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HOUSE APPROPRIATIONS COMMITTEE

February 3, 2012

TESTIMONY OF STATE TREASURER NANCY K. KOPP

Good afternoon, Chairman Conway, 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, Moody's negative outlook on Maryland, and comments from the rating agencies on the State's credit;
- 2011 Recommendation of the Capital Debt Affordability Committee;
- Recap of Calendar Year 2011 Bond Sales; and
- Outlook for the municipal bond market.

Rating Agency Update

Maryland is one of eight states with AAA ratings from all three rating agencies. The states are Maryland, Delaware, Virginia, North Carolina, Georgia, Missouri, Iowa, and Utah. On July 13, 2011 and in early September 2011, Moody's Investors Service, Standard & Poor's (S&P) and Fitch Ratings all affirmed the State's AAA rating. However, Moody's has assigned a negative outlook to the State's General Obligation Bonds due to their conclusion that Maryland has a high level of federal employment and federal procurement.

Moody's first assigned a negative outlook to Maryland and four other states (Virginia, New Mexico, South Carolina and Tennessee) on August 4, 2011, after the August 2, 2011 assignment of a negative outlook to U.S. government debt. On December 7, 2011, Moody's completed their review of the federal exposure of each of these states. As a result, the outlooks for South Carolina and Tennessee were changed to stable but Maryland, Virginia and New Mexico retained the negative outlook. In addition, the counties in Maryland rated Aaa by Moody's also retained a negative outlook.

In its report dated December 7, “Most Aaa-Rated State and Local Governments Revert to Stable Outlooks, Despite Negative Pressure on U.S. Government Rating”, Moody’s stated, “The Aaa-rated state and local government issuers with outlooks that have been restored to stable are considered to have lesser financial and economic linkage to the U.S. government, and if the U.S. sovereign rating was downgraded by one notch, these state and local governments could continue to be rated Aaa. In contrast, those municipalities with negative outlooks would not likely be rated higher than the U.S. government.”

S&P has also expressed concern about the effect of federal budget reductions on Maryland’s credit. In its Maryland rating report dated September 7, 2011 S&P stated, “Downside risk for the rating includes our view of the potential for significant reductions in federal funding that currently flows to the State. Standard & Poor's will continue to monitor the federal consolidation efforts stemming from the Budget Control Act and, once these are identified, will evaluate their effect on Maryland's finances and the State's response to these revenue reductions.”

In 2012, it is reasonable to expect the rating agencies to continue their focus on the U.S. and their evaluation of state and local governments’ level of federal dependency.

Meetings with Rating Agencies

Prior to the confirmation of the State’s AAA rating, analysts from Fitch Ratings, Standard & Poor’s and Moody’s Investors Service visited Annapolis on Wednesday, June 29 and Thursday, June 30 to attend meetings prior to rating the 2011 Second Series General Obligation Bonds. The State Treasurer’s Office extended this invitation to the rating agencies to highlight the progress made in the 2011 Legislative Session on the structural deficit and pension sustainability. Typically the rating agencies review the State’s credit by phone prior to each bond sale but periodically the Treasurer’s Office schedules a personal visit such as this one.

Working sessions included presentations on the Economy and Revenues, Video Lottery Terminals, Budget, Pension and Retiree Health Reforms, Legislative Updates and Debt Issuance plans. To demonstrate the positive impact of BRAC on the Maryland economy, the rating agencies toured Ft. Meade and surrounding areas on June 30.

Participating in the meetings were the Treasurer, Comptroller, Secretary of Budget and Management, Director of the Bureau of Revenue Estimates, Executive Director of the Maryland State Retirement Agency, the Director of Policy Analysis for the General Assembly and staff. Representatives from the Legislature were also in attendance. The Lieutenant Governor and his staff led the visit to the BRAC facilities at Ft. Meade.

The State Treasurer’s Office maintains frequent contact with the rating agencies throughout each year by transmitting Reports from the Board of Revenue Estimates,

Capital Debt Affordability Committee and the Department of Legislative Services. The Comprehensive Annual Financial Report (CAFR) and the Budget are also forwarded to the rating agencies.

Excerpts from Ratings Reports

Generally, there is consensus among the rating agencies in evaluating the State's credit strengths and weaknesses. The following summarizes the most recent reports:

Fitch Ratings, in assigning the AAA rating and stable outlook, noted:

- Debt oversight is strong and centralized, and the debt burden is moderate. The State has policies to maintain debt affordability, and the constitution requires GO and transportation bonds to amortize within 15 years.
- Pension funding levels have deteriorated, although the State is undertaking extensive pension and other post-employment benefit (OPEB) reforms.
- The State has a diverse, wealthy economy, benefiting from its proximity to the nation's capital.
- Financial operations are conservative, and the State maintains a Rainy Day Fund to manage revenue cyclicalities. 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.

Credit challenges that were cited by Moody's include:

- Continuing budget pressure;
- Low retirement system funded levels;
- Above average debt burden (S&P and Fitch consider the debt burden moderate.); and
- Reliance on federal jobs in an era of retrenchment.

Copies of the ratings reports for each bond sale are available on the Treasurer's website.¹

Affordability Analysis

The Capital Debt Affordability Committee (CDAC) sent a \$925 million conditional recommendation to the Governor, President of the Senate and Speaker of the House in a letter dated September 21, 2011. The letter noted that the motion to adopt this level specifically recognized that authorization levels proposed in the Governor's 2013 Capital Budget could be adjusted to reflect up-to-date economic and fiscal information, as well as the Board of Revenue Estimate's December revenue estimates. The letter further stated that the Capital Debt Affordability Committee might review its

¹ <http://www.treasurer.state.md.us/debtmanagement/rating-agency-reports.aspx>

authorization in December 2011 and make any necessary modifications to its recommendation.

The Committee did meet on December 19, 2011, and considered a proposed increase of \$150 million to its original authorization to provide funding for projects that are “shovel-ready” and that will stimulate immediate job creation. After extensive discussion, the Committee’s revised recommendation is a \$1,075 million limit for new general obligation authorizations by the 2012 General Assembly to support the 2013 capital program. The assumptions presented at the meeting included, for illustrative purposes, a \$150 million reduction in the projected authorization by the 2017 Session from \$1,200 million to \$1,050 million. Other out-year authorization patterns could also be used to constrain debt within the CDAC guidelines. With this authorization level of \$1,075 million, the debt affordability ratios remain within the CDAC benchmarks of 4% debt outstanding to personal income and 8% debt service to revenues from 2012 to 2021. See attached graphs at the end of this Report.

The Committee discussion reflected its clear intent that future year recommendations continue to maintain debt within the adopted affordability benchmarks of 8% debt service to revenues and 4% debt outstanding to personal income. The Committee noted that there are multiple annual authorization levels and patterns that would result in adherence to the benchmarks, depending on future levels of personal income and State revenue. The Committee’s projections for future authorizations will reflect updated revenue and personal income projections and authorization levels to adhere to these affordability benchmarks.

Calendar Year 2011 Bond Sales

While the federal American Recovery and Reinvestment Act (ARRA) authorization to issue Build America Bonds expired at the end of 2010, the State was still able to issue a limited amount of ARRA taxable bonds with a federal interest subsidy to achieve the lowest possible cost of capital. The State also realized debt service savings on refunding bonds.

Debt Service Savings achieved in 2011

SERIES	ISSUE SIZE	ISSUE	PV SAVINGS *
2011 Second Series C	\$ 15,900,000	Qualified Zone Academy Bonds (QZABs)	\$ 6,041,292
2011 Second Series D	\$ 6,500,000	Qualified Energy Conservation Bonds (QECBs)	\$ 2,029,863
2011 Second Series E	\$254,915,000	Refunding Bonds	\$ 11,090,862
			\$ 19,162,017

** Savings for QECBs and QZABs are calculated compared to tax-exempt yields at the time of issue. Refunding savings are achieved by refinancing higher cost bonds.*

OTHER NOTEWORTHY ACCOMPLISHMENTS IN 2011:

- **Priority to Maryland citizens to buy GO bonds in the following retail only sales:**

2011 Second Series A - \$130,770,770
 2011 Second Series B - \$ 71,730,000

- **Use of a website for retail investors:**

www.buymarylandbonds.com

- **Total Bonds Issued:**

Seven different Series totaling \$1,252,315,000

- \$254,915,000 refunding bonds
- \$997,400,000 new money bonds for capital projects

- **Low overall TICS (True Interest Costs) trended lower in 2011. Overall rates were historically low. See the following chart for details on interest rates:**

Series	Dates of Sales	Tax-Exempt Competitive	Tax-Exempt Negotiated	Taxable Direct Subsidy	Overall Tax-Exempt TIC
2011 First Series A	3/4/11 & 3/7/11		\$130.8 million		2.69%
2011 First Series B	3/9/11	\$354.2 million			3.49%
2011 Second Series A	7/25/11		\$71.7 million		1.99%
2011 Second Series B	7/27/11	\$418.3 million			3.08%
2011 Second Series C QZAB	7/27/11			\$15.9 million	.07% (a)
2011 Second Series D QECCB	7/27/11			\$6.5 million	.62% (a)
2011 Second Series E Tax-Exempt Refunding Bonds	9/13/11		\$254.9 million		1.20%

(a) *The 2011 Second Series C Qualified Zone Academy Bonds (QZABs) are special, federally-authorized taxable direct subsidy bonds where the subsidy payment is equal to the lesser of the tax credit rate as determined by the U.S. Treasury or the taxable interest rate on the bonds as established at the time of the sale. The State will receive 100% of the interest as a direct subsidy for the 2011 Second Series C QZABs. The 2011 Second Series D Qualified Energy Conservation Bonds (QECCBs) are special, federally-authorized taxable direct subsidy bonds where the subsidy payment is equal to the lesser of the amount of interest payable on the bonds as established at the time of the sale or 70% of the tax credit rate as determined by the U.S. Treasury. The State will receive 85.83% of the interest as a direct subsidy for the 2011 Second Series D Qualified Energy Conservation Bonds (QECCBs).*

Outlook for the Municipal Bond Market

Rating Agencies

Throughout 2011 and most likely in 2012, rating agencies will focus on the U.S. budget deficit, the U.S. debt level and the impact of federal budget reductions on state and local governments. The economic recovery, revenue collections, the resolution of structural deficits, and pension and OPEB funding levels will also continue to be closely followed by investors and the rating agencies.

Threat to Tax-Exemption

As policymakers consider tax reform and ways to reduce the federal budget deficit, the reports of two commissions (the Bowles-Simpson “Moment of Truth” and the Bipartisan Policy Center’s “Restoring America’s Future”), lawmakers, and even the President have issued proposals in 2011 to curtail or eliminate tax exemptions for municipal bonds. Many municipal issuers are concerned that eliminating tax deductibility would fundamentally alter how state and local government will pay for infrastructure at a time when infrastructure investment is needed.

Interest Rates

The State Treasurer’s Office monitors interest rates not only because they affect future debt service and bond premiums but they also impact refunding opportunities. Interest rates may rise from the 45 year lows that the market registered in mid-January. The factors that could increase rates are (1) how low they are presently, (2) an expected increase in Muni bond supply, and (3) a retreat from the flight to quality (because of European debt crisis) that pushed Muni yields down. If the federal government puts a cap on the federal tax-exemption for Muni interest, that could contribute to higher rates.

However, the unsettled conditions with the European debt crisis might keep yields roughly where they are currently. Also, if the tax cuts enacted under former President George W. Bush are allowed to expire, that would encourage people to buy Munis for the tax-exemption.

Comments on the Issues

The State Treasurer should brief the committees on the long-term outlook of the Annuity Bond Fund and the benefits of a dedicated revenue source for debt service. Insofar as there is a long-term General Fund deficit and the State has identified a dedicated revenue source for GO Bond debt service, the Department of Legislative Services (DLS) recommends that any shortfall in the Annuity Bond Fund be supported by additional State property taxes.

Both the Capital Debt Affordability Committee and the Commission on State Debt have recognized for some time that, at current property tax levels, there will be insufficient revenues in the Annuity Bond Fund to cover debt service in future years. Going back to Reports from the Commission on State Debt and from the Capital Debt Affordability Committee in 2007 through 2011, there were projections of gaps between revenues (primarily real property taxes) and debt service.

Since the General Fund subsidy to the Annuity Bond Fund in fiscal year 2008, the projected gap has not been realized in fiscal years 2009 through 2012 for three reasons:

- Interest rates have remained low as the economy continues to rebound slowly from the recession and as investors have sought high quality bonds like Maryland General Obligation Bonds.
- Debt service has been lower than initially forecast because of the issuance of refunding bonds and the use of ARRA bonds which were cheaper for the State than traditional tax-exempt bonds.
- Premiums are only forecast in the fiscal year of the CDAC and Commission on State Debt Reports because they can be volatile. Actual premiums have been significant in the last few years and have been able to fill the projected gaps forecasted in 2007 through 2011.

In late November 2011, the State's Financial Advisor projected that the sale of \$465 million in the 2012 First Series would result in a net premium of \$72.6 million. Currently, with these assumptions, the 2013 budget has sufficient revenues from the real property tax, federal interest subsidies on ARRA bonds, and bond premiums to meet the projected 2013 debt service.

Looking beyond the projections for fiscal year 2013, however, the gap between revenues and debt service expands to amounts that premiums cannot realistically fill. Exacerbating the gap are the increased authorizations and issuances of recent years and the declining property tax assessments. Specifically, in late November the projections showed shortfalls of \$240 million, \$300 million, \$380 million and \$425 million in fiscal years 2014, 2015, 2016 and 2017 respectively. These projections do not include premiums beyond fiscal year 2013 because they are volatile and difficult to predict. However, any premiums realized in these years would reduce the aforementioned shortfalls.

Beginning in fiscal year 2014, projections indicate that transfers from the General Fund or an increase in real property tax rates (or some combination) will be necessary. At current assessments, an increase of 1 cent in the tax rate will result in approximately \$64 million in tax revenue. 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. Annuity Bond Fund projections for 2013 will be rerun once the actual results of the March 7, 2012 sale of the 2012 First Series are known.

Investors and the bond rating agencies recognize the importance of the Annuity Bond Fund with a dedicated revenue stream that can only be used for payment of debt service. However, the rating agencies also have observed that Maryland's budgetary process and financial management are credit strengths. So the decision to increase property tax rates or to transfer General Funds to the

Annuity Bond Fund, or some combination thereof, should be a decision of the Administration and the Legislature. According to the Department of Budget and Management, this projected shortfall in the Annuity Bond Fund is included in the General Fund structural deficit that has been discussed with the rating agencies in recent years. The rating agencies are focused on the solution to the overall structural deficit and not specifically on the Annuity Bond Fund.

The State Treasurer should brief the committees on the effect of additional revenues on State debt capacity under current debt affordability guidelines.

One of CDAC's two debt affordability ratios is "debt service should not exceed 8% of revenues". The additional revenues cited by the analyst would expand debt capacity IF there are no increases to projected debt service as a result of increased interest rates OR increased debt issuances AND all other revenues remain constant. The Capital Debt Affordability Committee will meet again in the summer of 2012 and, at that time, will have updated revenue and debt projections. As described on pages 53 and 54 of the 2011 CDAC Report, the Committee has frequently recommended increased authorizations when there was sufficient capacity in recent years. The Report is available on the Treasurer's website.² The Committee members have also demonstrated their commitment to adhere to the 4% and 8% benchmarks and reduced authorizations when revenues declined (as they did in 2010), to remain within these benchmarks.

The State Treasurer should brief the committees on the efforts of the Capital Debt Affordability Committee to keep State debt within affordability guidelines.

The Capital Debt Affordability Committee, in its Reports and in its letters to the Governor and legislative leadership, has expressed its intention to remain within the two affordability ratios which are debt outstanding should not exceed 4% of personal income and debt service should not exceed 8% of relevant revenues.

In December 2011, the Committee increased the September 2011 recommended authorization of \$925 million by \$150 million to \$1,075 million to fund the 2013 capital program. The Committee increased the 2011 recommended authorization because there is need for infrastructure improvements, the cost of capital is at historic lows and construction costs are also low because of capacity in materials and labor. The increased recommended authorization is expected to finance "shovel ready" projects and provide economic stimulus in Maryland.

² http://www.treasurer.state.md.us/media/41257/2011_cdac_report.pdf

The assumptions presented at the December meeting also assumed a \$150 million reduction to the projected authorization in 2017 to stay below the target of 8% debt service to revenues. The Committee recognizes that there are multiple annual authorization levels and patterns that would result in adherence to the benchmarks, depending on future levels of personal income and State revenue. The Committee's projections for future authorizations will reflect updated revenue and personal income projections and authorization levels to adhere to the affordability benchmarks. However, as the ratios approach the 8% benchmark, there will be less flexibility if revenues decline again in the future.

DLS recommends that, prior to entering into a capital lease, the State compare the cost of leasing with the cost of issuing GO bonds and pursue the most cost-effective approach.

The Department of Health and Mental Hygiene (DHMH) public health lab was financed in late 2011 as a capital lease. MEDCO is the owner of the building and financed it by issuing MEDCO bonds. DHMH entered into a capital lease to occupy the building and their lease payments are pledged to cover the debt service on the MEDCO bonds. A project such as this could also have been financed with General Obligation Bonds if it was authorized in a MCCBL. Capital leases and General Obligation Bonds are both counted as tax-supported debt in the CDAC affordability analysis.

The State Treasurer's Office agrees with the DLS conclusion that the financing of the DHMH public health lab with MEDCO bonds was more expensive than the issuance of General Obligation Bonds. Assuming the same financing date, a financing with General Obligation Bonds instead of MEDCO bonds would have saved the State \$11 million in debt service and would have generated \$25 million in premium for deposit in the Annuity Bond Fund.

The State Treasurer's Office believes the State should compare the cost of leasing with the cost of issuing GO Bonds to determine whether entering into a capital lease is in the best interest of the State. In fact, this comparison occurred in the Capital Debt Affordability Committee meeting in July 2009. This analysis can be found on pages 56-59 in the 2009 CDAC Report.³ However, there are other factors that may influence the decision regarding the financing method. The need and impact on the public, a faster and more efficient delivery of the project and better maintenance of the building are several examples of such factors to consider.

The State Treasurer's Office should brief the committees on the level of proposed GO bond authorizations that are subject to private purpose restrictions. This should include a discussion of the likelihood, timing, and amount of any taxable debt issuance.

³ http://www.treasurer.state.md.us/media/20379/2009_cdac_report.pdf

Section 141 of the Internal Revenue Code sets forth private activity bond tests for the purpose of limiting the volume of tax-exempt bonds that finance activities of nongovernmental persons (i.e., persons or businesses, including the federal government, who are not state and local governmental entities). These tests serve to identify arrangements that actually or reasonably expect to transfer the benefits of tax-exempt financing to nongovernmental persons. A privately owned, for-profit cafeteria in a State building is an example of private use and the Department of Housing and Community Development (DHCD) single family loan program is an example of a loan program. There are two measures of private activity: if the bond finances private business use and private payment; or if the bond finances private loans.

The measure for private loans allows private loans up to 5% of the bond proceeds or \$5 million, whichever is less. The State Treasurer's Office is actively managing the authorizations for private loans so that as many taxable loans as possible are included in a tax-exempt bond series to fit within this exemption.

Specifically, the STO has identified authorizations for loan programs in the Department of Housing and Community Development, Maryland Department of Education and the Department of Planning that are likely to be considered private loans. The STO has also worked with the Comptroller's Office to direct expenditures for these projects into different series so that the private loan exemption of \$5 million in each series can be utilized.

Nevertheless, some authorizations for private loans may exceed allowable exemptions. Consequently, the STO may need to issue taxable bonds but the timing of issuances will be scheduled to limit taxable interest. Therefore, instead of issuing taxable bonds, incurring debt service and then waiting for expenditures, the STO will wait for sufficient expenditures to occur before issuing the taxable bonds. We can do this by utilizing the cash flow in the Capital Projects Fund and "red balancing" the taxable expenditures. When a sufficient level is reached, the STO will recommend the issuance of a taxable bond and reimburse the Capital Projects Fund.

Depending on market conditions, the difference between interest costs on a taxable bond and a tax-exempt bond can vary. The STO monitors this variable and will also consider market conditions when it determines when to issue taxable bonds. The STO will also structure the taxable bond issue with short maturities to limit any additional interest cost that may be incurred by taxable bonds.

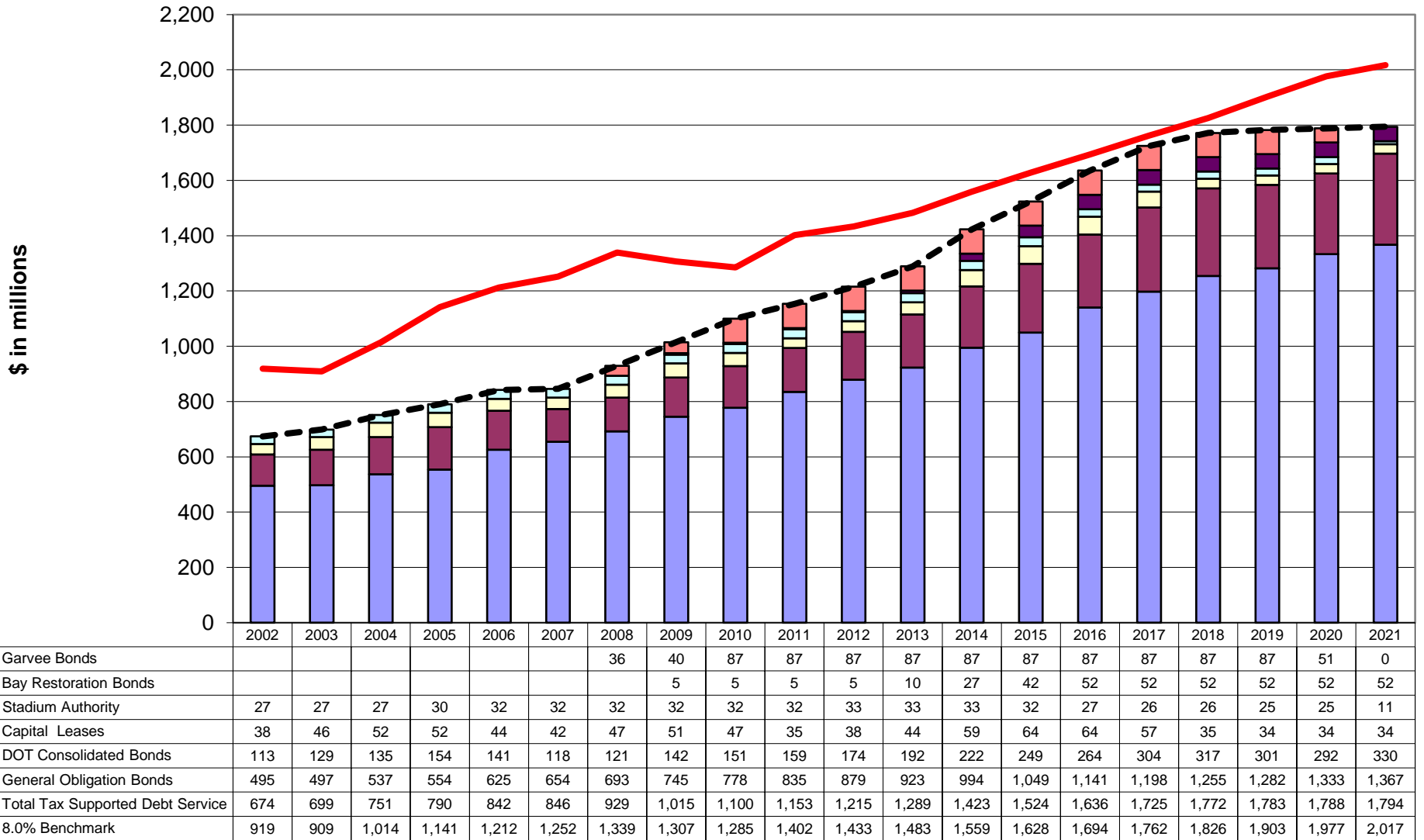
The STO has also identified private activity in the 2009, 2010 and 2011 MCCBL. At this time, we think that projects that have private activity can be financed with tax exempt bonds and will remain within the IRS parameters of the lesser of 5% or \$15 million.

In conclusion, the STO believes that there may be a need to issue some taxable bonds in the next year; however, the exact amount and timing are, at this point, not determined and are dependent to some degree on the speed and amount of expenditures related to these projects.

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

Tax Supported Debt Service to Revenues as of DECEMBER 2011

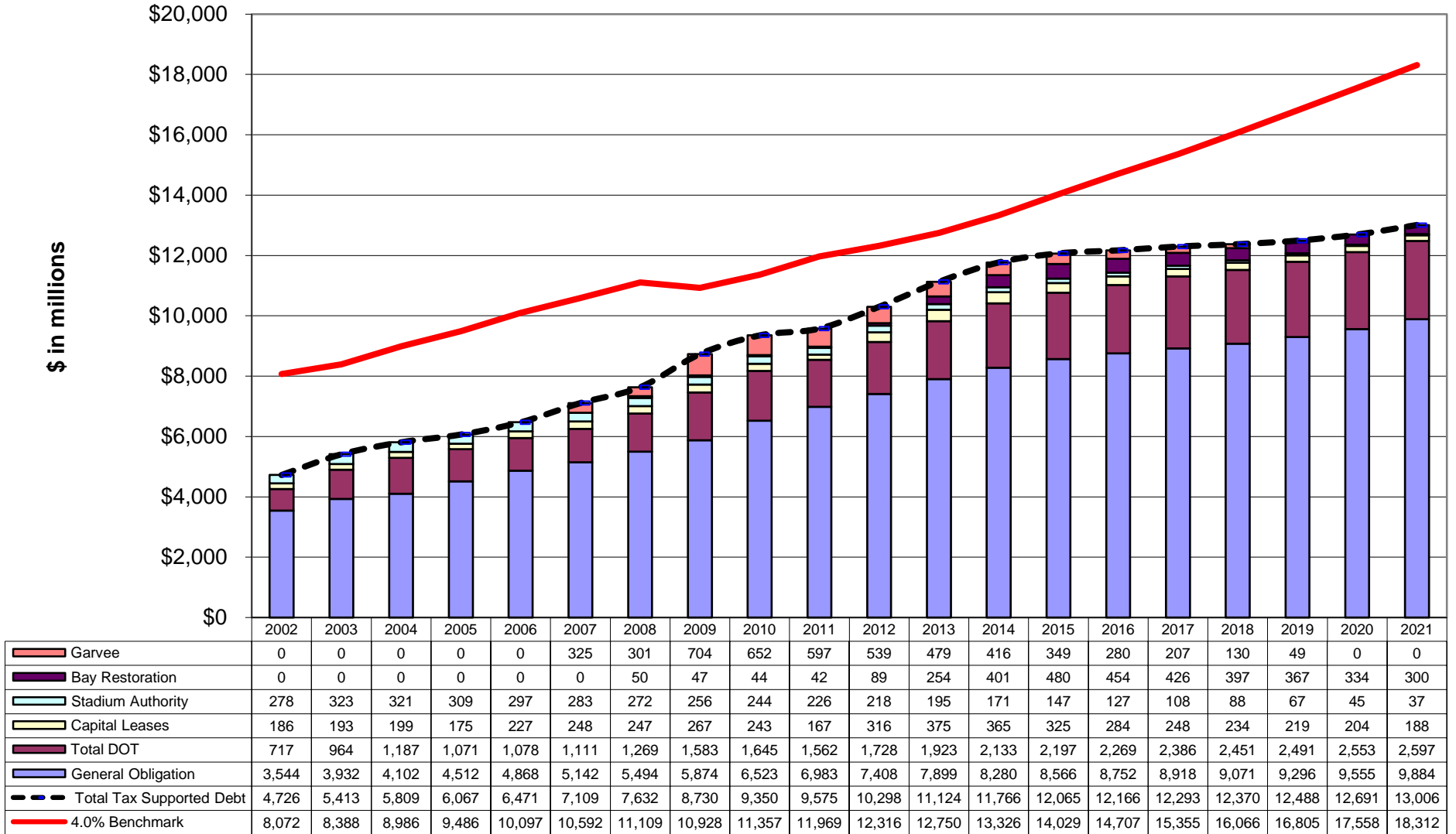
Fiscal Years 2002-2011 are final; Fiscal Years 2012-2021 are projections and subject to change



Source: Table 2A as of Dec. 2011

Tax Supported Debt Outstanding to Personal Income as of December 2011

Fiscal Years 2002-2011 are final; Fiscal Years 2012-2021 are projections and subject to change



Source: Table 1 as of December 2011