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# **CREDIT SCORING AND INSURANCE: COSTING CONSUMERS BILLIONS AND PERPETUATING THE ECONOMIC RACIAL DIVIDE**

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June 2007

**Credit Scoring and Insurance:  
Costing Consumers Billions and  
Perpetuating the Economic  
Racial Divide**

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## EXECUTIVE SUMMARY

The use of credit scores in home and auto insurance is a poorly understood phenomenon with a huge economic impact on Americans. It's also a practice that creates wide racial disparities. This report presents an overview of credit scores, which are three digit numbers designed to predict risk based on a consumer's credit record. The report also summarizes the multitude of studies showing the discriminatory impact of credit scoring. It analyzes these racial disparities in light of recent research about the enormous racial wealth divide and its historical origins.

Key findings of this report are:

- Consumers know little about the use of credit scoring and credit records in granting or pricing insurance - only 36% know that a credit history can affect insurance coverage or premiums. When they do find out, they overwhelmingly disapprove of the practice.
- Some of the factors used in insurance scoring models are questionable, such as penalizing consumers with fewer than 2 credit card accounts or those who have installment loans (such as auto loans). Credit scoring in general has been criticized on a number of bases, such as the high rate of errors in credit reports and inconsistent data between the major credit bureaus.
- Much of the insurance industry relies on credit scoring because it is allegedly predictive in forecasting which consumers will have higher loss ratios. Yet the industry has not offered a satisfactory explanation as to *why* there is a correlation between credit scores and loss ratios.
- The use of credit scoring is tied to a significant increase in profits for insurers, whose loss ratios have decreased substantially. Credit scoring may have benefited insurers (and thus cost consumers) somewhere in the neighborhood of \$67 billion from 2003 to 2006.
- Study after study has documented the fact that credit scores disfavor minority consumers. Since 1994, at least 5 studies of traditional credit scores (for credit granting purposes) have shown that African Americans and Latinos have lower scores as a group. At least two studies by state insurance bureaus have found that African Americans and Latinos are overrepresented among consumers with low credit scores and under-represented among those with high credit scores. Furthermore, minority consumers are more likely to lack the credit history necessary to even generate a credit score.
- Anti-discrimination laws present limited avenues to challenge the racial disparities created by credit scoring. There are some viable theories to challenge insurance scoring in home insurance, but fewer challenges available in auto insurance.

Finally, we argue that racial disparities in credit scoring are a product of historical economic discrimination against minorities. Government policies that economically boosted whites while leaving minorities behind are responsible for the racial wealth gap. Credit scores act as both a numerical reflection of that gap as well as a force widening the gap. We echo the call of many advocates to ban the use of insurance scoring in order to stop the perpetuation of economic discrimination. If states do continue to permit their use, insurers must be required to develop scoring systems that do not have a disparate impact on minority populations.

## I. INTRODUCTION

It is no secret that a huge wealth gap exists in this country, and it is divided along color lines. African Americans earn only 62 cents for every dollar earned by whites, and Latinos earn only 70 cents.<sup>1</sup> Even more disturbing is the divide in assets. African American families own less than seven cents for every dollar in wealth owned by white families, while Latino households own less than nine cents for every dollar of white wealth.<sup>2</sup> These huge disparities in income and wealth are due to a historical legacy of racism, redlining and segregation.<sup>3</sup> Unfortunately, the racial wealth gap is not closing.<sup>4</sup> Indeed, the policies and practices of both the government and the business sector have widened that gap in the last decade.

One of the practices that has reinforced and exacerbated the racial wealth gap is credit scoring. Study after study has shown credit scoring disfavors African Americans and Latinos, and that these communities have lower credit scores as a group. Credit scoring's disparate impact is alarming because this solitary number is being used in a growing number of economic transactions - not just granting of credit, but utility service, apartment rentals and even employment decisions. Credit scores are also being used to decide whether to issue home or auto insurance and at what cost, which is the focus of this report.

The difficult issue is that while credit scoring has a disparate impact, it has been shown to be predictive in the credit context. In the insurance context, companies claim that it is also predictive in forecasting which consumers will have higher loss ratios. Thus, credit scoring may be a useful tool for businesses, but one that discriminates. The issue for our society is whether we permit the use of this tool knowing that it not only hurts minorities, but also that the disparate impact of this tool reflects centuries of discrimination, exclusion, and exploitation of minority groups.

### A. *What is Credit Scoring?*

A credit score is a number generated by a computer program based on information from a credit history as recorded by a credit bureau such as Experian, Equifax, and Transunion (the 'Big Three' credit bureaus). A credit history contains information about a consumer's credit experiences, including bill-paying histories, the number and types of accounts she has, whether she has had bills sent to debt collection agencies, her outstanding debt amounts, and the age of her accounts. A credit score supposedly helps predict how creditworthy a consumer is. That is, how likely it is that the consumer will repay a loan and make the payments when due.

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<sup>1</sup> Carmen DeNavas-Walt, Bernadette D. Proctor, and Cheryl Hill Lee, *Current Population Reports, P60-229, Income, Poverty, and Health Insurance Coverage in the United States: 2004*, U.S. Census Bureau (August 2005).

<sup>2</sup> Rakesh Kochhar, *The Wealth of Hispanic Households: 1996 to 2002*, Pew Hispanic Center (October 2004)

<sup>3</sup> These disparities often lead unscrupulous sellers to target minority consumers for higher priced credit, not because of overt bias, but stemming from a perception that these consumers are more vulnerable to "sucker pricing." See Ian Ayres, *Pervasive Prejudice?: Unconventional Evidence of Race and Gender Discrimination* (2001); Jan Pillai & M. Tulloss, *Racial and Gender Discrimination at the Cash Counter*, Miss. State J. Int'l L. 507 (2003) (book review). These disparities sometimes become internalized as well, creating a self-perception by some minority borrowers that they do not qualify for affordable credit and their only option is expensive subprime credit. See generally David Dante Trott, *Ghettoes Revisited: Antismarkets, Consumption, and Empowerment*, 66 Brook. L. Rev. 1 (2000).

<sup>4</sup> According to the Pew report, since 1996 the median net worth of black families in the United States has fallen by 16.1 percent. For white families, net worth grew by more than 17 percent. Rakesh Kochhar, *The Wealth of Hispanic Households: 1996 to 2002*, Pew Hispanic Center (October 2004).

The most popular type of credit score is generated by Fair Isaac & Co and is often called a ‘FICO score’. It generally ranges between 300 and 850, and is primarily used in the credit context. A higher number is considered a better score. There are many other types of credit scores in addition to FICO scores, some of which are generated using information in addition to a credit history, such as data obtained from a credit application or other sources. The insurance industry uses its own specialized scoring models, discussed in Section II.

According to Fair Isaac, its credit scoring models generally evaluate the following types of information:

- Payment history (35%)
- Amount of credit utilized (30%)
- Length of credit history (15%)
- Recent applications for credit (10%)
- Number and types of credit accounts (10%).

### ***B. Uses of Credit Scoring***

Credit scoring has become an increasingly dominant factor in our economic lives. Credit scores dictate whether a person will be able to buy (and keep) a home by obtaining a reasonable mortgage. They also determine how expensive it will be to buy a car, a critical tool for many Americans to get to work. They determine access to other kinds of credit, such as credit cards, as well.

Credit scores, however, are being used far beyond simple credit decisions. Employers use credit scores when evaluating applicants, even for jobs that do not involve handling money.<sup>5</sup> Many utilities use credit scores to determine whether to turn on the lights or the heat without requiring a security deposit.<sup>6</sup> One utility even proposed using it to set the price of electricity for its customers.<sup>7</sup> Landlords use credit scores to decide whether or not to rent an apartment.

Credit scores have become as important a number, if not more so, than a person’s salary or grade point average. A bad credit score is a financial “Scarlet Letter” ostracizing a person from the land of reasonably priced credit, good jobs and (as discussed in this paper) insurance coverage.

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<sup>5</sup> John Cook, *Credit Follows Us Everywhere*, Contra Costa Times, May 19, 2003, at 4.

<sup>6</sup> National Consumer Law Center, *Access to Utility Service*, § 3.7.4.7 (3rd. ed. 2004).

<sup>7</sup> Sudeep Reddy, *Utilities Spark Data Debate: Customer Payment Histories May Be Used To Set Rates Under New Law*, Dallas Morning News, June 30, 2005.

## II. INSURANCE SCORING

Over the last decade a growing number of auto and home insurers have been using credit scores to determine whether to insure a consumer and at what price. An early survey found that 92 percent of auto insurers surveyed use credit scores.<sup>8</sup> As a result, a consumer with a poor credit history may be charged anywhere from 40% to several hundred percent more in premiums for automobile insurance.<sup>9</sup> A number of major home insurers use credit scores as well, including Allstate,<sup>10</sup> Nationwide Mutual<sup>11</sup> and Hartford Financial Services Group.<sup>12</sup>

### A. Criticisms of Insurance Scoring

Insurance companies justify their use of credit scores by citing several studies that have found a high correlation between credit scores and loss experience. For example, a June 2003 study commissioned by the insurance industry found that individuals with the lowest insurance scores incurred 33% higher losses than average, while the highest scorers incurred 19% lower losses.<sup>13</sup>

The primary criticism of this justification has been simple - there is no explanation for *why* a person with a lower credit score is more likely to cause higher loss to insurers. While there may be a correlation, there does not appear to be an easily identified and logical causal link between a consumer's credit history and whether she will have an auto accident or accident with her home. Even the industry admits they don't understand the link, with a trade association spokesperson noting "it's not the most intuitive connection, the way it is for making a mortgage."<sup>14</sup> The reason for the correlation might be caused by a factor that is not the fault of the consumer, or a factor that we as a society would want to ban as a justification for provision of service- such as race or income.

Insurers sometimes put forth a "moral person" hypothesis to explain the link between credit scoring and loss history, *i.e.*, they argue that a person who is reckless with credit may also be reckless with driving or irresponsible about maintaining a home.<sup>15</sup> This ignores the fact that many people end up in a financial crisis (thus lowering their credit score) due to illness, job loss or divorce.<sup>16</sup>

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<sup>8</sup> Brian Grow and Pallavi Gogoi, *Insurance: A New Way to Squeeze the Weak?* Business Week, January 28, 2002, at 92 (citing study by Conning & Co.).

<sup>9</sup> Pamela Yip, *One Number, Many Uses*, Dallas Morning News, April 8, 2002, at 1D; Kathy Chu, *Getting Personal: Poor Credit Can Drive Insurance Rates Higher*, Dow Jones Newswires, May 21, 2003.

<sup>10</sup> *DeHoyos v. Allstate Corp.*, 345 F.3d 290 (5th Cir. 2003).

<sup>11</sup> *Owens v. Nationwide Mutual Insurance Co.*, 2005 WL 1837959 (N.D. Tex. Aug. 2, 2005).

<sup>12</sup> *Reynolds v. Hartford Financial Services Group*, 435 F.3d 1081 (9th Cir. 2006), *rev'd sub nom.*, *Safeco Ins. Co. v. Burr*, -- S. Ct. ---, 2007 WL 1582951 (June 4, 2007).

<sup>13</sup> Michael J. Miller and Richard A. Smith, *The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity*, EPIC Actuaries (June 2003).

<sup>14</sup> Jonathan Epstein, *Outraged by 'Credit Scoring'? Auto, Home Insurers Use a Person's Credit History to Set Rates*, Buffalo News, November 28, 2004 (quoting spokesperson for the Property Casualty Insurers Association).

<sup>15</sup> See, e.g., Insurance Information Institute, *FAQs*, at <http://www.insurancescoring.info/faq.htm> (last viewed June 2007) ("people who manage their money well tend to manage their most important financial asset - their home - just as well. People who handle money responsibly also tend to handle their driving responsibly").

<sup>16</sup> See, e.g., David U. Himmelstein, Elizabeth Warren, Deborah Thorne, and Steffie Woolhandler, *Illness and Injury as Contributors to Bankruptcy*, Health Affairs - Web Exclusive, February 2, 2005, available at <http://content.healthaffairs.org/cgi/reprint/hlthaff.w5.63v1> (finding that half of all bankruptcies are caused in part by medical reasons, such as illness or injury, medical debt, or lost work due to medical reasons).

Consumer advocates believe that an alternative explanation for the correlation, if one truly exists, is simply wealth. There is a correlation between insurance scores and income (discussed below in Section IV.B). Consumers with lower incomes and lower scores simply may have fewer financial resources, and thus be more likely to file a claim rather than “eating” the loss.<sup>17</sup> For example, a Texas study found that while credit scores were related to loss experience, the correlation was due to a higher frequency of claims for low scorers, not a greater dollar amount per claim.<sup>18</sup> This suggests that to the extent there is a correlation, it is because low scoring consumers are more likely to file claims, not because they actually sustain greater losses.

Finally, there is some question as to whether this correlation between credit scores and insurance loss ratios actually exists and how robust it is. While industry studies claim there is a correlation, the underlying data behind these studies has never been provided so that the results can be independently verified.

For further resources on the problems with insurance scoring, readers should consult the Center for Economic Justice’s website at [www.cej-online.org/creditscoringmainpage.htm](http://www.cej-online.org/creditscoringmainpage.htm).

### ***B. Consumer Awareness of Insurance Scoring***

Most consumers are not aware that credit scores can have an impact on their ability to obtain insurance or the price they will pay for it. A telephone survey conducted by the Government Accountability Office of 1578 consumers found that only 36% of them knew that a credit history can impact their insurance coverage or premiums. More consumers (42%) actually believed the opposite, *i.e.*, that credit history does not affect insurance, and 22% of consumers responded that they did not know.<sup>19</sup>

Consumers also expressed their belief that the use of credit scoring in insurance is unfair. A Scripps Howard telephone poll conducted in Texas found that 68% of respondents favored a ban on the use of credit history for insurance underwriting and pricing.<sup>20</sup>

### ***C. Elements of an Insurance Score***

The credit scores used by insurers, or “insurance scores,” are specially developed for insurance purposes and not the same as generic FICO scores for credit granting. Insurance scores are generated using a different scoring model (or computer program) than for generic credit scores. Insurance scoring programs use different factors, and give those factors a different weighting than for generic credit scores. What they do share in common with FICO-type scores is a reliance solely on credit history.

In Texas, a consumer advocacy group was able to get a glimpse into the black box of insurance scoring. Texas Watch analyzed some of the scoring models used for home and auto insurance in

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<sup>17</sup> Carrie Teegardin, *Insurance Injustice? When Credit Matters*, Atlanta Journal-Constitution, December 10, 2006.

<sup>18</sup> Texas Department of Insurance, *Report to the 79th Legislature - Use of Credit Information by Insurers in Texas*, December 30, 2004.

<sup>19</sup> Government Accountability Office, *Credit Reporting Literacy: Consumers Understood the Basics but Could Benefit from Targeted Educational Efforts*, GAO-05-223, March 2005.

<sup>20</sup> *The Scripps Howard Texas Poll*, Spring 2003, results on file with author.



that state and found some interesting scoring criteria. Some of the examples being used in various insurance scoring systems included:<sup>21</sup>

- Average number of months all accounts on file have been open.
- Number of accounts opened in the last year. Consumers were penalized for opening more than 1 or 2 new accounts in a year.
- Age of oldest account in months. Consumers lost points for not having accounts that were over several years old. In addition to penalizing young consumers, it presents risks to a homeowner who pays off her 30 year mortgage, which may be her oldest account.
- Number of consumer-initiated credit inquiries in last 2 years. Insurance scores suffer after more than 2 inquiries.<sup>22</sup> Inquiries happen, not just when a consumer shops for credit, but if she switches cell phone service, rents an apartment, or opens a utility account (electric, heat, and even cable service). So consumers' insurance scores take big hits when they move.
- Number of credit card accounts open. Consumers with fewer than 2 credit cards are penalized.
- Number of credit card accounts where balance is 75% or greater than limit.
- Number of months since last account activity. Consumers lose points for not having any activity in the last month. So consumers are penalized, for example, if they have a credit card but don't use it.
- Number of installment loan accounts (car loans for example). Ironically, having a car loan costs points on an insurance score.
- Number of accounts in good standing *with a balance*. Not having a balance on an account can hurt a consumer. Once again, a consumer with a credit card is penalized for not using it. One would think paying off an account should be considered favorable.
- Number of open retail store or sale finance accounts. Having even one store card (e.g., Sears, Best Buy or Home Depot) will result in a lower insurance score.
- Number of open automotive related accounts. Consumers with car loans face a double whammy. They lose points for having an installment loan and having an auto-related loan.
- Number of open oil company accounts. Consumers get points for having a gas company credit card.
- Number of public records (includes bankruptcies, liens, collections, etc.).

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<sup>21</sup> Texas Watch, *Sample Credit Scoring Model, Consumer Insurance Tips - Credit Scoring* (undated).

<sup>22</sup> For credit granting purposes, FICO scores count multiple inquiries for home and auto loans with a certain time period, such as 14 days, as a single inquiry.

- Longest delinquency on an account.

Some of these factors, such as having too few credit cards, are questionable at best.

In Georgia, an analysis by the Atlanta Journal-Constitution of insurance scoring models in that state found similar factors being used, such as:<sup>23</sup>

- Some models reward customers with Visa or MasterCard credit cards over those with department store cards.
- Spreading debt over three credit cards can result in a better score than consolidating the same amount of debt onto one card.
- Too many credit cards would lower the score, but so would too few.
- Various insurance companies will score the same person in a completely different way.

Furthermore, the questions raised by some of the dubious criteria used in insurance scoring are in addition to problems presented by traditional credit scores. There have been a number of criticisms of credit scoring in general, including:

- Credit reports are notorious for containing errors. In one study, 79% of consumers reviewing their own credit reports found mistakes in the reports, and 25% of them contained mistakes that were serious enough to result in the denial of credit.<sup>24</sup> Another study estimated that at least one in five borrowers are likely being penalized because of an inaccurate credit score due to credit reporting problems.<sup>25</sup>
- Credit scores are inconsistent depending on which credit bureau's data is being used. An examination of over 500,000 consumer credit files found that 29 percent of consumers have credit scores that differ by at least 50 points between credit bureaus, while 4 percent have scores that differ by at least 100 points.<sup>26</sup> A difference of 50 points in a credit score could mean the difference in a mortgage, for example, between 6.522% APR (for a score of 670) versus 7.332% APR (for a score of 620), which is a difference of \$108 per month on a \$200,000 30-year fixed mortgage.<sup>27</sup>
- Credit scores penalize young consumers by favoring "old" credit.
- Credit scores allow creditors to artificially manipulate their customers credit scores by, for example, not reporting credit limits. Since one of the factors in a scoring model is the

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<sup>23</sup> Carrie Teegardin, *Insurance Injustice? When Credit Matters*, Atlanta Journal-Constitution, December 10, 2006.

<sup>24</sup> Alison Cassidy and Edmund Mierzwinski, *Mistakes Do Happen: A Look at Errors in Consumer Credit Reports*, MASSPIRG Educational Fund (June 2004).

<sup>25</sup> Consumer Federation of America and National Credit Reporting Association, *Credit Score Accuracy and Implications for Consumers*, December 17, 2002.

<sup>26</sup> *Id.*

<sup>27</sup> Rate quotes from the [www.myfico.com](http://www.myfico.com) website as of June 5, 2007.

ratio of credit used to credit available, failing to report a credit limit will depress a credit score by making it seem that a consumer is “maxed out.”<sup>28</sup>

#### ***D. Examples Of Consumers Hurt By Insurance Scoring***

The use of credit scoring in insurance has had a personal impact on many Americans. Here are some case studies of consumers who have seen their insurance rates skyrocket due to credit scoring:

Jose DeHoyos, a 65-year-old Hispanic-American from Somerset, Texas, saw his rates go up 25% with the use of credit scoring. DeHoyos had been a customer of Allstate for 26 years when the giant insurer raised his rates. During those 26 years, DeHoyos had filed only one claim --for hailstorm damage to his car five years ago. To add insult to injury, DeHoyos had only minor blemishes on his credit history -- two late payments totaling \$131 to a hospital and a gas station.<sup>29</sup>

Kathryn Perry fell behind in paying bills when her daughter died, but got back on track six months later. The black marks on her record from that six month period, however, cost her dearly. Her auto insurer refused to renew her policy at the \$435 a year she had been paying. Instead, she was offered a high risk policy costing a whopping \$6,000 per year.<sup>30</sup>

James White, a 60 year old assistant school superintendent, saw his rate rise by 60% for his homeowner’s insurance. His problem was that too many lenders had pulled his credit report. While some of the inquiries occurred when he went shopping for a mortgage, car, and other credit, more than half of the two dozen inquiries came unsolicited from business looking to sell him something.<sup>31</sup>

One group that is particularly vulnerable to insurance scoring is elders, because many of them have paid off their mortgages and do not use other types of credit. They may not have insurance scores or have low scores due to only a few accounts. For example:

Pat and Clyde Henry are a retired couple in their 60s from Akron, Ohio. They paid off their mortgage years ago, paid cash for their cars, and have no credit cards. As a result, they have no credit record and no insurance score. One would assume the Henrys are a good risk given their responsible financial behavior and lack of debt. But because they did not have a credit score, they were instead penalized. Their homeowner’s insurance premiums doubled, from \$286 per year to \$596 per year.<sup>32</sup>

The Henrys were not alone in being punished for not having or using credit cards:

Mattie Grainger, a senior citizen in South Carolina, had used the same insurance company for 34 years. This company increased her auto insurance premium by \$100

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<sup>28</sup> Evan Hendricks, *Credit Scores & Credit Reports: How the System Really Works, What You Can Do*, Privacy Times (2d ed. 2005), Ch. 22.

<sup>29</sup> Mr. DeHoyos is the lead plaintiff in the case, *DeHoyos v. Allstate Corp.*, 345 F.3d 290 (5th Cir. 2003).

<sup>30</sup> Kathy Chu, *Getting Personal: Poor Credit Can Drive Insure Rates Higher*, Dow Jones Newswires, May 21, 2003.

<sup>31</sup> Kathy Chu, *Getting Personal: Credit May Affect Your Insurance Rates*, Dow Jones Newswires, July 7, 2004.

<sup>32</sup> Betty Lin-Fisher, *Couple Penalized for Having No Debt*, Beacon Journal, February 29, 2004.

because her score was not considered top tier. Ms. Grainger's problem: she only had a few accounts and rarely used the two credit cards she owned. Her relatively debt-free life cost her points on her insurance score.<sup>33</sup>

Donald Tonack, who himself is a former insurance underwriter, was hit with an 11% increase in his auto insurance because of his insurance score. The 65 year old Oregon man had used the same insurance company for 17 years and had a clean driving record for 40 years. Despite this, Mr. Tonack saw his insurance rates rise because he didn't have a revolving credit account (*i.e.*, a credit card account).<sup>34</sup>

Finally, insurance scoring penalizes consumers who have been the victim of identity theft, the fastest growing crime in this country:

Ted Jordan, a Georgia resident, was victimized by an identity thief who took out \$18,000 in student loans in Jordan's name to attend a car repair trade school in California. Jordan was forced to file a lawsuit to clean up his credit record. In the meantime, Jordan saw his homeowner's insurance rate from Allstate spike due to the black marks on his credit record.<sup>35</sup>

### **III. INSURANCE CREDIT SCORING MAY BE LINKED TO BILLIONS IN INCREASED PROFITABILITY TO INSURERS**

When appearing before legislatures and regulators, insurers argue that insurance scoring allows them to more accurately price risks and is "revenue neutral." By "revenue neutral," insurers mean that insurance scoring raises the rates for some consumers and lowers the rates for others, but does not change the overall premium level. Insurers argue that insurance scoring simply enables them to better assign premiums to consumers based on the risk posed by those consumers.

In fact, insurers' use of credit scoring – the introduction of many, many rate levels based predominantly on the insurance score – may have contributed to a dramatic increase in insurance profitability. Table A shows loss ratios for private passenger auto liability insurance from 1999 through 2005. The loss ratio is the ratio of losses to premium<sup>36</sup> and shows what portion of the premium dollar is returned to consumers in claim payments. The table shows that loss ratios declined dramatically over the period – the same period in which insurers' use of credit scoring became more widespread and became more influential on rates charged. An explanation for the sources and calculation of the data is set forth in Appendix A of this report.

The data shown in Table A are inconsistent with insurers' claims about "revenue neutrality." If credit scoring was, in fact, revenue neutral, we would expect loss ratios to remain relatively constant over the period. The fact that loss ratios dropped dramatically indicates that premium growth far exceeded growth in losses and that insurers used credit scoring to raise rates for certain groups of

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<sup>33</sup> Elaine Gaston, *Bills Would Unlink Credit, Insurance*, Myrtle Beach Sun News, February 23, 2002.

<sup>34</sup> Kathy Chu, *Getting Personal: Credit May Affect Your Insurance Rates*, Dow Jones Newswires, July 7, 2004; Ellyn Ferguson, *Legal Battle Brewing Over Release of Credit Score*, Chicago Sun-Times, November 7, 2003.

<sup>35</sup> Carrie Teegardin, *Insurance Injustice? When Credit Matters*, Atlanta Journal-Constitution, December 10, 2006.

<sup>36</sup> The loss ratios presented are, more precisely, incurred losses to earned premiums. See Appendix A for a description of data, data sources and calculations.

consumers without commensurate reductions for other consumers and failed to lower rates to reflect lower claim costs.

Insurers would argue that the initial years in the period cited were unprofitable and that recent loss ratios are simply a return to profitability. Table A and Appendix A refute this claim by showing that rates and premiums have been, in recent years, significantly in excess of levels commensurate with a reasonable profit.<sup>37</sup> Premiums were excessive by about 8%, 14%, 11% and 14% in 2003, 2004, 2005 and 2006 respectively, for a total overcharge of \$67 billion during the four-year period.

When insurers pitch their company's stock to investment analysts, they tell a different story about credit scoring – they admit that credit scoring has increased insurer profitability. Consider the presentation by Ed Liddy, then CEO of Allstate, to investment analysts in 2005, in which he stated:

Tiered pricing helps us attract higher lifetime value customers who buy more products and stay with us for a longer period of time. That's Nirvana for an insurance company. That drives growth on both the top and bottom line.

This year, we've expanded from 7 basic price levels to 384 potential price levels in our auto business.

Tiered pricing has several very good, very positive effects on our business. It enables us to attract really high quality customers to our book of business.

Make no mistake about it, the economics of insurance are driven largely by retention levels. It is a huge advantage. And our retentions are as high as they have ever been.

The key, of course, is if 23% or 20% of the American public shops, some will shop every six months in order to save a buck on a six-month auto policy. That's not exactly the kind of customer that we want. So, the key is to use our drawing mechanisms and our tiered pricing to find out of that 20% or 23%, to find those that are unhappy with their current carrier, are likely to stay with us longer, likely to buy multiple products and that's where tiered pricing and a good advertising campaign comes in.

It [tiered pricing] has raised the profitability of the industry.<sup>38</sup>

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<sup>37</sup> Using the reasonable profit provision as determined by the Texas Commissioner of Insurance, discussed in Appendix A. The Texas Commissioner established a profit provision for private passenger auto which can be applied generally, not just for use in Texas. It was the outcome of a contested case hearing in which several parties put forth their proposed profit provisions and the Commissioner decided and explained in detail in his rate order why the specific provision was adopted.

<sup>38</sup> Partial Transcript of Presentation to Edward M. Liddy, Chairman and CEO, The Allstate Corporation Twenty-First Annual Strategic Decisions Conference, Sanford C. Bernstein & Co., June 2, 2005.

**Table A: Private Passenger Automobile Insurance, Loss Ratios and Excessive Premium**

	1999	2000	2001	2002	2003	2004	2005	2006
<b>Loss Ratio</b>	65.9%	71.3%	72.7%	67.5%	62.8%	58.6%	60.1%	57.9%
<b>% Excessive</b> (\$ billions)	3.5%	-2.7%	-4.1%	1.8%	7.8%	14.0%	10.8%	14.5%
<b>\$ Excessive (\$</b> (billions)	4.0	(3.3)	(5.6)	2.5	11.1	19.6	15.7	20.5

As with personal auto insurance, credit scoring may have increased insurers' profitability for homeowners insurance. Although homeowners results for insurers are affected by catastrophic events, such as Hurricane Katrina, the table below shows that insurers' payouts for homeowners claims did not exceed premiums on a nationwide basis even in 2005 when insurers experienced the worst catastrophe losses – by far – of any year.

**Table B: Nationwide Loss Ratios for Homeowners Insurance**

<b>Year</b>	<b>Ratio</b>
1999	63.7%
2000	66.4%
2001	77.2%
2002	65.9%
2003	59.2%
2004	66.0%
2005	75.2%
2006	48.2%

In most states, loss ratios have declined to 50% or less. In 2005 – a year in which several states were affected by Hurricanes Katrina and Rita – 20 states had loss ratios below 40% and 20 more states had loss ratios below between 40% and 50%. The increased profitability of homeowners insurance for non-catastrophic coverage is evident from a review of loss ratios in a number of states not subject to the hurricane risk along the southeast coast of the country and even in some southeastern states. For example, just looking at the three most populous states in the country shows loss ratios generally under 50% by 2004. Even in 2005, the year of Hurricane Rita, the Texas loss ratio was only 57%.

**Table C: Loss Ratios for Homeowners Insurance (CA, NY, TX)**

	2001	2002	2003	2004	2005	2006
<b>CA</b>	64.2%	59.2%	74.2%	30.9%	34.1%	33.3%
<b>NY</b>	55.6%	47.8%	51.5%	47.7%	43.3%	42.7%
<b>TX</b>	115.6%	108.3%	58.5%	28.1%	57.3%	33.8%

## IV. CREDIT SCORING AND DISCRIMINATION

The potentially most controversial issue in credit scoring in general, and insurance scoring in particular, is the impact on certain minority groups. Ever since credit scoring became prevalent, there have been concerns that scoring systems contain biases that disproportionately impact minorities and other disaffected groups. These concerns turned out to be justified, as study after study found that certain racial and ethnic groups tend to have lower credit scores than whites. Furthermore, minority consumers are less likely to even have the credit history necessary to generate a credit score.

The insurance industry's defense to charges of discrimination has been to cite (and commission) studies that show insurance scores are predictive. In essence, they are saying that minorities and low-income persons may have lower scores as a group, but they present more risk, so the use of scoring is reasonable and there is no discrimination.

As with their overall defense of insurance scoring, there is a disturbing "moral person" proposition in the insurers' argument with respect to the disparate impact of scoring, although it is never explicitly stated: minorities and low-income consumers are sloppy with their credit (and therefore with their driving). The counter argument is that the disparate impact in credit scoring reflects other correlations - race is correlated with wealth and wealth is correlated with risk because the more wealth one has, the more likely the consumer can "eat" insurance losses. Furthermore, as discussed in Section VI, the correlation between race and wealth is no accident, but a reflection of decades of intentional discrimination and exclusion of minorities from wealth building programs.

The following sections provide a brief overview of the statistical evidence of credit scoring's disparate impact both with respect to generic credit scores used for credit granting as well as insurance scoring specifically. It is important to note, as more fully discussed in Section V below, that a practice might be considered discriminatory because of its disparate impact on a minority group, even if the entity engaged in the practice did not have the intent to discriminate.

### A. General Credit Scoring Studies

The first study on the issue of race and credit scores came from home mortgage giant Freddie Mac. This study issued in 1994 found that African Americans were three times as likely to have FICO scores below 620 (a typical threshold for a "bad" credit score) as were whites. The same study showed that Hispanics are twice as likely as whites to have FICO scores under 620.<sup>39</sup>

During the mid-1990s, Fair Isaac conducted its own study of the relationship between scores and race, in response to concerns over disparate impact. Fair Isaac analyzed 800,000 consumer credit files to see how they performed over a two year period. Fair Isaac also used U.S. Census data to determine if the consumers lived in "high minority areas," employing neighborhood as a proxy for race. Fair Isaac's report found that its scoring models were equally predictive for consumers living in minority neighborhoods as in white neighborhoods. However, this same analysis also clearly showed that consumers living in minority neighborhoods had lower overall credit scores. For

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<sup>39</sup> Freddie Mac, *Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families*, September 1996, at 27.

example, over one quarter of consumers in minority neighborhoods scored under 620 while less than 14% of consumers in white neighborhoods scored that low.<sup>40</sup>

A few years later, researchers at the University of North Carolina analyzed the credit scores of 5,500 borrowers who had received community reinvestment mortgages. This analysis showed that one-third of African Americans in this pool had credit scores under 620, as compared to only 15 percent of whites. Furthermore, the study found that another one-third of African Americans had credit scores between 621 and 660 (as compared to 20% of whites), which means that two-thirds of African Americans in this pool had what is considered marginal or poor credit.<sup>41</sup>

In addition to having lower credit scores, minority consumers are also more likely to lack the credit history necessary to even generate a credit score, because they are less likely to have those forms of traditional credit that get reported to the credit bureaus. The University of North Carolina study discussed above found that 22% of Hispanics did not have enough of a credit history to generate a credit score, as opposed to fewer than 5% of whites.<sup>42</sup>

A study conducted by Federal Reserve Board researchers in 2003-2004 of over 300,000 credit history files found that fewer than 40% of consumers who lived in high minority neighborhoods had credit scores over 701, while nearly 70% of consumers who lived in mostly white neighborhoods had scores over 701. Furthermore, consumers living in minority and lower-income neighborhoods experienced errors or omissions in credit data more frequently.<sup>43</sup>

One of the most striking analyses of credit scoring disparities comes from a study published by the Joint Center for Housing Studies at Harvard University.<sup>44</sup> This study was based on a simulation of credit scores using a set of 200,000 credit files purchased by the Federal Reserve Board, matched with data from the triennial Survey of Consumer Finances. Researchers found that, for the period of 1989 to 2001, the median credit score had increased slightly for the general population. However, this increase masked a tremendous divergence in credit scores during that same period of time.

The study's researchers observed that the median credit score for whites increased significantly during the 1990s, from 727 to 738, while the median credit score for African Americans dropped from 693 to 676. The median score dropped even more for Latinos, from 695 to 670. The percentage of African Americans with credit scores under 660 (which is considered the cut off for "good credit") grew from 27% to 42% and for Latinos it grew from 29% to 49%, while among whites it rose only slightly from 17% to 19%.

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<sup>40</sup> Fair, Isaac & Co., *The Effectiveness of Scoring on Low-to-Moderate Income and High-Minority Area Populations*, Aug. 1997.

<sup>41</sup> Roberto G. Quercia, Michael A. Stegman, Walter R. Davis and Eric Stein, *Performance of Community Reinvestment Loans: Implications for Secondary Market Purchases*, in *Low Income Homeownership: Examining the Unexamined Goal* (Nicolas P. Retsinas and Eric S. Belsky, eds. 2002), at 363: Table 12-7

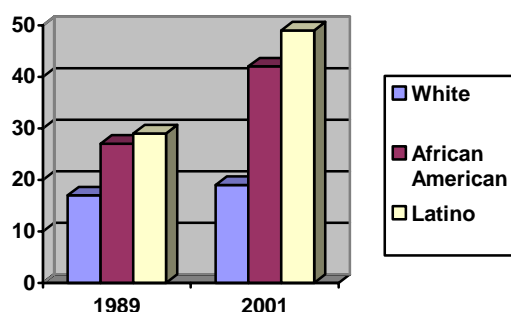
<sup>42</sup> *Id.*

<sup>43</sup> Robert B. Avery, Paul S. Calem, and Glenn B. Canner, *Credit Report Accuracy and Access to Credit*, Federal Reserve Bulletin, Summer 2004, at 313 (Table 2).

<sup>44</sup> Raphael W. Bostic, Paul S. Calem, and Susan M. Wachter, *Hitting the Wall: Credit as an Impediment to Homeownership*, Joint Center for Housing Studies of Harvard University, February 2004.



**Table D: Percentage of population with credit scores under 660, by race**



The most recent study showing a disparate impact in credit scoring comes from the Brookings Institution.<sup>45</sup> This study found that counties with relatively high proportions of racial and ethnic minorities are more likely to have lower average credit scores than predominately white counties. In the counties with a very low typical score (scores of 560 to 619), Brookings found that about 19 percent of the population is Latino and another 28 percent is black. On the other hand, the counties that have higher typical credit scores tend to be essentially all white counties. In particular, Brookings noted that in counties with average credit scores between 700 and 719, only about 5.1 percent of the population was Latino and just 1.1 percent was black. The study's author did caution that his finding was not evidence of bias, but "point[ed] to an association, which frankly is not very well understood..."

An important study on the statistical disparities in credit scoring by race is due (actually overdue) to be issued by the federal government. The Fair and Accurate Credit Transactions Act of 2003 required the Federal Reserve Board, Federal Trade Commission, and the U.S. Department of Housing and Urban Development to study the issue credit scoring and disparate impact in both the credit and insurance context, and to issue a report to Congress.<sup>46</sup>

In addition to racial disparities, there appears to be a growing credit scoring "gap," in which the divide between "good" and "bad" scorers seems to be growing, reflecting an increasing gulf between the credit haves and have-nots. For example, the Brookings Institution study found that counties with lower average credit scores saw a decline in those scores over a five year period of 17% on average, while counties with higher average scores saw them improve slightly.<sup>47</sup> This trend suggests that credit scores are "path dependent," i.e., low scoring consumers tend to see their scores decline while high scorers see them improve. The Brookings report expressed concern that this trend pointed to a "potentially ruinous fiscal cycle" for consumers with low credit scores. The Harvard Joint Center for Housing Studies study revealed similar results, finding that the median credit score for the top quintile of income increased significantly during the 1990s, from 729 to 754, while the median credit score for the bottom quintile dropped from 703 to 688.<sup>48</sup> Moreover, the percentage

<sup>45</sup> Matt Fellowes, *Credit Scores, Reports, and Getting Ahead in America*, Brookings Institution, May 2006.

<sup>46</sup> Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, § 215 (2003).

<sup>47</sup> Matt Fellowes, *Credit Scores, Reports, and Getting Ahead in America*, Brookings Institution, May 2006.

<sup>48</sup> Raphael W. Bostic, Paul S. Calem, and Susan M. Wachter, *Hitting the Wall: Credit as an Impediment to Homeownership*, Joint Center for Housing Studies of Harvard University, February 2004.

of consumers who scored under 660, and thus have marginal or worse credit, increased from 19% to 25% of the overall population.

### ***B. Insurance Scoring Studies of Race & Scores***

A number of state insurance commissions have conducted studies on the relationship between insurance scores and race, as well as gender, age, and income. While the first few studies were not conclusive, the most recent studies showed significant racial disparities similar to those found in the studies of traditional credit scoring.

The first few studies did not produce conclusive results. A study conducted by the Virginia Bureau of Insurance concluded that credit scoring would not be an effective tool for an insurer to redline out minorities, which would be disparate treatment; however, this study did not report findings on disparate impact.<sup>49</sup> In 2003, the Washington State Insurance Commissioner issued a study that showed a correlation between insurance scores and income. However, its findings regarding the racial impact of insurance scoring were inconclusive, primarily because of the small number of minorities sampled from Washington State's relatively homogeneous population.<sup>50</sup>

A Maryland study showed a correlation between race, income and insurance score, finding that in Baltimore City, the percentage of residents with high credit scores decreased as the percentage of minorities and lower-income households increased in a neighborhood. However, because the study used data prior to the passage of Maryland's statute regulating insurance scoring, the Maryland Insurance Administration declined to conclude that there was sufficient data to determine whether the use of insurance credit scores had an adverse impact on low-income or minority populations.<sup>51</sup>

In early 2004, the Missouri Department of Insurance released the first comprehensive study of race and insurance scoring to show definitive disparities.<sup>52</sup> The Missouri study found a stunning correlation between insurance scores and race, as well as income, age, marital status, and educational attainment. Using credit score data aggregated at the ZIP code level collected from the highest volume insurers in Missouri, the study found:

- Insurance scores were significantly worse for residents of high-minority ZIP codes. The average consumer in an "all minority" neighborhood had a credit score that fell into the 18.4th percentile, while the average consumer in a "no minority" neighborhood had a credit score that fell into the 57.3rd percentile – a difference of 38.9 percentile points.
- Insurance scores were significantly worse for residents of low-income ZIP codes. The average consumer in the poorest neighborhood had a credit score 12.8 percentile points lower than residents in the wealthiest communities.

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<sup>49</sup> Va. Bureau of Ins., *Report on the Use of Credit Reports in Underwriting to the State Commerce and Labor Committee of the General Assembly* (Dec. 1999). For an explanation of the difference between disparate impact & disparate treatment here, see section V below.

<sup>50</sup> Dave Pavelchek & Bruce Brown, Office of Wash. State Ins. Comm'r, *Effect of Credit Scoring on Auto Insurance Underwriting and Pricing* (Jan. 2003).

<sup>51</sup> Md. Ins. Admin., *Report on the Credit Scoring Data of Insurers in Maryland* (Feb. 2004).

<sup>52</sup> Brent Kabler, *Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri*, Missouri Department of Insurance – Statistics Section, January 2004.

- The correlation between race (high minority neighborhoods) and credit scores remained even after eliminating other variables, such as income, education, marital status, and unemployment. Residency in a minority concentration neighborhood proved to be the single most reliable predictor of credit scores.
- The gap in credit scores translated to the individual level. The average gap between the percentage of minorities with poor scores and non-minorities with poor scores was 28.9 points. The gap between lower-income and higher-income households was 29.2 percentage points.

The author and researcher of the Missouri study concluded that “the evidence appears to be credible, substantial, and compelling that credit scores have a significant disproportionate impact on minorities and on the poor.”

About a year later, the Texas Department of Insurance issued a study with similar findings.<sup>53</sup> Instead of using geographic neighborhood as a proxy for race, the Texas study was able to determine the actual race of policyholders by using motor vehicle records for approximately 2 million consumers. The Texas study found dramatic disparities by race, finding African Americans and Hispanics were over-represented in the lower credit score categories and under-represented in the better credit score categories.

- African Americans constituted 33% of consumers with the worst scores and only 2% of the consumers with the best scores. African Americans were about 13% of the population of the policyholders sampled.
- Hispanic consumers constituted 28% of consumers with the worst scores and only 5% of consumers with the best scores. About 19% of the population of the policyholders sampled was Hispanic.
- In total, African Americans and Latinos constituted over 60% of consumers having the worst credit scores but fewer than 10% of those having the best scores. (Asian Americans had scores that were the same or slightly worse than whites.) The Texas study concluded there was a consistent pattern of differences in credit scores among racial and ethnic groups, with whites and Asian Americans faring better than African Americans and Hispanics.
- The Texas study also found disparities by income, though they were less dramatic than those for race. The average credit scores for upper income consumers were better than those for lower and moderate income populations. Additionally, the moderate income populations tended to be over-represented in the worse than average credit score categories and under-represented in the better than average credit score categories.

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<sup>53</sup> Texas Department of Insurance, *Report to the 79th Legislature - Use of Credit Information by Insurers in Texas*, December 30, 2004.

### *C. A Less Discriminatory Alternative*

As we have noted, the difficult issue with credit scoring is that while it has a disparate impact, it is predictive in the credit context and claimed to be predictive in an insurance context as well. Thus, our society is faced with the decision of whether to permit the employment of a useful tool knowing that it not only disproportionately hurts minorities, but also perpetuates a historical legacy of discrimination.

One possible solution to this quandary is the idea of the “less discriminatory alternative” from civil rights law, which is discussed in Section V below. In disparate impact cases, a plaintiff can argue that a practice is discriminatory even if the defendant did not intend to discriminate. The defendant can then defend the practice if it can show a business necessity for the practice. If the defendant makes this showing, the plaintiff can still prove discrimination by demonstrating there is another equally usefully tool that can be used to fulfill the same necessity but that tool has less of a discriminatory impact on minorities.

There is evidence that such tools exist. For insurance, at least one study has found that formulas using attributes other than credit score yield almost the same correlations with loss ratios as formulas that use credit scores.<sup>54</sup> The settlement of a major discrimination lawsuit against Allstate resulted in that company implementing a new credit scoring algorithm which supposedly results in less disparate impact to minorities.<sup>55</sup>

In the credit granting context, researchers have shown evidence that the credit scoring models themselves could be modified so as to reduce racial disparities, at least for credit granting purposes.<sup>56</sup> Ironically, such modifications would need to actively take race into account. For example, one modification proposed by researchers would require including minority status as a “control variable” during the development of a credit scoring model.<sup>57</sup>

Taking race into account to eliminate racial disparities is not a new concept in civil rights law. As Supreme Court Justice Harry Blackmun noted, “In order to get beyond racism, we must first take account of race. There is no other way.”<sup>58</sup>

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<sup>54</sup> Wayne D. Holdredge and Katharine Barnes, *Good News, Bad News or Both?*, Tillinghast-Towers Perrin, February 2003.

<sup>55</sup> *DeHoyos v. Allstate Corp.*, 240 F.R.D. 269 (W.D. Tex. 2007).

<sup>56</sup> Michael LaCour-Little and Elaine Fortowsky, *Credit Scoring and the Fair Lending Issue of Disparate Impact* in Credit Scoring for Risk Managers: The Handbook for Lenders (Elizabeth Mays ed. South-Western Educational Pub. 2003); Elaine Fortowsky and Michael LaCour-Little, *Credit Scoring and Disparate Impact* (Dec. 2001), available at <http://fic.wharton.upenn.edu/fic/lacourpaper.pdf>.

<sup>57</sup> *Id.* at 20.

<sup>58</sup> *University of California Regents v. Bakke*, 438 U.S. 265, 98 S. Ct. 2733 (1978).

## V. LEGAL STATUS OF INSURANCE SCORING

In this section, we review both the current legal status of insurance scoring and the challenges actually filed or potentially possible using anti-discrimination laws.

### A. *State Insurance Laws*

Many states have passed legislation regarding the practice of insurance scoring.<sup>59</sup> Most of these statutes are based on a model law developed by the National Conference of Insurance Legislators (NCOIL).<sup>60</sup> The NCOIL model law permits insurance scoring and is viewed positively by the insurance industry.<sup>61</sup> It does contain some protections for consumers, such as prohibiting insurers from treating negatively the fact that a consumer has no credit cards or has medical bills sent to a collection agency. However, the enactment of the NCOIL model in many states is seen by advocates as anti-consumer, because it either permitted insurance scoring where it had not been permitted before, or at a minimum, legitimized the practice and prevented a stronger ban from being enacted.<sup>62</sup> State insurance regulators have attempted to rein in insurance credit scoring as well.<sup>63</sup>

### B. *Discrimination Challenges to Insurance Credit Scoring*

The dramatic racial disparities in credit scoring raise the obvious question whether the practice can be challenged as discriminatory. The answer to this question is complex and depends on whether the product at issue is credit, homeowner's insurance, or auto insurance.

There are two main types of discrimination theories under civil rights law - disparate treatment and disparate impact (or the "effects" test). Disparate treatment occurs when a business or employer treats a person differently on the basis of race or another prohibited basis (gender, age, religion, etc.). Disparate impact occurs when a business's policy or practice, neutral on its face, has a disproportionate negative impact on a protected group. Under this theory, the business's motive in treating applicants differently might not be race or another prohibited basis, but the effect is to adversely impact a particular protected class.

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<sup>59</sup> For a summary of some of these laws, see National Consumer Law Center, Fair Credit Reporting, Appendix H, (6th ed. 2006).

<sup>60</sup> National Conference of Insurance Legislators, *Model Act Regarding Use Of Credit Information In Personal Insurance*, November 22, 2002.

<sup>61</sup> National Ass'n of Mut. Ins. Cos., *NAMIC's State Laws and Legislative Trends State Laws Governing Insurance Scoring Practices*, undated, available at [www.namic.org/reports/credithistory/credithistory.asp](http://www.namic.org/reports/credithistory/credithistory.asp).

<sup>62</sup> See Testimony of Birny Birnbaum, Center for Economic Justice, Before the Colorado House Finance Committee, February 18, 2004, available at <http://www.cej-online.org/bb%20co%20test%20040218.pdf>.

<sup>63</sup> See, e.g., Florida Office of Insurance Regulation, *Use of Credit Reports and Credit Scores by Insurers*, Informational Memorandum OIR-06-10M, May 22, 2006, available at <http://www.florir.com/Memoranda/OIR-06-10M.pdf> (last visited June 2007) (requires insurers to demonstrate that their use of credit reports and credit scores does not disproportionately affect persons of any race, color, religion, marital status, age, gender, income, national origin, or place of residence). However, an administrative law decision has forced the Florida regulator to propose a new rule. The Michigan Insurance Commissioner attempted to ban the use of insurance credit scores; however, that rule was struck down by a Michigan court. *Michigan Judge Shoots Down Proposed Credit-Scoring Ban*, BestWire Services, April 26, 2005.

## 1. Elements of a disparate impact challenge

Only certain anti-discrimination laws allow for a disparate impact challenge to be brought. In the credit area, the Equal Credit Opportunity Act (ECOA) prohibits racial discrimination in the granting of credit in general, while the Fair Housing Act (FHA) prohibits discrimination in mortgage lending. Both of these laws permit a disparate impact claim to be brought.<sup>64</sup> However, the ECOA probably does not cover discrimination in insurance.<sup>65</sup> The FHA does apply to insurance as well as credit, but only where housing is involved.<sup>66</sup>

In order to make out a “prima facie” or initial case for disparate impact, the plaintiff must:

- **Identify** a specific policy (e.g., use of credit scores) that has a discriminatory effect;
- **Show a disparate impact** of the policy on a group protected by anti-discrimination laws; and
- **Show causation**, i.e. a link between the policy and the disparate impact.

Making out a prima facie case of disparate impact does not necessarily mean that a practice violates the ECOA or FHA. Under the disparate impact analysis, a creditor or company can defend its policy by showing a “business necessity.” Courts have articulated a number of different tests and definitions of “business necessity,” including “compelling need,” “manifest relationship,” “legitimate, non-discriminatory rationale,” and “demonstrably necessary.”<sup>67</sup>

With respect to ECOA, the Federal Reserve Board (which interprets that law) has indicated that creditors can defend a policy that produces disparate impact by showing “a demonstrable relationship between” the challenged policy and “creditworthiness.”<sup>68</sup> Thus, if a variable or factor in a credit scoring model causes a disparate impact, but is “demonstrably related” to creditworthiness, it may be permissible under fair lending laws. The variable or factor, however, must be related to creditworthiness and not some other reason, such as generating maximum profit.

Note that the business necessity analysis may differ for scoring models used for credit versus insurance. Credit scores are based on credit histories, and supposedly measure the consumer’s likelihood of repaying a loan. There is an understandable connection to their use to measure creditworthiness, and thus a “demonstrable relationship” argument can be easily made. While there might be some correlation between insurance credit scores and loss history, there has been no definitive understandable reason provided as to why credit scores are a good measure of “insurance worthiness.” However, one of the first courts to deal with the issue did hold that insurance scoring’s supposed predictiveness constitutes a business necessity, as discussed below.<sup>69</sup>

Furthermore, there is one final step in a disparate impact analysis -- whether there is a less discriminatory alternative that can be used to meet the “business necessity.” As discussed above,

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<sup>64</sup> National Consumer Law Center, Credit Discrimination, § 4.3.1 (4th ed. 2005 and Supp.).

<sup>65</sup> *Id.* at § 7.3.4.1.

<sup>66</sup> *Id.* at § 7.3.4.2.

<sup>67</sup> *Id.* at § 4.3.2.5.

<sup>68</sup> Official Staff Commentary to Regulation B, 12 C.F.R. § 202.6(a)-2.

<sup>69</sup> *Owens v. Nationwide Mutual Insurance Co.*, 2005 WL 1837959 (N.D. Tex. Aug. 2, 2005).

there are suggestions that viable alternatives to credit scoring exist in both the credit and insurance context that are less discriminatory toward minorities.

## 2. Is a disparate impact analysis available in insurance cases?

A disparate impact analysis is clearly available to challenge the use of credit scoring in the credit granting arena.<sup>70</sup> With respect to insurance, the availability of this theory is mixed, and depends on whether the product is homeowners versus automobile insurance.

Homeowners insurance is covered by one of the federal anti-discrimination laws, the Fair Housing Act.<sup>71</sup> As the Seventh Circuit Court of Appeals aptly noted: “no insurance, no loan; no loan, no house.”<sup>72</sup> Thus, the racial disparities created by insurance scoring in homeowners insurance could be challenged under the Fair Housing Act. To date, the leading major legal challenge brought against insurance scoring using this theory is *DeHoyos v. Allstate Corp.*, 345 F.3d 290 (5th Cir. 2003). This case ultimately resulted in a settlement that required Allstate to implement a new credit scoring algorithm which supposedly results in less disparate impact to minorities, and to refund from \$50 to \$150 to policyholders who filed a claim and whose scores rose due to the new formula.<sup>73</sup>

The initial challenge that the plaintiffs in *DeHoyos* had to overcome was the McCarran-Ferguson Act. Enacted in 1945, McCarran-Ferguson prohibits any federal law interpretation that invalidates, impairs, or supersedes any state insurance law unless the federal law specifically relates to insurance regulation.<sup>74</sup> The Fifth Circuit in *DeHoyos* held that applying the Fair Housing Act and anti-discrimination laws did not ‘impair’ any Texas or Florida insurance law. In *DeHoyos*, however, there was no state insurance law explicitly allowing or condoning insurance scoring at that time. A potential issue is that many states (including Texas after the *DeHoyos* decision) have enacted laws allowing for or condoning credit scoring.<sup>75</sup> However, every federal Court of Appeal considering the issue has rejected the argument that McCarran-Ferguson preempts an insurance discrimination lawsuit based on federal civil rights laws.<sup>76</sup>

The next hurdle for a disparate impact challenge to the use of credit scores in homeowners insurance is to counter the supposed predictiveness of scoring. At least one federal District Court has already accepted at face value the argument that the predictiveness of credit scores presents an adequate “business necessity” to withstand a disparate impact challenge.<sup>77</sup> The court engaged in little analysis of whether credit scores are truly predictive and why a credit history is related to the “insurance-worthiness” of a consumer. The court also accepted the insurance company’s claim that without the use of scoring, it would be at a competitive disadvantage. This latter reason seems

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<sup>70</sup> For a discussion of cases that have challenged credit scoring, see National Consumer Law Center, Credit Discrimination, § 6.4.4 (4th ed. 2005 and Supp.).

<sup>71</sup> *Id.* at § 7.3.4.2.1.

<sup>72</sup> *N.A.A.C.P. v. Am. Family Mut. Ins. Co.*, 978 F.2d 287, 297 (7th Cir. 1992).

<sup>73</sup> *DeHoyos v. Allstate Corp.*, 240 F.R.D. 269 (W.D. Tex. 2007).

<sup>74</sup> 15 U.S.C. § 1012(b).

<sup>75</sup> Tex. Ins. Code art. 21.49-2U. See William Goddard, *Swimming in the Wake of DeHoyos: When Federal Courts Sail Into Disparate Impact Waters, Will State Regulation of Insurance Remain Above the Waves?* 10 Conn. Ins. L. J. 369 (2003-2004).

<sup>76</sup> National Consumer Law Center, Credit Discrimination, § 7.3.4.2.2 (4th ed. 2005 and Supp.).

<sup>77</sup> *Owens v. Nationwide Mutual Insurance Co.*, 2005 WL 1837959 (N.D. Tex. Aug. 2, 2005). The court also held that the supposed predictiveness of insurance scores presented a “legitimate nondiscriminatory reason” to rebut a prima facie showing of disparate treatment under the McDonnell Douglas test.

questionable, because it implies that discrimination cannot be challenged if it is an industry standard, *i.e.*, if everyone discriminates, no one can be held accountable for discrimination.

Note that the plaintiff in this case appears to have failed to present evidence or an argument regarding a less discriminatory alternative. As discussed in Section IV.C above, there is evidence that less discriminatory alternatives exist, and this may be the best argument both legally and on a policy basis to argue against the form of insurance scoring now used by the industry.

As for automobile insurance, there may be few avenues to bring a disparate impact challenge to the use of credit scoring in that context. Discrimination in auto insurance is not generally covered under any federal law. Instead, one would need to look at the anti-discrimination provisions of state insurance laws. While approximately 40 states have anti-discrimination provisions in their insurance laws, many of these states do not allow for consumers to bring a private lawsuit under those laws.<sup>78</sup> Furthermore, there is no clear authority that these laws provide for disparate impact challenges.

One other potential source of legal challenge to insurance scoring might be state laws that prohibit discrimination by ‘places of public accommodation.’ However, the availability of a disparate impact challenge under these state laws is mixed at best.<sup>79</sup> Furthermore, it is unclear whether state statutes would consider an insurance company a ‘place of public accommodation.’<sup>80</sup> Finally, there may be county or municipal human relations laws that might cover auto insurance and provide a disparate impact challenge.

### ***C. Disparate Treatment***

Finally, one should not rule out the possibility of a disparate treatment analysis in challenging insurance scoring.<sup>81</sup> Given the very well-documented and well-publicized, controversial link between credit scores and race, it would not be unthinkable to argue that insurers may be tempted to use credit scoring exactly for the reason that it would screen out minorities from their pool of insured.

There are two methods to prove disparate treatment: direct proof and circumstantial evidence. Since very few businesses these days openly admit outright discrimination, many disparate treatment cases will rely on a circumstantial evidence test developed in the employment law area called the McDonnell Douglas test.<sup>82</sup> The McDonnell Douglas test, as adapted in the credit (or insurance) context, requires the plaintiff to show:

- membership in a protected class;

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<sup>78</sup> National Consumer Law Center, *Credit Discrimination*, § 7.3.4.4 (4th ed. 2005 and Supp.).

<sup>79</sup> For example, Minnesota, the District of Columbia and New York City civil rights laws permit disparate impact challenges. *Paper v. Rent-A-Wreck*, 463 N.W.2d 298 (Minn. Ct. App. 1991) (Minnesota); *Mitchell v. DCX, Inc.* 274 F.Supp.2d 33 (D.D.C. 2003) (District of Columbia); *Levin v. Yeshiva University*, 754 N.E.2d 1099 (N.Y. 2001) (New York City). California and Ohio public accommodations laws do not. *Harris v. Capital Growth Investors XIV*, 805 P.2d 873 (Cal. 1991) (California); *Derungs v. Wal-Mart*, 141 F.Supp.2d 884 (S.D. Ohio 2000) (Ohio).

<sup>80</sup> For example, under federal law, Title II of the Civil Rights Act of 1964 also prohibits discrimination by places of public accommodation; however, an insurance company does not fit into the definition of public accommodation in that statute. 42 U.S.C. § 2000a.

<sup>81</sup> A disparate treatment claim could be brought under the Civil Rights Acts of 1866. 42 U.S.C. §§ 1981 and 1982.

<sup>82</sup> This test is derived from the U.S. Supreme Court’s decision in *McDonnell Douglas Corp. v. Green*, 411 U.S. 792 (1973).



- application for credit (or insurance) for which the plaintiff was qualified;
- rejection despite qualification; and
- that the defendant continued to approve credit for similarly qualified applicants.<sup>83</sup>

There is an obvious circularity in the McDonnell Douglas test – what if a criterion being used for qualification is itself the alleged discriminatory conduct (*e.g.*, in the context of discrimination against public assistance recipients, what if the criterion for qualification is having employment) or a pretext for discrimination (as credit scores might be). Can that factor be included in analyzing whether the plaintiff is qualified for the credit or insurance? At least one court has held that a low credit score means that the plaintiff will not be able to make out a *prima facie* case under the modified McDonnell Douglas test.<sup>84</sup>

Also, the modified McDonnell Douglas test only applies when a consumer is rejected for credit or insurance. If a consumer receives the credit or insurance, a reverse redlining analysis is required. In that context, the applicable test is:<sup>85</sup>

- Plaintiff is a member of a protected class;
- She applied for and was qualified for credit;
- Credit was given to her on grossly unfavorable terms; and
- The lender continues to provide loans to other applicants with similar qualifications but on significantly more favorable terms.

Again, a critical issue is whether the disputed criteria (*i.e.*, credit scoring) can be used as a “similar qualification” to compare minority and white applicants.

## VI. REVERSE SOCIAL ENGINEERING THROUGH CREDIT SCORING

Credit scoring has become the numerical expression of the racial economic divide and wealth gap in this country. As such, it essentially serves as a proxy for certain behaviors that our society has sought to discourage these past few decades, including -

- redlining (refusing to make loans to or insure communities of color)
- reverse redlining (charging more to communities of color)
- denying services to low-income communities
- charging more to low-income communities.

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<sup>83</sup> National Consumer Law Center, Credit Discrimination, § 4.2.3.1 (4th ed. 2005 and Supp.).

<sup>84</sup> Curley v. JP Morgan Chase Bank, N.A., 2007 WL 1343793 (W.D. La. May 7, 2007).

<sup>85</sup> National Consumer Law Center, Credit Discrimination, § 4.2.3.3 (4th ed. 2005 and Supp.).

From a social policy standpoint each of these behaviors is considered destructive and reprehensible. They are also behaviors that can be highly profitable. Thus, the ability to use credit scoring is a way for lenders, insurers, employers, and others to reap the economic benefits of racial and economic discrimination without having to admit they are discriminating and without being barred from doing so by anti-discrimination laws. As even a high-level Fair Isaacs official admitted:

Unfortunately, income, property, education, and employment are not equally distributed by race/national origin in the United States. Since all of these factors influence a borrower's ability to meet financial obligations, it is unreasonable to expect an objective assessment of credit risk to result in equal acceptance and rejection rates across socioeconomic or race/national origin lines. By definition, low-income borrowers are economically disadvantaged, so one would not expect their score distributions to mirror those of higher-income borrowers.<sup>86</sup>

The effect of credit scoring is to create a spiraling down situation, in which minority and low-income consumers are denied credit and insurance, or forced to pay much more for it. The drain on income affects their ability to pay their current bills, let alone build assets to move ahead. These communities fall further and further behind while wealthy white communities get a break on their credit and insurance needs. Credit scoring widens and deepens the gap between haves and have-nots.<sup>87</sup>

In insurance, credit scoring runs counter to the fundamental concept of spreading the risk of loss. Credit scoring results in the insurance companies being able to shed consumers they don't want by denying them coverage or setting prices so high as to be unaffordable. What is the sense of an insurance system that permits insurance companies to cherry pick only well-to-do suburban Caucasians as consumers?

Finally, some might think it is an unfortunate fact that blacks and Latinos are less wealthy, but "that's life" and it should be no reason to change social policy. Groundbreaking research during the last several years shows, however, that the wealth gap is no accident. The wealth gap was created by policies that deliberately benefited whites while excluding African Americans and other racial minorities.<sup>88</sup> For example, during the early years of the Social Security program, pensions were denied for many years to domestic and agricultural workers —two of the most significant black occupations.<sup>89</sup> Unemployment insurance and the minimum wage did not apply to domestic workers or farm workers either.<sup>90</sup> Another striking example is that, of the 3,229 GI Bill-guaranteed loans for homes, businesses, and farms made in Mississippi in 1947, only two were offered to black veterans.<sup>91</sup>

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<sup>86</sup> Fed. Reserve Bank of Boston, *Perspectives on Credit Scoring and Fair Lending: A Five-Part Article Series* (pt. 1), Communities & Banking, Spring 2000, at 2 (statement of Statement of Peter L. McCorkell, Executive Vice President & General Counsel, Fair Isaac).

<sup>87</sup> Indeed, some insurance companies have decided to skip the step of credit scoring and go straight to directly discriminating against low-income consumers. For example, at least one insurance company has adopted guidelines that directly base insurance rates and eligibility on the factors of education and occupation. Press Release, *GEICO Ties Insurance Rates to Education, Occupation*, Consumer Federation of America, March 20, 2006.

<sup>88</sup> See Meizhu Lui, *et al.*, *The Color of Wealth: The Story Behind the U.S. Racial Wealth Divide* (The New Press 2006).

<sup>89</sup> *Id.* at 92-93.

<sup>90</sup> *Id.*

<sup>91</sup> *Id.* at 97.

In short, the racial disparities of credit scoring perpetuate the racist policies of decades past. The playing field was never level, and credit scoring preserves that advantage for whites and the well off. The use of credit scoring given the historical legacy of discrimination would be akin to excluding a sports team from playing games during the first half of a season, considering all those games to be losses, calculating the team's rankings on the basis of those "losses," and then telling the team they could not participate in the playoffs because of their shoddy record.

## **VII. POLICY RECOMMENDATIONS**

Credit scores represent a numerical reflection of the enormous racial wealth gap in this country. As such, their use in insurance - which determines whether a person will be able to own a home or afford to drive a car - perpetuates racial and economic inequality. State legislatures can and should have a role in limiting the use of insurance scores by:

- Enacting laws to ban insurance scoring.
- If insurance scoring continues to be permitted, regulators should require the development and use of scoring models that have less of a discriminatory impact on minority groups. After all, it appears that insurers have tools equally effective as credit scores to control for loss. Regulators should consider requiring insurers and scoring companies to take measures that actively reduce the effect of past racism.

## APPENDIX A

### Description of Excess Premium Analysis in Tables 1, 2 and 3

This analysis asks: what would premiums have been if insurers had charged rates that were reasonable in relation to actual losses incurred for private passenger automobile insurance?

Tables 1 and 2 show the analyses separately for private passenger automobile liability and physical damage coverages. Liability coverages include bodily injury and property damage liability, personal injury protection, medical payments and uninsured and underinsured motorists' coverages. Physical damage coverages include collision and comprehensive coverages. Table 3 provides a summary of Tables 1 and 2 for all private passenger automobile insurance combined.

#### *Description of Data Sources, Data Elements and Calculations for Tables 1 and 2*

Line 1 is the pure loss ratio – the ratio of incurred losses to earned premium. Earned premium is essentially the premium associated with the coverage in force during the calendar year. For example, if an insurer issued a six month policy on October 1 with a premium of \$1,000, the earned premium for the year in which the policy was issued would be about \$500 and also about \$500 in the following year.

Incurred losses are essentially the insurer's estimate of losses it will eventually pay out for policies issued during the calendar year. Incurred losses are losses actually paid during the year plus changes in loss reserves during the year. If insurers are estimating reserves accurately, losses eventually paid for a particular year's worth of policies should equal the incurred losses initially established for that year's worth of policies. Insurers have, however, overstated loss reserves for private passenger automobile insurance frequently in years where incurred loss percentages are high with the result that the ultimate payouts have been less than the initial estimates reflected in the ratio of incurred losses to earned premiums.

The data for the loss ratios come from the "Countrywide Direct" page of the Countrywide Profitability Results by Line section of the National Association of Insurance Commissioners *Report on Profitability by State by Line* for the years 1995 through 2005. These data are compilations of reports by insurance companies on the state pages of the statutory annual statement – Column 6, Direct Losses Incurred divided by Column 2, Direct Premiums Earned.<sup>92</sup> Year 2006 loss ratios were calculated from countrywide earned premium and incurred loss data compiled from the state pages. The raw data for all companies and all states were provided as a dataset by the NAIC. The 2006 data are preliminary. Earned premiums and incurred losses were compiled from the data and the loss ratios calculated. The NAIC is not responsible for any calculations or compilations developed from the data it provides.

Line 2 is the amount of loss settlement expense as a percentage of earned premiums as reported in the NAIC *Profitability Reports* on the same pages as the loss ratios in Line 1. The year 2006 percentage was assumed to be the average of the 2003 through 2005 three-year period.

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<sup>92</sup> The source of the data for homeowners insurance is the state page data from the statutory annual statement, as compiled by and reported in various issues of the *Property Insurance Report*.

Line 3 is the provision for fixed expenses, based on the decision by the Texas Insurance Commissioner in an industry-wide rate hearing in 1999 and 2000 – Commissioner’s Order 00-0909, Private Passenger and Commercial Automobile Insurance Benchmark Hearing, Docket 454-00-0408. Fixed expenses include Other Acquisition and General Expenses – which are reporting categories on the state pages described for Lines 1 and 2 – offset for a reduction for excess expenses and for income from installment fees. The actual amounts used are 8.56% for liability coverages and 8.54% for physical damage coverages

Line 4 is the provision for variable expenses, also based on the Texas Insurance Commissioner’s benchmark rate order cited in the Line 3 description. Variable expenses include commissions, taxes licenses and fees and the profit provision. The profit provision includes a reasonable return on capital offset by investment income earned by the insurer. The actual amounts used are 8.26% for liability coverages and 12.56% for physical damage coverages. The difference between the provisions for liability and physical damage coverages results from a greater profit provision for physical damage coverage because of less investment income earned for physical damage coverages than for liability coverages. The lesser investment income is a result of smaller reserves held for shorter periods of time and less capital per dollar of premium for physical damage coverage than for liability coverages – there is less money per dollar of premium to earn investment gains for physical damage coverages than for liability coverages.

Line 5 is the calculation of excessive premium as a percentage of the premium dollar. It is the sum of Lines 1, 2 and 3 divided by the number 1 less Line 4. If rates had been reasonable, this calculation would produce the value zero. The calculation specifically accounts for variable expenses as a percentage of premium with the result that variable expenses are a smaller dollar amount with a low loss ratio associated with excessive rates and premium.

Line 6 reports the direct premiums earned, and comes from the same page in the NAIC *Profitability Report* as the loss ratios in Line 1. Year 2006 loss ratios were calculated from countrywide earned premium and incurred loss data compiled from the state pages. The raw data for all companies and all states were provided as a dataset by the NAIC. The 2006 NAIC data are preliminary. Earned premiums and incurred losses were compiled from the data and the loss ratios calculated. The NAIC is not responsible for any calculations or compilations developed from the data it provides.

Line 7 is the calculation of excessive premiums in dollars, calculated by multiplying the percentage excessive in Line 5 times the earned premiums in Line 6.

Table 3 is the combination of Tables 1 and 2. Line 1 in Table 3 is the aggregate loss ratio for liability and physical damage coverages combined and is provided for information purposes. Line 1 is not used in the calculation of Lines 2 through 4 of Table 3. The data from Lines 1 and 2 come from the same sources as Lines 1 and 2 for Tables 1 and 2. Lines 3 and 4 in Table 3 are the sum of Lines 5 and 6 in Tables 1 and 2. Line 2 is calculated by dividing Line 4 by the difference between Line 3 and Line 4.

**Table 1: Private Passenger Automobile Liability**

	1999	2000	2001	2002	2003	2004	2005	2006
Incurred Loss / Earned Premium	67.6%	74.3%	76.6%	72.1%	66.4%	62.5%	62.3%	59.5%
Loss Settlement Expense / EP	14.4%	14.5%	14.5%	14.4%	14.0%	13.6%	14.0%	13.9%
Fixed Expense Provision	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%	8.6%
Variable Expense Provision	8.3%	8.3%	8.3%	8.3%	8.3%	8.3%	8.3%	8.3%
% Excessive	1.3%	-6.1%	-8.6%	-3.6%	3.0%	7.7%	7.5%	10.7%
Earned Premium (\$ 000)	69,666,735	69,766,221	73,779,662	80,712,942	88,836,953	93,790,088	95,669,288	96,276,656
Incurred Loss / Earned Premium	896,084	(4,273,884)	(6,369,467)	(2,920,939)	2,692,029	7,238,215	7,174,675	10,298,615

**Table 2: Private Passenger Automobile Physical Damage**

	1999	2000	2001	2002	2003	2004	2005	2006
Incurred Loss / Earned Premium	63.4%	67.3%	67.4%	61.3%	58.0%	53.1%	57.0%	55.6%
Loss Settlement Expense / EP	9.8%	10.0%	10.2%	9.7%	9.4%	9.4%	10.6%	9.8%
Fixed Expense Provision	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%
Variable Expense Provision	12.6%	12.6%	12.6%	12.6%	12.6%	12.6%	12.6%	12.6%
% Excessive	6.5%	1.8%	1.5%	9.0%	13.2%	18.8%	12.9%	15.4%
Earned Premium (\$ 000)	48,097,634	50,820,838	54,770,914	59,566,494	63,731,080	65,919,070	66,196,538	66,366,645
Incurred Loss / Earned Premium	3,135,367	929,933	814,298	5,381,694	8,381,832	12,363,595	8,554,676	10,246,451

**Table 3: Private Passenger Automobile Total**

	1999	2000	2001	2002	2003	2004	2005	2006
Incurred Loss / Earned Premium	65.9%	71.3%	72.7%	67.5%	62.8%	58.6%	60.1%	57.9%
% Excessive	<b>3.5%</b>	<b>-2.7%</b>	<b>-4.1%</b>	<b>1.8%</b>	<b>7.8%</b>	<b>14.0%</b>	<b>10.8%</b>	<b>14.5%</b>
Earned Premium (\$ 000)	117,764,369	120,587,059	128,550,576	140,279,436	152,568,033	159,709,158	161,865,826	162,643,301
Incurred Loss / Earned Premium	<b>4,031,451</b>	<b>(3,343,951)</b>	<b>(5,555,170)</b>	<b>2,460,755</b>	<b>11,073,861</b>	<b>19,601,810</b>	<b>15,729,351</b>	<b>20,545,066</b>