SB 319

Department of Legislative Services

Maryland General Assembly
2003 Session

FISCAL AND POLICY NOTE
Revised

Senate Bill 319 (Senator Lawlah, *et al.*)
(Joint Committee on the Management of Public Funds)

Budget and Taxation Appropriations

General Obligation and County Debt - Variable Interest Rate Bonds and Interest Rate Exchange Agreements

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This bill allows the State to issue variable interest rate bonds, limited in the aggregate to 15% of the State's outstanding general obligation bonds. The Board of Public Works may sell variable interest rate bonds at a private, negotiated sale on the terms and conditions that the board determines to be the most advantageous to the State. The State Treasurer is authorized to enter into interest rate exchange agreements for managing debt service and to contract with the necessary agents. In addition, Baltimore City and county governments are authorized to enter into interest rate exchange agreements.

The bill takes effect June 1, 2003.

Fiscal Summary

State Effect: General fund debt service expenditures could decrease significantly due to the issuance of variable interest rate bonds; however, the Treasurer's Office would have to continually monitor the bond market to ensure that the variable interest rate remains below the fixed rate.

Local Effect: Interest rate exchange agreements may lower the costs for publicly-financed projects.

Small Business Effect: None.

Analysis

Current Law: The Board of Public Works can only offer State bonds at a public sale. The board is not authorized to sale variable interest rate bonds.

Background: At the October 15, 2002 meeting of the Joint Committee on the Management of Public Funds, the State Treasurer discussed the need to expand from fixed rate financing to taxable and variable interest bonds to finance certain capital projects. The State is currently limited to issuing fixed rate debt, while variable rate debt has historically been significantly less costly. A balanced debt portfolio typically would include up to 15% of variable rate debt to reduce costs of debt service and offset low interest rate earnings on investment of general fund balances.

The Treasurer's Office reports that bond rating houses do not have any concerns with the State issuing variable rate debt as long as the threshold of variable rate bonds do not exceed 15% of the total State offering. Most states (37) are authorized to issue variable rate financing. About 26 states have actually issued variable rate bonds. Four states with AAA bond ratings (as rated by all three investment houses) have authorized variable rate financing: Minnesota (for housing), South Carolina (for health and environment projects), Utah, and Virginia.

Interest rate exchange agreements (swaps) are a device in public financing that can lead to reduced total interest costs during the life of a bond issuance. By altering between fixed and variable interest rates, a bond issuer and its agent can effectively manage the interest costs even after the point of issuance. The result can be added assurances for the governmental entity, and potentially lower costs for the publicly-financed projects.

State Fiscal Effect: Debt service tends to be lower on variable interest rate bonds than fixed rate bonds. Currently, the interest rate on variable interest rate bonds is approximately 3.2% for a 15-year loan. This rate is lower than the 3.55% and 4.03% fixed interest rates the State received at the two bond sales in 2002.

The Department of Legislative Services advises that any reduction in debt service expenditures resulting from the use of variable interest rate bonds depends upon the average variable interest rate remaining below the fixed interest rate for the duration of the life of the bond. Due to Maryland's AAA bond ratings, the State is able to issue general obligation debt at a low fixed interest rate. With a fixed rate, the State's interest payments do not change. However, with the issuance of variable interest rate bonds, the Treasurer's Office would have to continually monitor the bond market to ensure that the variable interest rate on average does not exceed the fixed rate. The State would incur additional costs if it decides to refinance previously issued variable rate debt due to an increase in the variable rate.

The Treasurer's Office reports that the State would have realized a $29 million debt service savings on the two-bond issuance in 2002 if the State had issued variable rate bonds instead of fixed bonds. The State is planning to hold another bond sale on February 19, 2003 with the issuance of $591 million in debt. If the State was able to issue variable rate bonds instead of fixed bonds, the State could realize a savings in debt service expenditures of $26 million over the life of the loan or approximately $1.8 million annually. **Exhibit 1** provides a comparison of the debt service costs for variable and fixed interest rates. This analysis assumes that the variable interest rate remains at 3.2% for the duration of the life of the bond. If the variable interest rate increases, the potential debt service savings would be lower or eliminated.

It is estimated that the State's outstanding general obligation debt will total $3.9 billion by the end of fiscal 2003. Based on the 15% limit established in this bill, the State could have approximately $587 million in variable interest rate debt.

Exhibit 1
Potential Savings By Using Variable Interest Rates Bonds

Bond Sale	Bond Issuance	Fixed Rate	Variable Rate	Potential Savings
2002-1st Series March 6, 2002	$309.9 million	4.03%	3.2%	$19 million
2002-2nd Series July 31, 2002	$515.8 million	3.55%	3.2%	$10 million
2003 – 1st Series February 19, 2003	$591.0 million (estimate)	3.73% (estimate)	3.2%	$26 million

Additional Information

Prior Introductions: None.

Cross File: HB 434 (Delegate Heller, *et al.*) – Appropriations.

Information Source(s): Department of Budget and Management, Comptroller's Office, Maryland State Treasurer's Office, Department of Legislative Services

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