U.S. Department of Labor

Labor-Management Services Administration
Washington, D.C. 20216

Reply to the Attention of:

OPINION 81-12A
408(b)(1), 404(a)(1)(B)

JAN 15 1981

Robert A. Georgine, Chairman
National Coordinating Committee for Multiemployer Plans
Suite 603
815 Sixteenth Street, NW
Washington, D.C. 20006

Dear Mr. Georgine:

Thank you for your submission of July 3, 1980, regarding the application of the Employee Retirement Income Security Act of 1974 (ERISA) to investment programs under which multiemployer plans may offer mortgage loans to plan participants and beneficiaries. We appreciate the significance of this matter, and feel that your detailed analysis has helped us focus on pertinent issues.

Analysis of a program of investment by an employee benefit plan in residential mortgage loans which may be available to the plan's participants involves consideration of three distinct questions: whether the program is "prudent" within the meaning of §404(a)(1)(B) of ERISA; whether particular loans within such a program are "prudent" within the meaning of that section; and where a loan is to be made to a plan participant, whether the rate of interest charged on a loan is "reasonable" within the meaning of §408(b)(1) of ERISA and §4975(d)(1) of the Internal Revenue Code. Section 404(a)(1)(B) of ERISA provides, in part, that:

> "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and …
>
> (B) with the care skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims …"

ERISA's federalized prudence requirement, although based upon the common law of trusts, does depart from traditional trust law in some respects. The Department interprets section 404 as providing greater flexibility, in the making of investment decisions by plan fiduciaries, than might have been provided under pre-ERISA common and statutory law in many jurisdictions.

As you are aware, the Department has adopted regulations under section 404(a)(1)(B). Under regulation 404(a)(1), a fiduciary must give appropriate consideration to all facts and circumstances that the fiduciary knows or should know are relevant to the particular investment decision involved, in order for the decision to be deemed prudent. The regulation identifies certain specific factors (although the list does not purport to be exclusive) to be taken into account by the fiduciary: (1) portfolio diversification; (2) the plan's liquidity needs; (3) the projected return of the portfolio relative to the plan's funding objectives; and (4) the opportunity for gain and risk of loss associated with the invest under consideration. In addition, the fiduciary must, on the basis of all such relevant factors, determine that the investment is reasonably designed to further the purposes of the plan.

In your submission you list a number of factors which you deem relevant to a fiduciary's consideration of a possible mortgage financing program which would include loans to participants. For instance, you state that, in deciding whether to establish a participant loan program, a fiduciary should consider potential earnings, risk, the relationship of these factors to the average return and risk of the plan's portfolio, and matters of diversification, cash flow, and funding. You state that, in deciding what interest rates to charge on participant loans, a fiduciary should consider the plan's funding requirements, the amount of a loan, the demand for similar loans at various rates, and certain matters related to risk. We agree that all these factors may appropriately be considered by plan fiduciaries in their investment deliberations. Of course this list is not exclusive, and obvious relevant additions which prudent plan fiduciaries would necessarily consider are the availability, riskiness and potential return of alternative plan investments. However, because the loan program or a particular loan is a plan investment and not a benefit provided participants under the plan, the incidental advantages which might accrue to borrowers from the availability of plan financing would not be appropriate for consideration in the plan's fiduciaries' investment decisionmaking.

Assuming that plan fiduciaries have prudently decided to make a particular mortgage loan or to undertake an investment program involving presidential mortgage financing where such financing may be made available to plan participants, the question then arises whether additional requirements are imposed, because those participants are parties in interest with respect to the plan. As you know, the ERISA statutory exemption which §408(b) provides from the prohibitions of §406 otherwise applicable to a plan's mortgage loan to a plan participant is available only when the loans:

> "(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 in an amount greater than the amount made available to other employees, (C) 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 Department has not issued regulations under §408(b)(1). You ask the Department's views concerning the "reasonable rate of interest" requirement.

ERISA was enacted against a backdrop of history in which private employee pension benefit plans had been governed in substantial part by the requirements of the Internal Revenue Code relating to the tax qualification of such plans. In administrating the Code provisions permitting the qualification of such a plan only if it was maintained "for the exclusive benefit" of participants and beneficiaries, the Internal Revenue Service developed rules and guidelines for interpretation of the statutory language and ruled on a variety of factual situations. In enacting ERISA, Congress was aware of these interpretations and rulings, as can be seen, for example, from the ERISA Conference Report, H.R. Report No. 93-1280, 93d Cong., 2d Sess. (1974), which provides, at p. 302:

> 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 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. The conferees intend that to the extent that a fiduciary meets the prudent man rule of the labor provisions, he will be deemed to meet these aspects of the exclusive benefit requirements under the Internal Revenue Code.

Because Congress intended to incorporate standards of fiduciary conduct no less protective of plans and their assets than the Internal Revenue Service rules cited by the conferees, including the rule that an investment provide a fair return commensurate with the prevailing rate, we understand the requirement of §408(b)(1) that participant loans bear a reasonable rate of interest to incorporate that objective standard.

However, the Department does not view the "prevailing rate of interest" as a single number, or view the prevailing rate standard as unduly rigid. To the contrary, we believe the prevailing rate standard is flexible, because it is a concept based on the composite of what persons and institutions in the business of lending money would obtain as compensation for the use of the money which they lend under similar circumstances. We are aware that lenders take into account a variety of different considerations (such as, e.g., term, security, amount of borrower's equity, discounts, prepayment provisions, etc.) in determining the interest rate at which they might make any particular loan, and that they accordingly differ to some extent as to the rate of interest they would charge on similar loans. 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. A plan could, for example, charge a lower rate of interest to a plan participant than the rate that would be appropriate on the basis of all other pertinent factors if appropriate fiduciaries determined, on the basis of their knowledge of the participant's employment background, that lending money to that participant involved less risk of loss than would ordinarily be associated with such a loan. Similarly a plan could charge a lower rate of interest to a participant, where some portion of the loan was secured by funds in the possession of the plan, such as the participant's vested benefit.

Thus, we concur with your statement that "[A] mortgage interest rate charged by a plan that is below the stated rate of other lenders for a similar loan may, under certain circumstances, be a 'reasonable rate of interest' within the meaning of section 408(b)(1) …". (Emphasis added). However, we reemphasize that any particular prospective mortgage loan or program of mortgage loans to be made by a plan, considered as a plan investment or investment course of action, and therefore selected (if at all) in preference to other investment alternatives, would generally not be prudent if the investment or investment course of action provided the plan with less return, in comparison to the risk involved, than comparable investments or investment courses of action available to the plan; or, alternatively, involved a greater risk to the security of plan assets than such other investment or investment course of action offering similar return. Accordingly, a mortgage loan program, adopted to provide mortgage financing for plan participants in a manner inconsistent with the above would not be lawful.

We trust this guidance will prove helpful.

Sincerely,

Ian D. Lanoff
Administrator
Pension and Welfare Benefit Programs