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TESTIMONY OF STATE TREASURER NANCY K. KOPP

Before the

Senate Budget and Taxation Committee
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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 2015 Bond sales; and
- Upcoming 2016 First Series General Obligation Bond sale.

Rating Agency Update

On June 19, 2015, in conjunction with the sale of Maryland's General Obligation Bonds State and Local Facilities Loan of 2015, Series A and B, Moody's Investors Service, Standard & Poor's 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. Standard & Poor's 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 Delaware, Georgia, Indiana, Iowa, Missouri, North Carolina, Texas, Utah and Virginia.

As of today, there have been no further rating actions. The Treasurer's Office has provided the rating agencies with regular updates on the financial condition of the State as well as responding to any informational requests. The next conference call with the rating agencies is expected prior to the sale of the 2016 First Series General Obligation Bonds in May, 2016.

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 weaknesses. All three major rating agencies cite Maryland's debt policies, fiscal management and economy as credit positives and the State's debt burden and pension funding as concerns. 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 credit strength. 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. In assessing Maryland's management practices, Standard & Poor's assigned a rating of "strong" to this factor, noting: "Long history of proactive financial and budget management, including implementation of frequent and timely budget adjustments to align revenues and expenditures." Fitch Ratings further said: "Financial operations are conservative, and the state maintains a well-funded rainy day fund. The state took repeated action during the course of the recession to address projected budget gaps, including raising tax revenues, cutting spending, and using rainy day and other balances."

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 and help offset concerns the rating agencies have regarding the State's debt burden. According to Fitch, [t]he burden of Maryland's total tax-supported debt is moderate, and its strong and centralized debt management remains a credit strength." Fitch specifically highlights the State's debt affordability policies and the constitutional requirement to amortize debt within 15 years. Moody's states the constitutional limit "somewhat offset[s] the credit impacts of a high debt burden." The Capital Debt Affordability Committee is referred to as having a positive role in debt management by both Moody's and Standard & Poor's, with Standard & Poor's stating "the clearly defined debt affordability process" has a positive stabilizing effect on the State's debt profile and "[s]till-moderate debt burden across all measures.

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, and; High wealth and income levels." Standard & Poor's further states: "The stable outlook on Maryland reflects our view of the state's proactive budget management in recent years and the economic recovery underway, although recent revenue growth has been hampered by events at the federal level." Fitch notes "the state has a diverse, wealthy economy, benefiting from its proximity to the nation's capital", and observed Maryland's "diverse and wealthy service-oriented economy remains a source of credit strength," citing 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 that there has been a decline in federal employment due to sequestration yet "the employment impacts on the state are less severe than nationwide." Standard & Poor's noted "[w]hile federal fiscal policy remains a challenge to the state's budget and long-term financial plan, we believe that Maryland continues to monitor developments and has options to mitigate this risk based on its well-developed budget policies and financial reserves." In assessing the State's economy, Fitch indicated "[t]he state's economy has long benefited from proximity to the nation's capital, although the prospect of federal budget austerity poses a degree of uncertainty for the state's large federal agency presence and associated private contracting."

Pension and other liabilities

Pension reforms enacted during the 2011 Legislative Session, the teacher pension sharing enacted during the 2012 Legislative Session, 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. On the topic, Fitch Ratings stated "Despite pensions being a comparative credit weakness, the state has taken multiple steps to reduce their burden and improve sustainability over time." Moody's indicated "[t]he 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." Standard & Poor's indicated "[t]he state's below-average pension funded ratios continue to represent downside risk to the rating."

The State Treasurer's Office provides information about the State's rating reports for each bond sale to all members of the General Assembly. Current reports are available on the Treasurer's website at www.treasurer.state.md.us.

Calendar Year 2015 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 2015 bond sales outlined below reflect a continuation of these efforts.

The 2015 First Series was sold on March 4, 2015 and totaled $883,360,000. The proceeds were used to finance new projects and refund existing bonds. The sale closed on March 17, 2015 and had two series:

Series A: $518.0 million in Tax-Exempt Bonds sold in a competitive sale primarily to institutions
Series B: $365.4 million of Tax-Exempt Refunding Bonds

The Series A bonds provided $518.0 million, at a TIC (True Interest Cost) of 2.65%, to finance investments in capital projects critical to our State. The Series B refunding bonds saved taxpayers $21.8 million in debt service costs. In addition, the State received a premium of $74,682,961 to offset FY2016 debt service costs and provide $48.4 million to fund capital projects on a paygo basis.

The 2015 Second Series was sold on July 16, 2015 and totaled $500,000,000. The proceeds were used to finance new projects. The sale closed on August 3, 2015 and had two series:

Series A: $450 million in Tax-Exempt Bonds sold on a competitive basis primarily to institutions
Series B: $50 million of Taxable Bonds

The Series A bonds provided $450.0 million, at a TIC of 2.83%, to finance investments in capital projects critical to our State. Series B provided $50 million, at a TIC of 1.36% (maturing August 1, 2018 and 2019) to finance loan programs and other capital projects with the potential to benefit non-governmental entities. In addition, the State received a premium of $45,918,725 to offset FY 2016 debt service costs.

The Treasurer's Office will continue to be diligent in identifying refunding opportunities. While refunding bonds do not extend the maturity of the State's 15-year debt, a successful sale of these bonds will result in debt service savings. While the opportunities to realize refunding savings have dwindled because of the amount of refunding that has already taken place, we monitor the potential for each sale.

Qualified Zone Academy Bonds (QZAB) of 2015 were sold on December 9, 2015, closed on December 17, 2015 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.

2016 First Series General Obligation Bonds

The next general obligation financing is scheduled for May 11, 2016 and is expected to total $518 million in tax-exempt bonds.

Requested Responses to the Analyst's Issues

The State Treasurer should be prepared to brief the committees on the use of bond sale premiums for GO bond debt services costs.

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.

The Analyst's description of what the State can do with Bond Sale Premiums is accurate and the State has deposited bond premiums in the Annuity Bond Fund (ABF) to pay debt service costs; as well as using the premiums to support the State's Capital Programs. It should be noted that resizing a bond issue to account for the premium would save the State money by reducing debt service costs in the out years. Maintaining the premium in the ABF would also save the State money by reducing the amount of General Funds necessary to cover debt service costs. In years where the State has chosen to deposit premiums into the ABF, the State historically has been very conservative in estimating bond sale premium for that fiscal year budget only. This is done so that the State is not relying on a volatile and difficult to predict revenue source to fund debt service.

Currently the Federal Reserve is anticipated to maintain low interest rates for the foreseeable future. As long as the interest rates remain low and investor preference for higher coupon rates continue, the State would anticipate continuing to receive a premium on its bond issues through the first sale of 2017, anticipated to take place in February or March 2017.

Even though the State anticipates that we will remain in the current low interest rate environment it is possible that the State will not realize the projected premiums to support the fiscal 2017 debt service costs. We concur with the Analyst's comment that if the estimated bond premium is not realized that the State will need to be prepared to appropriate additional funds in the ABF to cover debt service costs.

The Treasurer's Office will continue to monitor the market and update bond premium estimates as we get closer to the sale date in May, 2016. The Treasurer's Office will also continue to update the Annuity Bond Fund projections after each sale, once the actual results are known to include realized premiums.

The Administration should brief the committees on what action it will take if estimated bond premiums are insufficient to pay debt service for fiscal 2017.

I trust that the Administration will assure that sufficient funds are in the ABF to meet debt service requirements. As a triple A rated State, Maryland has always met and will continue to meet its annual debt service obligations.

The State Treasurer should be prepared to brief the committees on the effects of the Administration's and the SAC recommended level of debt authorizations.

The DLS analysis provides a very thorough overview of the effects of the Administration's and the SAC recommended level of debt authorizations. The numbers and results are quite similar to the results of the analysis which the Capital Debt Affordability, which I chair, has produced.

At the final meeting in September, 2015, the Capital Debt Affordability Committee reviewed its assumptions on revenues, personal income, interest rates, debt issuance, debt service and bond authorizations. At this meeting, the Committee considered several options for a recommended amount of new general obligation debt to be authorized. On a motion made by the Secretary of Budget and Management, the Committee approved a recommendation of $995 million for new general obligation authorizations to support the FY 2017 capital program. The vote was 4-1, I voted against the proposed amount.

In addition to determining and recommending a prudent affordable debt authorization level for the coming year, the Committee also sets out planning assumptions for the State to use in its capital program planning process. The Committee reviewed several options that were projected to maintain debt affordability ratios within the CDAC benchmarks of 4% debt outstanding to personal income and 8% debt service to revenues. Again, on a motion made by the Secretary of Budget and Management, in support of that motion, the committee voted to maintain the authorization at $995 million in future fiscal years. The vote was 4-1, once again I voted against the proposal commenting that the role of the Committee was to recommend an affordable authorization level while the role of the General Assembly was to balance the needs of the State. The affordability analysis presented at the Committee's meeting illustrates that, based on the Committee's historical projection of 3% annual growth in General Obligation Bond authorizations, debt service will continue to be within the affordability guidelines going into the future.

Projected Affordability Ratios-Baseline

Fiscal Year	4% Debt Outstanding to Personal Income	8% Debt Service to Revenues	Fiscal Year	4% Debt Outstanding to Personal Income	8% Debt Service to Revenues
2016	3.45%	7.28%	2021	3.47%	7.60%
2017	3.52%	7.56%	2022	3.46%	7.79%
2018	**3.52%**	7.84%	2023	3.39%	**7.94%**
2019	3.50%	7.73%	2024	3.33%	7.83%
2020	3.48%	7.59%	2025	3.26%	7.84%

The CDAC baseline reflects $1095 for FY 16 and a 3% annual growth rate beginning in FY 17 thru FY 25

Projected Affordability Ratios with $995 million Annual Authorization					
Fiscal Year	4% Debt Outstanding to Personal Income	8% Debt Service to Revenues	Fiscal Year	4% Debt Outstanding to Personal Income	8% Debt Service to Revenues
2016	3.45%	7.28%	2021	3.30%	7.48%
2017	**3.51%**	7.56%	2022	3.23%	7.59%
2018	3.49%	**7.84%**	2023	3.11%	7.65%
2019	3.44%	7.71%	2024	2.99%	7.42%
2020	3.37%	7.53%	2025	2.86%	7.30%

In conclusion, whether you use the Administration's, SAC's or the CDAC's authorization amounts, the State will continue to stay within the affordability guidelines.

While using the Administration's authorization level may result in lower out year debt service costs and save general fund appropriations to the ABF, the unmet capital needs of the State will continue to grow.

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