Bloomberg BNA Benefits Practice Resource Center™

Source: ERISA and Labor & Employment Proposed Regulations, Rules (Preambles), and Notices (Federal Register) > Department of Labor > Final Rules > Loans to Plan Participants and Beneficiaries Who Are Parties in Interest With Respect to the Plan—54 FR 30520

# Loans to Plan Participants and Beneficiaries Who Are Parties in Interest With Respect to the Plan—54 FR 30520

**Loans to Plan Participants and Beneficiaries Who Are Parties in Interest With Respect to the Plan**

**DEPARTMENT OF LABOR**

**Pension and Welfare Benefits Administration**

**29 CFR Part 2550**

**RIN 1210-AA09**

**AGENCY: Pension and Welfare Benefits Administration, Department of Labor.**

**ACTION: Final rule.**

**SUMMARY:** This document contains a final regulation under the Employee Retirement Income Security Act of 1974 (the Act or ERISA) relating to loans from employee benefit plans to plan participants and beneficiaries who are parties in interest with respect to the plan. The regulation is intended to clarify the scope of Section 408(b)(1) of the Act, and to define certain terms used therein. Section 408(b)(1) provides an exemption from certain prohibitions of section 406 of the Act for loans to plan participants and beneficiaries. The regulation will affect employee benefit plans, their sponsors and fiduciaries, and participants and beneficiaries engaging in such loan transactions.

**EFFECTIVE DATE:** The regulation will be effective for all participant loans granted or renewed after October 18, 1989, except that Sec. 2550.408b- 1(d)(2), which relates to the specific plan provisions requirement of section 408(b)(1)(C) of the Act, is effective for participant loans granted or renewed on or after the last day of the first plan year beginning on or after January 1, 1989.

**FOR FURTHER INFORMATION CONTACT:** Susan E. Rees, Plan Benefits Security Division, Office of the Solicitor, U.S. Department of Labor, (202) 523-9141; or Deborah S. Hobbs, Office of Regulations and Interpretations, Pension and Welfare Benefits Administration, U.S. Department of Labor, (202) 523-8671. (These are not toll-free numbers.)

**SUPPLEMENTARY INFORMATION:** On January 22, 1988, the Department of Labor published a proposed regulation at 53 FR 1798 which is intended to provide guidance on the scope of the statutory exemption under section 408(b)(1) of the Act, relating to loans from ERISA-covered employee benefit plans to plan participants and beneficiaries. The Department received over 200 comments in response to the proposal, and conducted a public hearing on the proposed regulation on April 25, 1988. The following discussion summarizes the proposed regulation and the major issues raised by the commentators and explains the Department's reasons for adopting the final regulation.

## Background

Section 408(b)(1) of the Act provides a statutory exemption which permits a plan fiduciary within the meaning of 3(21)(A) of the Act to make loans from the plan to plan participants and beneficiaries. In the absence of an exemption, such transactions would be prohibited under section 406 of the Act. Specifically, section 406(a)(1)(B) prohibits a plan fiduciary from engaging in the direct or indirect lending of money to parties in interest to the plan such as themselves or other fiduciaries, plan participants, or employers whose employees are covered by the plan; section 406(b) also prohibits a plan fiduciary from engaging in transactions on behalf of the plan in which he has a conflict of interest. The final regulation 29 CFR 2550.408b-1 defines the scope of the exemption and the specific conditions contained therein.

Under section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), the Secretary of Labor has the authority to promulgate regulations for section 4975(d)(1) of the Internal Revenue Code (the Code), a parallel provision to section 408(b)(1) of ERISA. Therefore, unless otherwise specified, all references herein to section 408(b)(1) of the Act apply also to section 4975(d)(1) of the Code.

## Discussion

A. Scope of the Regulation

Proposed regulation paragraph 2550.408b-1(a)(1) set out the terms of section 408(b)(1) of the Act under which participant loans are permitted. Specifically, the proposed regulation stated that the relief provided under section 408(b)(1) is available if loans made by a plan to participants and beneficiaries who are parties in interest with respect to the plan (A) are available to all such participants and beneficiaries on a reasonably equivalent basis; (B) are not made available to highly compensated employees, officers, or shareholders [1] in an amount greater than the amount made available to other employees; are made in accordance with specific provisions regarding such loans set forth in the plan; (D) bear a reasonable rate of interest; and (E) are adequately secured. The proposal made it clear that participant loan transactions that meet these criteria will not violate section 406(a) of the Act (which prohibits fiduciaries from engaging in certain transactions with parties in interest), section 406(b)(1) of the Act (which prohibits a fiduciary from dealing with plan assets in his own interest or for his own account) or section 406(b)(2) of the Act (which prohibits fiduciaries in their individual or in any other capacity from acting in any transaction involving the plan on behalf of, or representing a party whose interests are adverse to those of the plan, its participants, or its beneficiaries).

[1] Section 1114(b)(15)(B) of the Tax Reform Act of 1986 (Pub. L. 99- 514) amended section 408(b)(1)(B) by deleting the phrase "highly compensated employees, officers, or shareholders" and substituting the phrase "highly compensated employees (within the meaning of section 414(q) of the Internal Revenue Code of 1986). Thus, Sec. 2550.408b-1(a)(1) contains a provision reflecting the statutory amendment.

Proposed § 2550.408b-1(a) clarified that fiduciaries who are plan participants are permitted to receive loans under a participant loan program. Because the Department received no unfavorable comments on this paragraph, it has been adopted as proposed.

The Department notes, however, that the exemption encompasses certain transactions in which the potential for self-dealing by fiduciaries exists and in which the interests of fiduciaries may conflict with the interests of participants. To guard against potential abuses, the Department will subject loans to fiduciaries to special scrutiny to assure that the conditions of the regulation are met. In this regard, the regulation is designed to assure that participant loan programs are operated under strict objective criteria. Accordingly, the regulation specifically requires that a fiduciary may only receive a loan from a plan if: (1) The program is administered under strict objective criteria which assure the equitable availability of the assets committed to the program among qualified participants, and (2) the borrowing fiduciary does not receive more favorable consideration or terms than other plan participants requesting a loan. As did the proposal, the final regulation also states that section 408(b)(1) of the Act will not exempt transactions violating the provisions of section 406(b)(3) of the Act. Such a transaction is a separate transaction not covered by section 408(b)(1).

Proposed Sec. 2550.408b-1(a)(3) made clear that a loan will not be exempt under section 408(b)(1)unless it is arranged and approved by the fiduciary administering the loan program primarily in the interest of the participants and such loan otherwise satisfies the conditions set forth in section 408(b)(1) of the Act. For example, the section 408(b)(1) exemption does not provide relief for loan programs which grant loans only to employees who agree to apply the loan proceeds for the benefit of some other party in interest, such as the employer. [2] However, in the absence of any inappropriate precondition or other facts and circumstances indicating that the loan program is not administered primarily for the benefit of the participants, the proposal contained no restrictions on the uses that plan participants may make of the loan proceeds. In this regard, one commentator urged that the regulation specifically prohibit participant loan proceeds being reloaned to the employer because of the great potential for coercion of employees without such a limitation.

[2] Example (8) of Sec. 2550.408b-1(a)(4) of the final regulation indicates, however, that a loan program will not fall outside the scope of the regulation merely because the program, by its express terms, limits loans to certain stated purposes, e.g., hardship, medical or college education, which are not inconsistent with the interests of plan participants and beneficiaries. Any such limitation, however, must also meet the requirement of Sec. 2550.408b-1(b)(1) that loans under the program be available to participants and beneficiaries on a reasonably equivalent basis.

While the Department acknowledges that a potential for employer coercion may exist under the proposed regulatory scheme, it believes that any benefit which might be gained by imposing a strict prohibition against the subsequent use by or transfer to a party in interest of a participant loan would be far outweighed by the practical problems such a prohibition would create for the fiduciary administering the loan program, e.g., the monitoring by the administering fiduciary of the actual subsequent use of the proceeds of each loan by each participant.

As explained by Example (3) of § 2550.408b-1(a)(4), a loan program may meet all the conditions of section 408(b)(1) so that the loans will be exempt under that section, and yet if the employer exerts pressure on participants to borrow funds and reloan the proceeds to him, that coercion will be viewed by the Department as a separate transaction violative of Code section 4975(c)(1)(D) that is not exempt under ERISA section 408(b)(1) or Code section 4975(d)(1). As illustrated by that example, the employer would be liable for the excise taxes under Code section 4975. In this regard, the Department also notes that section 511 of ERISA makes it unlawful for a person to coerce a participant for the purpose of interfering with a right he has under a plan. In contrast, where a participant has taken out a plan loan and by exercising his unfettered discretion has transferred the proceeds to a party in interest, the final regulation, as did the proposal, contains no restrictions on the use of the loan proceeds.

In the event of a default on a participant loan, the preamble to the proposed regulation stated that the relief provided by section 408(b)(1) necessarily includes the foreclosure on, or sale or disposal of, a plan's security interest by a fiduciary. The Department stressed, however, that the section 408(b)(1) exemption does not extend to the sale or disposal of the security interest to a party in interest and further cautioned that, in circumstances other than default, the transfer of property by a party in interest in repayment of a participant loan will be viewed as a prohibited sale or exchange of property between a plan and a party in interest under section 406 of the Act.

One commentator queried why a sale of collateral on default to a party in interest must be prohibited. In response, the Department notes that Congress strictly delimited the exemptive relief provided by section 408(b)(1) to the otherwise prohibited transaction of a loan of plan assets from a plan to a party in interest who is either a participant or beneficiary of that plan. There is no evidence in either the statute or legislative history of a Congressional intent to exempt any other prohibited transaction—such as a sale of the plan security upon participant default to a party in interest— which may flow from, but is not a necessary result of, the loan transaction. It is the position of the Department that the sale of collateral upon default to a party in interest would constitute a separate prohibited transaction not described in section 408(b)(1).

As explained in the proposal, it is the Department's position that the exemption under section 408(b)(1) applies only to bona fide loans. If a loan is made with the understanding that the borrower has no intention to repay, the transaction would not be considered a participant loan for purposes of the relief provided by section 408(b)(1), but would merely constitute a transfer of plan assets to or for the benefit of a party in interest in violation of section 406(a)(1)(D) of the Act and section 4975(c)(1)(D) of the Code. Whether any particular loan satisfies the requirements of section 408(b)(1) will be determined based on all the facts and circumstances of the transaction. [3] The Department received no substantive comments in this area, and, accordingly, the Department has retained its position as proposed.

---

[3] The Department does wish to note that, in its opinion, the fact of a subsequent default will not, in itself, cause the Department to treat the loan as one which was entered into with no intention to repay.

---

Commentators also sought clarification as to the extent of fiduciary liability in administering a loan program with respect to both the general statutory requirement of diversification and the specific requirement of section 408(b)(1) that loans be made available on a reasonably equivalent basis. It was requested that the final regulation specifically limit the liability of all plan fiduciaries other than the fiduciary responsible for administering the loan program. In this regard, one commentator suggested that the regulation should be amended to clarify that the administration of a loan program is not a trustee responsibility under section 405(c)(3) of ERISA for the following reasons: (1) Participant loan programs are usually administered by a loan committee and not by the plan trustee(s), and (2) participant loans are regarded as an incidental plan benefit, and as such should not be considered as involving management of plan assets.

The Department notes that the exemption provided by 408(b)(1) provides relief from the prohibited transaction rule of section 406 of the Act but not the fiduciary responsibility rules set out in sections 404 and 405. In this regard, Congress stated that all statutory exemptions from the prohibited transaction rules are:

To have no effect with respect to the basic fiduciary responsibility rules requiring prudent action, diversification of investments, and actions exclusively for the benefit of participants and beneficiaries, etc. [4]

[4] H.R. Rep. No. 1280, 93rd Cong., 2d Sess. at 310-11 (1974) [hereinafter Conf. Rpt.], reprinted in Subcomm. on Labor, Senate Comm. on Labor and Pub. Welfare, Legislative History of the Employee Retirement Income Security Act of 1974, 4577-78 (Comm. Print 1976) [hereinafter Legis. Hist.].

Because the administration of a participant loan program is the management of plan assets, fiduciary conduct with respect to administration of a loan program must conform to the rules governing all other transactions involving plan assets, although plans are free to allocate fiduciary responsibility in this regard to the extent permitted by section 405(c) of the Act.

Lastly, the Tax Reform Act of 1986 amended section 408(d) of the Act to give the Department the authority to grant administrative exemptions under section 408(a) to permit owner-employees to participate in participant loan programs. In this regard, several commentators suggested that the Department utilize its authority and grant a blanket exemption in this regulation from the prohibited transaction rules for owner-employees. The Department has determined that such an exemption is beyond the scope of this regulation, which relates solely to the statutory relief provided by section 408(b)(1). [5] However, consideration will be given to individual requests for relief in this area in accordance with established procedures. (See ERISA Proc. 75-1, 40 FR 18471, April 28, 1975). [6]

[5] The Department notes that section 408(d), while amended to permit exemptions under section 408(a), specifically provides that the statutory relief under 408(b)(1) is not available to owner-employees.

[6] On June 28, 1988, the Department proposed a new prohibited transaction exemption procedure which the Department intends to finalize in the immediate future. (53 FR 24422).

B. Reasonably Equivalent Basis

Under section 408(b)(1)(A) of the Act, the 408(b)(1) exemption applies only if the loans are available on a reasonably equivalent basis to all participants and beneficiaries of the plan. Consistent with the legislative history of this provision, proposed § Sec. 2550.408b-1(b) required that such loans be made available to all plan participants and beneficiaries without regard to an individual's race, color, religion, age, sex or national origin, while permitting a plan to consider factors which would be considered in a normal commercial setting by an entity in the business of making similar loans, e.g., the applicant's creditworthiness. [7] Also consistent with the legislative history, the Department indicted that a plan could consider financial need in determining loan availability. [8]

[7] Conf. Rpt., supra at 311, reprinted in Legis. Hist., supra, at 4578.

[8] Id.

Finally, the proposal stated that both the form and operation of the participant loan program will determine whether, in actual practice, loans are unreasonably withheld from any applicant. As the proposed examples (1) and (2) at § 2550.408b-1(b)(2) illustrated, the proposed regulation would prohibit the practice of applying different terms to different loan applicants, e.g., offering lower interest rates to certain applicants without a commercial justification or informally restricting access to loans to certain participants. The proposal also indicated that under particular facts and circumstances, loan programs which have uniformly applied loan requirements but which in operation exclude large numbers of plan participants from receiving loans under the program may be found to have failed to make loans available to all participants on a reasonable equivalent basis. See, e.g., § 2550.408b-1(a)(4), Example (8), and § 2550.408b-1(b)(2), Example (3).

The Department received a number of comments asking whether loan programs that exclude all but active employees from participation would be considered to be providing loans on a reasonably equivalent basis. In this regard, it is the position of the Department that such an exclusion is not justifiable because the statute provides, without condition, that section 408(b)(1) applies to loans that, inter alia, are available to all participants and beneficiaries on a reasonably equivalent basis. It should be noted, however, that these regulations are intended to be sufficiently flexible to accommodate differing treatment of loan applicants based on valid economic differences which may exist between active employees and other participants and beneficiaries and which commercial lenders in the business of making similar types of loans legally recognize for purposes of loan availability. Thus, participants and beneficiaries other than active employees may be offered loans on different terms and conditions where such terms and conditions are based solely on factors that are legally considered by commercial entities in the business of making similar loans.

Several commentators requested clarification concerning the reference in the proposed regulation to creditworthiness as the type of commercial factor that plans could consider in granting loans. These commentators expressed concern that § 2550.408b-1(b)(1)(ii) might be read as requiring plans to consider each applicant's creditworthiness in order to meet the requirements of the regulation. As a point of clarification, consideration may be given to individual creditworthiness if the plan is so designed; however, the final regulation does not require that a program be so designed. In this regard, the Department reiterates that the fiduciary administering the loan program must do so in such a way as to comport with the general fiduciary responsibilities of ERISA, e.g., the provisions of section 404. Therefore, based on the facts and circumstances of any particular loan program, the administering fiduciary must decide what factors need to be taken into consideration in order to administer that particular program prudently.

Other commentators questioned whether minimum or maximum loan amounts, or required minimum account balances were permissible under this section. Commentators suggested that minimum loan amounts were necessary because of the administrative cost of processing loans, and many asked that the regulation provide a "safe harbor" minimum loan amount. One commentator questioned whether a plan could, consistent with the requirement that loans be available on a reasonably equivalent basis, charge fees for processing, and contract out and charge borrowers for loan administration. Several commentators queried whether loans are available on a reasonably equivalent basis where the loan program restricts accounts from which loans can be made. None of these limitations and conditions necessarily contravene the conditions of section 408(b)(1) of the Act or the provisions of this regulation. Such limitations, however, would have to be examined to determine whether in practice (1) the limitation is the basis for loans being unreasonably withheld from any applicant, and (2) the loan program, through such limitation, excludes large numbers of plan participants from receiving loans under the program, thereby raising the issue of whether the program meets the requirement of section 408(b)(1)(B) of the Act and Sec. 2550.408b-1(c) of the regulation.

In general, the Department does not believe that it is feasible to set a "safe harbor" with regard to permissible limitations in the areas mentioned above. However, based on the comments received and the testimony given concerning the proposal, it appears that many participant loan programs currently require a minimum loan amount due to administrative cost. Thus, in this regard, the Department has amended the regulation by adding Sec. 2550.408b-1(b)(2) which provides that a participant loan program will not fail the requirements of Secs. 2550.408b-1(b)(1) or (c) if the program establishes a minimum loan amount of up to $1000, provided that the loans granted by the program meet the requirements of Sec. 2550.408b-1(f) concerning adequate security.

C. Highly Compensated Employees

Section 408(b)(1)(B) states that the relief provided in section 408(b)(1) is available only if participant loans are not made available to highly compensated employees, officers, or shareholders [9] in an amount greater than the account made available to other employees. With regard to this provision, the legislative history indicates a Congressional intent to allow plans to lend the same percentage of a person's vested benefits to participants with both large and small amounts of accrued vested benefits, or to lend the same dollar amounts if security other than the vested benefit is provided. See Conf. Rpt., supra, at 312; Legis. Hist., supra, at 4579. In light of the expressed Congressional intent, proposed Sec. 2550.408b-1(c)(2) stated that a participant loan program would not fail to meet this requirement merely because the plan documents specifically governing the participant loan program set forth either (i) a maximum dollar limitation, or (ii) a maximum percentage of vested accrued benefit which no loan may exceed. If the second alternative (maximum percentage of vested accrued benefit) is chosen, the proposal explained that a loan program would not fail to meet this requirement solely because maximum loan amounts varied directly with the size of the participant's vested accrued benefit. [10] Section 2550.408b-1(c)(1) of the proposed regulation made it clear, however, that a loan program will satisfy the requirements of this paragraph if the program does not operate to exclude large numbers of plan participants from receiving loans.

---

[9] See footnote 1 infra.

[10] The Department notes that the Internal Revenue Code (the Code) places a number of restrictions on participant loans for tax purposes. Under section 72(p) of the Code, a participant loan will be treated as a taxable distribution from the plan unless such loan doe not exceed the lesser of: (i) $50,000 (which amount must be reduced by the outstanding balances for any previous participant

loans from the plan in accordance with section 72(p)(2)(A)(i)); or (ii) one-half of the present value of the nonforfeitable accrued benefit of the employee under the plan (but not less than $10,000). It is the view of the Department that a participant loan program administered pursuant to plan provisions which have been amended to preclude the making of loans which would be considered distributions under section 72(p) of the Code will not fail, by virtue of those provisions, to satisfy the condition in section 408(b)(1)(B) of the Act and Sec. 2550.408b-1(c) of this regulation.

The Department also notes that a determination that a particular plan loan program meets the requirements of Se. 2550.408b-1(c) will not determine the status of that plan's loan program under Code section 401(a)(4).

---

The Department received no substantive comment on this paragraph, and thus, this paragraph is published in final as proposed. Numerous commentators did, however, request a Departmental view as to fiduciary liability, if any, in those cases where in order to comply with the Department's articulated requirements of adequate security and reasonable rate of interest, a loan program, in operation, excludes a large number of plan participants from receiving loans. In part, the Department believes that the concern of these commentators may be answered by the clarifications contained in this final regulation concerning the adequate security and reasonable rate of interest requirements. In addition, as evidenced by the legislative history, Congress clearly believed that loan programs could be conducted under the rules specified within section 408(b)(1), as well as the general ERISA fiduciary rules which govern other plan investments, and still operate in a non-discriminatory manner. Thus, by definition, loan programs which meet the requirements concerning reasonable rate of interest and adequate security will not be deemed discriminatory for purposes of the provisions of either section 408(b)(1) (A) or (B) of the Act solely by reason of compliance with the requirements of section 408(b)(1) (D) and (E) of the Act and the corresponding provisions of this regulation.

D. Specific Plan Provisions

Section 408(b)(1)(C) of the Act requires that participant loans be made in accordance with specific provisions regarding such loans set forth in the plan. Under the proposed regulation at Sec. 2550.408b-1(d), all participant loan programs must be established pursuant to specific authority provided in a plan document. Additionally, a participant loan program which is contained in the plan or in a written document forming part of the plan must include, but need not be limited to, the following: (1) The identity of the person or positions authorized to administer the participant loan program; (2) a procedure for applying for loans; (3) the basis on which loans will be approved or denied; (4) limitations (if any) on the types and amounts of loans offered; (5) the procedure under the program for determining a reasonable rate of interest; (6) the types of collateral which may secure a participant loan; and (7) the events constituting default and the steps that will be taken to preserve plan assets in the event of such default. The proposal further specified that if a plan fails either to contain such specific provisions or to administer participant loans in accordance with a written program, loans made under such a program will fail to qualify for the relief extended in section 408(b)(1).

Under the proposed regulation, the specific terms enumerated above would apply to loans granted or renewed at any time on or after the last day of the first plan year beginning on or after January 1, 1989. Until that date, the Department will consider loans to satisfy the requirement of section 408(b)(1)(C) if the plan contains an explicit authorization for the establishment of a participant loan program. Example (1) of this paragraph also stated that the specific provisions describing he loan program, whether contained in the plan or in a written document forming part of the plan, affect the rights and obligations of the participants and beneficiaries under the plan and therefore must, in accordance with section 102(a)(1), be disclosed in the plan's summary plan description (SPD).

The Department received numerous comments seeking clarification as to what types of documents would satisfy the requirements of this subsection. Several commentators asked whether the SPD itself would be considered "a written document forming part of the plan" and, thus, satisfy the requirements of Sec. 2550.408b-1(d) of this regulation. Others asked whether the regulation would require that the summary plan description disclose all specific plan loan provisions.

As indicated in Example (1) of Sec. 2550.408b-1(d), the Department anticipates that the specific loan provisions under which the loan program is operated in many cases will not be contained in the plan itself but rather in a separate document forming part of the plan. The Department can find no reason to limit descriptively the range of documents which may form part of the plan. Thus, the Department sees no reason why an SPD could not satisfy the conditions of Sec. 2550.408b-1(d) if it contains the required loan program provisions and is a document forming part of the plan. With regard to the extent to which loan program provisions must be disclosed in the SPD, the Department notes that section 102 of ERISA requires that the SPD be sufficiently accurate and comprehensive to reasonably apprise participants and beneficiaries of their rights and obligations under the plan. In this regard, it is the opinion of the Department that satisfaction of the requirements of section 102 would, at a minimum, require summary disclosures with respect to those items listed in Sec. 2550.408b-1(d)(2). [11]

[11] Depending on the facts and circumstances of any particular loan program, the list of items required by Sec. 2550.408b-1(d) may not, alone, adequately describe the rights and obligations of participants of that plan, and, hence, additional information may be required.

The Department also received many comments arguing that the Department should require less detail in the plan documents because of the changing nature of loan programs and the expense of plan amendments. Several commentators opined that section 408(b)(1)(C) of the Act should not be read to require that such things as loan application procedures, interest rates and types of security be included.

In this regard, the Department reiterates that the specific terms enumerated in Sec. 2550.408b-1(d)(2) may be included in a separate written document forming part of the plan. Also, it is the view of the Department that the requirements of this paragraph of the regulation are sufficiently general to permit plan provisions to be framed in a manner which would limit the number of plan amendments. For example, Sec. 2550.408b-1(d)(2) does not require the inclusion in the plan of the actual rate of interest or the actual loan application form, but merely the general procedures for determining the interest rate and for applying for a loan.

A number of commentators indicated that sponsors of master and prototype plans would have difficulty complying with the requirements of Sec. 2550.408b-1(d) of the regulation because these types of plans have no effective mechanism for setting forth the specific provisions required in the regulation. It was suggested that special guidance be developed for these plans and that, if necessary, a later effective date should be provided for amendments to such plans.

The Department believes that there is no basis in the statute to conclude that participants and beneficiaries of master or prototype plans are entitled to less specific disclosure of their rights and benefits under their plan than participants of other types of plans. Thus, the final regulation contains no special rules for these plans. Lastly, the Department believes that the grace period for compliance with this paragraph should be sufficient to accommodate the adoption of any necessary changes to master and prototype plans, as well as other types of plans.

E. Reasonable Rate of Interest

Section 408(b)(1)(D) of the Act states that, in order for a loan to be covered by the relief provided by section 408(b)(1), such loan must bear a reasonable rate of interest. In line with the Department's view that a participant loan is a plan investment, Sec. 2550.408b-1(e) of the proposed regulation provided that a reasonable rate of interest is one which provides the plan with a return commensurate with the prevailing interest rate charged on similar commercial loans by persons in the business of lending money. This standard was first described in Advisory Opinion81-12A [12] and reflects the relevant legislative history and the practice under the Internal Revenue Code prior to the enactment of ERISA.

[12] Advisory Opinion 81-12A(letter to Robert Georgine, January 15, 1981) (A.0. 81-12A).

In A.O. 81-12A, the Department expressed its view that Congress intended to incorporate into 408(b)(1) the objective prevailing rate standard under existing IRS regulations. The Department described the prevailing rate standard as a composite of what persons and institutions in the business of lending money would obtain as compensation for the use of money which they lend under similar circumstances. The Department noted that the prevailing rate standard permits a fiduciary to consider those factors pertaining to the opportunity for gain and the risk of loss that professional lenders would consider in setting the rate of interest on a similar arm's-length loan, and emphasized that a participant loan as a plan investment would not be prudent if it provided a plan with less return, relative to risk, than comparable investments available to the plan, or if it involved a greater risk to the security of plan assets than other investments offering a similar return.

The Department's approach was not followed in *Brock v. Walton* [7 EBC 1769] 794 F.2d 586 (11th Cir. 1986), where the Court of Appeals held that a rate 2 1/8 percent lower than the prevailing rate in the community was neither imprudent under section 404(a)(1) of the Act nor unreasonable for purposes of 408(b)(1). After a careful review of the court's opinion, the Department issued the proposed regulation which adhered to the position that Congress intended participant loans to be treated as any other plan investment and, thus, governed by the objective prevailing rate standard.

Although several commentators agreed with the Department's position with respect to defined benefit plans, the Department received many comments arguing that less than commercial rates should be permitted for participant loan programs in individual account-type plans. In general, commentators disagreed both with the concept that participant loans are solely plan investments and with the position that for investment purposes prevailing commercial rates are the appropriate points of comparison. Many commentators argued that Congress did not intend that plans be required to charge the prevailing market rates of interest. Most in this group contended that the DOL should follow the *Brock v. Walton* rule that "reasonable rate" doesn't have to be prevailing market rate of interest. [13]

---

[13] In this regard, some commentators argued that the Department is required to follow *Brock v. Walton*, in part, because the Department did not seek review by the Supreme Court. To the contrary, the government is not bound to alter its national policy based on an adverse Court of Appeals decision. Such a rule would serve to prevent the development of important questions of law by giving the first decision preclusive effect on a particular issue. *United States v. Mendoza*, 464 U.S. 154, 160 (1984). In addition, the government is not required to seek Supreme Court review in order to preserve its position, particularly on the first adverse decision, in part because the Court's general practice is to review cases only after a conflict among the Circuits has developed. See S.Ct. Rule 17.1(a).

---

After due consideration of these comments, the Department continues to believe that the law of trusts establishes an objective standard of fiduciary conduct which has been incorporated by Congress in ERISA and applied in numerous cases thereunder. See, e g., *Donovan v. Cunningham*, [4 EBC 2329] 716 F.2d 1455, 1467-68 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984); *Donovan v. Mazzola*, [4 EBC 1865] 716 F.2d 1226, 1231-32 (9th Cir. 1983), cert. denied, 464 U.S. 1040 (1984); *Freund v. Marshall & Ilsley Bank*, [1 EBC 1898]] 485 F. Supp. 629, 635 (W.D. Wisc. 1979). In addition, as noted in the preamble to the proposed regulation, the legislative history clearly indicates that in section 408(b)(1) Congress provided an exemption from the prohibited transaction rues for participant loans "following current practice." Conf. Rpt., supra at 310-11. In discussing the state of the law prior to the passage of ERISA, Congress noted:

Under the Internal Revenue Code, qualified retirement plans must be for the exclusive benefit of the employees and their beneficiaries. Following this requirement, the Internal Revenue Service has developed general rules that govern the investment of plan assets including a requirement that cost must not exceed fair market value at the time of the purchase, there must be a fair return commensurate with the prevailing rate, sufficient liquidity must be maintained to permit distributions, and the safeguards and diversity that a prudent investor would adhere to must be present. Id. at 302 (Emphasis added.) See 26 U.S.C. 503(b)(1) (1970), Tres. Reg. 26 CFR 1.503(b)-1(c) (1960). Further, although Congress clearly intended, through the enactment of section 408(b)(1) to permit certain parties in interest, i.e., plan participants, to engage in what would otherwise be prohibited transactions involving plan assets, it is the opinion of the Department that Congress also clearly intended that the exemption would have no effect with respect to the requirements of the basic fiduciary responsibility rules. Conf. Rpt., supra, at 310-11; Legis. Hist., supra, at 4577-78. Based on the above, the Department issued A.O. 81-12A in which it concluded that both sections 404 and 408(b)(1) require participant loans to be treated as other plan investments, and that prevailing commercial loan rates are to be the appropriate benchmarks for determining a reasonable rate f interest. After careful review of the comments, the Department has determined to adhere to this longstanding interpretation. [14]

---

[14] Many commentators also argued that under the "facts and circumstances" prudent person test of A.O. 81-12A, a below-prevailing rate of interest is permissible for participant loans which are both secured by participants' vested accrued benefits and repaid through payroll deduction. It is the Department's view that these factors may not be relied upon to justify the granting of loans at less than the prevailing rate. The Department does, however, wish to clarify that plan fiduciaries may choose a loan rate which reflects these factors, to the same extent that commercial loan rates would, and fall within the narrow range of the prevailing rate.

---

Other commentators stated that requiring the use of commercial rates is particularly inappropriate where a loan is in effect a self-directed investment, the investment experience of which is attributable only to the participant. In the Department's view, there is no basis in the statute for departing from the position that participant loans should function as plan investments, whether the investment return is used to provide benefits to one participant or to all covered participants. Moreover, it is the opinion of the Department that the primary purpose of a pension plan is to provide the benefit of retirement income not to make participant loans. [15]

---

[15] In this regard, a number of commentators urged that all types of plans be permitted to use less

than prevailing rates in recognition of the plan loan as an incidental benefit of, and in the case of some plans, incentive for, plan participation. In the Department's view, this suggestion is not compatible with the express intent of Congress that participant loans be governed by the general rules of fiduciary responsibility, which require that participant loans function as other plan investments. In addition, adopting the view that a participant loan is an incidental benefit would constitute a major departure from the purpose of pension plans—to provide retirement income. Also, in the case of plans in which individual benefits are based on the investment experience of the general pool of plan assets, such an approach may be unfair to those participants who do not take out loans. Lastly, the Department does not believe that the purpose of the exemption is to encourage borrowing from retirement plans but rather to permit it in circumstances that are not likely to either diminish the borrower's retirement income or cause loss to the plan.

---

Many commentators sought clarification on how to determine the rate of interest, and how often it should be adjusted. A majority of the commentators argued that ascertaining the prevailing market rate would be administratively infeasible, and that the Department should adopt a standard rate such as the applicable federal rate, a GIC rate, prime or prime plus rate, rates comparable to other plan returns, or state usury law rates. Other commentators argued that plans administered on a nationwide basis should not be required to charge different rates of interest in different locales.

Providing a standard “safe harbor” interest rate would not be compatible with the Department's view that a reasonable rate of interest” is one which provides the plan with a return commensurate with the prevailing interest rate charged by persons in the business of lending money for loans which would be made under similar circumstances. A Departmentally-established standard rate would also run counter to the Department's view of a participant loan as an investment subject to the same standards of ERISA as any other investment, e.g., the prudence and exclusive benefit rules. Such a standard rate would also ignore the fact that the commercially prevailing rate may vary based on certain factors, e.g., creditworthiness of the borrower and the security given for the loan. Indeed, the Department believes that no one particular standard rate will consistently reflect the appropriate risk relative to return ratio for all plans and all participant loans. Thus, with respect to setting loan rates, the Department suggests that plan administrators conduct the same type of inquiry that would be prudent prior to making any other type of investment.

With respect to geographical differences in the market rates, the Department believes that administrative costs may justify the adoption of a national rate of interest by a plan which is administered on a nationwide basis. Such a plan may also grant loans on a regional basis at rates which reflect appropriate regional factors. In the case of a plan which is not a plan administered on a nationwide basis, the Department believes that an appropriate determination of the “reasonable rate of interest” must be based on appropriate regional factors.

A number of commentators questioned Example (3) of proposed Sec. 2550.408b-1(e) which states that a plan may not limit the rate of interest to the state usury limit if commercial institutions not subject to the usury laws are charging higher rates. According to these commentators, this places a plan sponsor in the untenable position of being forced to choose between complying with state usury laws or with the Department's regulation. In this regard, the Department notes that ERISA contains no mandate requiring ERISA-covered plans to provide loan programs for their participants; thus, there is no absolute conflict between state usury laws and ERISA. The Department continues to adhere to its position that a ”“reasonable rate of interest” is one which provides the plan with a return commensurate with the prevailing interest rate charged by persons in the business of lending money for loans which would be made under similar circumstances. Also, because participant loans are plan investments, a participant loan program which limits its interest rate to a maximum state usury ceiling when higher yielding comparable investment opportunities exist may not meet the requirements of ERISA section 403(c) and 404(a).

G. Adequate Security

Section 408(b)(1)(E) of the Act states that the relief provided by paragraph 408(b)(1) will apply only to loans that are adequately secured. Based on similar IRS regulations, the Department proposed Sec. 2550.408b-1(f) which provided a test for the adequacy of the security similar to that which would be required by a commercial lender. The proposed regulation made it clear that in the participant loan context, the security must be such that, in the event of default, the participant's retirement income is preserved and loss to the plan is prevented. The proposal indicated that at least a portion of a participant's vested accrued benefit under the plan may be used as security to the extent that it meets this test. Citing to the spousal consent requirements of ERISA and the Code, the Department also suggested in the preamble to the proposed regulation that restrictions on distributions in qualified plans could affect the adequacy of vested accrued benefits as security.

Virtually all commentators on this paragraph of the regulation requested clarification that vested accrued benefits could serve as adequate security for participant loans. Most of these commentators made their arguments with respect to loan programs administered by individual account plans under which principal and interest payments made on any particular participant's loan would be allocated totally to that same participant's account. Since in such plans any loss would be suffered only by the participant borrower, it was argued that the restrictions on timing of foreclosure due to the Code restrictions on in-service distributions should not affect the adequacy of accrued benefits as security. If such plans also require repayment by payroll deduction, it was argued that an account balance should be considered adequate security, at least in these types of plans, even though default could not occur until a distributable event, i.e., termination of service. Other commentators suggested that vested accrued benefits in either a defined benefit or defined contribution plan could be considered adequate as security if its value was discounted to take into account any time lag between a default and actual enforcement of the security interest. Another commentator suggested that an employer's guarantee of participant loans should provide the Department a basis for determining that vested accrued benefits are adequate security.

In contrast, a number of commentators agreed that loans from defined benefit plans or other plans in which each participant's benefit is based on a share of the plan's pooled asset investment experience might require collateral beyond that required for loans from individual account plans in order to assure that the plan suffer no loss in the event of default. In light of the comments, the Department has made the following amendments and clarifications to Sec. 2550.408-1(f). In the Department's view, Congress clearly intended that at least a portion of a participant's vested accrued benefit be a permissible form of security, see, e.g., Conf. Rpt., supra, at 312; reprinted in Legis. Hist., supra, at 4579. But in that regard, Congress also clearly intended that the security given must be adequate in commercial terms. Id. Because of the overriding concern for protecting the plan from loss and thus preserving the participant's retirement income, the Department has determined to retain the general requirement that the security for all participant loans be such that the plan will suffer no loss of principal or income if a default occurs. However, with regard to plan loan programs which intend to accept a participant's vested accrued benefit as security, the Department has also established a cap which places an upper limit on the amount of the vested accrued benefit which the plan administrator may consider for purposes of determining adequate security for participant loans made pursuant to section 408(b)(1). Specifically, the final regulation permits up to fifty percent of the present value of a participant's vested accrued benefit to be used as security for participant loans and taken into account in determining whether the security is adequate, leaving the remaining account balance unencumbered. [16] Thus, immediately after the origination of any participant loan to be secured in whole or in part by the vested accrued benefit, the amount of the participant's vested accrued benefit actually being considered as security for the outstanding balance of that participant's loans may not exceed the 50% cap. A participant loan program may, however, grant participant loans which require aggregate security in excess of the fifty percent cap provided that the plan receives additional collateral the value of which equals or exceeds the amount required in excess of the cap. The Department believes this cap is necessary to assure that the primary purpose of a pension plan is achieved—to provide retirement income for plan participants.

[16] The Department chose to correspond the cap to one of the upper limits imposed by section 72(p)(2)(A)(ii) of the Code, beyond which participant loans will be treated as taxable distributions. The Department wishes to note, however, that it is not adopting the provisions of section 72(p) as requirements of this regulatory exemption.

Like the proposal, the final regulation does not require enforcement of the security interest held by a plan at any particular time after a default by a participant borrower. Section 2550.408b-1(f)(1), however, does require that in order for the security posted for the loan to be considered adequate, (1) the plan must have the ability to foreclose on, or sell, or otherwise dispose of it in the case of default; and (2) the value of the security must be such that it can be reasonably anticipated that the plan will not suffer a loss of principal or interest from the loan due to the actual date of enforcement of the security interest resulting from a default. The requirement that the plan have the ability to foreclose on the security interest in the case of default does not require that the plan have the ability to foreclose immediately upon default. For example, where a portion of the vested accrued benefit is used as security, the plan's ability to enforce the security interest immediately upon default is not required as long as no loss of principal or income will occur to the plan due to the delay of such enforcement. Similarly, in the case of collateral other than a participant's vested accrued benefit, the Department is of the opinion that it is within the plan fiduciary's discretion to determine whether it is prudent to extend the date of enforcement of the security interest, as long as no loss of principal or interest occurs.

For plans which accept a portion of the vested accrued benefit as security, the Department understands that the effect of the “no loss” requirement will vary expending upon the type of plan. With regard to plans in which the investment experience of the plan's assets is shared by all participants or used to fund the benefits of all plan participants, additional loan program requirements in conjunction with the pledging of a portion of the participant's vested accrued benefit may be necessary in order to assure "no loss" of principal and interest to the plan. For example, a loan program in a 401(k) plan in which the investment experience is shared might meet this "no loss" requirement by using a portion of a participant's account balance as security in conjunction with mandatory payroll deduction repayment which would stop only upon the happening of a distributable event, i.e., retirement, separation from service or death. In addition, discounting the value of the vested accrued benefit to take into account the time delay between any possible default and the first distributable event for that participant's benefit may be another viable way of meeting the "no loss" adequate security requirement. ERISA's general fiduciary requirements may also require a plan administrator of a defined benefit plan who intends to use a portion of a participant's vested accrued benefit as security to consider additional factors such as the funding of the plan in determining the amount that may be borrowed based on the vested accrued benefit. However, where a plan provides an individual account for each participant and the investment experience of the assets contributed to that account is attributable solely to that plan participant's account, any participant who has a vested accrued benefit may borrow up to 50% of the present value of the vested accrued benefit secured by that 50% of the vested account balance. For example, a participant who has a vested accrued benefit the present value of which is $10,000 may borrow up to $5,000, secured by 50% of his vested account balance, i.e., $5,000, and meet the terms of Secs. 2550.408b-1(f) (1) and (2).

Finally, it was suggested that an employer guarantee of a participant loan might be a means of adequately securing the loan. In this regard, if requested, the Department will consider the issues surrounding this subject in the context of specific guarantee arrangements submitted for review.

H. Effective Date

Proposed Sec. 2550.408b-1(g) of the regulation stated that, if adopted, the regulation would generally be effective January 1, 1975, except that Sec. 2550.408b-1(d)(2) relating to specific plan provisions would be effective for loans granted or renewed on or after the last day of the first plan year beginning on or after January 1, 1989.

Many of the comments received by the Department urged that all provisions of the regulations be made prospective in effect, contending that it would be unfair to issue retroactive regulations which are inconsistent with current practice both as to rates of interest and the security required, and which may impose substantial liability on plan fiduciaries and cause possible disqualification of plans. Other commentators suggested that the effective date be extended to include the time which plans will need to comply with the Tax Reform Act of 1986. One commentator stated that the retroactive effective date was reasonable except as applied to existing loans designed to be reloaned to the plan sponsor since, in the commentator's view, the Department has not definitively called this practice a prohibited transaction. Another commentator opined that the regulations should be prospective because plans are complying with state usury laws.

In support, commentators noted that the 1974 legislative history of ERISA gave permission to continue current practice which various commentators believed to include use of lower than prevailing rates of interest and use of distribution-restricted vested accrued benefits as security for loans. With respect to the proposed definition of reasonable rate of interest, many commentators stated that the proposed regulation is inconsistent with A.O. 81-12A, which commentators contend led plans to believe that using less than prevailing rates was permissible. Commentators also asserted that many plans reasonably relied upon the 1986 *Brock v. Walton* decision where the Eleventh Circuit approved a participant loan rate less than the prevailing rate. Some commentators suggested that a grace period be given plans so that they would have the opportunity to come into compliance with the regulation. Others suggested that existing plan loans be "grandfathered," i.e., not be required to change their terms.

In response, the Department believes that the clarifications contained in this final regulation may alleviate some of the commentators' concern about the effective date of the regulation. It also believes, however, that many plans have in good faith attempted to follow the terms of the exemption but may not meet the precise terms contained in this final regulation. Section 2550.408b-1(g) has therefore been amended to provide that with the exception of the provisions of Sec. 2550.408b-1(d)(2), the regulation will be effective for all new or renewed loans 90 days from the publication date of this final regulation. [17]

---

[17] The Department notes that making the regulation prospective in effect does not necessarily create an inference that all existing loan programs are per se acceptable. For instance, the Department may find that certain existing loan arrangements are non-exempt prohibited transactions, based not on the regulation, but on the Department's longstanding interpretation of the reasonable rate of interest requirement, as contained in A.O. 81-12A and as argued in *Brock v. Walton*, 794 F.2d 586 (11th Cir. 1986). Consequently, the Department will continue to bring enforcement actions aimed at participant loans made prior to the effective date of the regulation at

below prevailing rates.

## Executive Order 12291 Statement

The final rule in this document is not classified as a "major rule" under Executive Order 12291 on Federal Regulations, because it is not likely to result in (1) an annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or (3) significant adverse effects on competition, employment, investment, productivity, innovation, or the ability of United States-based enterprises to compete with foreign-based enterprises in domestic or export markets. The action will impose some costs on employee benefit plans. These costs have been estimated to be one-time costs of just under $18 million and subsequent annual costs of less than $150,000.

## Regulatory Flexibility Act Statement

The Department has determined that this final regulation would not have a significant economic impact on small entities. The purpose of this regulation is to provide guidance to employee benefit plans and their sponsors and administrators who wish to provide a participant loan program to their plan participants and beneficiaries. A number of commentators suggested that the Department had underestimated the cost of implementing a participant loan program under the regulation. In conducting the analysis required under the Regulatory Flexibility Act, it was determined that several aspects of the final regulation will serve to alleviate their concerns. First, many commentators projected higher costs based on misinterpretations of the proposed regulation's requirements under ERISA section 408(b)(1)(E), relating to adequate security.

Second, the Department anticipates that, given the nature of the requirements of ERISA section 408(b)(l) as clarified by the regulation, employee benefit service providers will be able to develop standardized language for inclusion in plan documents and summary plan descriptions, thereby reducing costs incurred by individual plan sponsors. Finally, it should be noted that no plan sponsor is required under section 408(b)(1) of ERISA, or the regulation, to provide for a loan program as part of a plan; thus, only those plan sponsors voluntarily adopting loan programs will be affected by the regulation.

## Paperwork Reduction Act Statement

Section 2550.408b-1(d) of the final regulation contains a paperwork requirement which has been approved by the Office of Management and Budget under the provisions of the Paperwork Reduction Act of 1980 (Pub. L. 96-511). The final regulation is assigned control number 1210-0076.

## Statutory Authority

The regulation set forth herein is issued pursuant to section 408(b)(1), 29 U.S.C. 1108(b)(1), and section 505, 29 U.S.C. 1135, of the Act. The regulation is also issued under section 102, Reorganization Plan No. 4 of 1978, (43 FR 47713, October 17, 1978), effective December 31, 1978 (44 FR 1065, January 3, 1979), 3 CFR, 1978 Comp., 332, reprinted in 5 U.S.C. app. at 1163 (1982); and under Secretary of Labor Order No. 1-87.



ISSN 2161-8704