Litigation Economics SERIES

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What Litigators and Insurers Need to Know About the Expected Increases in Interest Rates

One of the leading topics in financial markets has been the expected increases in interest rates. This has led to concerns that a recession may follow which, in turn, has given the stock market jitters. This is because the Federal Reserve's anti-inflation policies involving interest rate increases have played a role in some prior recessions.

The expected rise in interest rates has very important ramifications for attorneys and insurers in settlement negotiations. Higher market rates affect the discount rates being used to bring projected loss amounts to present value. It is useful for litigators to have a basic understanding of the process and how higher rates should lead to lower present values of damages that may be paid in lawsuits. The present value of a settlement amount agreed to in a very low interest rate environment may be significantly higher than in the new higher interest rate environment that is coming soon.

General Reasoning

In Federal Court, personal injury damages are reduced to present value which is the same thing as saying they are discounted to present value using a specific discount rate. In state courts, discounting rules can differ. For example, in New York State, personal injury damages are presented at trial without discounting and the "discounting" takes place in a post-trial process, pursuant to Article 50-B, which is not real discounting and unlike normal discounting, actually increases, not decreases, the losses. Still, higher interest rates will lower damages more in New York relative to what they would be in a lower interest rate environment. Across the Hudson River in New Jersey, losses are discounted in a more normal process that is similar to Federal Court rules.

In personal injury lawsuits, the discount rate often assumed is derived from safe, low risk, investments such as U.S. Treasury bonds. Whether this is a correct view is a separate issue as realizable rates of return from a reasonable portfolio are typically well in excess of the rates of Treasuries. Nonetheless, courts have expressed a preference for the returns on low-risk investments for discounting in personal injury (not commercial) lawsuits.

Simple Discounting Explanation

As an example, if we assume a plaintiff has lost $100 next year, and we have a trial now and award that $100 one year "early", then the plaintiff could invest that award at some rate. If, let's say the current medium term Treasury rates are 2%, then an award of $100 would overcompensate that plaintiff as the plaintiff would have one year of interest, $2, plus the $100, by next year. So, to award the plaintiff just what he or she would have lost, we give $98 (roughly – simplistic example) and it will be $100 one year from now when we add the $2 of interest. Alternatively, if we assume that the plaintiff will lose $100 four years from now, as an example, then we need to provide even less money as the plaintiff would earn four years of interest – not just one year. If we forget about compounding, the plaintiff should only get $92 (really $92.38) and would get the remaining $8 from interest.

If the relevant interest rate was higher, the plaintiff could earn more interest (called a return) on an award that is received "early" on the trial date and, therefore, the present value of the damages (the amount the defendant should pay the plaintiff) would be lower as we would be using a higher interest or discount rate to reduce the future loss amount to present value.

Basic Discounting Rules

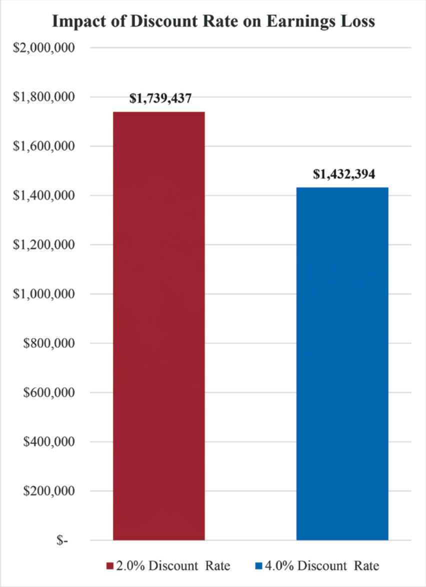
- The higher the discount rate, the lower the present value of the loss.
- The longer into the future the amounts are, the lower the present value will be.

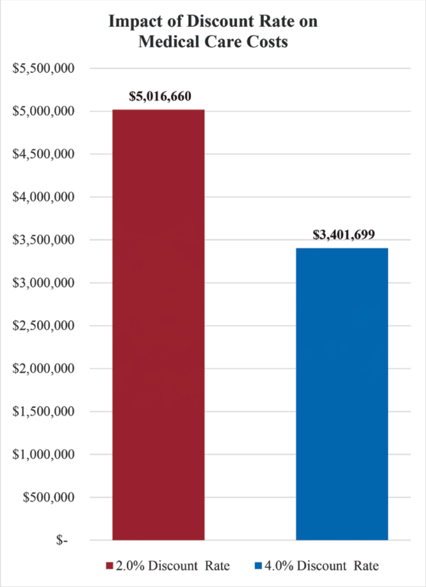
Expected Change in Monetary Policy

Interest rates are influenced by the Federal Reserve (Fed) – our country's central bank. Stated in an overly simplistic way, banks borrow money from the Fed and when the Fed charges them more interest, the banks' costs are higher, and they, in turn, increase the rates they charge customers who want loans (it is more complicated than that, but we want to keep this simple). Because the Fed is very worried about rising prices and inflation, it is raising interest rates to try to slow price increases or inflation in the economy (even though this inflation may have other causes – let's forget that now). The Federal Reserve's chairman, Jerome Powell, a non-economist, has announced that the Fed will do several interest rate increases this year. He did not say how many or how much each increase would be. The market expects a 50 basis point, or one half of one percent (a basis point is 1/100 of a percent), increase in this March's meeting of the Federal Open Market Committee. Goldman Sachs and Morgan Stanley predicted there will be seven such increases over the next year or so. Each increase is expected to be at least a ¼ of a percent (25 basis points), although it could be ½ of a percent (50 basis points). Some banks, such as Citibank, predict that we may have a 50 basis point increase this month (March 15-16, 2022). One 50 basis point increase plus six 25 basis point increases translates to a two percent cumulative increase in rates.

Simple Example of Using Higher Discount Rate

Consider the following simple example involving a hypothetical injured plaintiff who will lose $75,000 per year of employment-related earnings, which we grow at 3% for approximately 20 years (not to imply that such a general rate is appropriate for most plaintiffs), and who also will incur lifecare costs of $100,000 per year for approximately 40 years also growing at 3%. We show how the present values would differ if we used a 2% versus a 4% discount rate. The comparative values are shown in the figures below.





It is clear that just a 2% increase in the discount rate, has a significant effect on the loss of earnings, which is $300,000 lower ($307,043) and the care costs which are $1.6 million ($1,614,961) lower! Thus, interest rates matter. The higher the amount at issue, and the longer the time period involved, the more important the coming interest rate increases become for litigators and insurance companies. Defendants settling cases sooner in a low interest rate environment may pay a higher present value of losses.

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