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Kansas Pension-Bond Plan Revived Amid Budget Strain: Muni Credit.

Governor Sam Brownback's plan to divert pension cash to plug a budget deficit has Kansas Treasurer Ron Estes recommending a fiscal tool the state hasn't used in a decade — selling bonds to fund its retirement plan.

Brownback, a Republican who starts his second term in January, last week proposed shortchanging the state's pension contributions by $58 million to close a $280 million budget hole caused in part by tax cuts the governor championed. Kansas, with the fifth-weakest pension system among U.S. states, had its issuer ratings downgraded by Standard & Poor's and Moody's Investors Service this year.

To close a $7.35 billion funding shortfall, the state needs to keep commitments that were part of a 2012 pension overhaul, said Estes, a Republican who also won re-election last month. The plan called for more funding from the state, including revenue from casinos it owns, and raised the amount employees pay.

"We need to keep working on our pension reforms passed two years ago or we'll fall further behind," Estes said in an interview from Topeka.

2004 Example

Kansas can take advantage of interest rates close to five-decade lows to raise cash, increase the funding level and create fixed payments, Estes said. The state issued $500 million of pension bonds in 2004; a proposal to sell another round stalled in the legislature last year.

The 2004 bonds were sold through the Kansas Development Finance Authority. The debt, which is insured, has traded this month at an average yield of 4.5 percent for a May 2034 maturity, Bloomberg data show. That's about 1.9 percentage points above Treasuries.

Because of investment losses from the recession and insufficient contributions, public retirement plans nationwide are at least $1.3 trillion short of the assets needed to pay about $5 trillion of projected benefits, Federal Reserve data show. Since 2005, every state but Idaho has passed laws to boost pension funding, according to the National Conference of State Legislatures.

Kansas is among states and localities that have turned to debt to bolster their plans. Led by California's Orange County, municipalities have issued a combined $356 million of revenue-backed pension bonds this year, compared with $424 million in 2013, according to data compiled by Bloomberg. In 2003, Illinois sold $10 billion of bonds for its pensions.

Backfire Risk

The debt, which is typically taxable, carries risk. The strategy is to invest the proceeds, usually in stocks, and earn more than it costs to repay bond investors. The approach can backfire if issuers borrow when equities are at historic highs, said Jean-Pierre Aubry, assistant director of state and local research at the Center for Retirement Research at Boston College. The S&P 500 Index this week posted its best two-day gain in more than three years.

“There are instances where they can work, but they can be risky financial tools for cash-strapped borrowers,” Aubry said in a phone interview. “They’re gambling on the market and should be undertaken by those with the appetite for the risk and the ability to absorb the risk.”

Kansas, which was charged by the U.S. Securities and Exchange Commission in August with failing to disclose its pension liability to municipal-bond investors, passed legislation in 2012 to bolster its retirement plans. The state’s pensions were 56.4 percent funded as of 2013, higher than only four states, according to data compiled by Bloomberg. The ratio would reach 100 percent by 2033 if Kansas sticks to the changes laid out in 2012, Estes said.

Paying Up

Starting next month, workers’ contributions to the Kansas Public Employees Retirement System will increase to 6 percent of their salaries from 5 percent. About 281,000 people pay into the system, which has $14 billion of assets.

The system supports issuing bonds or any measure that boosts its funding, said Kristen Basso, a spokeswoman.

“Pension bonds would reduce our unfunded liability and improve our funded ratio,” she said in an e-mail.

Brownback’s plan would reduce the pension payment by almost 12 percent. He can make general-fund budget cuts on his own, without the legislature’s approval, according to Ashley Murdie, a spokeswoman for Estes.

“I can’t go into details right now, but the governor will address the long-term sustainability of KPERS,” said Eileen Hawley, the governor’s communications director. “It is one of his top priorities.”

The budget deficit for the state of 2.9 million arose when a committee that estimates revenue met this month and lowered its projection. After tax reductions approved by the legislature in 2012, the state took in about $340 million less than forecast during the year through June.

Debt from Kansas has earned 8.4 percent this year, compared with 8.8 percent for the entire municipal market, Barclays Plc data show.

In August, S&P cut the state to AA, the third-highest level. It assigned a negative outlook, citing budget pressure as scheduled income-tax cuts are phased in. Moody’s in April dropped it to an equivalent Aa2.

“There could be a threat of a downgrade if this situation goes on for several years,” said Estes.

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