

FITCH RATES \$250MM COMMONWEALTH OF MASSACHUSETTS GO MASSDIRECT NOTES 'AA+'

Fitch Ratings-New York-13 March 2014: Fitch Ratings has assigned an 'AA+' rating to the following Commonwealth of Massachusetts general obligation (GO) bonds:

--Up to \$250 million in MassDirect Notes

The Commonwealth plans to offer MassDirect Notes every day for two weeks of every month, with prices re-set daily. This is a new program for the Commonwealth and is targeted to retail investors. The current program authorization is \$250 million, which the current plan of finance anticipates exhausting in August with maturities ranging from two to ten years. The program will not increase the Commonwealth's overall borrowing plans, but rather is a different approach to selling earlier maturities. The notes will bear interest at a fixed rate.

The first offerings under the program, consolidated loan of 2014 series 1 and series 2 in the amount of \$30 million each, are scheduled to be sold the weeks of March 17 and 24, respectively.

In addition, Fitch affirms the 'AA+' rating on approximately \$19 billion of outstanding Commonwealth GO and Commonwealth guaranteed bonds.

The Rating Outlook is Stable.

SECURITY

General obligations of the Commonwealth, to which its full faith and credit are pledged.

KEY RATING DRIVERS

STRONG AND WEALTHY ECONOMY: Massachusetts has a broad and diverse economy with the second-highest personal income per capita in the nation.

PRUDENT FINANCIAL MANAGEMENT: The Commonwealth has benefited from conservative budgeting and sound financial practices over time. A limitation on the use of capital gains-related tax revenue has reduced the volatility of economically sensitive revenues in the budget, and the Commonwealth has shown a commitment to reserve funding.

COMPARATIVELY HIGH LIABILITY BURDEN: Massachusetts' debt levels are high for a U.S. state government, and Fitch expects them to remain so. This is partially explained by the above-average role played by the Commonwealth in relation to local levels of government when compared to most other states. In addition, the Commonwealth is responsible for the pension benefits of not only Commonwealth employees but also teachers statewide, contributing to a combined burden of debt and pensions that is also well above the median for U.S. states rated by Fitch.

RATING SENSITIVITIES

The rating is sensitive to shifts in fundamental credit characteristics including the state's commitment to strong financial management practices.

CREDIT PROFILE

Massachusetts' 'AA+' GO rating reflects considerable economic resources and a record of prudent financial management. Credit strengths are tempered by a comparatively heavy debt burden that Fitch expects to remain high. The Stable Outlook reflects the expectation that the Commonwealth will continue to act as needed to ensure budget balance and maintain an adequate budgeted reserve position.

FINANCES AND MANAGEMENT

Massachusetts' financial position has stabilized in recent years, with solid revenue recovery following a period of steep decline in the recession. Fiscal 2013 benefitted from the acceleration of income into calendar 2012 that took place in anticipation of federal tax increases; revenues from income tax estimated payments were up 15.4% year-over-year and final returns 24.7%. Baseline overall tax revenue growth of 5.6% also reflected increases of 3.5% in personal income tax withholding receipts and 2.4% in sales tax revenue.

Fiscal 2014 revenue results were \$281 million above budget expectations through the first half of the year, and in January 2014 the Commonwealth raised its revenue forecast for fiscal 2014 by \$403 million. Through February, income tax withholding receipts were up 5% (baseline), the sales and use tax 5.6%, and overall tax collections 7.7%. These results incorporate the retroactive repeal of a computer and software services tax that was included in the enacted budget (estimated impact of \$161 million) and the reduction of the income tax rate to 5.2% from 5.25% effective Jan. 1, 2014 that was triggered by recent revenue growth (estimated impact of \$65 million). Revenues fiscal-year-to-date, are \$288 million above the revised forecast, although most of the overperformance is related to one-time settlements.

Fitch believes that the Commonwealth retains significant flexibility to address budget underperformance and has repeatedly demonstrated its commitment to do so. Strong revenue results in fiscal 2011, which saw 9.1% year-over-year baseline tax revenue growth, allowed for an increase in the stabilization fund balance to \$1.4 billion, up from \$670 million at the end of fiscal 2010. Recovery continued in fiscal 2012, albeit at a more modest pace, with a 3.5% baseline increase in tax collections; the stabilization fund balance grew further to \$1.65 billion. In fiscal 2013, scheduled draws were expected to lower reserve funding to \$1.3 billion at year-end. However, the stabilization fund ended the year with a higher \$1.56 billion balance. The current forecast assumes that this will drop to a still significant \$1.39 billion at the end of the current fiscal 2014, which would then be reduced modestly under the governor's proposed budget for fiscal 2015, which begins on July 1. The proposed budget assumes tax revenue growth of 4.9% in fiscal 2015, in line with the expected fiscal 2014 increase.

Massachusetts' demonstrated commitment to taking timely action to ensure budget balance in recent downturns while maintaining some level of reserves is important given the nature of the Commonwealth's revenue system, which quickly reflects changing economic conditions. For example, in the last downturn tax revenue forecasts were reduced significantly over the course of fiscal 2009, from \$21.4 billion in the enacted budget to actual results of \$18.3 billion, and the year ended down 13% (baseline) compared to fiscal 2008.

In addition to solid ongoing budget management, the Commonwealth has proactively taken steps to reduce the impact of volatile revenues on its budget and has developed a long-term fiscal policy framework focused on budget sustainability. The variability and unpredictability of capital gains-related tax revenue has been a key factor in volatility over time. In response, the fiscal 2011 enacted budget included a new mechanism for budgeting capital gains-related tax revenue that limits the amount of such revenue that can be included in the Commonwealth's budget to \$1 billion (adjusted annually by a U.S. GDP growth-based formula starting in fiscal 2014), with excesses dedicated to reserve funding (90%) and retiree benefit obligations (10%). Capital gains tax revenues totaled \$1.4

billion in fiscal 2013, and this mechanism is a key reason that the reserve funding level remained largely unchanged for the year.

A similar change requires one-time judgments and settlement payments in excess of \$10 million to be deposited in the stabilization fund. The fund benefited from an unusually high \$375 million of such revenue in fiscal 2012. The fiscal 2013 figure was \$32 million, but through February of this fiscal year one-time judgments and settlement payments in excess of \$10 million totaled \$391 million. With the fiscal 2015 executive budget, the governor has proposed modifying the policy to establish a baseline above which such monies would be deposited in the stabilization fund, similar to the policy for capital gains, rather than the current requirement to deposit the whole amount.

ECONOMY

Massachusetts has a fundamentally strong and wealthy economy. Institutions of higher education and health care are significant and lend stability, in addition to supporting development and innovation in other areas. At 128% of the U.S. average, personal income per capita is the second highest of the states.

The Commonwealth's economic performance in the recent recession was significantly better than the national experience, in contrast to 2002-2004 when Massachusetts experienced among the steepest employment drops in the country. Employment losses in 2009 were less severe than those of the U.S. (3.3% versus 4.3%), and Commonwealth employment rose 0.3% in 2010 while U.S. employment fell 0.7%. Employment continued to grow in 2011 (1.2%) and 2012 (1.4%) at a pace generally in line with the national trend. Year-over-year growth of 1.7% in December 2013 matched that of the nation. Massachusetts' unemployment rate of 7.1% for December 2013 was up from 6.7% in December 2012 and, unusually for the Commonwealth, above the 6.7% rate for the U.S.

DEBT AND OTHER LONG-TERM LIABILITIES

The Commonwealth's net tax-supported debt equals a comparatively high 9.5% of personal income, including sales tax obligations of the Massachusetts Bay Transportation Authority and the Massachusetts School Building Authority, as well as contract assistance commitments to the Massachusetts Department of Transportation. The comparatively high debt levels are partially explained by the Commonwealth's above-average role in relation to local levels of government when compared to most other states. GO debt continues to represent the majority of outstanding debt. Fitch expects debt levels to remain high for a U.S. state.

The Commonwealth is responsible for the pension benefits of not only Commonwealth employees but also teachers statewide. Massachusetts has undertaken some pension reforms and projects manageable growth in pension funding requirements going forward. A recent agreement accelerates the pension funding schedule by increasing annual contributions by 10% per year through fiscal 2017 and 7% in subsequent years. Full system funding is projected for fiscal 2036 based on current assumptions, although the statutory requirement remains fiscal 2040. The fiscal 2015 contribution is \$1.8 billion. The estimated total unfunded liability of the state employees and teachers systems, adjusted for a 7% investment return assumption, equals about 9% of personal income.

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In addition to the sources of information identified in Fitch's report 'Tax-Supported Rating Criteria', this action was additionally informed by information from IHS Global Insight.

Applicable Criteria and Related Research:

--'Tax-Supported Rating Criteria' (Aug. 14, 2012);

--'U.S. State Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

Applicable Criteria and Related Research:

Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015

U.S. State Government Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033

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