

The 10-Year Treasury Roller Coaster Update

The Burbank Group

The use of the 10-year Treasury to determine discount rates has now achieved universal acceptance, and is not just for personal injury and wrongful death cases brought under Amended New York 50A.

The statute refers 10-Year Treasury bond rate in effect at the time of the verdict. It appears that the drafters of the statute were intent upon giving guidance to the Courts and practitioners for the full array of cases and not limited to cases covered by the statute in which reference appears. The 10-Year Treasury seems to have been chosen for its perceived stability.

Putting aside the reference to a 10-Year 'bond' that does not exist, the major issues is which 10-Year rate is to be used. The choice is fairly important as a 25 basis point (0.25%) difference in rate will produce a change in the net Award and fee of approximately 2.5% or 10 times the rate difference.

Overall, there are three rates related to the 10-Year note. They are

- The Auction rate or the rate of interest that the government will pay on the face amount of the note of \$10,000.
- The Auction yield or the rate of interest that will be paid on the amount for which the note was sold at auction. If the \$10,000 note carried a rate of 4.00%, and sold at auction for \$9,500, the yield at auction would be $[\.04/(9500/10000)]$ or 4.21%.
- The transaction yield. As notes are traded they move up or down in price and, therefore down or up in yield. The weighted sum of these transaction yields produce daily, weekly, monthly and annual yields.

To make things somewhat more complicated, 10-Year Treasury notes are regularly issued in the middle month of each quarter, with additional, auctions in the following month. And, a number of different series are in the market at any time. [In order to not complicate the issue further, we ignore both inflation-adjusted notes and the impact of accrued interest on note prices.]

Over a long period since the passage of Amended 50A, the auction rate has fluctuated between 4.00% and 5.125%. The auction yield premium over the rate has typically been between 8 and 12 basis points (00.08% to 00.12%), but the premium has been as small as 2 and as large as 54 basis points. For the longest, there were no occasions when the auction yield was below the auction rate. That has remained true for the Regular Auctions, but in a recent interim auction, the yield went below the stated rate.

Over the past two years, 10-Year Treasury trading yields have moved up from under 4.25% to over 5.30% and then down to 3.31%. The last downward movement started in the late spring of 2007. While the yields have not moved in a single direction nor moved in a steady way, the most consistent trend has been downward. The rates/yields seem to have moved when there was intervention of the Federal Reserve in lowering Fed Funds

and Fed Discount rates, but the movement was not always in the same direction. The 10-Year Treasury rate decline seems to have been an effect of a flight to safety.

This flight to safety is attributed to fears concerning core inflation, credit risks associated with sub-prime mortgages, and the financing of imports and the willingness of supplier countries to take paper in exchange for goods. (For a fuller discussion see [The Market and Ten Year Treasury Rates](#)) Those exporting to the US are now taking US securities that yield less than inflation, and with the continuing weakening of the dollar, they may receive less in their currency when they sell the notes than they invested when they purchased the notes.

So much for stability!

Prior to Amended 50A, selection of discount rates was largely a matter of negotiation. Now, the selection of index rate is a matter of negotiation. For that reason, it is best to review the statutory provision of Amended 50A. [As there are no 10-Year Treasury Bonds, substitute 'Note' for 'Bond'.]

The discount rate to be used in determining the present value of all streams of payments for periods of up to twenty years shall be the rate in effect for the ten-year United States Treasury Bond on the date of the verdict. As to any streams of payments for which the period of years exceeds twenty years, the discount rate to be used in determining the present value shall be calculated by averaging, on an annual basis, the rate in effect for the ten-year United States Treasury Bond on the date of the verdict for the first twenty years and two percentage points above the rate in effect for the ten-year United States Treasury Bond on the date of the verdict for the years after twenty years.

What is the "rate in effect"? These are words of Art, and have to be interpreted as such. First, the rate as used with Treasury issues is the stated or face interest rate of the instrument. The auction yield is the rate of interest that is based on the amount paid for the Note at the time of auction, and the transaction yield is the rate of interest that is based on the amount paid for the Note at the time of purchase. Average yields are the weighted average of transaction yields during the period specified (day, week, month, year).

It should be clear that an historic event like an individual transaction is not 'in effect', nor is some average of historic transactions. That leaves only stated auction rates and/or auction yields, but which ones?

As previously mentioned, there are a number Note issues in the market at any time. The most recent auction may be in effect, but so too are the other issues that are outstanding. The rate at the last auction may not be current.

The auction yields are historical. They relate to the auction event and are not in effect, but they more accurately represent what the Government had to pay for the funds that it borrowed. Again, there are different auction yields for the different note issues.

The following is a listing of the regularly scheduled auction rates and yields since the passage of Amended 50A

#	<u>Auction</u>	<u>Rates</u>	<u>Yields</u>
1	8/15/03 Rate	4.25%	4.37%
2	11/17/03 Rate	4.25%	4.36%
3	2/17/04 Rate	4.00%	4.06%
4	5/17/04 Rate	4.75%	4.85%
5	8/16/04 Rate	4.25%	4.27%
6	11/15/04 Rate	4.25%	4.28%
7	2/15/05 Rate	4.00%	4.05%
8	5/16/05 Rate	4.13%	4.22%
9	8/15/05 Rate	4.25%	4.35%
10	11/15/05 Rate	4.50%	4.58%
11	02/15/06 Rate	4.50%	4.54%
12	05/15/06 Rate	5.13%	5.14%
13	08/15/06 Rate	4.88%	4.93%
14	11/15/06 Rate	4.63%	4.63%
15	2/15/07 Rate	4.63%	4.74%
16	5/15/07 Rate	4.50%	4.61%
17	08/15/07 Rate	4.75%	4.86%
18	11/15/07 Rate	4.25%	4.35%
19	02/15/08 Rate	3.50%	3.62%
20	Update		3.51%

The 10-Year Note was selected to reduce or eliminate negotiation, and to provide stability and predictability.

- If the daily yield were selected, the entire process would become something of a crap shoot with the defense looking for a verdict or settlement on a day when the yields were high, and plaintiff looking for lower rates.
- If the last auction rate was chosen, short-term stability and predictability would be achieved but the rate might not bear much of a relationship to the Government's current cost of money.
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Until the Legislature or an Appellate Court further defines "in effect", the fairest method for selecting an index rate would be to negotiate some average.

This would have the effect of providing some long-term stability, as averages move more slowly and are consistent with long-term trends. They could be

- Some average of auction rates/ yields as a proxy for a rate in effect. This would stabilize the rates being used but might not necessarily reflect the current market.
- Some average of yields incorporating an imputed next auction yield. As the last regular auction becomes more distant, the impact of the current market can be incorporated through an imputed next regular auction yield.
- Some weighted average of auction rates/yields. This would be used to emphasize the more recent Auction rates/yields. The earliest auction would have a weight of 1 with each succeeding auction increased by a given weighting.

The following is a listing of averages. They incorporate all auctions since the passage of Amended 50A and are updated through the other than regular 3/17/2008 auction.

	Wgtd @ .5					
	Rate	Yield	Update	Rate	Yield	Update
All Years	4.39%	4.46%	4.42%	4.41%	4.49%	4.40%
2 Year	4.53%	4.42%	4.41%	4.61%	4.37%	4.23%
1 Year	4.25%	4.38%	4.08%	4.25%	4.13%	3.91%

We operated certain models using the range of 10-Year Treasuries, and compared the Net payments amounts (the amount that the liability carrier must pay out). The components of an Award are intertwined through application of application of lump sums, expense and fee rates so that only the cash out is a fair comparison, even though the discount rate does not directly affect all of the Award.

First, we used the range of daily yields. 4.31% was the middle of the current range. As employed, the change in rate produced an increase in cash out as follows,

	<u>5.31% to 4.31%</u>	<u>5.31% to 3.31%</u>
- 50A Model	09.00% more	19.80% more
- Amended 50A	06.23% more	13.55% more
- 50B model	10.17% more	22.42% more

We then used the weighted updated yield of 4.40% and the one year of 3.91%. As employed, the change in rate produced an increase in cash out as follows,

	<u>5.31% to 4.40%</u>	<u>5.31% to 3.91%</u>
- 50A Model	08.12% more	13.08% more
- Amended 50A	05.63% more	09.02% more
- 50B model	09.18% more	14.80% more

We believe that plaintiffs' attorneys should move to settle the case, before or after verdict, on the basis of a fully valued Award that incorporates

- Taxes on lost or impaired earnings, if appropriate
- Collateral Source Offsets, if applicable
 - Including past maintenance costs
 - Including continuing maintenance
 - Reducing Taxes, if the offset applies against lost or impaired earning
 - Reducing the value of the offset for application expenses and fees.

(The statutes provide that expenses and fees will be applied against individual net elements of future loss, not individual net element values adjusted for offsets. When they are applied, the net result compares closely to sum of the annual discounted values for the future loss element.)

- Including interest from determination of liability, if at an earlier point in time, and utilizing second level discounting, as appropriate.
- Discounted by rates indexed to some average 10-Year Treasury rate or yield
- Direct that shorter-term future losses be resolved for cash.
- Set a date for acceptance or further negotiation.

Further, we believe that, to gain plaintiff's informed consent, the attorney should provide the client with the comparisons used in the decision process.