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Before the

Senate Budget and Taxation Committee
February 17, 2015

Good afternoon, Mr. Chairman, and members of the committee. I am pleased to have the opportunity to appear before you to address the important issue of the public debt budget. As usual, the Department of Legislative Services, and particularly Mr. Frank, has done an excellent job in his analysis of the budget and issues surrounding it.

Before turning to a discussion of the matters raised by Mr. Frank, I would like to update you on the following:

- Maryland's AAA ratings and comments from the rating agencies on the State's credit;
- Recap of Calendar Year 2014 Bond sales; and
- Upcoming 2015 First Series General Obligation Bond sale.

Rating Agency Update

On July 3rd and 7th, in conjunction with the sale of Maryland's General Obligation Bonds State and Local Facilities Loan of 2014, Second Series A, B and C, Moody's Investors Service, Standard & Poor's (S&P) and Fitch Ratings all affirmed their AAA ratings for Maryland's General Obligation debt. Maryland is one of only ten states to hold the coveted AAA rating, the highest possible rating, from all three major rating agencies. S&P has rated the bonds AAA since 1961. Moody's has assigned the bonds a rating of Aaa since 1973, and Fitch Ratings has rated the bonds AAA since 1993. The other nine states that hold AAA ratings from all three rating agencies are Alaska, Delaware, Georgia, Iowa, Missouri, North Carolina, Texas, Utah and Virginia.

As of today, there have been no further rating actions. The Treasurer's Office provides the rating agencies regular updates on the financial condition of the State as well as responding to any informational requests. Conference calls were held last week and I expect to receive ratings on February 19th for the March 4th sale of the 2015 First Series General Obligation Bonds.

Once the ratings have been received we will advise the Legislature and supply webpage links to the full reports.

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Excerpts from Ratings Reports

Included in each Rating Report is a section on the rational for the current rating in which each rating agency discusses the State's strengths and potential challenges. Generally, there is consensus among the rating agencies in evaluating the State's credit strengths and noted challenges. All three agencies cite Maryland's debt affordability policies, strong financial management, broad diverse economy, high personal income levels and adequate reserves as credit strengths. There is also consensus regarding the state's pension funding as a challenge; however, all three rating agencies note the significant reforms that were undertaken to improve sustainability and the unfunded liability of the pension system. The following summary provides highlights of the most recent reports:

Financial Management

All three rating agencies point to the State's history of strong, sound financial management as a strength for Maryland. Moody's cites a "history of strong financial management" and "adequate reserve levels despite recent draws" as two of the three highlighted "strengths" of Maryland's credit profile. S&P assigned a rating of "strong" to Maryland's management practices, noting in its report that "Maryland has made continuing efforts to institutionalize 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 RSF (Revenue Stabilization Fund) at or above its legal minimum of 5% of revenues." Fitch Ratings further said: "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 also 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."

Debt Policies and Debt Burden

In the case of all three rating agencies, the state's debt affordability guidelines and rapid amortization of debt are considered credit strengths. Fitch notes that the state's "total tax-supported debt is moderate and its strong and centralized debt management remains a credit strength" and specifically highlights the debt affordability policies and the constitutional requirement to amortize debt within 15 years. S&P notes the state's "Moderate debt burden, which we expect to continue due to a clearly defined debt affordability process that limits annual issuance, coupled with a constitutional 15-year debt maturity schedule." Moody's notes the state's "Above average debt burden" and that the State "has historically remained within the recommendations of its Capital Debt Affordability Committee," and further highlights the 15 year amortization of tax-supported debt.

Economy

In assigning its 'AAA' long-term rating and stable outlook, Standard & Poor's said: "The rating reflects what we view as the state's: Broad and diverse economy, which has experienced tepid recovery due to sequestration and federal fiscal policy uncertainty; we expect growth to accelerate due to resolution of certain federal budget and fiscal issues; High wealth and income levels;…" Fitch simply says "the state has a diverse, wealthy economy, benefiting from its proximity to the nation's capital". Fitch continues to state Maryland's "…diverse and wealthy service-oriented economy remains a source of credit strength", citing a lower than national unemployment and high personal income as strengths of the Maryland economy.

Each rating agency cites ties to the federal government as both benefits and risks to Maryland's economy. Moody's noted there has been a decline in federal employment due to sequestration yet "the employment impacts on the state are less severe than nationwide." S&P noted "While federal fiscal policy remains a challenge to the state's budget and long-term financial plan, we believe that Maryland continues to actively monitor developments and has options to mitigate this risk based on its well-developed budget policies and financial reserves." Fitch indicated "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."

Pension and other liabilities

Pension reforms enacted during the 2011 Legislative Session, the 2012 legislation shifting a portion of the employers' funding of the teachers pensions and the phase-out of the corridor funding method that was enacted during the 2013 Legislative Session are noted by each of the three rating agencies. Fitch Ratings noted "Despite pensions being a comparative credit weakness, the state has taken multiple steps to reduce the burden of pensions and improve sustainability over time." S&P indicated "Pension funding levels have deteriorated in recent years and other post employment benefit liabilities are significant but recent reform initiatives in both areas should improve the funding levels of both in future years." Moody's indicated "The financial condition of Maryland's retirement system represents a credit challenge for the state" but goes on to recognize that "[t]he state has taken a number of measures to reduce its pension burden" and " has been appropriately addressing its … pension funding concerns…"

The complete reports are available on the Treasurer's website at www.treasurer.state.md.us.

Calendar Year 2014 Bond Sales

We continue to plan and conduct our bond sales effectively, while striving to maintain Maryland's coveted AAA bond rating. We monitor the market routinely to take advantage of savings as they become available, such as by refunding our General Obligation Bonds or issuing new types of debt such as Qualified Zone Academy Bonds. The calendar year 2014 bond sales outlined below reflect a continuation of these efforts.

The 2014 First Series was sold on March 5, 2014 and totaled $736,855,000. The proceeds were used to finance new projects and refund existing bonds. The sale closed on March 18, 2014 and had three series:

Series A: $450.0 million in Tax-Exempt Bonds sold in a competitive sale primarily to institutions;
Series B: $50.0 million in Taxable Bonds sold in a competitive sale primarily to institutions;
Series C: $236.9 million in Tax-Exempt Refunding Bonds sold in a competitive sale primarily to institutions.

The Series A and Series B bonds provided $500.0 million, at a combined TIC (True Interest Cost) of 2.77%, to finance investments in capital projects critical to our State. Series B was an advanced refunding of certain outstanding General Obligation Bonds and saved taxpayers a net present value of $12.6 million in debt service costs.

The 2014 Second Series was sold on July 23, 2014 and totaled $1,149,715,000. The proceeds were used to finance new projects and refund existing bonds. The sale closed on August 5, 2014 and had three series:

Series A: $50.4 million in Tax-Exempt Bonds sold in a negotiated retail sale with first priority to Maryland citizens;
Series B: $449.6 million in Tax-Exempt Bonds sold in a competitive sale primarily to institutions; and
Series C: $649.8 million in Tax-Exempt Refunding Bonds sold in a competitive sale primarily to institutions

The Series A and Series B bonds provided $500.0 million, at a TIC of 2.40%, to finance investments in capital projects that benefit communities throughout the State. Series C was an advanced refunding of certain outstanding General Obligation Bonds and saved taxpayers a net present value of $58.3 million in debt service costs.

Qualified Zone Academy Bonds (QZAB) of 2014 were sold on December 8, 2014, closed on December 18, 2014 and totaled $4,625,000. These were tax credit bonds bearing no interest. QZAB proceeds are used to fund capital improvements and repairs at existing schools in which at least 35% of the students are eligible for free or reduced-price lunch.

During calendar year 2014, the Treasurer's Office saved taxpayers a net present value of $70.9 million through our refunding efforts, while financing nearly $1 billion worth of critical capital projects throughout the State. As in the past, the largest proportion of projects funded were public elementary, secondary and higher education facilities.

2015 First Series General Obligation Bonds

The next general obligation financing is scheduled for March 4, 2015 and is expected to total up to $1,268,000,000 in two series. Series A is expected to total $518 million in tax-exempt bonds and Series B is expected to total up to $750 million in tax-exempt refunding bonds. The amount actually refunded will depend on market conditions in the days leading up to the sale.

Requested Responses to the Analyst's Issues

The Department of Legislative Services (DLS) recommends reducing the general fund appropriation by $21 million and maintaining an ABF balance that is equivalent to at least one-half of the bond sale premiums anticipated in that year.

The State Treasurer's Office respectfully disagrees with the DLS recommendation. While I can recognize that the proposal appears to represent a relatively painless way of cutting the general fund. I believe it is a departure from Maryland's conservative financial management practices.

A bond premium (or discount) is the difference between the par or face value of a bond and the amount that that bond is bought or sold for. This situation arises when the bond pays a higher rate of interest (the coupon rate) than a market interest rate. Historically investors in the State's bonds have preferred a 5% coupon rate which requires a premium payment in today's low interest rate environment.

It is critical to understand that the receipt of bond premium does not mean that the State had a more successful sale than if no premium were received. It is important to evaluate the cash flow over the life of the bonds, not just at the time of sale. The premium paid on a bond is intended to offset the future cost of debt service of that particular bond. Therefore, premium truly is a reflection of future debt service cost and if the premium is not retained in the Annuity Bond Fund (ABF) for future debt service payments, all else held constant, the true economic cost to the State of a premium bond is higher than a market rate bond with no premium.

Consistent with prior budget practices, the Governor's Budget estimates bond premium for the upcoming March sale. The March sale is completed before the budget is finalized so that actual bond premium is known and adjustments can be made if there is a shortfall in the estimated amount. **The enacted budget thus includes a combination of known revenues sufficient to fund the appropriation**. This is done to reduce the risk to the State of relying on a volatile and difficult to predict revenue source to fund debt service. This assures both the rating agencies and bond investors that funds to pay debt service are actually there and that the State is not potentially underfunding the ABF if bond premium is overestimated.

As Mr. Frank noted, interest rates increased by 38 basis points (bps) from July 3 to July 24, 2013. Based on the estimates prepared by the State's financial advisor, this resulted in an 11.3% or $6.4 million reduction in premium. The market saw a recent increase of similar magnitude as yields increased by 25 bps between January 29 and February 10, 2015. If the

anticipated premiums are not realized, a deficiency appropriation would be required from the General Fund. This volatility and uncertainty could be mitigated by maintaining a larger balance in the ABF, however you could avoid the volatility all together by simply maintaining the State's conservative budgeting practices in regards to bond premium.

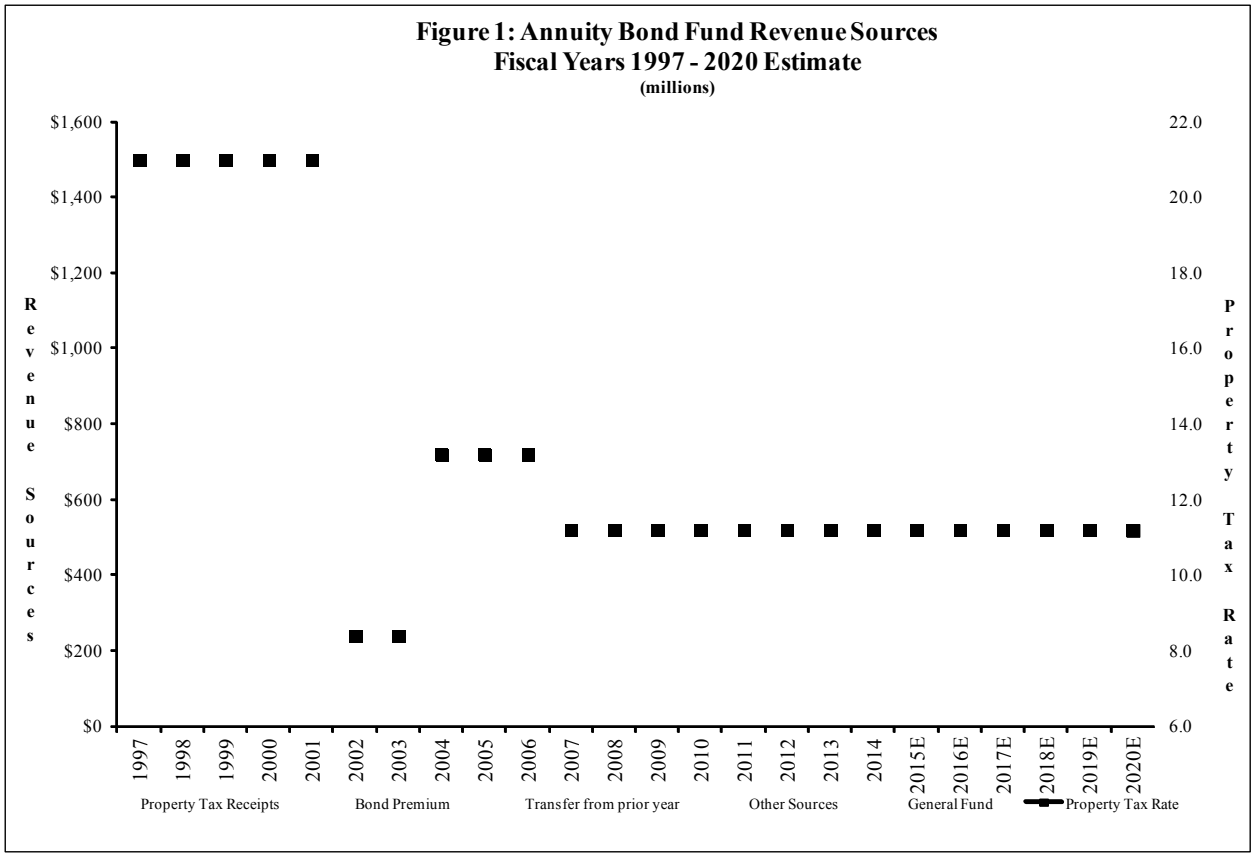
More importantly, I cannot recommend incorporating assumptions of premium in the future year's budget. It simply is not commonly accepted as a prudent financial practice. Because bond premium is essentially bond proceeds it is most common for issuers to use premium receipts to either pay for specific capital projects within an issue or downsize the overall size of the total debt being issued. DLS is suggesting a different approach for Maryland. The use of what are essentially bond proceeds to replace the one-time use of General Funds is analogous to financing operating or "soft costs" with debt, a practice Maryland has always avoided. Our financial advisor has researched this practice and determined that similarly rated (AAA) states do not budget premium as recurring revenue. There is concern that incorporating this practice into written policy (such as the budget) would be viewed negatively by the credit rating agencies.

The State's ability and willingness to repay debt is the most important factor in any credit analysis. Unlike many other states, the Maryland legal framework is already unusually restrictive in that a budget and appropriation are necessary in order to make debt service payments. We in Maryland are proud that all funds flow through the appropriation process and would not seek to change that. But, I am concerned that a fiscal 2016 Public Debt budget that does not include the necessary general funds but simply assumes potential future premium receipts will decrease investor confidence in Maryland bonds.

The Treasurer should be prepared to respond to questions the committees have about the status of the ABF.

The DLS analysis provides a very thorough overview of the status of the Annuity Bond Fund (ABF). The numbers and results are quite similar to the analysis which the Commission on State Debt, which I chair, has produced and circulated each of the last several years prior to the annual Board of Public Works meeting to set the property tax rate for the ensuing year.

Figure 1, shown below, details the various revenue sources that historically have contributed to debt service payments paid from the ABF. General fund appropriations were consistently used to support debt service prior to 2004. The State property tax rate was raised significantly in 2003, then reduced in 2006 and has remained constant at 11.2 cents per $100 of assessed value since fiscal year 2007. Had the rate not been reduced, the picture might be very different. Property tax revenues peaked at $798 million in fiscal year 2011. After three years of declines, due in part to the impact of the Homestead Tax Credit as well as to declines in property values, property tax revenues are anticipated to increase to nearly $726 million in fiscal year 2015 and total $741 million in fiscal year 2016. Property tax revenues are not expected to reach fiscal year 2011 levels until 2020, although this depends on the rate of increase in property values.



Note: Between fiscal years 1983 through 2001 real property was assessed at 40% of full cash value and the property tax rate was .21 cents per $100 of assessed valuation. In fiscal year 2002, real property began to be assessed at 100% of full cash value and the rate was adjusted to the mathematical equivalent of 8.4 cents per $100 of valuation in order for there to be no change to the overall tax burden.

At current assessments, a 1 cent increase in the property tax rate will result in gradually increasing approximately $65 million in additional revenue, with the tax base. Consequently, there would be a need of significant property tax increases to close the future expected gap between revenues and expenditures without a General Fund transfer. See DLS Public Debt Analysis Exhibit 11. Annuity Bond Fund projections for 2016 will be rerun once the actual results of the March 4, 2015 sale of the 2015 First Series are known.

I would be happy to respond to any questions regarding the status of the ABF.

The State Treasurer should be prepared to respond to questions that the budget committees have about the State debt affordability process and the State's ability to avoid breaching the affordability limits.

The Capital Debt Affordability Committee, in its Reports and in its letters to the Governor and Legislature, has expressed its intention to remain within the two affordability ratios: 1) Debt outstanding should not exceed 4% of personal income; and 2) Debt service should not exceed 8% of relevant revenues. In October 2014, the Committee recommended a $1,170 million new general obligation authorization for the fiscal year 2016 capital program as

prudently meeting a portion of recognized infrastructure need while remaining within the accepted affordability guidelines. The Committee specifically recognized that should the economic and fiscal information underlying its recommendation change significantly, the Committee could reconvene and make any necessary adjustments. Subsequently, the Board of Revenue Estimates (BRE) met on December 15, 2014 and decreased revenue estimates for fiscal year 2015 and fiscal year 2016. The revised revenue projections were low enough to cause the State's debt service to revenue ratio to exceed the 8.0% benchmark in FY 2018 for the CDAC FY 2016 debt authorization recommendation made in its October 2014 report. Because the Spending Affordability Committee's (SAC) decision-making meeting was to take place two days after the BRE meeting, there was no time to reconvene CDAC to review the impacts of the revenue write-downs on the October recommendation and to make any revised recommendations. Therefore, after updating all of the CDAC members, I, as Treasurer and not as CDAC Chair, notified the Governor, Presiding Officers, SAC Leadership and legislative staff of the breach anticipated in FY 2018 and the FY 2022, FY 2023, and FY 2024 out years and provided a revised capital debt affordability analysis run by my Office's Debt Management Division that incorporated the revised revenue estimates. I also noted in my letter that CDAC's planning assumptions for future authorizations would be reviewed in preparation for the 2015 report and authorization levels may be adjusted to adhere to the debt affordability benchmarks.

DLS recommends committee narrative requiring CDAC to review its affordability process.

As Chair of CDAC, I would be happy to have the committee review the affordability process should the General Assembly include this narrative. I believe it is very appropriate to review the process, assumptions and performance regularly.

The Administration should brief the committees on any plans it has to return to the practice of supporting private activity capital projects with general funds. DLS further recommends restricting $21 million of general fund pay-as-you-go to be used for housing to be used for school construction. This maintains funding for housing and school construction at levels proposed by the Governor but has the benefit of reducing the need to sell taxable bonds. This will save future debt service costs for the State.

I trust that the Administration will brief the committees regarding support of private activity capital projects with general funds.

I would be happy to address any questions you may have.