FitchRatings

Fitch Rates Maryland's $550MM GOs 'AAA'; Outlook Stable

Fitch Ratings-New York-26 July 2019: Fitch Ratings has assigned a 'AAA' rating to the following $550 million State of Maryland general obligation (GO) bonds, state and local facilities loan of 2019, second series:

--$500,000,000 second series A, tax-exempt bonds (competitive);
--$50,000,000 second series B, taxable bonds (competitive).

The bonds are expected to be offered by competitive sale on or about Aug. 14, 2019.

Additionally, Fitch has affirmed the Long-term Issuer Default Rating (IDR) of the State of Maryland at 'AAA' and the following ratings on securities that are linked to the IDR:

--$9.6 billion in outstanding state GO bonds at 'AAA';
--$47.96 million in outstanding bonds issued by the Maryland Department of Transportation and the Maryland Transportation Authority supported by annual state general and transportation appropriations at 'AA+';
--$122.8 million in Maryland Stadium Authority lease revenue bonds at 'AA+';
--the public private partnership (PPP) counterparty obligation rating for the Maryland Department of Transportation's Purple Line PPP Project at 'AA-'.

The Rating Outlook is Stable.

SECURITY

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

Appropriation-backed debt issued by the Maryland Transportation Authority, the Maryland Department of Transportation, and the Maryland Stadium Authority are rated one notch below the state's IDR, reflecting repayment from annual state appropriations.

ANALYTICAL CONCLUSION

Maryland's 'AAA' IDR 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 than for most states 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 relative to resources and carefully managed.

Economic Resource Base
Maryland's economy is wealthy, diverse and service-oriented. The federal government's presence 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 also significant given Baltimore's prominence. Economic expansion continues and accelerated in recent years, after several years of drag caused by federal sequestration. The state anticipates modest deceleration over the next several years, partially driven by weakness in federal employment but also headwinds facing the national economy.

KEY RATING DRIVERS

Revenue Framework: 'aaa'
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. Maryland retains unlimited legal authority to raise operating revenues. Cyclical revenue performance is a risk given both the prominence of individual income tax (IIT) 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'
Maryland has a strong ability to change its spending commitments in response to shifting economic and revenue circumstances. Education and Medicaid remain the largest components of spending. Carrying costs for liabilities remain moderately low but are above the median for states, partly due to the state's extensive role in funding education needs, including for capital and accrued pension liabilities.

Long-Term Liability Burden: 'aa'
The burden of debt and net pension liabilities is elevated for a state but only a moderate burden in relation to Maryland's resource base. Pensions are the more significant burden; however, the state has implemented multiple changes to benefits and contribution policies to improve pension sustainability and accelerate funded ratio improvement over time.

Operating Performance: 'aaa'
Financial resilience is exceptionally 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 MANAGEMENT PRACTICES: The state's IDR is sensitive to continued sound management practices and maintenance of fiscal flexibility, providing the state with the ability to respond to economic or budgetary uncertainties in a manner consistent with the 'AAA' rating.

LINKED TO STATE IDR: The ratings on the various appropriation-backed debt and the public private partnership (PPP) counterparty obligation rating are sensitive to changes in Maryland's IDR, to which they are linked.

CREDIT PROFILE

Revenue Framework
Maryland's revenue framework includes a broad range of tax revenues, with IIT making up the majority of the state's annual general fund revenues. Sales and use taxes are also significant, at approximately one-fourth of general fund revenue. Gaming revenues (approximately $500 million) provide an important source of support for K-12 education spending, and flow through the state's Education Trust Fund. Transportation receipts, most significantly motor fuel taxes, have been reallocated by the legislature at times for general spending, but recent changes tightened the dedication of these revenues for transportation needs. The state also levies a small

statewide property tax to support general obligation debt that flows through the annuity bond fund.

Maryland's wealthy, service-oriented economy is the basis for a revenue growth profile that, while subject to economic cyclicality and federal policy actions, is likely to grow ahead of, or in line with, national economic growth over time.

The state has an unlimited legal ability to raise revenues through rate increases or base broadenings.

Expenditure Framework

Education and social services represent Maryland's largest spending commitments. K-12 education spending, provided via transfers to counties, remains the most significant expenditure item for the state. Education spending also includes amortization contributions for local teacher retirement liabilities, capital support and a large network of higher education institutions. Social services, primarily for Medicaid, are also a substantial and growing component of the state's budget.

Education funding demands will likely escalate over the next several years based on findings from the Commission on Innovation and Excellence (also known as the Kirwan Commission), which was statutorily-empaneled to make recommendations on education policy and funding. As discussed in more detail below, the 2018 and 2019 legislative sessions dedicated significant funding for preliminary Kirwan Commission recommendations. A final report is due at the end of 2019 and will likely call for additional ongoing state spending, as well as increased funding from local governments. NEW PARA Consistent with most states, Fitch anticipates Maryland's spending will be in line with to marginally above expected revenue growth absent offsetting policy action, driven by social services spending needs. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. Federal action to revise Medicaid's programmatic and financial structure appears less likely in the near term given divided control in Congress.

Maryland's carrying costs for liabilities are higher than the median for states but remain well within the state's ability to control given its resources. Debt service is elevated due partially to a constitutional requirement to amortize most tax-supported borrowing within 15 years. Carrying costs also include those for accrued pension liabilities of local teachers, although newly earned benefits are the responsibility of local governments.

The state regularly contributes additional resources to pensions to accelerate funding progress, including both an annual supplemental contribution and a "sweeper" provision to divert a portion of unappropriated surpluses. The sweeper provision was originally scheduled to sunset in 2021. The state waived the sweeper provision for the fiscal 2018 and 2019 budgets but also lifted the 2021 sunset and extended the sweeper indefinitely; when the pension system reaches 85% funding, the statute triggers an analysis of the necessity of maintaining the sweeper provision. These changes also split the sweeper between supplemental pension and OPEB payments beginning in 2021. Since these contributions are beyond the actuarially determined contributions, Fitch does not incorporate them into the carrying cost metric.

Long-Term Liability Burden

On a combined basis, debt and net pension liabilities attributable to the state as of Fitch's 2018 state pension update are above average, measuring 14.2% of 2017 personal income, compared with a statewide median of 6%. Based on the most recently available data, Fitch estimates the long-term liability burden at approximately 13% of 2018 personal income. Fitch's calculations incorporates project debt associated with the Purple Line availability payment-based PPP entered into by the state's department of transportation (total $1.2 billion, of which $875 million is an untapped construction loan from the federal government), and Maryland Stadium Authority bonds issued for Baltimore City Public Schools (approximately $720 million) that partially benefit from state revenue support. The state's debt affordability guidelines include holding tax-supported debt as defined by the state (which excludes the PPP and Baltimore school obligations noted above) at or below 4% of personal income.

Last December, the governor announced a legislative proposal to issue gaming revenue-backed bonds for $1.9 billion in school construction projects over the next five years. The proposal follows up on a constitutional amendment approved by voters in November that requires the state to use gaming revenues to provide supplemental K-12 funding, rather than as replacement of other dollars. The legislature considered an alternative measure, the Build to Learn Act, which would have authorized $2.2 billion in bonding for school construction. Neither measure passed, but the policy incentives for school construction funding remain, and Fitch anticipates similar legislation could be pursued in future legislative sessions. If a measure on the scale of the proposed bills is eventually enacted, Fitch does not anticipate the additional issuance would affect the 'aa' assessment of Maryland's long-term liability burden.

Pensions are a comparative credit weakness in Maryland, although the state has taken repeated action since 2011 to revise benefits and contribution practices to improve sustainability. Specific measures include lower benefit accruals, longer 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.

Most of the state's net pension liability (NPL) consists of obligations for state employees and local teachers in the State Retirement and Pension System, which calculates its liabilities based on a 7.45% investment return assumption (down from 7.75% in fiscal 2012). Fitch estimates the consolidated ratio of the state's pension assets to liabilities as reported in its comprehensive annual financial report is approximately 63%. The Fitch-adjusted ratio, based on a 6% investment return assumption, is approximately 56%.

Changes in 2011 to other post-employment benefits (OPEB) are estimated to have reduced the state's liability by approximately 40% as measured at the time. The state's reported total net OPEB liability as of June 30, 2018 is $11.4 billion, or 3% of personal income.

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 drawdowns of general fund balance and from the revenue stabilization account (RSA; the state's primary rainy day account) when confronted with budgetary weakness. Legislation enacted in the 2017 legislative session is intended to address revenue volatility and build up reserve balances to provide additional financial resilience. Beginning in fiscal 2020, personal income tax revenues from non-withholding components that exceed a 10-year average will be diverted from routine spending and instead be directed to build the total rainy day fund up to 10% of general fund revenues and cover pay-go project needs for K-12 and higher education.

Maryland has disciplined consensus revenue forecasting and monitoring that identify material changes in the direction of state economic and revenue performance in a timely manner. The Board of Public Works (BPW), which includes the governor, comptroller and treasurer, has the power to trim governmental 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 has been consistently funded at 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, reaching $857 million at the end of 2018 and estimated by the administration to be $882 million at the end of fiscal 2019 (both approximately 5% of general fund revenues and spending).

Recent improvements to the state's budgetary management practices include the transition to full actuarial funding of pensions (fiscal 2017), implementation of the revenue volatility cap, and an increase in the state's primary reserve fund, the RSA, to 6.5% of estimated general fund revenues with the fiscal 2020 budget. Together, these measures reflect the state's commitment to rebuilding and enhancing its financial flexibility and a shift away from nonrecurring support of operations.

Current Developments

Fiscal 2018 (ended June 30) general fund revenues were up 4%. IIT receipts were up approximately 5%, while sales and use tax receipts were up roughly 2%. Maryland's sharper growth in IIT receipts in fiscal 2018 could have been attributable to taxpayers accelerating payments into tax year 2017 to avoid the new limitation on state and local tax deductions, or other responses to TCJA. The state also reports that strong 2017 capital markets performance could have been a factor.

In response to the federal tax changes, the state enacted its own tax changes. The state's Board of Revenue Estimates (BRE, its official revenue forecasting body) estimates that under current state law, the TCJA will increase state and local income tax collections $440 million annually, with just under two thirds (or $276 million) going to the state. The BRE's March 2019 estimate forecasts robust income tax (individual and corporate) growth in fiscal 2019 of 6.7%, supporting overall general fund revenue growth of 3.2%.

The March estimate revised down personal and corporate income tax estimates by less than 1%, reflecting weakness in non-withholding personal income tax collections through January. The decline was partially attributable to a shift in the timing of estimated individual income tax payments as the TCJA's new cap on state and local tax deductions limited the incentive to report income by the end of each calendar year. The March 2019 forecast also projects sales and use tax revenues to be up nearly 5% in fiscal 2019, driven mainly by the board's estimates of the short-term economic stimulus of TCJA and the 2018 federal bipartisan budget act (BBA) that raised statutory caps on federal discretionary spending through Oct. 30, 2019. BRE also noted benefits of the U.S. Supreme Court's Wayfair decision allowing states to more easily tax remote sales.

For fiscal 2020, BRE forecasts the short-term economic stimulus noted above will weaken, bringing growth in income tax and sales and use tax to just over 3% and general fund revenues to approximately 3% as well. Fitch notes the recent announcement from Congressional leadership and the White House of a tentative agreement to raise the federal debt ceiling and increase federal spending by $320 billion above sequestration caps over the next two federal fiscal years (beginning Oct. 1, 2019) could provide another boost to Maryland's economic activity.

Collections for fiscal 2019 were well ahead of the March 2019 forecast with preliminary results through June indicating 7.1% growth in general fund revenues (versus the 3.2% forecast), with IIT, SUT, and corporate income taxes all out-performing. The state appears on track to end the year with a sizable general fund revenue surplus of approximately $200 million. Per statute, any surplus will be allocated to a supplemental pension contribution ($25 million), OPEB (also $25 million), with the remainder going to the RSA. To the extent the revenue gains prove sustainable, rather than one-time, the higher baseline entering the current year could also support above-forecast performance for fiscal 2020.

Fiscal 2020 Budget Focus on Education Spending

The 2019 legislative session included a fiscal 2020 budget and various related revenue and spending measures. For education, the legislature dedicated approximately $255 million for fiscal 2020 to fund preliminary recommendations of the Kirwan Commission. The funding comes primarily from a $200 million reserve established in the fiscal 2019 budget for Kirwan Commission spending and from gaming revenues constitutionally dedicated by voters in November 2018 for supplemental K-12 spending.

The legislature also mandates the state spend an additional $355 million in fiscal 2021 and as much as $500 million in fiscal 2022 to address the Kirwan Commission's final recommendations, which are anticipated by Dec. 1, 2019. Funding is not fully laid out in the legislation but could include the dedicated gaming revenues, sales and use tax revenues above $100 million collected annually from marketplace facilitators and certain out of state sellers, and other revenue measures that could be considered in the 2020 session. Fitch anticipates the state will manage the increased spending demands in future years with commensurate revenue increases or offsetting expenditure reductions, consistent with its track record of responsible budget management.

The enacted fiscal 2020 budget also includes a $443.8 million appropriation to the RSA that would bring it to $1.2 billion, or 6.5% of general fund revenues. The legislature proposed reallocating $90 million of the RSA appropriation for school construction, but the governor intends to maintain the RSA at 6.5%. This would be the highest level since the RSA's 2007 pre-recession peak of $1.4 billion, or approximately 11% of general fund revenues. . The budget also includes a statutorily-mandated $75 million supplemental pension contribution beyond the ADC.

Maryland Stadium Authority Rating Details

Lease revenue bonds of the MSA are secured by leases between the MSA and the State of Maryland, with lease payments subject to annual legislative appropriation. The 'AA+' long-term rating on the bonds is thus linked to the credit quality of the State of Maryland. The MSA has funded several sports, cultural and convention venues statewide using a master lease structure, and MSA borrowing is part of state debt oversight.

Please see "Fitch Rates Maryland Stadium Auth's $55M Lease Rev Bds 'AA+'; Outlook Stable," published on April 12, 2019 for additional information on the MSA revenue bonds.

Maryland Department of Transportation (MDOT) Certificates of Participation (COPs) Details

MDOT's COPs are payable solely from purchase installments from MDOT pursuant to purchase agreements, subject to appropriation in each year by the Maryland General Assembly. MDOT intends to make payments from the department's Transportation Trust Fund, but the state's full resources are available for appropriation.

Please see "Fitch Rates Maryland DOT's $30MM COPs 'AA+'; Outlook Stable," published on Feb. 20, 2019 for additional information on the MDOT COPs.

MDOT Purple Line PPP Counterparty Obligation Rating Details

The Purple Line is a planned 16.2-mile light rail transit line between Bethesda and New Carrollton, MD. It will include 21 stations and intersections with three existing Washington Metro Area Transit Authority (WMATA) lines, Amtrak and Maryland Area Regional Commuter (MARC) train lines. It would be owned by MDOT and the Maryland Transit Administration (MTA), the arm of MDOT that oversees various transit operations for the state. The grantor obligations under the PPP agreement meet Fitch's expectation for a rateable PPP counterparty obligation. The commitment of the grantors, MDOT and MTA, to make construction progress payments, milestone payments, and long-term availability payments to the concessionaire, is structured to resemble the state's existing transportation COPs. All MDOT and MTA obligations under the PPP agreement benefit from MDOT's contractual commitment to seek annual legislative appropriations for all scheduled payments.

Please see "Fitch Affirms Purple Line Transit Partners Sr PABs & TIFIA Loan at 'BBB-'; Outlook Stable," published on May 17, 2019 for additional information on the project revenue bonds.

Contact:

Primary Analyst

Eric Kim
Senior Director
+1-212-908-0241
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Douglas Offerman
Senior Director
+1-212-908-0889

Committee Chairperson
Arlene Bohner
Senior Director
+1-212-908-0554

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

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com
Applicable Criteria
Public-Sector Counterparty Obligations in PPP Transactions Rating Criteria (pub. 28 May 2019)
U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
Solicitation Status
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