Good afternoon, Chairman Guzzone 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 2019 bond sales;
- Municipal bond market update; and
- The upcoming 2020 First Series General Obligation bond sale.

**Rating Agency Update**

On July 29, 2019, as part of the sale of Maryland’s General Obligation Bonds State and Local Facilities Loan of 2019, 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](http://www.treasurer.state.md.us).

Maryland is one of only thirteen 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 twelve states that hold AAA ratings from all three rating agencies are Delaware, Georgia, Florida, Indiana, 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 February 12 to discuss the State’s rating in advance of the March 4 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.

It is important to note that Maryland is weaker relative to other triple-AAA states on quantitative measures such as pension liability and outstanding debt load. According to their credit rating scorecards, both Moody’s and S&P Global Ratings would consider Maryland to be in the AA+ category based on quantitative factors but notch the State up to the AAA category based on our institutions and other more subjective factors. When it comes to Maryland’s credit rating, our greatest strength is our reputation for prudent fiscal management.

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 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. 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, as well as subsequent legislation to require marketplace facilitators such as Amazon and eBay to collect and remit sales tax on behalf of third party sellers, has 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 these changes. However, more needs to be done to modernize our taxation system.

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1The Bureau of Revenue Estimates studied this problem at length and its report can be found here: https://www.marylandtaxes.gov/reports/static-files/revenue/BRE_reports/FY_2018/BRE%20Report%20on%20Age%20Demographics.pdf
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, and 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.

Calendar Year 2019 Bond Sales

We continue to plan and conduct our bond sales with an eye towards minimizing risk for
the State while taking advantage of innovations and new opportunities in the municipal bond
market. The calendar year 2019 bond sales outlined below reflect a continuation of these efforts.

Notably, the Treasurer’s Office did not offer advance refunding or qualified zone academy
bonds in 2019. 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 2019 State of Maryland Bond Offerings

<table>
<thead>
<tr>
<th>Series</th>
<th>Date</th>
<th>Type of Sale</th>
<th>Par Amount</th>
<th>All-In TIC</th>
<th>Bond Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019 1st Group 1</td>
<td>3/26/2019</td>
<td>Tax-Exempt New Money</td>
<td>$265.0m</td>
<td>1.787%</td>
<td>$53.4m</td>
</tr>
<tr>
<td>2019 1st Group 2</td>
<td>3/26/2019</td>
<td>Tax-Exempt New Money</td>
<td>$225.0m</td>
<td>2.713%</td>
<td>$39.3m</td>
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<tr>
<td>2019 2nd A Group 1</td>
<td>8/14/2019</td>
<td>Tax-Exempt New Money</td>
<td>$248.7m</td>
<td>1.141%</td>
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<tr>
<td>2019 2nd A Group 2</td>
<td>8/14/2019</td>
<td>Tax-Exempt New Money</td>
<td>$251.3m</td>
<td>1.990%</td>
<td>$32.2m</td>
</tr>
<tr>
<td>2019 2nd B</td>
<td>8/14/2019</td>
<td>Taxable New Money</td>
<td>$50.0m</td>
<td>1.625%</td>
<td>$0.0</td>
</tr>
</tbody>
</table>

Municipal Bond Market Update

U.S. municipal bond volume bounced back in 2019, increasing to $421.7 billion from
2018’s lower than usual level of $343.4 billion. Analysts disagree about 2020 volume, with some
predicting it will eclipse the previous record set in 2017 of $446.8 billion and others predicting it
will fall short of the $400.0 billion mark.

Despite being quite low by historical standards throughout 2019, municipal bond yields
have plunged even lower in 2020 and surprisingly hit a new all-time low on January 30, 2020.
As fears of recession have eased and recent economic conditions appear to be holding steady,
interest rate hikes and decreases in 2020 have become less likely. At present, it appears that the
current environment of very low interest rates will continue in the short term, though external
events could change that very quickly.
2020 First Series General Obligation Bonds

The next general obligation financing is scheduled for March 4, 2020 and is expected to total $495.0 million of tax-exempt new money sold in two tranches, $50.0 million of taxable new money, and up to $255.0 million in current refunding bonds, all on a competitive basis. You may recall that the tax subsidy on advance refunding bonds was eliminated by the 2017 federal tax cuts; however, current refundings are still allowed. The current refunding bonds in the 2020 1st Series bonds are projected to achieve approximately $20.6 million in net present value savings over the next several fiscal years. Overall, the Treasurer’s Office expects Maryland to once again receive excellent borrowing costs given the low interest rate environment.

Responses to the Analyst’s Issues

Bond premium: We noted last year that the Governor was making aggressive assumptions about bond premium attainment and using it to fund current year debt service, which is an operating cost, rather than resizing to reduce overall debt issuance or funding the State’s capital needs. Unfortunately, the Governor has allocated even more bond premium for this purpose fiscal year 2021 – a total of $166.5 million.

Bond premium is paid to the State when a bank wants a higher annual return on bonds it has purchased than the market interest rate dictates. Since bond premium is meant to make up for this higher interest rate the State will pay on the bonds over the long term, spending bond premium on current year debt service is costly, inefficient, and fiscally irresponsible.

Additionally, as the analyst notes, the Volcker Alliance has criticized Maryland for this practice in the past. While the rating agencies and Internal Revenue Service have not explored it to date, there is an omnipresent risk that they might also decide to investigate the practice more closely. Such an investigation could jeopardize the State’s credit rating and/or lead to additional regulation of tax-exempt bonds which could be harmful to the State.

Therefore, the State Treasurer’s Office strongly supports the analyst’s recommendation that the State Treasurer’s Office, in conjunction with the Department of Legislative Services and Department of Budget and Management, work together to study resizing the State’s bond sales and examine the use of bond premium. The Treasurer’s Office also recommends examining other best practices for use of bond premium such as funding critical infrastructure projects. For the fiscal year 2021 budget, the Treasurer’s Office recommends that any bond premium above the $166.5 million already allocated for debt service be directed to capital projects and/or used to resize bond sales during fiscal year 2021.

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 to base today’s policy on the budgetary impact more than ten years in the future. We also note that under current forecasting 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.

I would be happy to address any questions the Committee may have.
The Department of Budget and Management (DBM) appreciates this opportunity to respond to the Department of Legislative Services’ (DLS) analysis of the Public Debt budget.

As noted in the analysis, Maryland’s debt ratios are above average; but the analysis correctly points out that this is due in large part to Maryland’s constitutional limitation of State debt to 15 years, which credit ratings agencies consider advantageous as the State retires debt more quickly and is burdened less by prior issuances. To that point, the State is able to improve the trajectory of its debt ratios quickly. As of FY 2016, the ratio of debt service to revenues was projected to be 7.81 percent in FY 2020. However, that ratio now sits nearly half a percentage point lower, at 7.35 percent.

DBM’s responses to the recommendations raised in the analysis are provided below.

**DLS Recommendation:** Reduce the debt service appropriation by $5 million to reflect lower debt service costs than assumed in the budget bill.

**DBM Response:** DBM concurs with the DLS recommendation.

**DLS Recommendation:** Adopt narrative to request a report that examines the use of bond sale premiums.

**DBM Response:** DBM concurs with this recommendation and looks forward to working with the Treasurer and General Assembly to study bond premium use and the potential for resizing bond sales.
DLS Recommendation: DBM should be prepared to brief the committees on its methodology, including inputs and financial modeling

DBM Response: DBM agrees with the analysis that caution is advised when estimating bond premiums. When possible, DBM prefers to match DLS estimates in the current fiscal year to ensure that the budgeting process for debt service begins with an agreed-upon set of numbers.

When making projections for bond premiums beyond the current fiscal year, there are a few factors involved. The first is based on a five-year history of bond premiums compared to the par value of sales. In that time period, there has been only one sale that has a bond premium attainment of less than 14.0 percent—July, 2015, at 9.7 percent. The average attainment is 15.7 percent. For a conservative approach, DBM typically will estimate a premium of 10.0 to 12.0 percent attainment. The $54 million estimate for the FY 2021 winter sale matches the 10.0 percent estimate—in line with the lowest attainment in the past five years.