New Issue: Moody's assigns Aaa rating to Maryland's $728 million General Obligation State and Local Facilities Loan of 2012, Second Series

Global Credit Research - 18 Jul 2012

State has $10.15 billion in debt outstanding; Outlook remains negative

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

Moody's Rating

ISSUE		RATING
State and Local Facilities Loan of 2012, (Tax-Exempt) Second Series A		Aaa
Sale Amount	$75,000,000	
Expected Sale Date	07/27/12	
Rating Description	General Obligation	
State and Local Facilities Loan of 2012, (Tax-Exempt) Second Series B		Aaa
Sale Amount	$430,000,000	
Expected Sale Date	08/01/12	
Rating Description	General Obligation	
State and Local Facilities Loan of 2012, (Tax-Exempt) Second Series E		Aaa
Sale Amount	$187,600,000	
Expected Sale Date	08/01/12	
Rating Description	General Obligation	
State and Local Facilities Loan of 2012, (Taxable Qualified Zone Academy Bonds) Second Series D		Aaa
Sale Amount	$15,320,000	
Expected Sale Date	08/01/12	
Rating Description	General Obligation	
State and Local Facilities Loan of 2012, (Taxable) Second Series C		Aaa
Sale Amount	$20,000,000	
Expected Sale Date	08/01/12	
Rating Description	General Obligation	

Moody's Outlook

Opinion

NEW YORK, July 18, 2012 --Moody's Investors Service has assigned a Aaa rating to the State of Maryland's General Obligation State and Local Facilities Loan of 2012, Second Series. The borrowing consists of $75 million in negotiated tax-exempt bonds (Second Series A), $430 million in tax-exempt bonds (Second Series B), $20 million in taxable bonds (Second Series C), $15.32 million of Qualified Zone Academy bonds (Second Series D) and $187.6 million in tax-exempt refunding bonds (Second Series E). Series B through E are expected to be sold competitively on August 1.

SUMMARY RATINGS RATIONALE

The highest quality rating reflects Maryland's strong financial management policies, stable economy with high personal income levels, and ability to maintain positive available reserves despite sustained pressure on its budget. The rating also acknowledges the state's above average debt burden and large unfunded pension liabilities relative to the size of its economy. The outlook is negative, reflecting Maryland'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

ENACTED BUDGET BALANCED WITH TAX INCREASES, SPENDING CUTS AND PENSION SHIFT

The enacted fiscal 2013 budget closed a gap that was projected at $1.3 billion at the time the executive budget was proposed in January. Spending from the general fund and the budget restoration fund, a special fund that was created because the fiscal 2013 budget was appropriated over two legislative sessions, is $15.023 billion, an increase of less than 1% from fiscal 2012.

A personal income tax increase on taxpayers with incomes greater than $100,000 (for singles) or $150,000 (for married couples) is projected to raise nearly $250 million in fiscal 2013. In addition to higher marginal tax rates on these households, exemptions will be reduced for some of these taxpayers and eliminated for the highest earning taxpayers (singles with income exceeding $150,000 and couples with income exceeding $200,000).

A second significant measure enacted for fiscal 2013 is the phased shift of responsibility for certain teacher pension costs from the state to school districts. As originally proposed, the shift would have required counties to pick up 50% of the combined cost of social security and pension contributions for school employees, saving the state $240 million before counting about $60 million in actions designed to cushion the impact on local governments. As enacted, the legislation will shift less of the pension burden to local governments and offset more of the cost, at least in the near term. The pension shift is expected to result in fiscal 2013 net general fund savings of just more than $100 million.

In addition to pension savings, the enacted budget includes about $560 million of other spending reductions. These are dominated by Medicaid cost containment measures, worth about $340 million.

The enacted budget also relies on non-recurring resources to achieve balance. The largest of these are a transfer of about $100 million from capital funds, which the state would replace by using general obligation borrowing authority, drawing down its budgetary balance from $323 million at the end of fiscal 2012 to $200 million at the end of fiscal 2013, and receipt of a $50 million payment in conjunction with the privatization of its worker's compensation insurance program. The budget also includes about $84 million in savings from temporary fund swaps and mandate relief and deferment of certain expenditures to fiscal 2014.

FISCAL 2013 BUDGET SHRINKS STRUCTURAL BUDGET GAP

Maryland entered the recession with a persistent structural budget gap of roughly $1.3 billion, adding to the magnitude of budget balancing actions during the downturn. In response to recommendations by the Spending Affordability Commission, the structural gap is being addressed through a multi-year program that began with fiscal 2012. The enacted budget reduces the structural deficit by half, after factoring in one-time resources and expenditures, leaving a structural deficit of about $560 million to be addressed in coming years.

STATE REBUILDING RESERVES TO 5% TARGET

Maryland ended fiscal 2011 with a rainy day fund balance of $624.4 million, near the target 5% of general fund revenues. The budget projects a gradual increase in the Revenue Stabilization Fund (RSA) to $672 million in fiscal 2012 and $713.5 million at the end of fiscal 2013, falling just short of the state's 5% target. The state projects that the RSA balance will be kept at or near the 5% target level through 2017.

During the recession, the state drew from available fund balances, including the RSA, that had grown to more than 15% of revenues. Available funds outside the RSA have been depleted, although accounting changes make an accurate assessment of trends in available balances difficult.

MARYLAND ECONOMIC RECOVERY CONTINUES SLUGGISH AND FEDERAL DOWNSIZING POSES RISK

Based on employment trends, Maryland's economic growth in 2011 was on par with the nation's slow recovery from the deep recession. In calendar year 2011, average payroll employment grew 1.2% nationwide and in Maryland. The state's pace of growth slowed from December to May 2012, when payroll employment expanded 0.2% versus 0.6% nationally. The state's job gains have been concentrated in business and professional services, health and education, and federal employment. The latter trend was aided by the final phases of the relocation of military personnel under the Base Realignment and Closure process, which consolidated certain defense operations in Maryland.

During the recession, the state fared better than the nation. Nationwide, employment remained 6% below peak employment for 18 months from mid-2009 until the end of 2010, Maryland's payroll level was 6% below peak for only one month. The state's unemployment rate has also remained below the nation's. National unemployment peaked at 10% in October 2009 and fell to 8.2% in May 2012, while Maryland's topped out at 8% in early 2010 and stood at 6.8% in May.

With a population of just 5.9 million, Maryland's per capita personal income of $51,038 is significantly higher than the national average of $41,663. The gap between the state's personal income per capita and the nation's widened significantly from 2000 to 2010. 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. Based on the large federal presence in Maryland, however, the state's economy is exposed to federal downsizing that may occur as part of deficit reduction measures.

MARYLAND BENEFITS FROM POOL OF PAY-AS-YOU-GO CAPITAL RESOURCES

Throughout the downturn, the state has benefited from its ability to convert the sizeable pay-as-you-go portion of its capital plan to bonds as a budget balancing tool. In fiscal 2011, 2012 and 2013, the general fund received $90 million, $189 million, and $97 million, respectively, from capital funds, bringing total capital transfers since 2008 to about $600 million. The state has converted $709 million in pay-as-you-go capital into $692 million in general obligation bonds since the recession hit in 2008. The transfers have not impaired the capital programs most affected by the transfers, the Maryland Water Finance Authority Bay Restoration Fund and the Transfer Tax, as the state has funded their scheduled projects from its general obligation program.

While the financial flexibility this mechanism confers to the state is a positive feature of the credit, the state's recent reliance on capital transfers is a function of its need to address its structural gap.

STATE HAS HIGH DEBT BURDEN BUT RAPID AMORTIZATION

State debt levels relative to 50-state medians are high. Moody's 2012 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 high debt burden, Maryland's constitution requires a rapid 15-year amortization of taxsupported 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 PENSIONS A CREDIT CHALLENGE

The funded levels of Maryland's retirement system represent a credit challenge for the state. The state ranks among the top 20 in its ratio of unfunded pension liabilities to GDP, well above the norm for its Aaa-rated peers. The reported funded level is low at approximately 64% as of June 30, 2011. This represents a decline from 87.8% from June 30, 2005 and is at a lower level than most similarly-rated states. In addition to asset losses associated with the financial crisis, the deterioration in funded status stems from 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%. In fiscal 2011, this resulted in a state payment of $1.378 billion compared to the actuarially required rate of $1.914 billion.

In its 2012 legislative session, the General Assembly approved a measure to shift funding for teacher pensions to local governments. The state has traditionally paid all teacher pension contributions. School districts (funded by counties) will now be responsible for paying the normal cost - the amount of future benefits accrued annually - while the state will continue to make amortization payments on the system's unfunded liabilities. The state will also offset most of the costs for local governments, in aggregate, through increasing local revenue resources and mandate relief.

The shift will be phased in over four years in increments of 50%, 65%, 80% and 100%. In the first year, state pension contributions to the teachers pension fund will decline $137 million for general fund savings of $109 million, after local government offsets.

The funding shift comes on the heels of pension reforms enacted in the 2011 legislative session. The state will use a portion of the savings from those reforms to increase its annual pension contribution. The legislature also enacted changes to retiree health benefits ("OPEB") that are projected to reduce the state's OPEB liability roughly by half. Consequently, the state's OPEB actuarially required contribution fell from $1.2 billion to about $700 million. The state has also created a Postretirement Health Benefits Trust Fund as an irrevocable trust whose assets were valued at $196 million as of the state's fiscal 2011 financial audit.

OUTLOOK

The outlook on Maryland's Aaa rating is negative due to its indirect linkages to the weakened credit profile of the US 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 December 7 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, or high levels of short-term and puttable debt. Please see the special comment from December 7, 2011 entitled "Most Aaa-Rated State and Local Governments Revert to Stable Outlooks, Despite Negative Pressure on U.S. Government Rating" 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

-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

The principal methodology used in this rating was General Obligation Bonds Issued by U.S. Local Governments published in October 2009. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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