TESTIMONY OF STATE TREASURER NANCY K. KOPP

Before the

House Appropriations Committee

March 1, 2019

Good afternoon, Chairman McIntosh and members of the committee. I am pleased to have the opportunity to appear before you to discuss the public debt budget. As usual, Mr. Frank and the Department of Legislative Services staff have done an excellent job in the analysis of the budget and with the 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 overview of the State's credit;
- Recap of calendar year 2018 bond sales;
- Municipal bond market update; and
- The upcoming 2019 First Series General Obligation bond sale.

Rating Agency Update

On July 24, 2018, as part of the sale of Maryland's General Obligation Bonds State and Local Facilities Loan of 2018, Second Series, Moody's Investors Service, S&P Global (S&P) and Fitch Ratings all reaffirmed their AAA ratings for Maryland's General Obligation debt. The rating reports from this sale are available on the Treasurer's website at www.treasurer.state.md.us.

Maryland is one of only twelve 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 Investors Service has assigned the bonds a rating of Aaa since 1973, and Fitch Ratings has rated the bonds AAA since 1993. The other eleven states that hold AAA ratings from all three rating agencies are Delaware, Georgia, Florida, Iowa, Missouri, North Carolina, South Dakota, Tennessee, Texas, Utah and Virginia.

The State of Maryland is scheduled to have a call with all three major rating agencies on March 7 to discuss the State's rating in advance of the March 26 bond sale. As always, the Treasurer's Office will provide updates on the rating agency reports once we receive the State's ratings.

Overview of Maryland's Credit

There is broad consensus about the State's credit strengths and challenges. An overview of some of those factors follows, but should not be considered exhaustive. As mentioned above, reports issued in conjunction with the State's bond sales are available on our website. The rating agencies also frequently issue general research reports pertaining to credit issues and challenges which are available upon request.

Credit strengths:

Strong fiscal management institutions: One of Maryland's greatest credit strengths is its fiscal management, which is supported by strong institutionalized tools. These include the Capital Debt Affordability Committee (CDAC) process, which ensures State tax-supported debt remains within affordable levels; the Board of Revenue Estimates process, which produces a consensus revenue forecast agreed upon by the different branches of government; the strong Executive budgeting system; the Board of Public Works (BPW)'s ability to make midyear spending adjustments; the lack of a supermajority requirement for tax increases; and rapid fifteen-year amortization of general obligation debt required by the Constitution, among other things.

Track record of excellent fiscal management: The State also has a proven track record of proactive fiscal management. Operating budgets are balanced and nearly always passed within the 90 day legislative session, the BPW has made numerous spending adjustments in response to new revenue information over the years, and adjustments such as tax increases and reforms to the pension system have been made when necessary. Maryland's "middle temperament" and tradition of proactive cooperation on fiscal matters are subjective but critically important factors in the State's credit rating.

Stable, diversified economy: Maryland has a broad-based, service-oriented economy anchored by the federal government, which has a positive impact on the State's economy overall despite occasional drag caused by dysfunction in the federal government. The State's economy has a long record of resilience and above average performance relative to the nation as a whole. Maryland also tends to have lower unemployment and more high-paying jobs than the national average.

Highly educated population and above average income: The State's population ranks in the top echelon of the U.S. in terms of its educational attainment status and income level, creating a dynamic and reliable revenue base. Policies that help us maintain our status as a highly educated, wealthy state are critical to the State's ability to retain its AAA bond rating.

Credit challenges:

Pensions, debt, and other long-term liabilities: Long-term liabilities in Maryland are considered to be somewhat high relative to peer triple AAA states. The State's debt burden is considered moderate, and the Constitutional requirement to retire debt within fifteen years, though a credit positive overall, leads to higher annual debt service costs. Maryland also directly

funds a large portion of school construction needs for its counties, which is unusual among states. Pensions are still below the ideal levels of funded status, and though the rating agencies credit us for the 2011 reforms, they also warn against any backsliding on the reforms that could jeopardize the progress we have made. Taking steps to manage these long-term liabilities while still meeting Marylanders' need for State services is crucial.

Aging infrastructure and deferred maintenance: Despite the need to manage liabilities, the State continues to have significant need for capital investments that will keep the State economically competitive in the 21st century. Demand for capital projects such as school renovation and replacement, economic development, housing, etc. have consistently far exceeded actual spending, a trend which has accelerated over the last few years. During the Great Recession and years of slow growth that followed, maintenance on State facilities was deferred due to budgetary restraints, leading to a significant backlog that must be addressed. Though it is important to manage long-term liabilities, the State must continue to make investments in its people and infrastructure, while protecting its existing assets to avoid the need for more expensive repairs or replacements in the future.

Revenue challenges caused by suboptimal demographic trends and taxation system: In the State's long-term forecasts, revenues are not expected to keep up with expenditures. As Maryland's Bureau of Revenue Estimates recently reported, this is in part due to depressed revenue growth resulting from the demographic structure of the State's population, in which a growing portion of Marylanders are above prime working age, while prime-age workers themselves are participating in the labor force at lower rates than they have historically[1]. Policies that attract new immigrants and prime-age workers, retain the workers we have, or encourage participation by those not currently in the workforce can offset this decline. An additional revenue challenge is that the State's taxation system is designed for a 20th century economy. The State is transitioning to a service-based economy, meaning a growing sector of the economy is not taxed; likewise, the State has not adjusted for technological change, such as taxing digital goods and subscriptions. The *South Dakota vs. Wayfair, Inc.* decision delivered some rare good news on this front, allowing the State to tax online sales of entities with no physical footprint in Maryland. The State is already seeing significantly increased sales tax revenue from this change.

Federal government dysfunction: Brinksmanship at the federal level such as forcing a government shutdown or threatening a debt ceiling breach in an attempt to coerce unrelated policy concessions have an outsized impact on Maryland due to our reliance on the federal government. Shutdowns typically lead to decreases in State revenue; an actual debt ceiling breach would directly impact the State's rating, since it is unusual for a subordinate state to be rated higher than its sovereign. Management issues at federal agencies that lead to high vacancy rates and churn also directly impact the State's bottom line.

---

[1]The Bureau of Revenue Estimates studied this problem at length and its report can be found here: https://finances.marylandtaxes.gov/static_files/revenue/BRE_reports/FY_2018/BRE%20Report%20on%20Age%20Demographics.pdf

Calendar Year 2018 Bond Sales

We continue to plan and conduct our bond sales effectively, while striving to maintain Maryland's coveted AAA bond rating. The calendar year 2018 bond sales outlined below reflect a continuation of these efforts.

The 2018 2nd Series was the first bond sale in which the State of Maryland divided its new money offerings into two smaller tranches. The goal was to marginally improve pricing and expand the distribution of bidders on the bonds by selling smaller, more digestible chunks of money. The Treasurer's Office believes both these goals were met, with at least a one basis point pricing improvement and increased participation and competitiveness by different institutions. The Treasurer's Office plans to continue this practice for the 2019 1st Series.

Notably, the Treasurer's Office did not offer advance refunding or qualified zone academy bonds in 2018. This is because the federal tax cuts enacted at the end of 2017 minimally offset the cost of those cuts by eliminating the tax exemption and interest subsidies, respectively, on those bonds. Losing access to these programs will ultimately increase the debt service cost borne by Marylanders. The Treasurer's Office remains hopeful that these programs may be restored in the future, but the prospects of that occurring are presently dim.

Calendar Year 2018 State of Maryland Bond Offerings					
Series	**Date**	**Type of Sale**	**Par Amount**	**TIC**	**Bond Premium**
2018 1st A	3/7/2018	Tax-Exempt New Money	$475.0m	2.832%	$71.3m
2018 1st B	3/7/2018	Taxable New Money	$50.0m	2.593%	$0.0
2018 2nd Group 1	8/1/2018	Tax-Exempt New Money	$275.3m	2.337%	$45.6m
2018 2nd Group 2	8/1/2018	Tax-Exempt New Money	$234.7m	3.130%	$36.4m

Municipal Bond Market Update

U.S. municipal bond volume was down significantly in 2018, decreasing to $343.4 billion from 2017's record high of $448.6 billion. The decrease was primarily caused by the aforementioned elimination of tax-exempt advance refundings as well as a surge in offerings at the end of 2017 as issuers moved up sale dates to avoid being impacted by changes to the tax code. The Securities Industry and Financial Markets Association expects 2019 volume to be close to 2018 levels.

Municipal bond yields have decreased since the spike in rates at the beginning of 2018. As of February 27, 2019, the 10-Year Municipal Market Data (MMD) index was 2.08%, only 10 basis points higher than it was at the end of 2017 before the federal tax cuts went into effect. Additionally, the Board of Governors of the Federal Reserve System ("the Fed") has now indicated that it is pausing planned rate hikes, meaning a near-term future of continued low interest rates and excellent borrowing costs, especially for highly rated issuers such as the State of Maryland. Pausing rate hikes at current levels means the Fed will have less flexibility to

address recessionary forces in the future. Some have speculated that this could lead the Fed to experiment with negative interest rates in the event of a major recession; the impacts of this are unclear.

2019 First Series General Obligation Bonds

The next general obligation financing is scheduled for March 26, 2019 and is expected to total $490 million of tax-exempt new money sold in two tranches on a competitive basis. The Treasurer's Office expects Maryland to once again achieve excellent borrowing costs given the low interest rate environment.

Responses to the Analyst's Issues

Overly aggressive bond premium assumptions: As noted in the analysis, the Governor's operating budget proposal assumes $140 million in bond premium will be realized in the following year and a half. The budget then uses these funds to offset debt service.

Given that bond premiums are impossible to predict, we believe this assumption is too aggressive. If the State should attain any amount less than $140 million in bond premiums over that period – a very real possibility – the State would lack the funds necessary to pay its debt service, leading to a problematic situation in which the State would require a deficiency appropriation during the 2020 legislative session to be able to pay its bills. This would be unbecoming of a triple AAA state and should be avoided.

Furthermore, using bond premium to offset debt service costs at all makes Maryland an outlier among its triple AAA peers. Few if any other highly rated States use premium to offset operating costs. Instead, paying debt service with bond premium puts us in a peer group with Connecticut, a state whose credit is widely considered challenged, and even there the practice is controversial.

Instead of using bond premium to offset operating costs, the State should be using it to reduce the size of its offerings. Using premium to "resize" the par amount of bond sales is a common method used by most sophisticated issuers. The practice would improve the State's debt management and credit resilience in three ways:

- *Eliminating underattainment risk to the State.* By ending the reliance on bond premium for debt service, the State would no longer risk running out of funds to pay its bills due to underattainment of assumed premium.
- *Immediately reducing the State's outstanding debt load.* Over the last decade, bond premium earned on our sales has frequently been somewhere in the range of $50-75 million per sale. Over a five year period, if the State were to size down the par amount of its two annual sales by $50 million each, the State would avoid issuing $500 million of debt. If more premium were attained, the avoided debt would be even greater. Resizing would thus quickly and dramatically reduce the size of the State's outstanding debt. Given the importance to our credit rating of managing long-term liabilities, this would be a significant and immediate credit positive.

- *Significantly reducing long-term debt service costs.* Similarly, by reducing the amount of debt issued, the debt service paid by the State would decrease. If the State were able to issue $500 million less over a five year period, the avoided interest over the life of those loans would total around $250 million. When adding the avoided principal and interest together, the State would avoid paying around $750 million in debt service over the life of the loans. These avoided costs would continue to accumulate for as long as the State continued to resize its sales. However, unless other fund sources are found, there would be a one year increase in general fund spending as the State moved to using general funds to pay the portion of its debt service currently funded by bond premium. No bond premium is assumed in the long-term forecast for fiscal years 2022 and beyond, so the structural gap in those years would be unaffected.

We understand that to some extent bond premium is already baked into the fiscal year 2020 budget. At minimum, we recommend that any bond premium assumed in fiscal year 2020 be redirected to PAYGO capital projects which can be canceled or receive alternate funding in the event we fall short of premium estimates. Moving forward, the State should end the practice of assuming bond premium to offset debt service costs.

Finally, any discussion about reforming the State's debt management practices should include changing the way the State amortizes its debt. To ease short-term budgetary pressures, the State currently delays principal payments on its debt until the third year after a sale. Were we to begin paying principal the year after issuance, the interest savings would significantly decrease debt service payments over time. However, the State would pay more total debt service during the first two years after issuance since it would also be making principal payments.

Capital Debt Affordability Committee assumptions: The analysis notes that the impact of increased bond authorizations is not fully captured in the State's CDAC projections. This is primarily due to the fact that CDAC only makes projections for a ten year timeframe. While the impact of bond authorizations does continue beyond ten years, we do not consider it prudent, within reasonable limits, to base today's policy on the budgetary impact more than ten years in the future. We also note that even under current methods, the CDAC process has been effective at maintaining the State's debt within affordable levels due to prudent, conservative assumptions and the ability to make timely adjustments as needed to stay within the guidelines. However, we are always open to dialogue on how to improve the State's debt management practices.

Impact of change to GASB treatment of leases: The GASB changes to the definition of operating leases have taken effect and will need to be studied by CDAC this year. The Treasurer's Office plans to convene a workgroup on the subject over the summer and make a recommendation to CDAC in October. The workgroup will use the report released by the Departments of Budget and Management, General Services, and Transportation as a starting point to determine the amount, if any, that should be included in the CDAC analysis.

I would be happy to address any questions the Committee may have.