pension liabilities attributable to the state and adjusted for a 7% return at approximately \$21.1 billion. Given the changes implemented to date, Fitch views the prospects for funding improvement to be increased assuming investment performance matches expectations. Additionally, changes in 2011 to other post-employment benefits are estimated to have reduced the state's OPEB liability approximately 40% as measured at the time; the total unfunded OPEB liability as of June 30, 2016 is \$11.8 billion.

Operating Performance

Maryland's financial resilience is exceptionally strong. Historically the state has relied on spending cuts, revenue increases and the use of non-recurring resources, including draws from the revenue stabilization account (RSA; the state's rainy day fund) when confronted with budgetary weakness.

The state has disciplined consensus revenue forecasting and monitoring that identify material changes in the direction of state economic and revenue performance. The Board of Public Works, which includes the Governor, Comptroller and Treasurer, has the power to trim spending during

the year in response to budgetary weakness, and demonstrated this ability repeatedly during the last downturn.

The state routinely budgets to maintain flexibility both in the form of a general fund unencumbered balance and the separate RSA balance, the latter of which has been consistently funded at or near the statutory target of 5% of general fund revenues, including through most of the last downturn. The RSA balance has risen in step with the budget in recent years, and is forecast at \$833 million (5% of general fund revenues) in fiscal 2017 and \$860 million in fiscal 2018.

Recent budgetary performance has been steady, although actual general fund revenues in fiscal 2017 have underperformed earlier estimates, bringing down the outlook for fiscal 2018 collections as well. The current fiscal 2017 forecast, at \$16.6 billion, has been lowered twice since the start of the fiscal year, but remains 2.6% higher than fiscal 2016 actual revenues. Recent collections year-to-date through January are just above prior year levels and just below target. Including legislative actions to cover fiscal 2017 deficiencies and absorb the shifting revenue outlook, the state forecasts a general fund ending balance of \$68.5 million (0.4% of general fund revenues), compared to \$365 million in the adopted budget.

The legislature is currently deliberating the fiscal 2018 budget. The general fund revenue forecast anticipates revenues rising 3.4% in fiscal 2018, to \$17.2 billion. The governor's executive budget proposed savings from Medicaid, delayed employee salary increases and agency reductions, among other actions to address the impact of the lowered revenue growth forecast. Including proposed actions, the fiscal year would end with a general fund balance of \$144 million (0.8% of general fund revenues).

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Date of Relevant Rating Committee: May 25, 2016

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

Applicable Criteria

Rating Public-Sector Counterparty Obligations in PPP Transactions -- Effective January 15, 2016 to July 12, 2016 (pub. 15 Jan 2016)

<https://www.fitchratings.com/site/re/876726>

U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)

<https://www.fitchratings.com/site/re/879478>

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