Legal Backgrounder

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"DISPARATE IMPACT" THEORY PROVIDES NO SUPPORT FOR BANNING CREDIT SCORING IN INSURANCE

by

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Lawyers experienced in the practice of employment discrimination law are all too familiar with the "disparate impact" theory of discrimination. Originally conceived by the U.S. Supreme Court in 1971,[1] the theory holds that a standard or practice is presumptively illegal if it has a disproportionate negative impact on members of a group defined by race, ethnicity, or sex—even though the challenged practice makes no reference to these characteristics, and the resulting adverse group impact was not intended by those who designed and implemented the practice. Significantly, however, defendants can rebut the presumption of unlawful discrimination by showing that the challenged practice is required by "business necessity," which will be further discussed in this LEGAL BACKGROUNDER.

Until recently, the use of disparate-impact analysis has largely been confined to the courts, and specifically to cases involving employment discrimination claims brought under Title VII of the Civil Rights Act.[2] Recently, however, the idea of applying disparate-impact analysis to evaluate the fairness of particular business practices has migrated from judicial precincts to state legislatures. The issue driving this transformation of legal doctrine into public policy dogma is, of all things, insurance companies' use of consumer credit information to underwrite and price automobile and homeowners insurance coverage.

How and Why Insurers Use Consumer Credit Information. During the 1990s, a growing number of personal lines insurance companies began using consumer credit information to help them decide whether to issue or renew a policy, and to establish its price. Today most large automobile and homeowners insurers use credit-based "insurance scores" for underwriting and rating purposes. Insurers are interested in credit information for one specific reason: An individual's experience managing credit is an accurate predictor of whether he will file a claim for automobile or homeowners insurance, and the potential size of losses.[3]

It should come as no surprise that once the link between credit history and property insurance claims was established, insurers would regard credit information as a valuable underwriting and rating tool. When an insurer acquires information that allows it to improve the accuracy of its ability to assess risk, it can more closely align the price it charges for coverage with the cost of providing that coverage. Insurers that predict claim costs better than their competitors prosper, while the least prescient end up losing money. This

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[1]See *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971). Congress codified the use of disparate impact analysis to prove employment discrimination claims in 1991. *See* 42 U.S.C. § 1981a.

[2]42 U.S.C § 2000e *et seq.*

[3]Numerous studies have confirmed the relationship between consumer credit ratings and property insurance losses. *See*, *e.g.*, 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).

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market-driven incentive to accurately assess risk ensures that the price of insurance will be commensurate with the level of risk that a particular policyholder presents.

Nevertheless, risk-assessment techniques that appear to exert an adverse "disparate impact" on particular demographic subgroups have occasionally been the subject of class-action litigation. In the 1990s, a spate of federal lawsuits filed under the Fair Housing Act accused several large homeowners insurers of urban "redlining" based on statistics showing that use of a home's age and market value as underwriting variables disproportionately harmed black homeowners living in inner city communities. (All of the cases were settled out of court.) In contrast to the redlining cases, opponents of credit scoring have lacked credible evidence to support their contention that the practice has a disparate adverse impact on minority populations. That has changed, however, with the release of a new report by the Texas Department of Insurance (TDI).

The Texas Department of Insurance Study. While earlier studies had confirmed the relationship between credit history and insurance risk, the TDI study is arguably the most thorough and authoritative. TDI released the main body of the report in December 2004, and issued a supplemental report in January 2005. The TDI study was based on data obtained from six leading insurers for approximately 2 million policies. Of these, approximately 1.2 million were for personal auto insurance and 800,000 were for homeowners insurance. The personal auto policies covered roughly 2.5 million vehicles.

The TDI study was unusual both because of the size of its database, and because it included individual information on race and ethnicity. That information was missing from other studies because insurers do not collect information concerning the race or ethnicity of their policyholders. The TDI, however, was able to draw on the resources of the Texas Department of Public Safety and the Texas Office of the Secretary of State. Based on data supplied by those agencies, the TDI was able to classify individual policyholders as white, black, Asian, and Hispanic.

The TDI then analyzed "whether the use of credit scoring: (1) impacts certain classes of individuals more than others; and (2) predicts claims experience."[4] The first question was answered unambiguously in the first installment of the report issued in late December 2004: "Whites and Asians, as a group, tend to have better credit scores than Blacks and Hispanics. In general, Blacks have an average credit score that is roughly 10 percent to 35 percent worse than the credit scores for Whites. Hispanics have an average credit score that is roughly 5 percent to 25 percent worse than those for Whites. Asians have average credit scores that are about the same or slightly worse than those for Whites."[5] As the report's executive summary put it, "Blacks and Hispanics tend to be over-represented in the worse credit score categories and under-represented in the better credit score categories."[6]

The December report also concluded that "there appears to be a strong relationship between credit scores and claims experience on an aggregate basis," but cautioned that "credit scores, to some extent, may be reflective of other risk characteristics associated with claims."[7] The report explained that the department would need to perform a multivariate analysis to determine whether credit scoring enables an insurer to predict losses more accurately than it could by relying solely on more traditional underwriting variables. A month later, the department released its supplemental report containing the multivariate analysis. It found 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 score, insurers can better classify and rate risks based on differences in claim experience."[8]

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[4]"Report to the 79th Legislature: Use of Credit Information by Insurers in Texas," Texas Department of Insurance (Dec. 30, 2004), at 3.

[5]*Id*. at 13.

[6]*Id*. at 3.

[7]*Id*.

[8]"Supplemental Report to the 79th Legislature: Use of Credit Information by Insurers in Texas: The Multivariate Analysis," Texas Department of Insurance (Jan. 31, 2005), at 2.

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This finding so surprised Texas Insurance Commissioner Jose Montemayor that he felt obliged to acknowledge, in a letter to Governor Rick Perry, that his "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." The study, however, "did not support those initial suspicions." Moreover, credit scoring "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."[9]

Predictably, insurers hailed the supplemental report's confirmation of what they had been saying all along, and were especially heartened by Commissioner Montemayor's public declaration that credit scoring is not unfairly discriminatory. Opponents responded by ignoring Montemayor's letter and dismissing the report's conclusion that credit scoring is a legitimate and valuable underwriting tool. Instead, they focused intently on the report's disparate impact findings. Typical was the reaction of Texas Senator Rodney Ellis (D-Houston), who declared, "It doesn't matter if credit scoring is actuarially justifiable, it is morally unacceptable." Sen. Ellis promptly introduced a bill to ban the practice.[10]

Meanwhile, the Federal Trade Commission is conducting a study analyzing whether the use of credit information affects the affordability and availability of insurance and other financial services products, including the degree to which it may have a disparate impact on various demographic groups. The Fair and Accurate Credit Transactions (FACT) Act requires the FTC to complete its study by the end of 2005, and to include recommendations for legislative or administrative action.

How Should State Policymakers Respond? Assuming that the FTC's disparate-impact analysis of credit scoring replicates the findings of the TDI study, thoughtful policymakers—including those who support the use of disparate impact analysis in Title VII litigation—will be forced to ponder two critical questions: First, is disparate impact analysis an appropriate means of identifying unfair discrimination in insurance underwriting and rating? And if it is, should disparate impact analysis serve as the basis for new legislation to ban credit-based insurance scoring?

A survey of pertinent case law suggests that the answer to both questions is no. In the first place, courts have generally been reluctant to apply disparate-impact analysis to discrimination claims that don't involve employment. Moreover, in non-employment cases where it has been applied, courts have tended to depart from the onerous "compelling business necessity" defense familiar in Title VII cases. That defense requires defendants to show that the purpose behind the challenged practice is "sufficiently compelling to override any racial impact" and that "no acceptable alternative policies or practices [exist] which would better accomplish the business purpose advanced, or accomplish it equally well with a lesser differential racial impact."[11]

In place of the business necessity test, courts have substituted a much looser "legitimate business justification" standard in disparate-impact cases brought under the Fair Housing Act (FHA) and the Equal Credit Opportunity Act (ECOA). For example, in a case that challenged a housing community's numerical occupancy limits on disparate impact grounds, the U.S. Court of Appeals for the Tenth Circuit rejected plaintiff'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."[12]

Similarly, in a case brought under both the FHA and the ECOA, the U.S. Court of Appeals for the Seventh Circuit affirmed a lower court's dismissal of a 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. Applying the legitimate business justification standard, the court explained that

[9] Letter to Gov. Perry from Commissioner Montemayor, Jan. 31, 2005, at 2.
[10] Daniel Hays, *Texas Legislator Calls Credit Scoring Immoral*, NAT'L UNDERWR., Feb. 2, 2005.
[11] *Robinson v. Lorillard Corp.*, 444 F.2d 791 (4th Cir. 1971).
[12] *Mountain Side Mobile Estates v. HUD*, 56 F.3d 1243, 1254-55 (10th Cir. 1995).

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"the Fair Housing Act's prohibition against denying a loan based upon the location of the dwelling does not require that a lender disregard its legitimate business interests or make an investment that is not economically sound."[13] Several years later, in yet another Seventh Circuit decision rejecting the application of a Title VII-style compelling business necessity standard to 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."[14]

These decisions suggest that courts have increasingly come to recognize that serious economic problems would result if the Title VII version of the disparate impact doctrine became the template from which courts, legislatures, and administrative agencies reflexively construct disparate impact standards for other areas of commerce. 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 first decides how many positions must be filled, then chooses among the most 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 it believes that this level of profitability will be achieved. Challenging the lender's creditworthiness criteria on disparate impact grounds—and requiring it to defend those criteria as required by "business necessity"—would essentially place a court in the position of determining the level of profit that is "necessary" to operate a bank.[15]

If lenders and credit card issuers can cite legitimate business justifications for race-neutral evaluation criteria that produce disparate impacts, it seems reasonable to infer that insurers should be allowed to do the same. A test that recognizes insurers' legitimate need to accurately assess risk would presumably uphold any challenged criteria—including credit scores—that served this purpose.

Disparate Impact Analysis is an Inappropriate Basis for Legislative Prohibitions of Credit Scoring in Insurance. Policymakers should be no less cautious than judges in deciding whether the disparate impact doctrine provides a sound basis for insurance regulation. That is especially so when one considers that a law that restricts the use of underwriting criteria on disparate impact grounds differs significantly from a legal doctrine that establishes disparate impact as a formal theory for bringing and defending against lawsuits. A legislative or regulatory ban on credit-based insurance scoring is just that—a ban. Once the law is passed, it is not necessary to show that a particular insurer's use of credit information produces a disparate impact among that insurer's current or prospective policyholders. Nor is there an opportunity for the insurer to defend its use of credit information as a legitimate business practice.

It is quite possible, therefore, to approve of disparate-impact analysis as an employment litigation tool while opposing its use as a rationale for enacting insurance underwriting restrictions. In disparate impact cases brought under the Fair Housing Act or the Equal Credit Opportunity Act, legal scholar and disparate impact proponent Peter Mahoney has argued that plaintiffs should be required to identify an equally effective alternative practice that would have less of a disparate impact than the challenged practice. Courts should then consider "the cost to a defendant of adopting and maintaining such a practice or policy as an alternative to the challenged practice."[16]

In a legislative or regulatory setting, it follows that this burden should rest with the policymaking body. If policymakers believe that an alternative to insurance scoring exists that produces less of a disparate impact, that is no more expensive to use, and that is equally effective in meeting the legitimate business purpose of assessing risk, let them identify it.

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[13] *Cartwright v. American Savings & Loan Ass'n*, 880 F.2d 912, 923 (7th Cir. 1989).

[14] *Latimore v. Citibank Fed. Sav. Bank*, 151 F.3d 712, 712-14 (7th Cir. 1998).

[15] *See* Earl M. Maltz, *The Expansion of the Role of the Effects Test in Antidiscrimination Law: A Critical Analysis*, 59 NEBRASKA L.R. 345, 361 (1980).

[16] Peter E. Mahoney, *The End(s) of Disparate Impact: Doctrinal Reconstruction, Fair Housing and Lending Law, and the Antidiscrimination Principle* 47 EMORY L.J. 409, at 523-525 (1998).

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