

A Good Problem To Have: Unlocking Strategic Value from Pension Surplus

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For much of the past twenty years, pension sponsors have focused on managing deficits, minimizing PBGC premiums, and mitigating balance sheet volatility. Today, many sponsors face a very different challenge. Rising interest rates, favorable market returns, and disciplined liability-driven investing programs have created a growing population of plans that are overfunded, and in some cases, substantially so.

While an overfunded pension plan is often viewed as a sign of good funding discipline, surplus assets can represent far more than a financial cushion. They can become a source of strategic flexibility, allowing sponsors to rethink retirement programs, improve workforce management initiatives, create value in corporate transactions, and potentially reduce future benefit costs. As surplus levels grow, the pension plan increasingly evolves from a liability management exercise into a corporate finance and human capital asset.

At these funded status levels, the key question is no longer whether a sponsor has surplus assets. The key question becomes how best to preserve, deploy, and maximize the value of that surplus while managing investment risk, maintaining flexibility, and minimizing regulatory and tax “leakage”.

Defining Surplus: Why the Measurement Matters

Before evaluating strategic alternatives, sponsors must first determine what “overfunded” actually means.

Many plans appear overfunded based on accounting measures or minimum funding calculations; however, many of these plans would still require additional assets if terminated today. For this reason, the most meaningful measure of pension health is often economic funded status, which compares current plan assets to the value of the liabilities based on current interest rates.

This distinction is important because strategic options change dramatically once a plan exceeds full economic funding. A plan funded at 105% on a funding basis may have little practical flexibility. By contrast, a plan funded at 120% or 150% on an economic basis may possess substantial surplus value that can support broader corporate objectives. For the purposes of this discussion, surplus and funding levels are based on an economic measure.

Investment strategy plays a central role in this analysis. The composition of assets, hedge ratio, duration alignment, liquidity profile, and expected return assumptions all influence both the sustainability and usability of surplus assets. Sponsors that fail to align investment strategy with long-term objectives often find themselves with a surplus that is difficult to preserve or deploy effectively.

Mildly Overfunded Plans: Preserving Optionality

Funding Level: Up to 110%

When a plan first crosses the threshold into economic surplus, the primary objective is typically preservation rather than utilization.

At this stage, the surplus is valuable because it creates breathing room. The sponsor may be insulated from future required contributions, balance sheet volatility may decline, and pension risk transfer alternatives become increasingly viable. However, the margin for error remains relatively small. A modest decline in asset values or decrease in discount rates could quickly eliminate the surplus.

Reaching full economic funding commonly initiates a formal termination analysis. Sponsors often begin modeling termination costs once the plan is fully funded and typically revisit the analysis in greater detail as funded status approaches or exceeds 110%. At that point, termination may be economically viable, but it should be evaluated alongside hibernation and other surplus strategies rather than treated as the only path forward.

For many sponsors at this funding level, hibernation remains the preferred strategy. Under this approach, the plan remains ongoing while investment strategy becomes increasingly liability-focused. The objective is not necessarily to maximize returns but to instead preserve funded status and maintain flexibility for future strategic decisions.

Investment strategy often becomes the most important decision at this stage. Derisking glide paths frequently continue de-risking as funded status improves, increasing allocations to long-duration fixed income and reducing return-seeking assets. While this approach is designed to protect the surplus, it can also limit future growth opportunities. As a result, some sponsors, particularly those with limited ability to contribute to the plan, are reexamining whether the traditional end-state portfolio remains appropriate once economic surplus has been achieved. In these cases, it may be appropriate to explore maintaining a core liability hedge while allowing a portion of the surplus itself to remain invested in return-seeking assets, effectively separating liability protection from surplus growth.

For sponsors in this range, patience is often the most powerful strategy. The focus should remain on preserving optionality and allowing surplus to compound rather than attempting to immediately monetize the excess assets.

Moderately Overfunded Plans: Converting Surplus into Strategic Value

Funding Level: 110% to 150%

This range often represents the "sweet spot" for surplus analysis.

At these funding levels, sponsors frequently possess enough surplus to weigh maintaining the plan indefinitely via 'hibernation' against a full plan termination and the strategic use of excess assets. Consequently, the termination discussion commonly shifts from "Can we terminate?" to "If we terminate, how should we utilize the surplus?"

One of the most attractive opportunities available to sponsors interested in plan termination is the ability to transfer excess assets to another qualified retirement plan ("QRP"), such as a 401(k) plan, for the benefit of employees. This option can reduce or avoid significant excise taxes that might otherwise apply if assets revert directly to the organization. This approach can substantially improve the economic efficiency of a termination strategy.

For many sponsors, this represents an ideal outcome. They eliminate pension risk, reduce administrative burden, strengthen their defined contribution program, and preserve more of the economic value of the surplus than would be possible through a direct reversion.

Another option available to certain sponsors is a "Section 420 Transfer"¹. Under applicable IRS rules, surplus assets in excess of 110% funded may be transferred from an ongoing pension plan to help fund retiree medical obligations. For organizations with

¹ <https://www.groom.com/resources/secure-2-0-creates-new-opportunity-to-use-surplus-pension-assets-for-retiree-welfare-benefits/>

significant retiree healthcare liabilities, this strategy can create value by redirecting otherwise trapped pension surplus toward another employee benefit obligation, thereby reducing future corporate cash expenditures.

Legislative developments may eventually expand the range of available surplus utilization strategies. The proposed Strengthening Benefit Plans Act of 2025² would permit sponsors of ongoing defined benefit plans to transfer excess pension assets to a defined contribution plan for purposes of funding nonelective employer contributions. While the legislation has generated considerable interest among pension sponsors, its future remains uncertain, and sponsors should not rely on its enactment when evaluating current strategies.

Investment strategy also deserves careful consideration in this range. While many sponsors remain heavily hedged to protect a near-term termination objective, others begin evaluating whether surplus assets could be invested more aggressively if the expected value of continued surplus growth exceeds the incremental value obtainable through immediate termination.

Highly Overfunded Plans: Pension Surplus as a Corporate Asset

Funding Level: Greater Than 150%

At this stage, the pension plan may represent one of the largest underappreciated assets on the sponsor's balance sheet. The focus shifts from protecting surplus to determining how best to unlock its value.

Historically, sponsors often viewed plan termination as the natural conclusion for highly overfunded plans. While termination continues to be an important option, it is no longer the only logical destination. Many sponsors increasingly recognize that excess assets possess strategic value that extends well beyond a traditional pension end game.

One of the most intriguing opportunities is plan redesign. For many organizations, an overfunded legacy pension plan may serve as the foundation for a modern cash balance program. Rather than viewing the pension as a closed legacy obligation, sponsors can utilize surplus assets to support retention, improve recruitment, and strengthen retirement readiness initiatives.

This approach may be especially attractive for organizations including law firms, other professional service firms, medical & dental practices, engineering firms, and financial institutions. A cash balance design can provide meaningful retirement benefits that align well with succession planning and executive retention objectives while allowing sponsors to direct existing surplus toward future benefit accruals rather than funding from corporate assets.

Investment strategy becomes increasingly nuanced at this stage. Sponsors must balance three competing objectives:

- Protect accrued liabilities.
- Preserve the existing surplus.
- Generate enough return to support future strategic uses.

As a result, many sponsors begin evaluating strategies to optimize surplus. Instead of treating all assets identically, assets needed to secure liabilities remain heavily hedged while assets representing excess surplus may be invested with a higher expected return profile.

Sponsors may also consider workforce initiatives such as early retirement programs, enhanced retirement windows, or retiree medical funding strategies. In these instances, pension surplus serves not simply as a retirement asset but as a tool for facilitating broader organizational change.

² <https://www.congress.gov/bill/119th-congress/senate-bill/2003/text/is>

Pension Surplus as a Competitive Differentiators in M&A

One of the most overlooked aspects of pension surplus is its role in mergers and acquisitions.

Historically, pension plans have been viewed largely as transaction complications. Underfunded plans often reduced valuations and created additional diligence requirements. An overfunded pension can produce the opposite effect.

For an acquiring company, a well-funded pension may create negotiating advantages. The acquirer possesses a retirement plan capable of absorbing additional obligations and reducing future contribution requirements. In some situations, an overfunded plan can be combined with an acquired pension plan to improve aggregate funded status and create additional flexibility.

For a target company, the pension itself may become part of the transaction value proposition. Buyers must evaluate not only the liabilities but also the surplus and the strategic options it creates. While market participants frequently discount surplus due to uncertainties surrounding access and taxation, sophisticated buyers increasingly recognize that a large surplus can represent a valuable economic asset rather than a contingent liability.

Simply put, an overfunded pension may be used as a negotiating tool in a plan sponsor's M&A toolkit.

Special Considerations for Banks

Few industries are better positioned to benefit from pension surplus than financial institutions, including banks and credit unions. These organizations operate in a highly regulated environment where capital efficiency, earnings stability, and balance sheet management are critical. An overfunded pension can meaningfully improve all three.

In many cases, the pension surplus contributes positively to regulatory capital measures, including tier one capital treatment, while also generating pension-related income that supports earnings. As a result, an overfunded pension may be viewed not simply as excess retirement assets, but as a valuable balance sheet and income-producing asset.

For this reason, many banks favor a long-term hibernation strategy even when termination is economically feasible. While termination may eliminate pension risk and administrative complexity, it may also reduce capital flexibility and eliminate future pension income. Accordingly, banks often compare the after-tax proceeds available through termination against the ongoing value of maintaining the surplus as a productive corporate asset.

Investment strategy plays a critical role in this analysis. Most banks seek to maintain sufficient liability hedging to protect funded status and preserve future termination optionality, while evaluating whether surplus assets can continue to generate returns and support earnings. Consequently, the optimal strategy is often not simply to terminate or maintain the plan, but to determine which approach can potentially maximize the combined value of capital allocation, pension income, retention and attraction of top talent, strategic flexibility, and future surplus utilization opportunities.

Conclusion

For decades, plan termination represented the logical end game for most frozen defined benefit plans, and, for many sponsors, it remains the most compelling use of pension surplus. Achieving a fully funded status often marks the beginning of serious termination discussions. Funding levels above 110% may provide an ideal balance between termination feasibility and efficient surplus utilization through qualified replacement plans.

However, as surplus levels continue to increase, sponsors may discover that termination is only one of several viable paths. In some situations, maintaining the pension plan and strategically deploying surplus assets through future benefit programs,

retirement plan redesign, workforce initiatives, or corporate transactions may generate greater long-term value than terminating the plan and extracting assets.

For overfunded plans, evaluating plan termination as the benchmark against which all other surplus strategies are measured rather than the default answer can lead to better outcomes for the organization and its employees. The ultimate objective should not be to simply eliminate pension risk, but to maximize the economic value created by the surplus itself.

Organizations that derive the greatest value from pension surplus are often those that evaluate their options before they need to act. We'd welcome the opportunity to discuss your plan's funded status, strategic alternatives, and the opportunities available to your organization. To connect with a member of our team, [click here](#).

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