

# NAMIC Policy Briefing

March 2009

## Credit-Based Insurance Scoring: Separating Facts From Fallacies

### Introduction

Credit-based insurance scores have been used by insurance company underwriters and actuaries for nearly two decades to more accurately assess risk and price coverage for automobile and homeowners' insurance policies.

The use of insurance scores encourages competition and enables insurers to offer coverage to more consumers at a fairer price. Furthermore, consumers benefit from insurance scoring because it keeps the insurance marketplace competitive, resulting in lower prices, better service, and more product choices. Insurance scores provide an objective, fair, and consistent tool that insurers use with other information to better predict the likelihood of future claims and the cost of those claims.

During the 1990s, lawmakers and regulators in several states began enacting laws and regulations that established procedures for insurers to follow in using an individual's credit information. In 2002, the National Conference of Insurance Legislators (NCOIL) created a "Model Act Regarding Use of Credit Information in Personal Insurance," which became the basis for additional legislation in other states. Today, 47 states have laws or regulations pertaining to credit-based insurance scoring.<sup>1</sup>

In spite of an apparent consensus on this issue, some public officials and advocacy groups have continued to press for further restrictions on the use of insurance scores, or to prohibit the practice entirely.

This *Policy Briefing* provides a review of the evolution of credit-based insurance scoring, the laws governing its practice, some misconceptions about insurance scoring, and studies that have examined the impact of insurance scoring on consumers. It is intended to educate legislators and other policymakers who may be unfamiliar with insurance scoring and its utility as a predictive tool that benefits insurers and consumers alike.

### Credit Scores and Insurance Scores: An Important Distinction

Insurance scores are not credit scores. Credit scores predict the likelihood that an individual will default or be delinquent in paying a credit obligation. By contrast, a credit-based insurance score predicts the likely "loss ratio relativity" of a particular individual. A loss ratio is the amount paid out by an insurance company in claims divided by the amount collected in premiums. Loss ratio relativity measures whether an individual will experience more or fewer losses than average.<sup>2</sup>

Another important distinction between a credit score and a credit-based insurance score is that the latter is only one of more than two dozen factors that are used by insurers to make an underwriting or rating decision about an individual. Other factors typically include an individual's motor vehicle report, claims history, or the condition of one's home.

### The NCOIL Model

As noted above, NCOIL adopted a model law in 2002 (updated in 2005) that imposes conditions on insurers' use of credit information in personal insurance transactions. Twenty-seven states have adopted

#### Headquarters

3601 Vincennes Road  
Indianapolis, IN 46268  
317.875.5250  
Fax: 317.879.8408

#### Washington Office

122 C Street, N.W.  
Suite 540  
Washington, D.C. 20001  
202.628.1558  
Fax: 202.628.1601

[www.namic.org](http://www.namic.org)

Founded in 1895, the National Association of Mutual Insurance Companies (NAMIC) is a full-service national trade association serving the property/casualty insurance industry with more than 1,400 member companies that underwrite more than 40 percent of the property/casualty insurance premium in the United States. NAMIC members are small farm mutual companies, state and regional insurance companies, risk retention groups, national writers, reinsurance companies, and international insurance giants. Together, we are NAMIC.

**NAMIC**<sup>®</sup>  
NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

EFFECTIVE **ADVOCACY**  
STRATEGIC **PUBLIC POLICY**  
VALUABLE **MEMBER SERVICES**

the model while other states have adopted at least portions of the model in their statutes.<sup>3</sup>

The model imposes at least eight specific restrictions on how insurers use credit information in underwriting or rating risks. For example, the model prohibits insurers from using an insurance score that is calculated using income, gender, address, zip code, race, ethnicity, religion, marital status, or an individual's nationality.

The model also prohibits an insurer from denying, canceling or non-renewing a personal insurance policy solely on the basis of credit information. An insurer cannot deny insurance coverage solely on the grounds that the consumer does not have a credit account. Significantly, given the state of the economy, the model allows for exceptions for extraordinary life events that may affect a consumer's credit rating.

One provision in the model outlines a process for insurers to follow if they raise a policyholder's premium or decline to renew coverage based on credit information. Other provisions lay out procedures that a consumer can follow in challenging a credit report or in challenging an adverse action taken against them by an insurer.

### **Insurance Scoring Misconceptions**

The issue of credit-based insurance scoring can lead to emotional debate among competing interest groups, which can often result in several misconceptions about how insurers use insurance scores. As a general matter, such misconceptions lose sight of the fact that insurance is a competitive business, and insurers use insurance scores because they want to offer products to more individuals at the lowest price possible.

Some critics have argued that credit-based insurance scoring should be prohibited because it unfairly discriminates against minorities. This is a specious claim because insurance scoring does not consider characteristics such as race, ethnicity, gender, national origin, or income level.

Every empirical study has concluded that insurance scoring is neutral on its face with respect to race, ethnicity, and income, and is applied neutrally by insurers. The use of insurance scoring is not motivated by a desire to discriminate based on race, ethnicity, or income nor do insurers collect or use this information. Nevertheless, some critics contend that even if the correlation between credit scores and loss history is statistically valid, insurance scoring should be banned if it produces a disproportionate or disparate impact on particular racial, ethnic, or income groups.

### **Insurance Scoring and the Financial Crisis**

In some recent published reports, critics of insurance scoring have suggested that the practice is particularly problematic due to the current economic crisis. However, this contention is based on unproven assumptions and a lack of understanding regarding why insurers use credit-based insurance scores. In fact, this underwriting tool remains an effective and important risk assessment mechanism.

#### **Scores have remained very stable**

Fair Isaac, a leading provider of credit-based insurance scores, found in a recent countrywide study that average scores have remained virtually the same for the general population. Noting the significance of this finding during an economic downturn with a growing number of people who are delinquent, Fair Isaac suggests that the "overall stability of scores may be caused by a greater number of consumers making certain to pay all bills on time, paying down outstanding balances, and perhaps not seeking more credit obligations." In other words, "more and more consumers appear to be realizing the value of prudent financial and credit management practices."

#### **Not all credit-related incidents will affect insurance underwriting and rating**

It is undeniable that a growing number of consumers are experiencing credit-related incidents such as loan defaults and foreclosures, but it is important not to make assumptions or generalizations about the impact of such incidents on insurance underwriting and rating. Some individuals who experience such incidents may not see an impact because they previously had credit issues that were already reflected in scores. And it is important to remember that insurers use scores in a variety of ways to differentiate applicants and insureds on a relative basis in terms of insurance risk, not credit risk, to compete for and price business appropriately. Fair Isaac found in its most recent score performance studies that its insurance scores "continue to appropriately rank-order consumers based on insurance risk." Even if credit scores were to deteriorate in general, those with the higher insurance scores would still benefit, and there is no reason to expect that the percentages of those who benefit would change.

#### **The financial crisis demonstrates the importance of risk assessment**

While there has been much discussion over assignment of blame for the current economic crisis, it is apparent that it is rooted in a failure to properly assess risk. It is only due to insurers' recognition of credit-based insurance scoring as a highly valuable risk assessment tool that it has become a common practice. It would be both ironic and inappropriate for a financial crisis caused by failure to assess risk to prompt policymakers to take a valuable risk assessment tool out of the hands of insurers.

“Disparate impact” is a legal term that refers to situations in which a policy or practice has the effect of disproportionately harming or excluding members of a group defined by race, ethnicity, disability, or gender—even though the challenged practice makes no reference to these characteristics and even though the resulting adverse group impact was unintentional.

Disparate *treatment*, on the other hand, refers to situations in which a decision-maker intentionally discriminates against people *because of* their race, ethnicity, disability, or gender. Intentional discrimination based on such characteristics is what most people think of when they hear the term unfair discrimination, and it is generally illegal under federal and state law.

Credit-based insurance scoring does not involve disparate treatment of customers based on race, ethnicity, income, or any other legally prohibited characteristic. To the contrary, insurers apply the same credit standards to all consumers—in other words, insurance scoring is a means of affording equal treatment in the underwriting process to all individuals regardless of race, ethnicity, or income. Policymakers should consider which form of discrimination is truly unfair—disparate impact on groups or disparate treatment of individuals.

Even if one is inclined to accept the notion that disparate impact somehow equates to unfair discrimination, it is important to note that as used in the courts, a showing of disparate impact serves only to establish a *rebuttable presumption* that illegal discrimination has occurred. Moreover, courts have generally confined use of the disparate impact theory to cases involving allegations of employment discrimination. In employment cases, defendants may rebut the presumption of unfair discrimination by demonstrating that the practice having a disparate impact is justified by “business necessity.”

In the few instances where disparate impact analysis has been applied to settings similar to insurance underwriting and pricing—e.g., mortgage lending and the granting of credit—the courts have upheld challenged practices where defendants have shown a “legitimate business justification” for the practice.

Because of its proven validity as an underwriting variable, it is undeniable that insurers have a legitimate business justification for using credit-based insurance scores.

Furthermore, insurer use of insurance scores is subject to the protections of the Fair Credit Reporting Act, federal and state anti-discrimination laws, and state insurance rating laws. These laws prohibit insurers from discriminating on the basis of race, religion, or national origin and include strong penalties for any violations.

Another popular misconception is that an individual’s insurance score will be affected if too many requests are made to examine the individual’s credit information. This is not an issue in states that have adopted the NCOIL model, as it expressly prohibits insurers from treating as a negative factor credit inquiries not initiated by the consumer or inquiries requested by consumers to examine their own credit information.

## **Research and Reports on Credit-Based Insurance Scoring**

Since 1999, at least a dozen studies have examined credit-based insurance scoring. They have tended to fall into two broad categories: those studies that have looked at the predictability of insurance scores on loss performance or insurance risk and those that have examined the impact of insurance scoring on consumers, especially minority or low-income populations.

Among the studies worth noting are three that employed multivariate analysis techniques. In 2003, EPIC Actuaries, in the largest and most comprehensive study ever undertaken at the time, found that a consumer’s credit-based insurance score is directly connected to that consumer’s propensity for auto insurance loss. Even more significant, the EPIC study found that insurance scores are consistently among the most important rating variables used by insurers. The EPIC study looked at 2.7 million automobile insurance policies and found that the propensity for loss decreased as the insurance score increased.<sup>4</sup>

In 2005, the Texas Department of Insurance (TDI) completed an exhaustive study based on data obtained from six leading insurers for approximately two million automobile and homeowners’ policies. The TDI report concluded that “for both personal auto liability and homeowners, credit score was related to claim experience even after considering other commonly used rating variables. *This means that credit score provides insurers with additional predictive information distinct from other rating variables. By using credit scores, insurers can better classify and rate risks based on differences in claims experience.*”<sup>5</sup>

In July 2007, the Federal Trade Commission (FTC) released a study that reached conclusions virtually identical to those of the TDI report. It also found that when credit-based insurance scoring is used, 59 percent of consumers pay less for insurance.<sup>6</sup>

In 2005, the Arkansas Department of Insurance began an annual survey of the effect of the state's insurance scoring law, which is based on the NCOIL model, on insurance consumers.<sup>7</sup> Similar to the results of the 2005 and 2006 surveys, the 2007 survey concluded that of 3,026,092 personal lines policies written or renewed in that year, 32 percent of customers received a discount, 9 percent received an increase, and the remaining 59 percent of consumers saw a neutral impact due to insurer use of insurance scores. In other words, 91 percent of personal lines customers either received a discount for credit or it had no impact on premium. For policies where credit played some role in determining the final premium, those receiving a decrease outnumbered those receiving an increase by a ratio of 3.44 to 1.

## **Conclusion**

Effective underwriting allows insurers to operate profitably and to compete in the marketplace. Likewise, appropriate underwriting ensures that consumers benefit by not subsidizing other policyholders who pose worse insurance risks, resulting in unfair cross-subsidization among risk classes.

Banning or limiting the use of any valid underwriting or rating factor that is known to be predictive of insurance losses leads to decreased coverage availability and higher insurance prices. A legislator or regulator considering a prohibition on the use of credit-based insurance scoring should be prepared to explain to constituents, including those of every ethnic background and income level, why he or she decided they should pay more for insurance.

Experience has shown time and again how limitations on insurers' use of proven risk factors such as geography and age of driver have destroyed competitive markets and increased prices. A ban on the use of credit-based insurance scores would be counterproductive and would harm, rather than benefit, consumers.

## **Endnotes**

<sup>1</sup>The National Association of Mutual Insurance Companies has compiled a chart showing the actions taken in various states with regard to credit-based insurance scoring. The chart can be found at [www.namic.org/compliance/CreditBasedInsuranceScoring.pdf](http://www.namic.org/compliance/CreditBasedInsuranceScoring.pdf)

<sup>2</sup>The Fair Isaac website ([www.fairisaac.com/ficx/](http://www.fairisaac.com/ficx/)) provides an excellent explanation of how credit risk and credit-based insurance scoring models work.

<sup>3</sup>A copy of the NCOIL Model Act Regarding Use of Credit Information in Personal Insurance can be ordered at the NCOIL website ([www.ncoil.org/](http://www.ncoil.org/)).

<sup>4</sup>Michael J. Miller and Richard A. Smith, "The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity: An Actuarial Study (June 2003). [www.ask-epic.com/Publications/Relationship%20of%20Credit%20Scores\\_062003.pdf](http://www.ask-epic.com/Publications/Relationship%20of%20Credit%20Scores_062003.pdf)

<sup>5</sup>"Supplemental Report to the 79<sup>th</sup> Legislature: Use of Credit Information by Insurers in Texas: The Multivariate Analysis," Texas Department of Insurance (Jan. 31, 2005), p. 2. (Emphasis added.)

<sup>6</sup>Federal Trade Commission, "Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance," (July 2007). [www.ftc.gov/os/2007/07/P044804FACTA\\_Report\\_Credit-Based\\_Insurance\\_Scores.pdf](http://www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf)

<sup>7</sup>Information about the annual credit-scoring reports can be obtained by accessing the Arkansas Insurance Department website at: <http://insurance.arkansas.gov/>

# **The Legal Theory of Disparate Impact Does Not Apply to the Regulation of Credit-Based Insurance Scoring**

A NAMIC Public Policy Paper

Copyright©2004

Released: July 7, 2004

## **NAMIC<sup>®</sup>**

National Association of Mutual Insurance Companies

3601 Vincennes Road

Indianapolis, IN 46268

(317) 875-5250

*www.namic.org*

NAMIC is a full-service trade association with more than 1,350 member companies that underwrite 41 percent (\$170 billion) of the property/casualty insurance in the United States. NAMIC membership includes four of the seven largest property/casualty carriers, every size regional and national property/casualty insurer and hundreds of farm mutual insurance companies. NAMIC benefits member companies through government relations, public affairs, education and arbitration services, and insurance and employee benefit programs. Information about the association, its member companies and the property/casualty insurance industry is available at *NAMIC Online*, *www.namic.org*.



## Preface

One lesson learned from working in the states on almost any insurance issue is the need for more information on the public policy consequences of new laws that could change the way companies actually conduct their business and the effect of those changes on consumers.

A challenging issue today is the use and regulation of credit-based insurance scoring for underwriting and rating purposes. While not utilized by all property/casualty insurance carriers, the practice is employed by a substantial part of the industry, affecting millions of policyholders and attracting the attention of regulators and legislators across the country seeking to assure protections for the insurance buying public.

NAMIC deeply involved itself in this issue a number of years ago when a series of bills were introduced in legislatures either to restrict, or impose an outright ban on, the use of credit-based insurance scoring as an underwriting tool. From these beginnings, companies and trade associations agreed to work together to gain approval from the National Conference of Insurance Legislators (NCOIL) for a model bill that permits the use of credit-based insurance scoring as long as it is not the *only* factor a company used for underwriting and rating.

In fewer than two years, the substance of the NCOIL Model is effective either by rule or legislative enactment in 22 states as of this writing. But even this level of attention and consensus has not stopped critics of credit-based insurance scoring from continuing a campaign to eliminate its use. For this reason, we offer this critique of the applicability of the disparate impact legal theory to the regulation of credit-based insurance scoring.

Many people are to be thanked for their contributions to this paper, chief among them, Dr. Robert Detlefsen of Ardet Advocacy in Alexandria, Va. Dr. Detlefsen conducted the bulk of the research and provided the thematic roadmap that was put before several groups of NAMIC member companies for approval. These groups include the NAMIC Board of Directors, Legislative Steering Committee and State Affairs Committee.

Special thanks also to our advocacy colleagues at the American Insurance Association for the time and resources they devoted to the project and to the Property Casualty Insurers Association of America for its input. Finally, my two right hands, Neil Alldredge and Peter Bisbecos, directors of State Affairs and Regulatory Affairs were also very helpful, as always.



Roger H. Schmelzer, J.D.  
Senior Vice President, State and Regulatory Affairs





# Table of Contents

<b><i>Introduction</i></b> .....	9
The Legal Theory of Disparate Impact Does Not Apply to the Regulation of Credit-Based Insurance Scoring .....	9
<b><i>Why “Disparate Impact” Analysis is Misapplied to Insurance Underwriting</i></b> .....	13
Evidence of Insurance Scoring’s Valid Purpose .....	13
The Particular Misapplication of “Disparate Impact” to Insurance Regulation .....	14
Purported Evidence of Disparate Impact Caused by Insurance Scoring .....	15
Consumers Are Already Protected from Discrimination by State Laws.....	17
<b><i>Evolution of the Disparate Impact Theory of Discrimination</i></b> .....	21
Griggs v. Duke Power: Emergence of the Idea.....	21
From “Job Relatedness” to “Business Necessity” .....	22
Reflecting on Griggs .....	23
<b><i>Judicial Limits of the Disparate Impact Approach</i></b> .....	25
Setting Standards .....	25
Limits of Disparate Impact .....	27
<b><i>Disparate Impact Analysis Applied to Insurance Regulation Creates Unfairness and Inequity</i></b> .....	29
<b><i>Conclusion</i></b> .....	31



## Executive Summary

An individual's experience managing credit is an accurate predictor of both whether a claim for automobile or homeowners insurance will be filed and for the potential size of a loss. On average, loss costs are 33 percent higher for insureds with the worst insurance scores and 19 percent lower for insureds with the best insurance scores.

Acknowledging the validity of credit report information as an underwriting tool, Congress has expressly authorized its use under the federal Fair Credit Reporting Act (FCRA), 15 U.S.C. Section 1681 *et seq.* State laws also allow risk classification while guarding against "unfair discrimination."

Most large automobile and homeowners insurers use credit-based "insurance scores" for underwriting and rating purposes. This information allows an insurer to improve the accuracy of its ability to assess risk so that it can more closely align the price it charges for coverage with the cost of providing that coverage. Consumers benefit through the elimination of subsidization, greater availability and lower overall prices.

Insurance directly touches the lives of people, and risk-assessment techniques that appear to adversely affect particular subgroups within the population have been viewed with some skepticism by legislators, regulators and others. However, most states that have seriously considered the matter have concluded that the tool is effective and should be preserved, albeit with some restrictions.

Still, debate persists. Some regulators oppose its use while legislators continue to introduce bills to curtail or abolish credit-based insurance scoring. Opponents often base their efforts on perceptions of statistics that may suggest an adverse impact on racial and ethnic minorities.

The term "disparate impact" is sometimes used as shorthand for these statistics when discussing credit-based insurance scoring in this public policy context. However, "disparate impact" is a term for a specific legal standard that has not been applied to insurance; and in any case, cannot legitimately be invoked when based merely on a statistical conclusion.

This is just one of several reasons why caution should be used before considering transfer of this term to insurance in a non-judicial setting.

- While federal courts have used a multi-part disparate impact analysis, they have done so in defined legal settings – Title VII employment discrimination cases and under the Federal Housing Act. The analysis comes complete with affirmative defenses and shifting burdens of proof for adjudicating disputes between discrete parties. A court applying the doctrine to insurance would permit individual insurers to defend their use of insurance scoring by showing that it serves a legitimate business purpose while a legislative or regulatory ban on credit-based insurance scoring would simply assume that no insurer's use of credit information could ever serve a legitimate purpose.

- On the relatively few occasions when the disparate impact theory has been applied to areas similar to insurance, such as mortgage lending and the granting of credit, courts have found it necessary to modify the theory, making it easier to defend challenged practices.
- In 2003, Congress expressly reauthorized the use of credit information for insurance purposes. States may not use their authority to circumvent laws passed by Congress.
- State laws permit the classification of risk and the pricing of insurance according to the risk accepted by the insurer. These practices are heavily regulated by state departments of insurance to assure solvency in addition to fair and actuarially-sound benefits for insurance consumers.

Perhaps the two most compelling reasons for caution are the most straightforward:

- The majority of consumers benefit by paying less for insurance because of the positive impact of their credit-based insurance score.
- Insurance scoring allows companies to write more business. The ability to more accurately predict the risk of loss allows insurers to insure more consumers. Additionally, evidence suggests that insurance scoring allows companies to identify new customers that might not have been identified using traditional underwriting tools. Choices for consumers are increased, which generally has a positive influence on price.

Application of the disparate impact theory to insurance underwriting erodes the moral consensus on which the nation agreed to abolish racial discrimination in the Civil Rights Act of 1964. It is antithetical to the historic civil rights goal of legal and institutional “colorblindness,” encouraging citizens, politicians and business leaders to distinguish among individuals on racial and ethnic grounds. It seeks to impose a kind of group egalitarianism, in which equality is conceived as statistical parity among groups.

Acceptance of the disparate impact theory encourages the very sort of discrimination – unequal treatment of similar individuals based on race – which American society properly regards as reprehensible.

## Introduction

### **The Legal Theory of Disparate Impact Does Not Apply to the Regulation of Credit-Based Insurance Scoring**

An individual's experience managing credit is an accurate predictor of both whether a claim for automobile or homeowners insurance will be filed and for the potential size of a loss.<sup>1</sup> On average, loss costs are 33 percent higher for insureds with the worst insurance scores and 19 percent lower for insureds with the best insurance scores.<sup>2</sup>

Acknowledging the validity of credit report information as an underwriting tool, Congress has expressly authorized its use under the federal Fair Credit Reporting Act (FCRA).<sup>3</sup> State laws allow for the classification of risk to assure solvency and already prohibit discriminatory underwriting.

With the link between credit history and property insurance claims empirically established and recognized as a matter of public policy under federal law, and with state laws prohibiting unfair discrimination, most large automobile and homeowners insurers use credit-based "insurance scores" for underwriting and rating purposes.

Though the precise methodology for calculating insurance scores varies among insurers, scores are typically based on such factors as payment history, forced collections, bankruptcies, ratio of account balances to credit limits, types of credit utilized and any pending credit applications. This information allows an insurer to improve the accuracy of its ability to assess risk so that it can more closely align the price it charges for coverage with the cost of providing that coverage. Consumers benefit through the elimination of subsidization, greater availability and lower overall prices.

---

<sup>1</sup> Numerous studies have confirmed the relationship between consumer credit ratings and property insurance losses. See Michael J. Miller and Richard A. Smith, "The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity," EPIC Actuaries, LLC (June 2003); Bruce Kellison, Patrick Brockett, Seon-Hi Shin, and Shihong Li, "A Statistical Analysis of the Relationship Between Credit History and Insurance Losses," Bureau of Business Research, McCombs School of Business, University of Texas at Austin (March 2003); American Academy of Actuaries, "The Use of Credit History for Personal Lines of Insurance; Report to the National Association of Insurance Commissioners" (November 15, 2002); James E. Monaghan, "The Impact of Personal Credit History on Loss Performance in Personal Lines," Actuarial Society Forum (Winter 2000); Commonwealth of Virginia, State Corporation Commission, Bureau of Insurance, "Use of Credit Reports in Underwriting" (1999); Fair, Isaac & Co., "Predictiveness of Credit History for Insurance Loss Ratio Relativities" (1999).

<sup>2</sup> Mike Miller, "Research Confirms Value of Credit Scoring" (2003)

<sup>3</sup> 15 U.S.C. Section 1681 *et seq.*

Economist Scott Harrington observes: “The pressure for increased accuracy is relentless. Insurers that predict claim costs better than their competitors prosper. Insurers that respond slowly end up insuring a disproportionate volume of business at inadequate rates; they lose money and either take corrective action or disappear.”<sup>4</sup> This market-driven incentive to accurately assess risk ensures that the price of insurance will be commensurate with the particular degree of risk that a policyholder presents; i.e. the lower the risk, the lower the rate charged for coverage. Greater accuracy in risk assessment can also result in the availability of insurance for people who may previously have been considered uninsurable.

Since insurance directly touches the lives of people, risk-assessment techniques that appear to adversely affect particular subgroups within the population have been viewed with skepticism by legislators, regulators and others. However, most states that have seriously considered the matter have concluded that the tool is effective and should be preserved, albeit with some restrictions.

Still, debate persists. Some regulators oppose its use while legislators continue to introduce bills that would curtail or abolish credit-based insurance scoring. Opponents often base their efforts on perceptions of statistics that may suggest an adverse impact on racial and ethnic minorities.

The term “disparate impact” is sometimes used as shorthand for these statistics when discussing credit-based insurance scoring in a public policy context. However, “disparate impact” is a term for a specific legal standard that has not been applied to insurance; and in any case, cannot legitimately be invoked based merely on a statistical conclusion.

This is just one of several reasons why caution should be used before considering transfer of this term to insurance in a non-judicial setting:

- **While federal courts have used a multi-part disparate impact analysis, they have done so in defined legal settings – Title VII employment discrimination cases and under the Federal Housing Act. The analysis comes complete with affirmative defenses and shifting burdens of proof for adjudicating particular disputes between discrete parties.** Under that analysis, a standard or practice is presumptively illegal if it has the effect of disproportionately harming members of a group defined by race, ethnicity, or sex – even though the challenged practice makes no reference to these characteristics, and even though the resulting adverse group impact was not intended. However, where disparate impact analysis is permitted, a process for rebuttal of the presumption of illegality is available to the plaintiff.

---

<sup>4</sup> Scott Harrington, “Repairing Insurance Markets,” *Regulation* (Summer 2002).

Therefore it must be assumed that **if** the legal theory was applied to insurers, the same opportunity would be available to defend the use of credit-based insurance scoring by showing that it serves a legitimate business purpose. On the other hand, a legislative or regulatory ban on insurance scoring would simply assume that no insurer’s use of credit information could ever serve a legitimate purpose.

- **On the relatively few occasions when the disparate impact theory has been applied to areas similar to insurance, such as mortgage lending and the granting of credit, courts have found it necessary to modify the theory, making it easier to defend challenged practices.** The application of the disparate impact theory to credit-based insurance scoring is particularly problematic because it is unclear at what point in the process the analysis would occur. With employment, it is clear that the point of analysis occurs when the applicant is rejected. Because a person has an opportunity to correct or improve his/her credit-based insurance score, applying a disparate impact analysis before a person has that opportunity would be similar to applying a disparate impact analysis to a person before he/she took an employment test.
- **In 1992, the Seventh Circuit explained why the disparate impact standard in an insurance setting is inapplicable.**<sup>5</sup> Interpreting the facts in the best light for the plaintiffs, the Court assumed that the defendant *had committed intentional unfair discrimination* rather than *employed a practice* that had resulted in a disparate impact to the plaintiff. The Court noted a distinction between “disparate treatment” (i.e. intentional unfair discrimination) and “disparate impact” which included the statement, “Insurance works best when the risks in the pool have similar characteristics.”<sup>6</sup>
- **In 2003, Congress expressly reauthorized the use of credit information for insurance purposes.** Under the Fair Credit Reporting Act, insurers are even authorized to take certain “adverse action” based upon credit reporting agency data. Since states may not use their authority to circumvent laws passed by Congress, using state authority to effectively ban, or severely restrict, the use of credit information is improper. Conforming to distinctions in state laws that enable and supplement a federal legislative scheme, while burdensome, is a fact of life. Having to discern whether each state has effectively barred application of a federal legislative scheme

---

<sup>5</sup> *NAACP v. American Family Mutual Insurance Co.*, 978 F.2d 287 (7<sup>th</sup> Cir. 1992).

<sup>6</sup> *Id.* at 290

destroys the law's credibility and serves to create a hodgepodge of regulatory environments that impede the ability of multi-state insurers to operate efficiently across the country.

- **State laws permit the classification of risk and the pricing of insurance according to the risk accepted by the insurer, while prohibiting the related collection and use of data about factors such as income, race, ethnicity, religion, culture, color, age, disability, or sex.** These practices are heavily regulated by state departments of insurance to assure solvency in addition to fair and actuarially sound benefits for insurance consumers.

Perhaps the two most compelling reasons for caution are the most straightforward:

- **The majority of consumers benefit by paying less for insurance because of the positive impact of their credit-based insurance score.** All research indicates that in terms of sheer numbers, consumers benefit from the use of credit-based insurance scoring. Some companies have revealed that as many as two-thirds of their customers realize a lower rate than they otherwise would.
- **Credit-based insurance scoring allows companies to write more business.** The ability to more accurately predict the risk of loss allows insurers to actually insure more consumers. Additionally, evidence suggests that credit-based insurance scoring allows companies to identify new customers that might not have been identified using traditional underwriting tools. Choices for consumers increase, which generally has a positive influence on price.

---

*This paper seeks to inform the unfolding debate over disparate impact and insurance scoring by drawing upon the collective wisdom of courts and socio-legal scholars – wisdom gained from America's 30-plus years of experimentation with the disparate impact theory of discrimination. The paper places the current controversy over credit-based insurance scoring in historical context, tracing the development of the disparate impact doctrine in Title VII employment discrimination law during the 1970s and '80s. It then examines judicial attempts to apply the doctrine to housing and lending discrimination claims, and assesses several theoretical justifications for the disparate impact approach to antidiscrimination law. Finally, the paper offers a critical analysis of current attempts to apply the disparate impact theory to credit-based insurance scoring, exposing the theory's inherent flaws and highlighting the special difficulties that arise when the theory is applied to situations other than employment discrimination litigation.*



## **Why “Disparate Impact” Analysis is Misapplied to Insurance Underwriting**

A statute or rule restricting the use of underwriting criteria on “disparate impact” grounds differs significantly from application of a legal standard that relies on a multi-part process for proving and defending against primarily employment-related lawsuits.

Proponents of a ban on credit-based insurance scoring justify it on the grounds that a “disparate impact” exists as a matter of public policy whenever the practice is used. This conclusion is often drawn from a statistical analysis alone. While statistics may show existence of an impact that is “disproportionate,” whether it constitutes a “disparate” impact involves a higher level of scrutiny. If applied to insurance, the “disparate impact” analysis would trigger an opportunity for the insurer-defendant to demonstrate that the use of credit information is a legitimate business practice. “Disparate impact” analysis involves a defined and accepted set of shifting burdens of proof upon which all parties have come to rely.

Importantly, the foundation of the business of insurance underwriting and rate-making is classifying policyholders by risk. Since insurers make decisions based on actuarial and business principles that group policyholders for the reason of treating similar policyholders similarly, any potential correlation to race is not part of the risk assessment process. This renders the disparate impact test an unreliable means by which to identify illegal discrimination. As the Seventh Circuit stated in *NAACP v. American Family Mutual Insurance Co.*, 978 F.2d 287 (7<sup>th</sup> Cir 1992), “[r]isk discrimination is not race discrimination.”

Once a law or rule is passed, however, not only is it no longer necessary to show that a particular insurer’s use of credit information produces a disparate impact among that insurer’s current or prospective policyholders, the need for a showing becomes irrelevant. This result is contrary to statistical proof of the practice’s validity.

### **Evidence of Insurance Scoring’s Valid Purpose**

As it now stands, the disparate impact analysis allows the opportunity for proof that a legitimate business purpose exists to justify the process. If the theory was applied to insurance, an impressive body of empirical evidence exists – numerous studies conducted since the mid-1990s have demonstrated a correlation between an individual’s credit-based insurance score and the likelihood that a claim will be filed. A correlation also exists between credit-based insurance scores and the monetary amount of insured losses that policyholders generate. The relationship occurs with respect to both personal auto insurance and homeowners insurance.

Two recent studies are especially impressive:

- A March 2003 study by the Bureau of Business Research at the University of Texas at Austin, using a random sample of 175,000 Texas auto insurance policies, found an inverse relationship between credit-based insurance scores and the policy loss ratio (i.e., higher credit scores tend to produce lower loss ratios).<sup>7</sup>
- A June 2003 study published by EPIC Actuaries LLC examined the relationship between credit-based insurance scores and the propensity for loss in private passenger automobile insurance. This study drew upon a sample of nearly 2.7 million automobiles nationwide, by far the largest sample for any completed credit-based insurance scoring analysis. The results showed that the probability of loss declined as credit scores improved, and that this relationship is generally evident across all 50 states. To explore the possibility that credit-based insurance scores are simply proxies for other risk factors (as some critics contend), the study examined credit scores both in isolation and as one item in a multivariate analysis containing other frequently used auto insurance underwriting factors, such as model year, age, gender, and policy limits. The multivariate analysis revealed that credit scores were among the three most accurate predictors of loss in all major coverage segments, including bodily injury, physical damage and collision.<sup>8</sup>

### **The Particular Misapplication of “Disparate Impact” to Insurance Regulation**

As defined by the courts in its narrow application, the disparate-impact theory of discrimination holds that a standard or practice is presumptively illegal if it has the effect of disproportionately harming members of a group defined by race, ethnicity, or sex – even though the challenged practice makes no reference to race or ethnicity and even though the resulting adverse impact to the group was unintentional. Although this presumption exists, so does the opportunity for it to be rebutted.

Prospectively applied to the business of insurance by critics of credit-based insurance scoring, the theory assumes that to be “fair,” underwriting and rating criteria must not affect different demographic groups differently. With respect to credit-based insurance scoring, those asserting the disparate impact argument suggest that because its effect on designated racial and income

---

<sup>7</sup> Bruce Kellison, Patrick Brockett, Seon-Hi Shin, and Shihong Li, “A Statistical Analysis of the Relationship Between Credit History and Insurance Losses,” Bureau of Business Research, McCombs School of Business, University of Texas at Austin (March 2003).

<sup>8</sup> Michael J. Miller and Richard A. Smith, “The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity,” EPIC Actuaries, LLC (June 2003).

groups is not statistically the same, credit-based insurance scoring is discriminatory with respect to those characteristics.

In the public policy debate over credit-based insurance scoring, most attention has focused on the empirical question of whether statistical group disparities actually result from the practice of credit-based insurance scoring and whether this result can even be determined. In a report commissioned by the National Association of Insurance Commissioners (NAIC), the American Academy of Actuaries gave a sobering assessment of the definitional and methodological issues that would confront researchers attempting to apply an abbreviated disparate impact test:

*While designing a regulatory study, a primary consideration should be the potential usefulness of its results. This requires that there be some determination, prior to the study, of the magnitude of disproportionate impact that would trigger regulatory concern. The decision regarding the magnitude would then influence the size of the population that would need to be sampled in order to generate statistically significant findings.<sup>9</sup>*

Consider too the many different risk-based variables on which differential rates are based. Common homeowners insurance factors include claim history of applicant, construction material(s), distance from fire station, dog/breed of dog owned, fire suppression devices, home-based business presence and type, lead paint potential (constructed pre-1978), loss history of property, roofing material, trampoline use, slab versus basement and the presence of an operational security system. Common personal automobile insurance factors include policyholder age, coverage limits desired, deductibles selected, driving record/at-fault crashes, gender, marital status, miles driven, territory and age, make and model of the vehicle.

To accurately determine whether there is a correlation between race and insurance rates, the risk-based variables supporting a higher rate would have to be eliminated from the calculation. This calls into question conclusions drawn simply from statistical samplings and helps explain why the business of risk classification defies a disparate impact analysis.

### **Purported Evidence of Disparate Impact Caused by Insurance Scoring**

Neither the dearth of solid evidence confirming the existence of disparate impact, nor the lack of serious attention to the actual social implications of disparate impact, has deterred critics of credit-based insurance scoring from invoking a portion of the doctrine.

---

<sup>9</sup> American Academy of Actuaries, “The Use of Credit History for Personal Lines of Insurance; Report to the National Association of Insurance Commissioners” (November 15, 2002), p. 32.

To take but a few recent examples:

- A state legislator in Connecticut, while acknowledging the actuarial validity of credit-based insurance scores, declared, “If they’re discriminatory to a protected class, you still shouldn’t use them.”<sup>10</sup>
- Speaking before a gathering of the Professional Independent Insurance Agents of Illinois, an agency management consultant dismissed credit-based insurance scoring as “a thinly veiled form of redlining.”<sup>11</sup>
- A representative of Consumers Union testified before lawmakers in Texas that there is “clearly an impact on low-income people and minorities.” Insurance companies, he declared, “Should be required to demonstrate that the factors they are using don’t have a negative impact on consumers and don’t unfairly discriminate against certain groups.”<sup>12</sup>
- According to another insurance industry critic, “Insurance credit scoring very likely has a disproportionate impact by race and income.” He added, “I have personally testified before state legislatures and insurance commissioners in many states, and the issue of whether credit scoring has a disproportionate impact ... has arisen in each state.”<sup>13</sup>

A recent study that purports to explore the relationship between credit-based insurance scores and ethnicity is highly problematic. In January 2004, the Missouri Department of Insurance issued a report based on a statistical analysis of average credit scores in “high-minority” and “low minority” ZIP codes within the state of Missouri.

Using a series of aggregate regression models, the report’s author claimed to find a “substantial correlation between minority concentration and credit score, even controlling for a wide variety of other socioeconomic characteristics.” He concluded, “Individuals that reside in areas with large minority concentrations tend to have significantly worse credit scores than those that reside elsewhere.”<sup>14</sup>

---

<sup>10</sup> Rep. Art Feltman, quoted in Diane Levick, “Bad Credit Drives Up Insurance Costs,” *Hartford Courant*, May 5, 2002, p. A1

<sup>11</sup> Kevin B. O’Reilly, “Agents Must Watch for Possible Discrimination, Agent Says,” *Insurance Journal*, March 23, 2003.

<sup>12</sup> Comments of Rob Schneider, quoted in Terrence Stutz, “Insurers’ credit scoring blasted,” *Dallas Morning News*, August 27, 2002.

<sup>13</sup> Comments of Birny Birnbaum, quoted in Michael Ha, “Credit Scoring Debated At NAIC Meeting,” *National Underwriter*, March 17, 2003, p. 17.

<sup>14</sup> Brent Kabler, “Insurance-Based Credit Scores: Impact on Minority and Low-Income Populations in Missouri,” Missouri Department of Insurance, January 2004, p. 39.

That finding was subsequently challenged. Actuarial statisticians at EPIC Consulting produced a lengthy critique citing several serious flaws in the report's data selection and methodology.<sup>15</sup> The EPIC authors were especially troubled by the report's misleading title: *Insurance-Based Credit Scores: Impact on Minority and Low-Income Populations in Missouri*. That title, together with speculative statements contained in the text, strongly imply that credit-based insurance scoring negatively affects both the availability and the affordability of auto and homeowners insurance among minority consumers.

Yet as the EPIC authors point out, even if the Missouri study's data selection and analysis had not been fatally flawed, such inferences would not be warranted because the study made no attempt to consider how credit scores are actually used by insurers to determine premiums and coverage eligibility.<sup>16</sup> As for the impact of insurance-based credit scores on the availability of insurance among minorities and low-income groups, the Missouri study mistakenly assumed that greater accuracy in risk assessment necessarily leads to decreased coverage availability in hard-to-serve markets, when the opposite is more likely true.<sup>17</sup>

### **Consumers Are Already Protected from Discrimination by State Laws**

Perhaps most relevant to a discussion of whether further laws banning credit-based insurance scoring are warranted are the myriad regulations and state laws already in effect and enforced by insurance regulators and other state authorities that prohibit discriminatory underwriting activity and assure solvency. These laws, coupled with the federal authorization of credit-based insurance scoring, strike the proper balance of protecting consumers from racial and unfair discrimination while permitting the fair and effective pricing of risk by insurers.

State insurance laws largely reflect the principles underpinning property/casualty insurance pricing. Actuarial science is relied upon to determine rates that most accurately measure loss potential. This is accomplished by identifying relationships between factors and risk of loss and then allocating costs accordingly, the very essence of risk-based pricing.

---

<sup>15</sup> Michael J. Miller and Richard A. Smith, "A Critique Of: 'Insurance-Based Credit Scores: Impact on Minority and Low-Income Populations in Missouri,' Study by Brent Kabler, PhD, Missouri Department of Insurance," EPIC Consulting, LLC, February 2004. The authors write: "In our judgment none of the major conclusions in the Study are supported by the data and data analysis described in the Study. There was a failure to control how the average scores were calculated by each participating insurer. There was a failure to call for data necessary to "normalize" the average scores for potential biases arising from non-geographic factors. There are apparent flaws in the regression analyses because of a failure to determine the extent of any non-linear relationships and to further investigate other important variables.

<sup>16</sup> Ibid, pp. 5-6.

<sup>17</sup> Ibid, p. 5.

The insurer is typically required to have experience justifying its rates. In some states this information must be supplied to insurance regulators for approval because restricting rates, when contrary to actuarial indications, violates the prohibition against rates that are “excessive, inadequate, unreasonable or unfairly discriminatory.”

“Unfair discrimination” has a very specific meaning by which insurers have been governed for many years. According to model legislation developed by the National Association of Insurance Commissioners, there are essentially two ways in which an insurer could engage in unfair discrimination. Making underwriting and rating distinctions “between individuals or risks of the same class and essentially the same hazard” is one way; the other occurs when underwriting and rating decisions are unsupported by “the application of sound underwriting and actuarial principles related to actual or reasonably anticipated loss experience.”<sup>18</sup> Reviewing these standards, it should be clear that the “unfair discrimination” standard is in direct conflict with the concept of disparate impact.

Put another way, “discriminating” on the basis of risk is regarded by insurance experts and regulators not only as fair, but necessary.<sup>19</sup> In fact, pricing programs of most insurers **depend** on making distinctions based upon a number of different risk factors. All things being equal, the consumer who reflects a higher risk based on these factors will pay more. This is because the process of risk classification involves segmenting groups of individuals expected to have similar costs.<sup>20</sup>

The use of more segments makes for a more granular approach in which actuaries can finely hone review of an individual in order to more accurately create class plans and measure risk potential. When there are a greater number of risk levels and pricing variations, insureds may be placed with others who share a risk profile, resulting in a fairer price while insurers are better able to offer coverage to people they might have otherwise declined. To disregard the predictive value of credit-based insurance scoring as a legitimate underwriting factor:

1. Ignores actuarial support;
2. Results in subsidization of the worst risks by the best; and

---

<sup>18</sup> “Unfair Discrimination,” Sec. G (3), Unfair Trade Practices Act, NAIC Model Regulation Service, January 1993, pp. 880-884.

<sup>19</sup> A leading textbook for students of insurance regulation instructs that “in insurance, discrimination is not necessarily a negative term so much as a descriptive one. For insurance, fair discrimination is not only permitted, but necessary.” See Kathleen Heald Ettlinger, *State Insurance Regulation* (Insurance Institute of America, 1995), pp. 29-30.

<sup>20</sup> *Ibid.*

3. Moves closer to a one-size-fits-all approach in direct conflict with risk classification standards.

Under the law, if a rate can be supported by actuarial measurement, it cannot be unfairly discriminatory. To make an even finer point, by disregarding the predictive value of a valid factor, insurers ignore actuarial science, risking violation of state prohibitions against “unfairly discriminatory” insurance rates. From this standpoint alone, banning the use of credit-based insurance scoring runs counter to years of public policy designed to protect and benefit consumers.

Former Illinois Director of Insurance, Nat Shapo, summed up the stakes involved with over-regulation of credit-based insurance scoring. When his former NAIC colleagues were considering a study of disparate impact, he said if they singled out this one underwriting factor, they would “call into question a basic tenet of insurance regulation – that discrimination on the basis of risk is legal, appropriate, and socially beneficial.”<sup>21</sup>

---

*If policymakers and judges transform insurance laws to equate disparate impact with unfair discrimination, it will not matter that credit-based insurance scores do not consider income, race, ethnicity, or other prohibited characteristics. Nor does it matter that insurers who use credit information do not intend to discriminate on the basis of income, race, and so on. Insisting that claims of disparate impact be supported by accurate and meaningful statistics may not be adequately persuasive either.*

*In that event, a critical examination of the central premise of the disparate impact theory – that standards and practices that produce disproportionate outcomes among groups are inherently discriminatory – is useful to demonstrate the complexities of taking a well-defined legal precedent and utilizing it outside of the judicial process.*

---

<sup>21</sup> Nat Shapo, “Credit Scoring/disparate impact,” memorandum to NAIC membership, September 15, 2003.





## Evolution of the Disparate Impact Theory of Discrimination

The disparate impact theory has been a subject of considerable controversy since its inception.<sup>22</sup> It was originally conceived strictly as a legal doctrine to be applied in the context of employment discrimination cases brought under Title VII of the Civil Rights Act of 1964. Thus, while the disparate impact approach to discrimination claims has a 33-year history in the United States, nearly all of that history is confined to employment and labor issues; applying the doctrine to insurance underwriting and rating has not caught on in the courts.

### Griggs v. Duke Power: Emergence of the Idea

The U.S. Supreme Court first enunciated the disparate impact theory of discrimination in the 1971 case of *Griggs v. Duke Power*.<sup>23</sup> The Court held that where members of a racial minority group had been intentionally excluded from employment prior to the enactment of Title VII, the use of such criteria – in this case, performance on a general intelligence test and possession of a high school diploma – was *prima facie* unlawful if it produced, as between blacks and whites, a “disparate impact” that was adverse to blacks as a group.

*Griggs* represented a radical departure from the traditional discrimination doctrine, which prohibited intentional discrimination against specific individuals. Under *Griggs*, “good intent or absence of discriminatory intent does not redeem” employment procedures or testing mechanisms that operate as “built-in headwinds for minority groups and are unrelated to measuring job capability.”<sup>24</sup> While discriminatory intent was now irrelevant, employers could rebut allegations of disparate impact by showing that the practice in question was job-related.<sup>25</sup>

By 1972, the lower courts had extended the *range* of employment criteria that were governed by the disparate impact doctrine. One decision, for example, established that an employer could not refuse to hire applicants with multiple arrest records (unless he/she could prove the job-relatedness of this criterion), because national statistics revealed that blacks are arrested more frequently than whites.<sup>26</sup> Other courts struck down selection standards as previous work record and wage garnishments as not job-related. Rather than attempt to satisfy the increasingly onerous requirements of the business necessity test, many employers simply stopped using any objective criterion that yielded a disparate racial impact.

---

<sup>22</sup> See, e.g., Roger Clegg, The Bad Law of “Disparate Impact”, *The Public Interest* (Winter 2000), p. 79; Michael Evan Gold, Griggs’ Folly: An Essay on the Theory, Problems and Origin of the Adverse Impact Definition of Employment Discrimination and a Recommendation for Reform, 7 *Industrial Relations Law Journal*, 429 (1985).

<sup>23</sup> *Griggs v. Duke Power*, 401 U.S. 424 (1971).

<sup>24</sup> *Ibid.*

<sup>25</sup> *Griggs v. Duke Power*, 401 U.S. 424, 431-32 (1971). (Emphasis in original.)

<sup>26</sup> *Gregory v. Litton Systems, Inc.*, 316 F.Supp 401, 403 (C.D. Cal. 1970), *aff’d*, 472 F.2d 613 (9th Cir. 1972).

## From “Job Relatedness” to “Business Necessity”

The “job-relatedness” element of the *Griggs* decision evolved into what is known today as the “business-necessity” rule. The courts have construed this rule to permit practices that further legitimate business-related goals, even when those practices result in a disparate impact.

For example, in the context of disparate impact claims brought under the Fair Housing Act (FHA), courts have held that “a demonstrated disparate impact in housing [may] be justified by a legitimate and substantial goal of the measure in question.”<sup>27</sup> In other words, a defendant who shows “that the discriminatory practice has a manifest relationship” to a legitimate housing-related purpose can successfully demonstrate business necessity.<sup>28</sup>

Similarly, in the employment context, courts have interpreted the “business necessity” test to permit policies that are “reasonably necessary to achieve an important business objective.”<sup>29</sup> Importantly, as the court explained in *Davey v. City of Omaha*, 107 F.3d 587, 593-94 (8th Cir. 1997), the defendant “need not demonstrate that the practice is essential or indispensable” in order to demonstrate business necessity.

Plaintiffs bear a heavy burden in attempting to prove the existence of a feasible, non-discriminatory alternative. The plaintiff must demonstrate that his proposed alternative is as effective as the challenged practice, and that “[i]n determining whether proffered alternatives are equally effective, the fact finder may consider factors such as efficiency, cost, or other burdens associated with the alternative.”<sup>30</sup> The plaintiff must also show that the defendant refused to implement the alternative.<sup>31</sup>

---

<sup>27</sup> *Langlois v. Abington Housing Authority*, 207 F.3d 43, 51 (1st Cir. 2000).

<sup>28</sup> *Mountain Side Mobile Home Estates Partnership v. Secretary of Housing and Urban Development*, 56 F.3d 1243, 1254 (10th Cir. 1995). Indeed, “there is no requirement that the defendant establish a ‘compelling need or necessity’ for the challenged practice to pass muster.”

<sup>29</sup> *Donnelly v. Rhode Island Board of Governors for Higher Education*, 929 F. Supp. 583, 593 (D. R.I. 1996), *aff’d*, 110 F.3d 2 (1st Cir. 1997).

<sup>30</sup> *Davey*, 107 F.3d at 593.

<sup>31</sup> See, e.g., *Donnelly*, 929 F. Supp. at 594 (rejecting disparate impact claim when “there is no evidence that the plaintiffs proposed any of those [alternative] plans to [the defendant] let alone that [the defendant] refused to adopt them”).

## Reflecting on Griggs

The disparate impact theory of discrimination was not codified or sanctioned by Congress in the original Civil Rights Act of 1964 – the statute that the Court was supposedly interpreting in *Griggs*.<sup>32</sup> But apart from whether the *Griggs* decision can be reconciled with the relevant statutory language of the time or its legislative history, in retrospect, it is clear that the ruling was predicated on a dubious assumption: that it is possible to distinguish empirically those employment standards that are truly “job-related” from those that are not. According to Thomas Sowell, an economist:

*[T]he “job-relatedness” of the standards [cannot] be assessed in any mechanical way by the nature of the task. Standards that are person-related play the same economic role as standards that are job-related. If people who finish high school seem to the employer to work out better than dropouts, third parties who were not there can neither deny this assessment nor demand that it be proved to their uninformed satisfaction. It makes no difference economically whether this was because the specific task relates to what was learned in high school or because those who finish high school differ in outlook from those who drop out. Neither does it matter economically whether those who score higher on certain tests make better workers because the kind of people who read enough to do well on tests tend to differ from those who spend their time in activities that require no reading.*<sup>33</sup>

In short, personal characteristics that are not demonstrably “job-related” may nevertheless provide a reliable basis for predicting successful performance on the job. Applied to insurance underwriting, one could make a similar observation regarding personal characteristics that are correlated with risk: though they may not be demonstrably “risk-related” in the sense that they would cause a person to have a greater propensity to file an insurance claim, the presence (or absence) of certain personal characteristics could serve to predict whether an individual will file a claim.

---

<sup>32</sup> Legal scholar Richard Epstein has called *Griggs* “a travesty of statutory construction.” Richard Epstein, *Forbidden Grounds: The Case Against Employment Discrimination Laws* (Harvard Univ. Press, 1992) p. 192.

<sup>33</sup> Thomas Sowell, *Civil Rights: Rhetoric or Reality?* (New York: William Morrow, 1984) pp. 115-116. (Emphasis in original.)



## Judicial Limits of the Disparate Impact Approach

Far from adopting a “pure” disparate impact model – in which all policies with adverse racial or ethnic effects would be viewed as presumptively illegal – courts, legislatures, and administrative agencies<sup>34</sup> invoking disparate impact analysis have generally refrained from applying it reflexively to all areas of discrimination law. In 1976, for example, the U.S. Supreme Court held that the disparate impact model cannot be applied to claims of state-sponsored discrimination under the Equal Protection Clause of the Fourteenth Amendment.<sup>35</sup> In other cases, federal courts rejected the disparate impact theory in the context of age discrimination claims<sup>36</sup> and as a means of proving wage discrimination in “comparable worth” sex discrimination cases.<sup>37</sup> The refusal of these courts to mechanically apply the disparate impact theory to every scenario in which discrimination is alleged raises the question of whether, even from a legal perspective, the theory can even be plausibly applied to insurance underwriting.

### Setting Standards

The answer began to take shape in the late 1980s and continued in earnest after Congress passed the Civil Rights Act of 1991, which codified the disparate impact approach to employment discrimination. Consistent with *Griggs*, Title VII under the 1991 Act explicitly sets forth a three-step framework for adjudicating disparate impact claims. In the first step, the plaintiff establishes a *prima facie* case of disparate impact by demonstrating that the challenged employment practice causes a statistically significant workforce disparity. Next, the burden of proof shifts to the employer to justify its use of the challenged practice. An employer defending against a disparate impact claim must prove that the challenged practice is “job related for the position in question and consistent with business necessity.”<sup>38</sup> If the employer succeeds in carrying its burden under this second step in the process, the third step provides that plaintiffs may still prevail if they can demonstrate that an alternative employment practice would reduce the disproportionately adverse effects while also serving the employer’s legitimate business interests.<sup>39</sup>

---

<sup>34</sup> A notable exception was the U.S. Department of Housing and Urban Development under the Clinton administration.

<sup>35</sup> *Washington v. Davis*, 426 U.S. 229, 242 (1976).

<sup>36</sup> *Mullin v. Raytheon*, 164 F.3d 696, 701-02 (1st Cir.), *cert. denied*, 528 U.S. 811 (1999).

<sup>37</sup> *AFSCME v. Washington*, 770 F.2d 1401, 1406 (9th Cir. 1985).

<sup>38</sup> Section 2000e-2(k)(1)(A)(ii).

<sup>39</sup> *Ibid.*

While courts continued their narrow reading of the business necessity defense in Title VII cases, they began to develop more flexible and creative interpretations of business necessity in cases outside the employment context brought under the Fair Housing Act (FHA) and the Equal Credit Opportunity Act (ECOA). Even as the U.S. Department of Housing and Urban Development (HUD) adopted the Title VII version of disparate impact analysis to address allegations of homeowners insurance “redlining” during the 1990s,<sup>40</sup> the courts made clear that the doctrinaire application of the *Griggs* business necessity test to non-employment discrimination cases was impractical and unjust. Instead, courts struggling to adapt the disparate impact doctrine to claims of discrimination in mortgage lending and the granting of credit began to articulate a standard of “legitimate business justification” as the defendant’s burden in rebutting a *prima facie* disparate impact claim.

For example, in *Mountain Side Mobile Estates v. HUD*,<sup>41</sup> the Tenth Circuit Court of Appeals rejected HUD’s argument in support of a “compelling business necessity” standard, declaring that “there is no requirement that the defendant establish a ‘compelling need or necessity’ for the challenged practice to pass muster since this degree of scrutiny would be almost impossible to satisfy.”<sup>42</sup> Instead, the court held that defendants could rebut a showing of disparate impact by citing legitimate, non-pretextual justifications for the challenged practices.

Similarly, in a case brought under both the FHA and the ECOA, the Seventh Circuit Court of Appeals affirmed a lower court’s dismissal of a plaintiff’s discrimination and redlining claim against a lender for denying a mortgage loan application. The disparate impact in that case had resulted from the lender’s refusal to grant a \$90,000 rehabilitation loan in a neighborhood in which most homes were assessed at a value of \$60,000 or less. The court found that the lender’s explanation for its decision satisfied the “legitimate business justification” standard, declaring that “the Fair Housing Act’s prohibition against denying a loan based upon the location of the

---

<sup>40</sup> A December 1993 HUD memorandum announced that “[insurance redlining] cases which have been brought under the Fair Housing Act should now be analyzed using a disparate impact analysis...” It noted that “a respondent may rebut a *prima facie* case by evidence that the policy is justified by a business necessity which is sufficiently compelling to overcome the discriminatory effect. The business necessity justification may not be hypothetical or speculative. ... Each [respondent] should be investigated to determine if there are genuine business reasons for the policy. The respondent should also be queried as to whether or not the respondent considered any alternatives to the particular policy, and what the reasons for rejecting the alternatives, if any, were. ... [T]he investigation should consider whether there are any less discriminatory ways in which the respondent’s business justifications may be addressed. These steps are important because if there is a less discriminatory way by which genuine business necessities may be addressed, it may be argued that the respondent should have adopted a less discriminatory alternative.” HUD Memorandum to All Regional Directors, Office of Fair Housing and Equal Opportunity, on “Applicability of Disparate Impact Analysis to Fair Housing Cases,” December 17, 1993.

<sup>41</sup> 56 F.3d 1243 (10<sup>th</sup> Cir. 1995).

<sup>42</sup> *Ibid*, at 1254-55.

dwelling does not require that a lender disregard its legitimate business interests or make an investment that is not economically sound.”<sup>43</sup> Several years later, in yet another Seventh Circuit decision rejecting the imposition of a Title VII-style “business necessity” standard on a lender, the court pointedly observed that the “wholesale transportation” of discrimination theories and standards of proof from one statutory context to another “display[s] insensitivity to the thinking behind the standard.”<sup>44</sup>

## **Limits of Disparate Impact**

Over the course of several decades, as a result of many tightly argued and thoughtfully considered cases, courts have increasingly come to recognize that serious economic problems would result if the employment law application of the disparate impact doctrine became the template from which courts, legislatures, and administrative agencies reflexively construct disparate impact standards for other consumer or business decisions. Applying the disparate impact approach to claims of discrimination in the granting of credit, for example, presents special difficulties because the task of evaluating applications for credit differs significantly from that of selecting job candidates. A prospective employer is likely to decide first how many positions there are to be filled and then choose from among the qualified applicants to obtain the fixed number necessary to fill those positions. A lender’s task, by contrast, is to determine the amount of profit it must derive from each loan, and then extend credit in all cases where he believes that this level of profitability will be achieved. Challenging the lender’s creditworthiness criteria on disparate impact grounds – and thereby requiring it to defend those criteria as required by “business necessity” – would essentially place the court in the position of determining the level of profit that is “necessary” to operate a bank.<sup>45</sup>

If lenders and credit card issuers can cite legitimate business justifications for neutral evaluation criteria that produce disparate impacts, it seems obvious that insurers should be able to do the same. While the Title VII version of the disparate impact doctrine would require insurers to demonstrate that underwriting standards challenged on disparate impact grounds are necessary “for the safe and efficient operation of the business,” a test that recognizes the legitimate need by insurers to accurately assess risk would presumably uphold any challenged criteria that served the same purpose.

---

<sup>43</sup> *Cartwright v. American Savings & Loan Ass’n*, 880 F.2d 912, 923 (7<sup>th</sup> Cir. 1989).

<sup>44</sup> *Latimore v. Citibank Fed. Sav. Bank*, 151 F.3d 712, 712-14 (7<sup>th</sup> Cir. 1998).

<sup>45</sup> Earl M. Maltz, “The Expansion of the Role of the Effects Test in Antidiscrimination Law: A Critical Analysis,” 59 *Nebraska Law Review* 345, 361 (1980).





## **Disparate Impact Analysis Applied to Insurance Regulation Creates Unfairness and Inequality**

Application of the disparate impact theory to insurance underwriting erodes the moral consensus on which the nation agreed to abolish racial discrimination in the Civil Rights Act of 1964. It is antithetical to the historic civil rights goal of legal and institutional “colorblindness,” encouraging citizens, politicians and business leaders to distinguish among individuals on racial and ethnic grounds. It seeks to impose a kind of group egalitarianism, in which equality is conceived as statistical parity among groups.

These features are fully evident when the disparate impact analysis is applied to credit-based insurance scoring. Critics of credit-based insurance scoring often inappropriately refer to Freddie Mac statistics compiled in 1999 as “proof” of disparate impact.<sup>46</sup> The mail survey – intended to help design educational programs – asked whether individuals have had bad credit, made late payments, maxed-out credit limits or filed for bankruptcy. While it was not a rigorous or valid analysis, some still offer it to show that if insurers base coverage and pricing decisions on credit information, African Americans and Hispanics will be statistically overrepresented among those who are denied or pay more for coverage. But this argument is unconcerned with whether the racial disparities were intended, and it ignores the question of whether the individuals subjected to credit-based insurance scoring were treated equally.

The ideology of statistical group parity that could trigger the first step in a multi-part disparate impact analysis can be seen by examining the effect of insurance scoring on particular individuals. Suppose that Alice and Beth apply for auto insurance from XYZ Insurance Company. Based on their credit histories, the insurer calculates insurance scores for both applicants. Because Alice and Beth have similarly unstable credit histories, they both receive the same, relatively low score. Accordingly, the insurer offers the same policy at the same higher-than-average rate to both Alice and Beth. Examining this scenario, it is apparent that the insurer has treated Alice and Beth equally: it applied the same objective risk-assessment technique to each of them, and when Alice and Beth were shown to have identical risk profiles, they were offered the same policy and quoted identical rates. Nevertheless, if Alice and Beth belong to different groups and a greater percentage of Alice’s group than Beth’s group receives low insurance scores, there may be “disproportionate impact” but not necessarily “disparate impact”

---

<sup>46</sup> “Freddie Mac & Historically Black Colleges and Universities Launch Multi-Million Initiative to Boost Minority Home Ownership” (<http://www.freddiemac.com/news/archives1999/cceire13.htm>). See also Melanie Eversley, Minorities Less Likely to Get Loans, survey Finds Disparities in Credit Records, *Detroit Free Press*, September 22, 1999.

as some would suggest. In order to eliminate credit-based insurance scoring, its opponents seek to stop at the very first step, based merely on statistical indicators of disproportionality, and avoid the multi-step analysis established by courts.

The hypothetical case of Alice and Beth is a good illustration of Richard Epstein’s maxim that disparate impact analysis “reduces the individual . . . to a condition of relative invisibility.”<sup>47</sup> Indeed, the experience of particular individuals is entirely irrelevant to the disparate impact theory. A conception of equality that focuses on group parity measured through statistics, rather than on the manner in which individuals are treated, stands in stark contrast to the American creed.

Still another reason for rejecting disparate impact analysis as a basis for regulating insurance scoring is the implausibility of any suggestion that insurance scores are a pretext for intentional discrimination against certain groups.<sup>48</sup> This reasoning does not hold up under closer scrutiny. It is simply doubtful that any insurance company today would use insurance scoring as a pretext for discriminating against racial and ethnic minorities. It is contrary to economic logic to conclude that insurers would intentionally utilize a method to disadvantage minority policyholders that would also have the effect of overcharging or excluding the largest demographic segment of their available marketplace.

---

<sup>47</sup> Epstein, *op. cit.*, p. 205.

<sup>48</sup> For example, a pending class action lawsuit charges that Allstate Insurance Company “uses credit scores to charge minorities higher rates than Anglo customers—essentially as a replacement for geographic redlining.” Claudia Grisales, “Unsettling Score: Consumers, Insurers Battle Over Linking Rates to Credit History,” *San Antonio American-Statesman*, Sunday, May 12, 2002.

## Conclusion

As articulated by the courts, the disparate impact theory of discrimination is not concerned with intentional acts of injury or denial of rights caused by racial prejudice; rather, it seeks to eliminate objective standards and criteria that adversely affect a greater percentage of some groups more than other groups. Congress and the federal courts have endorsed the use of disparate impact analysis in Title VII employment discrimination cases. Nevertheless, courts and legal theorists have recognized that applying disparate impact analysis to other areas of law is highly problematic.

Inasmuch as the theory was developed as a tool for ferreting out covert discrimination in employment, it is ill suited to settings in which the nature and purpose of the challenged evaluation criteria are fundamentally different from those used to hire and promote workers. Furthermore, because the disparate impact theory has developed as a legal doctrine – complete with standards of proof and affirmative defenses – for adjudicating particular disputes between discrete parties, it is an inappropriate basis for enacting industry-wide laws and regulations that provide no recourse to those regulated.

It is one thing for a legislature to pass an anti-discrimination law that allows the use of disparate impact analysis to prove claims of illegal discrimination, as Congress did when it passed the Civil Rights Act of 1991. It would be another matter entirely, however, if a legislature were to enact a wholesale prohibition on practices such as credit-based insurance scoring merely because of a *perception* that the practices in question create a disproportionate statistical racial or ethnic impact. The multi-part disparate impact doctrine followed by the courts would allow insurers to rebut the presumption of illicit discrimination by demonstrating that insurance scoring serves a legitimate business purpose. Legislation prohibiting insurance scoring on disparate impact grounds would simply assume that no insurer's use of credit information could ever serve a legitimate purpose. Finally, apart from these formal considerations, a strong argument can be made that the disparate impact theory of discrimination, as applied to insurance, is socially unacceptable. Therefore, policymakers should reject the application of disparate impact theory to insurance.





## **Texas Department of Insurance**

*Commissioner of Insurance, Mail Code 113-1C*

333 Guadalupe • P. O. Box 149104, Austin, Texas 78714-9104  
512-463-6464 telephone • 512-475-2005 fax • www.tdi.state.tx.us

***Jose Montemayor***

January 31, 2005

The Honorable Rick Perry  
Governor of Texas  
P.O. Box 12428  
Austin, Texas 78711

The Honorable David Dewhurst  
Lieutenant Governor of Texas  
The Capitol  
Austin, Texas 78711

The Honorable Tom Craddick  
Speaker, Texas House of Representatives  
P.O. Box 2910  
Austin, Texas 78768

Dear Governors and Mr. Speaker:

It is my honor to present the remainder of the credit scoring study mandated by Senate Bill 14, 78th Regular Session.

The first phase of the analysis, published December 31, 2004, indicated that credit scoring is correlated to risk. The first phase also indicated that certain age, income and race groups tended to have worse credit scores, though not all minorities have bad credit scores. Because the Texas Insurance Code does not prescribe a precise threshold or legal definition for determining disproportionate impact, I expressed disproportionate impact in terms of a relationship, i.e., over or under-representation in the various credit score categories.

The second phase of the study evaluates if, and to what extent, credit scoring enables an insurer to more accurately predict losses when used in conjunction with other variables. Overall, the second phase indicates that credit scoring significantly improves pricing accuracy when combined with other rating variables in predicting risk.

To approach the development of a credit scoring policy, it is important to understand the distinction between unfair discrimination, intentional discrimination and disproportionate impact. The Texas Insurance Code defines unfair discrimination to be the unequal treatment of individuals in the same class or hazard. Underwriting or rating classifications are not unfair, though, if they are actuarially supported. On the other hand, overt

classifications or discriminations based on race, color, religion or national origin are intentional discrimination and are prohibited by law, regardless of actuarial support.

Disproportionate impact is a lack of symmetry, or unequal percentages. In other words, disproportionate impact is an uneven distribution of each racial group within a given risk factor, although the uneven distribution is not caused by one's race. Also, disproportionate impact changes over time. For credit scoring, the disproportionate impact changes as economic conditions and population distribution change. By the nature of risk-based pricing and underwriting, all factors used in insurance have a disproportionate impact to some extent. One could make a convincing argument to ban the use of all risk-related factors based solely on disproportionate impact. Effectively, we would ban risk-based pricing and underwriting and revert to a pricing system where we homogenize the risk and essentially charge everyone the same price--regardless of risk. That would be a set-back to all Texans, of all races, especially those of moderate to lower income whose risk remains low.

As Commissioner, I have the authority to end a practice that is either unfairly or intentionally discriminatory. However, I do not have a legal basis to ban a practice that has a disproportionate impact if it produces an actuarially supported result and is not unfairly or intentionally discriminatory. Prior to the study, my initial suspicions were that while there may be a correlation to risk, credit scoring's value in pricing and underwriting risk was superficial, supported by the strength of other risk variables. Hence, there would be evidence that credit scoring was a coincidental variable that served as a surrogate for an unlawful factor in rating and underwriting. If this were proven to have been the case, I would have had a legal basis to make the connection between disproportionate impact and intentional discrimination, and either ban credit scoring outright or adopt an allowable rate difference of zero, meaning no rate differences due to credit scoring.

The study, however, did not support those initial suspicions. Credit scoring, if continued, is not unfairly discriminatory as defined in current law because credit scoring is not based on race, nor is it a precise indicator of one's race. Recall that not all minorities are in the worst credit score categories. Further, its use is justified actuarially and it adds value to the insurance transaction. Without a change in statute that disallows credit scoring as a matter of public policy, any action to ban may be tied up in court for several years, further frustrating public expectation.

Be advised, however, that banning credit scoring overnight, by rule or law, creates pricing and availability disruptions in a market that has just stabilized and begun a rebound. The same effect would occur if a narrow rate limit, or collar, due to credit scoring were adopted with immediate effect. Premiums would go up for a very large number of policyholders if the collar on credit scoring (or any other risk variable for that matter) is set too narrow, because it would force an immediate price shock that would be unrelated to a change in risk. Further, I believe that, based on the analysis, a collar would have only visual effect, giving the public the impression that any disproportionate impact had been corrected once and for all. A collar would simply be a guess about what is publicly acceptable, and I have no valid, objective way of determining that number. Therefore, any action to ban or restrict the use of credit scoring must allow for changes in the pricing and underwriting systems to

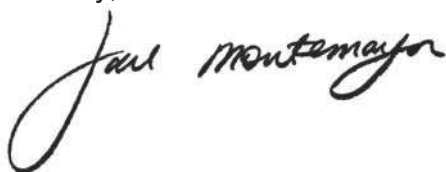
occur over a period of time, ensuring that all Texans pay a rate that is fair and based on risk.

Modern insurance pricing relies on the law of large numbers, which assumes that the more observations one makes, the greater the certainty. Credit scoring allows for a finer level of observation, but measuring propensity for risk strictly by the numbers can seem callous. Unlike other risk-related factors, credit scoring does not have that readily discernable, causal link to risk, such as driving record. As a result, credit scoring has earned the outward appearance of being a surrogate for something sinister. Unfortunately, there is no formula that reconciles economic reality with the public perception of fairness; it is a matter of guessing the right answer for the times.

Allowing credit scoring to be used, as contemplated under SB 14, 78th Regular Session, will ensure its link to risk under some of the strongest consumer protections in the nation, especially for people that suffer hardship. However, if the presence of credit scoring in insurance will only feed suspicion and divide us as Texans, its continued use to any degree may simply not be worth it. If the Legislature determines that credit scoring should be eliminated, then I recommend that it be phased out over time.

I hope the analysis and my thoughts on this matter help in your deliberations. As always, I remain at your service.

Sincerely,

A handwritten signature in black ink that reads "Jose Montemayor". The signature is written in a cursive style with a large, looping initial "J".

Jose Montemayor  
Commissioner of Insurance

c: Members of the 79<sup>th</sup> Texas Legislature