July 22, 2020 General Obligation Bond Sale

On July 22, 2020, the State sold $1,011.4 million in general obligation (GO) bonds for capital projects. This included $540 million in new tax-exempt bonds, $115.8 million in tax-exempt refunding bonds, and $355.6 million in taxable advanced refunding bonds. Maryland typically issues tax-exempt GO bonds twice a year to support the State’s nontransportation capital program.

The true interest cost (TIC) for the sale bonds is 1.11%. The TIC for the most recent bond sale on March 4, 2020, was 1.38%. The TIC was low because interest rates have declined since the last sale, and the State issued $471 million in refunding bonds, which have shorter maturities and lower interest rates. As with other recent issuances of new debt, the new bonds sold generated a substantial premium, which totaled $180 million.

The refunding issuances reduce projected fiscal 2021 debt service costs by $61 million, and the new issuances generated a bond sale premium that increases the Annuity Bond Fund (ABF) balance by $78 million and provides $102 million of funding for capital projects. The ABF, which supports GO bond debt service costs, has sufficient revenues to fund fiscal 2021 debt service costs and leave an estimated $53 million surplus for fiscal 2022.

Tax-exempt Bonds to Institutional Investors

The State issued $540 million in GO bonds, which was a large bond sale. In an effort to increase competition, the State Treasurer’s Office (STO) divided the sale into two bidding groups, $290 million in Group 1 and $250 million in Group 2.

Six underwriters bid for the $290 million of bonds sold in Group 1. Bank of America Merrill Lynch submitted the winning bid with a TIC of 0.55%. The bonds’ maturities ranged from 3 years to 11 years with an average maturity of 6.9 years. The Group 1 sale generated a premium totaling $85.1 million, after deducting the cost of issuance and the underwriters’ discount.

Five underwriters bid for the $250 million of bonds sold in Group 2. Wells Fargo Bank, National Association submitted the winning bid for Group 2 with a TIC of 1.74%. The bonds’ maturities range from 11 years to 15 years with an average maturity of 13.1 years. The higher TIC for Group 2 is attributable to the longer maturities. After deducting the cost of issuance and the underwriter’s discount, the Group 2 sale generated a premium totaling $94.7 million.

Refunding Bonds

Most long-term GO bonds issued by the State are callable. This allows the State to retire those bonds early and issue lower interest rate bonds in their place if interest rates decline. For
example, in August 2012, the State issued $27.3 million in bonds that mature in August 2027 and are callable in 2020. To take advantage of the lower interest rates, the State is calling these bonds on September 4, 2020, and replacing them with the lower interest cost refunding bonds.

Prior to 2018, federal tax law allowed issuers of tax-exempt bonds one advanced refunding issuance for each new debt issuance. This allows issuers to defease bonds prior to the call date. The federal Tax Cuts and Jobs Act (TCJA) of 2017 changed federal tax law so that advanced refunding bonds are no longer tax deductible. This eliminated a key advantage since taxable bonds are more expensive than tax-exempt bonds. After the new law was enacted, there was a sharp decline in refunding issuances. From calendar 2009 to 2017, Maryland issued advanced refunding bonds at 11 bond sales, which saved the State $316 million in debt service costs. No advanced refunding bonds were issued in calendar 2018 and 2019.

In March 2020, the State issued its first refunding bonds since the enactment of the TCJA. The State issued $232 million in tax-exempt bonds to replace bonds that were callable in April 2020. This saved $25 million in debt service costs. The sale did not issue any advanced refunding bonds.

Interest rates have declined substantially in 2020. Rates have declined to the point that it is advantageous, in some cases, to issue taxable advanced bonds to refund tax-exempt bonds. STO has determined that there are savings associated with issuing refunding bonds with this sale. The State issued tax-exempt refunding bonds, which will be called in September 2020, and taxable advanced refunding bonds, which are callable in March and August 2021. Six underwriters bid for the $115.8 million in tax-exempt bonds. Bank of America Merrill Lynch was the winning bidder with a TIC of 0.58%. Five underwriters bid for $355.6 million in taxable advanced refunding bonds. J.P. Morgan LLC was the winning bidder with a TIC of 0.75%. These bonds will mature between fiscal 2022 and 2029.

The current coronavirus pandemic has resulted in a substantial loss in State revenues. To minimize fiscal 2021 expenditures, STO has structured the refunding sale so that $61 million in savings are realized in fiscal 2021, thereby realizing less than $1 million in savings beyond fiscal 2021. Savings were moved forward by issuing debt that matures later than the debt that is called. This is a departure from previous practice in which refunding bonds are structured so that new debt is retired at about the same time that previously issued debt would have been retired. In the sale, the average life of the refunded tax-exempt bonds is 3.5 years, while the newly issued tax-exempt refunding bonds’ average life is 7.4 years. Past refunding issuances have kept the average life of the refunded and refunding bonds roughly equal to maximize savings over the life of the issuance. This sale maximizes short-term savings but increases long-term costs by increasing interest payments. The Department of Legislative Services (DLS) estimates that this increases average debt service costs by less than $1 million annually. Insofar as the cost of delaying principal payments is low while interest rates are low, and the current stress on the State’s budget is substantial, it is reasonable to minimize short-term debt service costs instead of minimizing debt service costs over the life of the bonds. However, DLS recommends that the
State return to the practice of minimizing total debt service costs when economic conditions improve.

**Effect on the State Budget**

The refunding issuances reduced fiscal 2021 debt service costs and the new issuances realized substantial premiums that are deposited in the ABF. Exhibit 1 shows that ABF revenues will exceed fiscal 2021 debt service costs by $53 million.

**Exhibit 1**

**Debt Service Costs**
**Fiscal 2021**
**($ in Millions)**

<table>
<thead>
<tr>
<th>Total Debt Service Costs</th>
<th>$1,277.6</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Available Resources</strong></td>
<td></td>
</tr>
<tr>
<td>Beginning Annuity Bond Fund Balance and Other Revenues</td>
<td>$291.7</td>
</tr>
<tr>
<td>Estimated State Property Taxes</td>
<td>892.5</td>
</tr>
<tr>
<td>General Fund Appropriation</td>
<td>131.0</td>
</tr>
<tr>
<td>July 2020 Board of Public Works Reductions</td>
<td>-62.0</td>
</tr>
<tr>
<td>Net July 2020 Bond Sale Premium(^1)</td>
<td>77.8</td>
</tr>
<tr>
<td><strong>Total Available Resources</strong></td>
<td>$1,331.0</td>
</tr>
</tbody>
</table>

**Available Resources in Excess of Debt Service Costs**

<table>
<thead>
<tr>
<th></th>
<th>$53.4</th>
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</thead>
</table>

\(^1\) Bond sale premium totaled $179.8 million, of which $102 million supports capital projects.

Source: Public Resources Advisory Group; State Department of Assessments and Taxation; Department of Budget and Management; Department of Legislative Services

**Maryland Bonds Rated AAA-stable**

Prior to the bond sale, the three major rating agencies – Fitch Ratings, Moody’s Investors Service, and S&P Global Ratings – reaffirmed the State’s AAA bond rating for GO bonds. All three agencies consider the rating stable. Maryland remains 1 of 12 states to have the AAA rating from all three major rating agencies. The other states are Delaware, Florida, Georgia, Iowa, Missouri, North Carolina, South Dakota, Tennessee, Texas, Utah, and Virginia.
With respect to Maryland, the rating agencies identified the following strengths:

- **Wealth and Income Levels:** S&P notes that Maryland’s per capita personal income was 116% of the national average in 2019.

- **Broad and Diverse Economy:** Strengths include abundant higher education and research institutions; proximity to the nation’s capital; transportation facilities such as the Port of Baltimore; and a concentration of employment in higher paying sectors such as business services, education and health services, and government. Moody’s notes that Maryland has a highly educated workforce whereby 40% of the population over 25 has at least a bachelor’s degree, compared to about 32% nationwide.

- **Strong and Well-embedded Financial Practices:** Fitch notes that the State has “very strong fiscal management with consensus-oriented long-term planning and multiple sources of flexibility, all of which position the state to address implications of the ongoing coronavirus pandemic.” Moody’s considers Maryland’s “proactive financial management” to be a credit strength and that BPW “is able to respond swiftly to midyear budget challenges.” S&P considers that Maryland’s financial “practices are strong, well embedded, and likely sustainable.” The agencies also noted that the State has made numerous attempts to address the unfunded pension liability, such as increasing State and employee retirement contributions, moving to an actuarially approved approach, reducing benefits, and increasing the length of time that it takes new employees to vest. Strengths of the capital budget process include the Capital Debt Affordability Committee process and the State constitution limiting GO bond maturities to 15 years.

- **Adequate Reserves and Liquidity:** Moody’s considers the State’s adequate budgetary reserves and strong liquidity to be a credit strength. Approximately $1.1 billion is currently available in the Rainy Day Fund.

    However, the rating agencies did identify challenges. The most significant and consistently noted challenges relate to the State’s long-term liabilities, such as pension-funded ratios and Other Post Employment Benefits liabilities. Maryland’s pension-funded rate is lower than most AAA-rated states.

    Rating agencies have identified factors that could lead to Maryland being placed on credit watch or downgraded, which include:

    - economic and financial deterioration that results in deficits, fund transfers, and reserve draws without a plan for near-term replenishment and structural balance;
    - failure to keep a commitment to fully fund pensions; and
- S&P notes that if the State relies “on nonrecurring resources to balance its budget, prove unable to enact budget cuts or make other or make other timely corrective action, or draw down reserves that is unlikely to be meaningfully replenished, we may revise our outlook or lower the rating.”

**Rating Agency Coronavirus Pandemic Comments**

The rating agencies recognize that the nation is in a recession that is stressing state budgets. The agencies note that there is considerable uncertainty about the depth and length of the recession. Much of the agencies’ assessment relates to how well the State is able to manage this initial coronavirus shock. While this will require the State to make difficult choices, the consensus is that Maryland is a good position to manage its budget. S&P notes that “Maryland has a long history of proactive budget management” that is likely to continue. Fitch added that “Maryland is well positioned to utilize its superior gap-closing capacity to manage through the current downturn.”