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Risky Pension-Bond Strategy Considered in Kansas.

Kansas is considering a corner of the municipal-bond market most states have come to avoid because of its risk—a $1.5 billion sale of so-called pension bonds to boost returns at the state retirement system.

The strategy, which Gov. Sam Brownback is proposing in the face of a growing state deficit, would help lower annual state contributions to the Kansas Public Employees Retirement System. Under the plan, the state would issue bonds and then invest the proceeds, making a decadeslong bet that pension-fund returns will exceed current interest rates for taxable municipal bonds.

Where Kansas sees a market opportunity, some bond investors see a warning. Pension-obligation bonds remain only a sliver of the $3.6 trillion municipal market even as many states wrestle with oversize retirement-system shortfalls. Such debt offerings can be seen as a sign of distress since governments such as California, New Jersey and Illinois are among the largest issuers and hold the lowest credit ratings among states.

The bonds "can be used beneficially in some situations, but they are often inappropriately used by the desperate and irresponsible," said Alicia Munnell, director of the Center for Retirement Research at Boston College. Debt tied to pensions played a role in Detroit's bankruptcy and that of Stockton, Calif.

Supporters of the offering in Kansas, which would be the largest since Illinois sold $3.7 billion of the debt in 2011, see the bonds as a straightforward opportunity to maximize pension-fund returns and hold down annual payments, which have risen sharply, squeezing other government services. The state had success with a smaller pension-bond issuance a decade ago, and supporters say their approach would avoid the pitfalls that hobbled other states.

"Pension-obligation bonds, given near historically low interest rates, are an increasingly good option to manage debt," said Jeff King, a Republican and vice president of the state Senate.

Kansas' offering, if approved by the state legislature in coming months, could take advantage of yield-hungry investors and pent-up demand for bonds amid a period of relatively low new borrowing by U.S. cities, states and other government entities.

Initial plans call for selling 30-year bonds at a rate below 5% and reaping pension-fund returns of 8%, according to state and pension-fund officials.

Over the last year, Moody's Investors Service and Standard & Poor's Ratings Services have downgraded Kansas, as sharp tax cuts have dried up revenues. The state last year also settled with the Securities and Exchange Commission over charges it didn't adequately warn bondholders of the risks posed by its pension liabilities. Officials improved disclosures and increased employee contributions to the plan, settling with the SEC without admitting wrongdoing or paying a penalty.

Kansas is trying to strengthen a retirement system that the Pew Charitable Trusts last year ranked as one of the nation's most underfunded.

The pension system for teachers and state workers has about 57% of the assets needed to meet promised retirement benefits.

Many investors in the municipal-bond market are concerned that retirement costs will eventually cripple states, particularly in Illinois and New Jersey, which also have settled SEC charges related to pension disclosures. State retirement systems have far less funds than they need to meet all their projected payouts, with the Pew study putting the combined shortfall at $915 billion as of 2012.

Eric Friedland, portfolio manager at Schroders PLC, said the sale of pension bonds can be a warning of eroding credit. Along with the threat that the invested funds won't generate as high a return as anticipated, the practice reduces an issuer's options, swapping a pension-fund promise that can be modified for a fixed obligation to bondholders.

Also, the bonds offer a weaker form of protection in a bankruptcy.

"That's not a type of security I've been very fond of," Mr. Friedland said.

Kansas officials say the bond proposal takes advantage of a market opening and avoids problems that have given pension-obligation bonds a checkered reputation.

Illinois, for example, used the bonds to pay annual pension contributions, saddling the state with increased debt costs while only partially increasing pension-fund assets.

Even under the best circumstances, pension bonds come with the risk that expected spreads won't materialize. Since Oakland, Calif., sold the first pension-obligation bonds in 1985, cities and states have issued about $105 billion of the debt, the Center for Retirement Research said last year. Those deals have had returns averaging 1.5% annually since 1992, thanks to market gains following the financial crisis, the center said.

"It is a bet and that's a concern," said Kansas Rep. Ed Trimmer, a Democrat.

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