Another View of the Impact of Indexing Discount Rates to 10-Year Treasuries

The amendment to New York Article 50A (Medical Malpractice) incorporates indexing of discount rates to ".. the rate in effect for the ten-year United States Treasury Bond on the date of the verdict...". The statute further provides that the discount rate applicable to a particular element of future loss be determined by the period over which the future loss is to be paid. The 10-year rate is to be used as the discount rate for all elements with a future period of 20 years or less, and a weighted average of the 10-year rate for the first 20 years and 2 percentage points above the 10-year rate for years beyond 20 years.

In its simplest terms, application of discount rates is a mechanical process that, when applied to a stream of future payments, produces a present value or an amount if invested at the discount rate will produce the stream of future payments.

The 10-Year Treasury was selected as the most prominent risk-free and stable instrument. The rate "in effect" has been interpreted as the daily yield, and, as the first and only guidance on the subject, its application is now extended to original 50A and 50B (General Liability) cases.

In recent years, both risk-free and stable have been challenged. The daily yields have plunged from 4.5% to just over 2% or almost 250 basis points and then rebounded.

Auction rates and yields have also fluctuated.

- The August 17, 2009 10Year issue had a stated rate of 3.625%, and a yield of 3.734%.
- The November 16, 2009 10 Year issue had a stated rate of 3.375%, and a yield of 3.47%.
- The December 15, 2009 9Year-11month interim has a stated rate of 3.375%, and yield of 3.448%.

In a little over a year daily yields have moved from 2.08% (12/18/2008) to 3.85% (12/31/2009). That is a change of 178 basis points, and, with all other things being equal, might cause a downward move in Net Awards by as much as 17.5%. The yield range in the last quarter has been from 3.21 and 3.85%. These movements seem to be tied more to pronouncements of the Fed, fear of future underlying inflation, and expected price deterioration in Treasury Notes. Predicting rate movement is a no-win proposition. The experts seem to be in two camps, those who predict a movement to the 3.75 to 4.75% over the next year, and those who expect movement of yields between 2.5% and 3.5% over the next year.

With the active intervention of the Fed in balancing currency value, underlying inflation and interest rates, no one can be sure what Treasury yield range will prevail. Add to that, the Fed's prior record in managing the competing factors and the questionable accuracy of market data (e.g. the recent adjustment to previously reported employment data), all bets are off.

The selection of the daily yields, and their current rates and instability have produced a series of unanticipated consequences.

- Application of the daily yield on the date of the verdict produces something of a crap shoot, the lower the daily yield the higher the net value.
- Low rates, when combined with statutory inflation and applied to shorter term future Awards (20 years or less), yield a discounted Award before deductions and adjustments that is higher than the undiscounted Award.
- Depending on the cost of annuities, the Net Award may be far greater than the cost of the related annuity. Under the provisions of the Structured Settlement Protection Act, those costs should be reported.
- Attorney fees and interest are based on the net values, but the real Net Award may be the lower annuity costs. How is any excess to be dealt with?

The relationship between Net Awards and annuity costs deserve further review.

The statutes provide that “The defendants and their insurance carriers shall be required to offer and to guarantee the purchase and payment of an annuity contract to make annual payments in equal monthly installments of the remaining streams of payments specified .... after deductions and adjustments...”. It does not require that the plaintiff accept any part or all of the offer and guarantee.

Excluding punitive damages, an Award is exempt from taxes under Section 104 of the Internal Revenue Code. Periodic payments are tax exempt when established in accordance with the provisions of Section 130 of the Internal Revenue Code. Otherwise, the total of periodic payments in excess of their cost would be taxable. The cost would be the amount surrendered by the plaintiff to gain the annuity stream, or the net Award.

We have built a series of models to illustrate some of the unintended consequences. The models incorporate,

1. Periodic payments adjusted for inflation in accordance with the statutes.
2. Periodic payments over different periods from 8 to 35 years.
3. Treasury rates of 2.75% and 3.25% for periods up to 20 Years, adjusted in accordance with the statute for longer periods.
4. Annuity costs calculated using discount rates of 4.4 and 4.8% and a broker fee of 4%.
5. Tax benefits calculated using an effective tax rate of 28.5%.

Without exception, the Net Awards for each period exceeded the annuity cost. The excess would be the amount that a plaintiff would surrender at the beginning to gain a tax benefit spread over a period of years.

A. Awards calculated at low discount rates produce net Awards that exceed annuity costs.

Average Net Award Over Annuity Cost

	8 Years	10 Years	15 Years	20 Years	25 Years	30 Years	35 Years
Index 3.25% - Ann. 4.8%	$1,659	$3,332	$10,377	$20,328	$20,937	$20,356	$19,042
Index 3.25% - Ann. 4.4%	$240	$1,348	$6,187	$13,337	$10,654	$6,366	$990
Index 2.75% - Ann. 4.8%	$3,540	$6,008	$16,317	$30,743	$35,980	$40,472	$44,607
Index 2.75% - Ann. 4.4%	$2,133	$4,037	$12,140	$23,765	$25,710	$26,495	$26,567
Index 3.25% - Ann. 4.8%	1.74%	3.03%	6.64%	10.23%	8.78%	7.36%	6.06%
Index 3.25% - Ann. 4.4%	0.25%	1.20%	3.84%	6.47%	4.24%	2.11%	0.16%
Index 2.75% - Ann. 4.8%	3.71%	5.47%	10.45%	15.50%	15.13%	14.72%	14.37%
Index 2.75% - Ann. 4.4%	2.20%	3.61%	7.57%	11.56%	10.33%	9.12%	8.01%

B. The gain represented by the total periodic payments less the Net Award are only substantial in the extended periods. Likewise, the tax benefits (gains times effective rates) are likewise small until longer periods.

	8 Years	10 Years	15 Years	20 Years	25 Years	30 Years	35 Years
Amended 50A							
Index rate 3.25% - % Gain	13.93%	16.69%	25.73%	35.19%	51.20%	68.26%	86.22%
Index rate 3.25% - Tax Ben.	3.97%	4.76%	7.33%	10.03%	14.59%	19.45%	24.57%
Index rate 2.75% - % Gain	11.74%	14.05%	21.59%	29.43%	43.55%	58.57%	74.33%
Index rate 2.75% - Tax Ben.	3.35%	4.00%	6.15%	8.39%	12.41%	16.69%	21.18%
Original 50A or 50B							
Index rate 3.25% - % Gain	13.94%	17.90%	28.70%	40.92%	62.58%	88.15%	118.22%
Index rate 3.25% - Tax Ben.	3.97%	5.10%	8.18%	11.66%	17.83%	25.12%	33.69%
Index rate 2.75% - % Gain	11.74%	15.05%	24.02%	34.07%	52.85%	74.86%	100.50%
Index rate 2.75% - Tax Ben.	3.35%	4.29%	6.85%	9.71%	15.06%	21.33%	28.64

C. For the most part, the amount sacrificed is only slightly less than the imputed tax benefit, and on a few occasions more. Only longer term awards show a substantial tax benefit advantage. If the tax benefit is discounted over the future payment period, the amounts sacrificed are more significant.

Average Net Award Above/(Below) Tax Benefit

	8 Years	10 Years	15 Years	2 0 Years25	Years30	Years	35 Years
Index 3.25% - Ann. 4.8%	(2,195)	(2,231)	(2,510)	(3,362)	(20,950)	(45,390)	(76,900)
Index 3.25% - Ann. 4.4%	(3,615)	(4,215)	(6,699)	(10,353)	(31,233)	(59,379)	(94,952)
Index 2.75% - Ann. 4.8%	228	1,215	5,131	10,028	(1,612)	(19,533)	(44,042)
Index 2.75% - Ann. 4.4%	(1,179)	(756)	954	3,050	(11,883)	(33,510)	(62,082)

Average Net Award Above/(Below) Discounted Tax Benefit

Index 3.25% - Ann. 4.8%	(1,748)	(1,436)	128	2,805	(6,767)	(18,717)	(32,479)
Index 3.25% - Ann. 4.4%	(3,166)	(3,420)	(4,062)	(4,187)	(17,050)	(32,707)	(50,531)
Index 2.75% - Ann. 4.8%	560	1,805	7,117	14,738	9,792	2,629	(6,244)
Index 2.75% - Ann. 4.4%	(848)	(166)	2,940	7,760	(479)	(11,348)	(24,284)

If the periodic payment schedules are projected forward to judgment and/or payment and the interim payments made in cash, those interim payments should be discounted to adjust the net Award. It is likely that the Award amount to be sacrificed would become even larger, and the gain and tax benefit smaller. The longer the interim period, the greater the effect.

Of course, a broker could provide annuities that approximate the net Award, but that would have to be the real cost or the reporting under the provisions of the Structured Settlement Protection Act would be subverted. If the difference between index rate and annuity rate is reduced, the amount sacrificed is reduced, but the value of the tax benefit remains unaffected.

[In an effort to provide a guide that allows continuing evaluation under changed index, tax and annuity rates, we are placing models on the network to test different assumptions. Links are located on the reports page. To navigate, select

New York 50A Tests

New York 50B Test

[Needless to say, our comprehensive valuation systems for Amended 50A, Original 50A and 50B incorporate a provision for analysis of annuity payments of future damages, the net Award sacrificed, and the tax benefits for each Award element. They also calculate interim payments by element, the discounting of those payments to the verdict, calculation of a weighted average date for payments and the calculation of interest on payments from verdict to some average date after the verdict.]

Conclusion

If the plaintiff were required to accept any and all annuities independent of the net value of the Award, it would work to reassign a portion of the Net Award back to the defendant. The guarantee advantage would be preserved but the tax benefit would be marginal, and might approximate the reassigned amount.

The plaintiff or a guardian should be free to select which elements of future loss to take as annuities and which to take as cash. That would be consistent with the statute, and it would allow the plaintiff to retain or surrender any excess of an element’s Net Award over an annuity cost.

For some time, we have been recommending full valuation as the basis for fair and early settlement, and the use of average 10-Year Auction rates or yields to provide a stable settlement rate.

The statutes provide in "**Settlements.** Nothing in this article shall be construed to limit the right of the plaintiff, defendant or defendants and any insurer to settle ... claims as they consider appropriate and in their complete discretion."

The latest averages of auction rates and yields include the December 15 interim auction as part of the updated yield.

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December 15	**Rate**	**Yield**	**Update**	**Rate**	**Yield**	**Update**
All	4.15%	4.22%	4.19%	4.00%	4.07%	4.03%
2 Year	3.50%	3.58%	3.56%	3.43%	3.51%	3.49%
1 Year	3.22%	3.30%	3.46%	3.30%	3.39%	3.48%

[Weighting is applied at 50%. Each successive auction rate/yield is weighted at 50% more than its predecessor.]

These averages compare with a low range of 2.50 to 3.50%, and a high range of 3.75 to 4.75%. For a broader perspective, we provide graphic displays of the various average auction rates/yields with yields updated for the December 15 interim auction (Attachment A.), and various weighted, average auction rates/yields with yields updated for the December 15 interim auction (Attachment B.). As you will note, the updated 2-Year yield equals the December 15 daily yield. The weighted updated 2-Year still tracks lower.

To avoid delays and extended negotiation, and to present an offer that would warrant and perhaps require a good faith response, plaintiff should submit a comprehensive settlement offer that incorporates all of the elements of loss for which reimbursement is sought, any adjustments and offsets, any interest applicable to the Award, and a proposal on which future Award elements to take as cash or annuities.

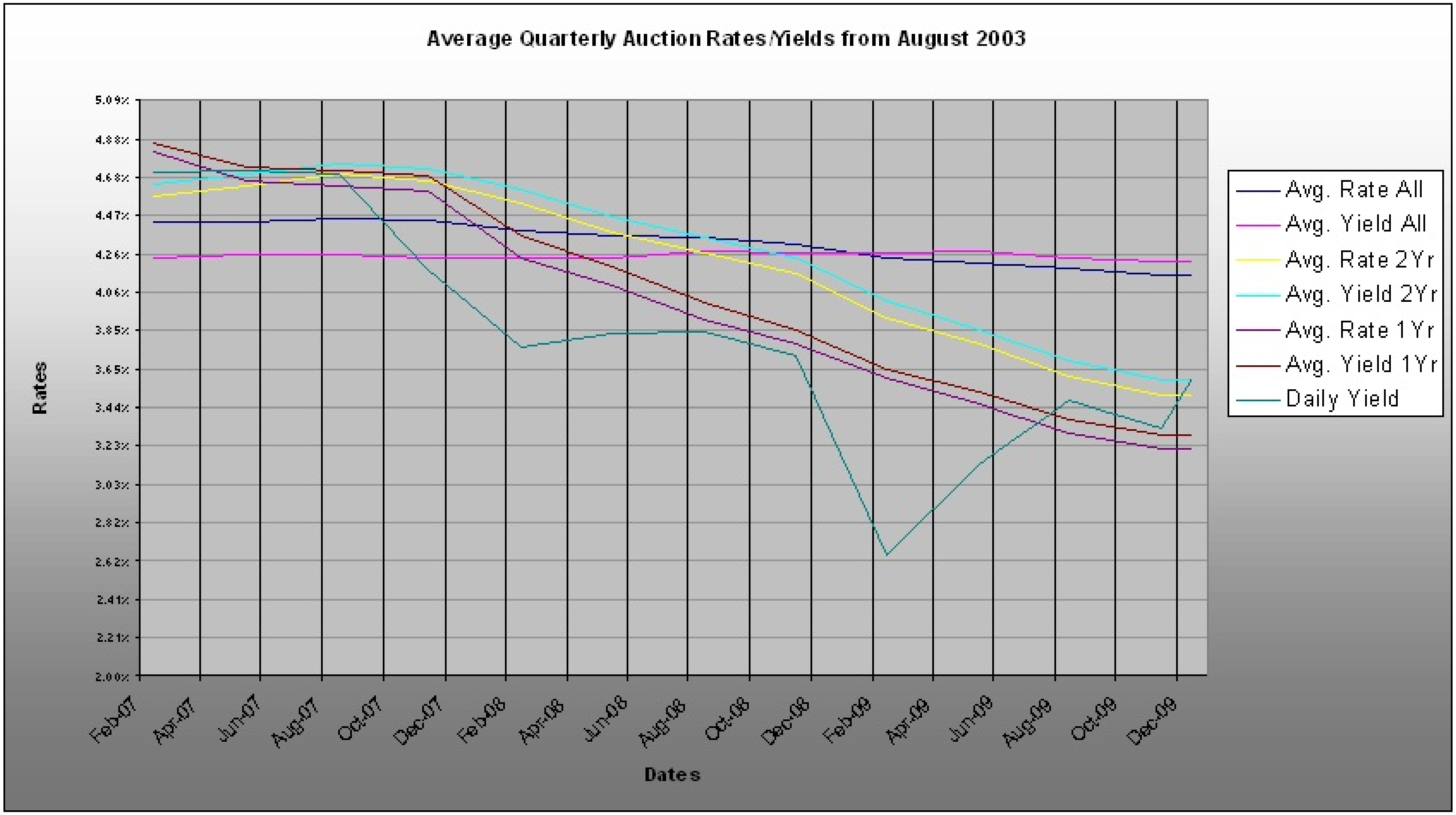
Presenting a comprehensive settlement Award, places the rate/yield risk on the defendant and its insurer, together with the risk of any verdict premium and incremental defense costs.

To assist in the settlement process, we perform Award valuation, testing of alternatives and analyses of results. In the process,

- We Advise clients on the application of statutes and related case decisions.
- We test the impact of changing variables
- We provide detailed reports, documentation and reconciliations
- We Apply interest to Awards or discounted Awards, as appropriate.
- We provide periodic payments updated to judgment and/or payment
- We provide analyses of Award element annuity alternatives.

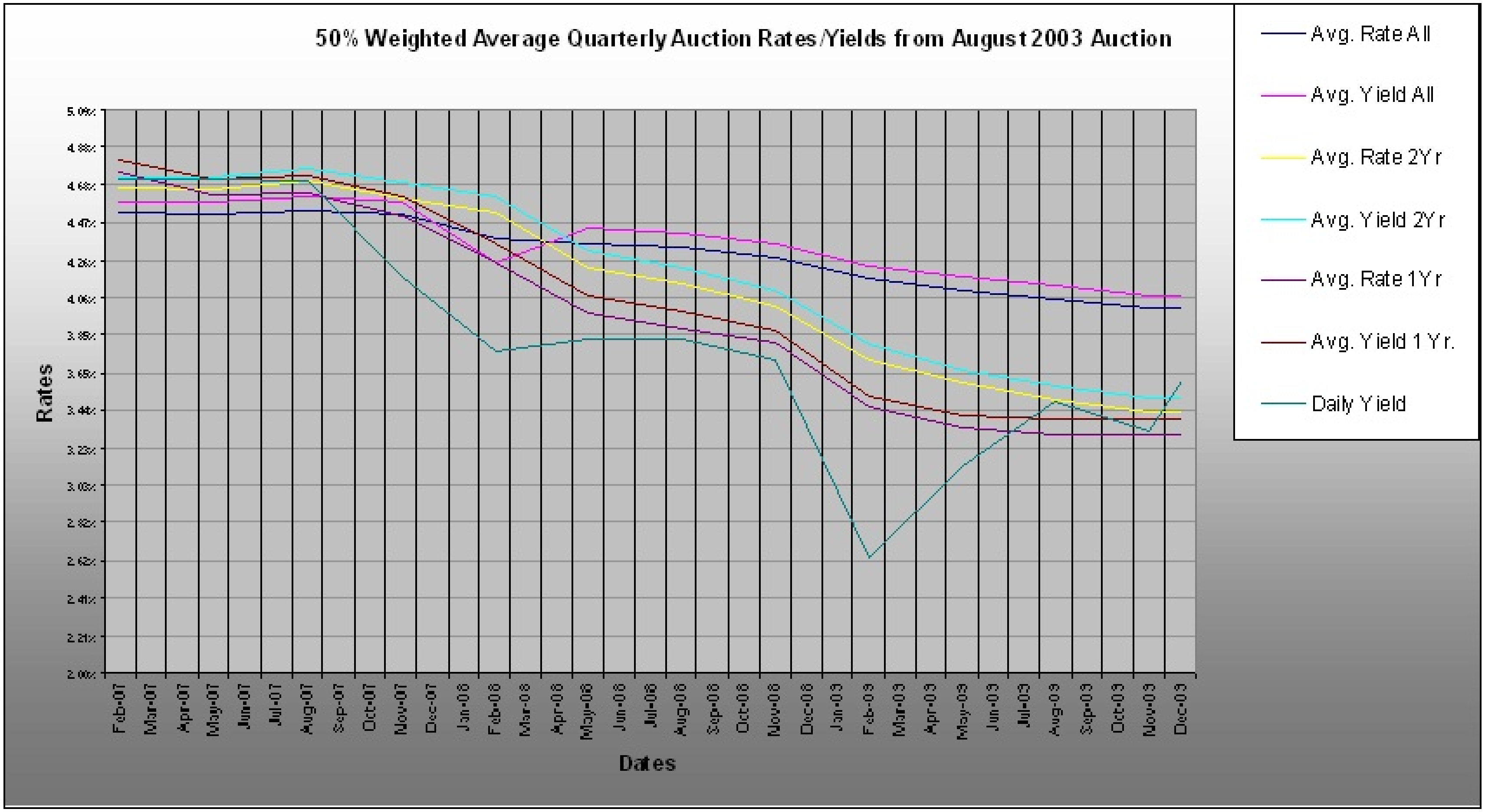
It is not necessary that the client be able to execute the valuation, adjustments or interest, or to operate the systems, it is sufficient that the client understand the basic statutory scheme, the options that may apply and the choices that should be made.

Attachment A.



The average auction rates and yields for all include the regular quarterly auctions through February, May, August and November of the year at the bottom of the page. The update includes the interim auction as if it were the next regular auction. The 2 and 1 year averages are the last 8 or four regular auctions of the year at the bottom of the page. The update includes the interim auction as if it were the next regular auction plus seven and three regular auctions.

Attachment B.



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