New Issue: Moody's Assigns Aa1 Rating to $350 million of Massachusetts General Obligation Bonds

Global Credit Research - 21 May 2012

$18.5 Billion of General Obligation Debt Outstanding; Outlook is Stable

MASSACHUSETTS (COMMONWEALTH OF)
State Governments (including Puerto Rico and US Territories)
MA

Moody's Rating

ISSUE		RATING
General Obligation Bonds, Consolidated Loan of 2012, Series B		Aa1
Sale Amount	$350,000,000	
Expected Sale Date	05/22/12	
Rating Description	General Obligation	

Moody's Outlook N/A

Opinion

NEW YORK, May 21, 2012 --Moody's Investors Service has assigned an Aa1 rating to the Commonwealth of Massachusetts' $350 million General Obligation Bonds, Consolidated Loan of 2012, Series B. Proceeds of the bonds, scheduled to price on May 22, will be used to finance portions of the commonwealth's capital plan.

SUMMARY RATING RATIONALE

The rating reflects the Commonwealth of Massachusetts' strong financial management practices and its demonstrated willingness to balance its budget when necessary through spending cuts, revenue increases and use of reserves; a large education and health care sector that generates high wages and that has helped to mitigate job losses in the current downturn; debt levels that are among the highest in the nation; and relatively low pension funding levels. The outlook is stable.

STRENGTHS

-- Strong financial management during economic downturns, particularly a willingness to promptly identify and close budget gaps through expenditure reductions, revenue increases and prudent use of reserves

-- Budget reserves that provide an adequate cushion to another downturn and the commonwealth's demonstrated commitment to rebuild them to stronger levels, including through a new statutory mechanism to replenish them going forward

-- High wealth and high levels of educational attainment and the presence of large, highly-rated higher education and health care institutions in the Boston area has lent a degree of economic stability and have mitigated some job losses during recessions

CHALLENGES

-- Managing expenditure pressures, especially from health care and social services, in a lower revenue environment and amid ongoing economic uncertainty

-- Debt ratios that are among the highest in the nation combined with relatively low pension funding ratios

-- Managing the challenges from federal downsizing during the next several years, which could have a heavy impact on the commonwealth's important healthcare sector

DETAILED CREDIT DISCUSSION

COMMONWEALTH ENDS FISCAL 2011 IN STRONG FINANCIAL POSITION

Massachusetts ended fiscal 2011 last June with tax collections up 10.6% (nearly $2 billion) compared to the prior year, and 3.6% greater than forecast. Personal income taxes, which account for 56% of general fund revenue in the high wealth state were especially strong, increasing by 14.5%, growth driven by strong nonwithholding collections. Sales taxes (24% of the total) increased by 6.4% compared to fiscal 2010, and corporate income taxes (11% of the total) were up by 5.1%. All other collections (9% of the total) were up by 5.6%. The commonwealth ended the year with a budgetary basis $460 million general fund surplus, mostly as the result of the strong nonwithholding collections. On a GAAP-basis, Massachusetts ended fiscal 2011 with a Moody's adjusted available fund balance equal to 10.1% of operating revenue.

FISCAL 2012 BUDGET REFLECTS SPENDING REDUCTION AND REDUCES RELIANCE ON ONE-TIME RESOURCES; REVENUE FORECAST REVISED UPWARDS

The $30.6 billion fiscal 2012 budget reduces total state spending by approximately $666 million, or 2.1%. It works toward a greater structural balance by reducing the commonwealth's use of one-time resources, which in the current fiscal year reflect 1.5% of the total budget compared to 6.0% in fiscal 2011. Including a supplemental measure passed in October, the budget includes a $200 million draw from the Budget Stabilization Fund and suspends the statutorily-required transfer into the fund equal to 0.5% of tax revenue. Following the planned draw, the stabilization fund will total $1.5 billion, or 7.5% of budgeted fiscal 2012 tax revenue.

Last October, the fiscal 2012 consensus revenue forecast was revised upwards substantially. While collections included in the enacted budget were estimated to increase by only 0.5%, the new forecast calls for 2.4% growth. Year-to-date through April, tax collections are up by 2.0% compared to the prior year, and thus are greater than the budgeted forecast but are lower than last fall's revised estimates.

The commonwealth updates its consensus revenue forecast four times a year, a strong practice which allows it to quickly make mid-year budget adjustments if necessary. Estimates for fiscal 2013 collections released in January reflect 4.5% growth over the current year. Based on the commonwealth's statutory limitation on revenue growth, the personal income tax rate decreased on January 1, 2012 to 5.25% from 5.3%. The current forecasts include that change, which is expected to reduce personal income tax collections by as much as $56 million in the current fiscal year and by as much as $117 million in fiscal 2013. Earlier this month, the commonwealth introduced a new multi-year financial plan that includes five-year forecasts of revenues and expenditures. The multi-year plan will be an important one for Massachusetts considering its high costs for debt service, pensions and health care, to the extent that it becomes an institutionalized component of its budget process.

MASSACHUSETTS ECONOMIC METRICS REMAIN FAVORABLE COMPARED TO THE NATION

Massachusetts' employment picture continues to be brighter than the nation. The commonwealth's unemployment rate was 6.3% compared to the 8.1% national rate. Jobs are not increasing in Massachusetts as fast as they are nationally, however, with nonfarm employment growth of only 0.9% in April while they increased by 1.4% for the nation. Still, the commonwealth continues to be aided by its large education and health sector, which makes up more than 20% of employment, and a large financial activities sector, with a significant mutual fund presence; both industries that help push incomes in Massachusetts up. While the important healthcare sector is partly behind Massachusetts's above-average employment and income performance, future federal downsizing could impact healthcare and have a significant impact in Massachusetts. The state is characterized by high wealth and education levels but with slow population and job growth over the longer run. Per capita personal income in 2013 was $53,621,ranking second among the states. Despite its highly educated population, however, during the last two recessions Massachusetts lost more jobs than the nation and gained fewer during the expansions that followed. Among the commonwealth's economic challenges are high business and housing costs and slow population growth with negative migration trends. Indeed, high costs have pushed some suburban Boston growth into more affordable New Hampshire.

HEAVY TAX-SUPPORTED DEBT LOAD; HIGH PENSION COSTS ALTHOUGH REFORMS WILL PROVIDE LONG-TERM BENEFITS

The commonwealth has a high debt burden, with $18.5 billion in outstanding general obligation bonds and nearly $32 billion in total net tax-supported debt. Debt levels have been driven upwards in part by the commonwealth's issuance of bonds to finance projects that in other states would be paid for at the local level. Based on Moody's 2011 state debt medians, the state's debt levels ranked second-highest among the 50 states on both a per-capita basis and as a percentage of personal income, respectively, and is the sixth highest as a percentage of state gross domestic product. The commonwealth's debt per capita was $4,711, 9.5% of its personal income, and 8.7% of its gross domestic product.

A pension reform enacted by the state last year provides long-term benefits to the state. Based on an updated actuarial valuation released in September 2011, Massachusetts' pension funded ratio had improved to 71.1% as of January 1, 2011 from 67.5% in 2010. Among the changes, the pension reform measure extends the funding schedule from 2025 to 2040, which reduces the fiscal 2012 contribution from $2.2 billion to $1.4 billion (although that is still larger than then fiscal 2011 amount). The negative impact of pushing out the period to fully fund the retirement obligations is partially offset by increasing the retirement age for most state employees; eliminating early retirement subsidies; increasing the period for calculating retirement from an average of three years to five years; and eliminating double-dipping. The measure also prohibits the commonwealth from making less than the annual payment required by the new schedule if investment returns exceed expectations: greater-than-expected gains would be used to shorten the schedule. It further dedicates future tobacco settlement monies to the commonwealth's other post-employment benefits (OPEB) trust fund, starting in phases in fiscal 2013. The combined ratio of Massachusetts' pension and OPEB actuarially required contributions (ARC) to revenue is 16%, slightly higher than average. Left unchecked, those costs could limit the commonwealth's fiscal flexibility going forward, but the new plan should help to mitigate them.

CLOSELY MANAGED VARIABLE RATE DEBT AND SWAPS PORTFOLIO

Approximately 19% of the commonwealth's general obligation debt is variable rate, including variable rate demand bonds, index rate bonds, and auction rate bonds. The variable rate debt is largely swapped to fixed rates through cost-of-funds swaps, eliminating basis risk. In recent years, Massachusetts has reduced its exposure to external liquidity facility risk through the issuance of SIFMA index bonds, although the need to roll or take out maturities of those bonds creates both market access and liquidity risks. The commonwealth's variable rate and derivatives portfolio is closely managed and its liquidity facilities and swap agreements contain provisions favorable to the commonwealth and offset its relatively low available cash balances. Liquidity facilities contain a mix of three- and five-year term-out provisions. The commonwealth does not have exposure to European banks as liquidity providers in its variable rate portfolio although it does have $400 million of variable rate bonds with liquidity support provided by Bank of America (A2/P-1, both ratings under review for downgrade); the commonwealth is in the process of replacing a portion of that exposure.

Swap counterparties are well-diversified and do not reflect collateral posting requirements on the part of the commonwealth. Just more than $1 billion of the commonwealth's $3.4 billion total outstanding swap notional amount is with European counterparties, and in our opinion any challenges in that portfolio should be manageable for the commonwealth. As of June 30, the mark-to-market value of Massachusetts' general obligation swaps was -$369 million.

OUTLOOK

The outlook for Massachusetts is stable, reflecting its good reserve levels and efforts to regain structural budget balance. The outlook also reflects our expectation that the commonwealth will continue to take proactive measures to close budget gaps if they emerge and continue its trend of strong financial management. Going forward, heavy reliance on one-time budget solutions, tighter cash margins, unexpectedly severe economic deterioration, or a large increase in tax-supported debt could be credit challenges.

WHAT COULD MAKE THE RATING GO UP

-- Continued rebuilding of reserves and establishment of stronger constraints on their use

-- Established trend of structural budget balance

-- Reduced debt ratios relative to Moody's 50-state median

WHAT COULD MAKE THE RATING GO DOWN

-- Protracted structural budget imbalance driven by deeper and/or prolonged economic downturn

-- Depletion of Budget Stabilization Fund to inadequate levels

-- Increased leveraging of the commonwealth's resources to pay debt service or further erosion in funding ratios

-- Narrowed cash flow that strains the commonwealth's liquidity

The principal methodology used in this rating was Moody's State Rating Methodology published in November 2004. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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