

Disparate Impact, Federal/State Tension, and the Use of Credit Scores By Insurance Companies

By Ian O'Neill*

I. INTRODUCTION

Efficient markets rely on the free flow of information. In virtually every financial market, key sources of that information are credit rating, credit reporting, and credit scoring companies. In addition, post-9/11 rules have made the use of credit reports for identity verification an absolute requisite in virtually every type of financial service transaction. Consider the U.S.A. PATRIOT Act's stricter anti-money laundering provisions and prohibitions on extending credit or financial services, including insurance, to any person listed on the Office of Foreign Assets Control list.

Despite the prevalence of credit rating and reporting, there is one area that is currently causing significant legal turmoil: the use of consumer credit scores as an actuarial factor in pricing consumer insurance products. To date, forty-eight states have taken some form of legislative or regulatory action to control or prohibit the use of credit scores by insurers.¹ In addition, plaintiffs in Louisiana and Texas have filed class-action lawsuits claiming that the practice is racially discriminatory and unconstitutional.² Several state governments have commissioned or completed significant studies looking into the issue

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¹NAMIC ONLINE, NAMIC'S STATE LAWS AND LEGISLATIVE TRENDS: STATE LAWS GOVERNING INS. SCORING PRACTICES 1 (2004), <http://www.namic.org/reports/credithistory/credithistory.asp> (last visited Oct. 24, 2006). (Pennsylvania and Vermont are the only two states that do not address this issue either by legislative or regulatory methods.)

² Dave Kaiser, *Credit-based Insurance Scoring Remains a Key Legislative, Regulatory Issue*, INS. JOURNAL 1 (November 7, 2005), available at <http://www.insurancejournal.com/magazines/southeast/2005/11/07/features/62355.htm> (last visited October 24, 2006).

at taxpayer expense.³ Hawaii has already banned the use of credit scores in pricing certain insurance products.⁴ Despite this opposition, “90% of automobile insurance companies nationwide, use credit scores as a means of setting rates.”⁵

This article examines the current legal turmoil surrounding the practice of using credit scores to price insurance products. Part I explains what a credit score is, how it is calculated, and the role it plays in the insurance marketplace. Part II examines the legal background of this contentious practice, from its inception in 1970 with the enactment of the Fair Credit Reporting Act, to the sudden surge in related litigation and legislative action within the past thirty-six months. Part III discusses the current debate surrounding the practice, including the most recent accusations that insurance scores constitute a novel form of “redlining” by insurance companies. These problems are weighed against the many benefits of credit scoring. Part IV proposes a solution based on federal preemption of state law.

II. AN INSURANCE SCORE PRIMER

A. What is a credit score and where does it come from?

A credit score or rating is a numerical calculation intended to represent the specific level of risk that a person or entity brings to a particular transaction. When used to rate businesses and financial institutions, credit scores predict factors such as financial stability, solvency, and risk of liquidation. In a similar manner, a consumer credit score is calculated to represent the particular level of risk that the individual consumer poses in a commercial transaction. Three national credit reporting companies maintain credit histories for more than

³ See, e.g., FRANK M. FITZGERALD, COMM’R, OFFICE OF FIN. AND INS. SERV., THE USE OF INS. CREDIT SCORING IN AUTO. AND HOME OWNERS INS.: A REPORT TO THE GOVERNOR, THE LEGISLATURE AND THE PEOPLE OF MICH. (2002) www.michigan.gov/documents/cis_ofis_credit_scoring_report_52885_7.pdf (discussing the use of credit history information within the scope of Michigan insurance laws and the Fair Credit Reporting Act).

⁴ HAW. REV. STAT. § 431:10C-207 (2005).

“No insurer shall base any standard or rating plan, in whole or in part, directly or indirectly, upon a person's race, creed, ethnic extraction, age, sex, length of driving experience, credit bureau rating, marital status, or physical handicap.”

⁵ GOAPPLY.COM, HOW CAN CREDIT SCORING AFFECT YOUR INSURANCE? (2004), <http://www.goapply.com/newsletters/20040715/insurance.cfm> (last visited April 30, 2006).

200,000,000 market-active adults in the United States: TransUnion, Experian and Equifax.⁶ These histories are compiled into credit reports. Credit scores are calculated by applying complex formulas, also known as statistical models, to specific information contained within the consumer's credit report.⁷ Unlike a traditional credit score, which is designed to predict the likelihood that a consumer will default on a financial obligation, an insurance score is designed to predict the likelihood that the insured will file a claim within a specific window of time. "An insurance credit score is a three digit number that represents a 'snapshot of that individual's risk level' based on a person's credit history at a particular point in time." The intent is that credit information can be put into a mathematical model that statistically predicts the probability of the insured filing a claim in the near future.

B. How insurers use credit scores

Underwriters have used credit information "for decades to help . . . decide whether to accept or reject applications for insurance."⁸ The Fair Credit Reporting Act ("FCRA") specifically authorized the use of insurance credit scores in 1970. As a result of recent advances in scoring technology, the practice has become widespread within the past few years. Today insurance companies use the scores as one factor in determining "if [a carrier] will offer a consumer a . . . residential insurance policy and how much to charge for the policy offered."⁹ Insurers use insurance scores "in a variety of ways—for underwriting (including rating tier selection), rating (or premium development), coverage eligibility, marketing, and payment plan eligibility."¹⁰ Under the FCRA and its successor, the Fair and Accurate Credit Transactions Act ("FACTA"), insurers may only use insurance scores as one factor among many, including motor vehicle records,

⁶ <http://www.transunion.com> (last visited Oct. 17, 2006). (For more information on how the three national credit reporting companies compile information, visit www.experian.com or www.equifax.com.)

⁷ Fitzgerald, *supra* note 3, at 4-5.

⁸ CREDIT SCORING: THE TOPIC, INSURANCE INFORMATION INSTITUTE 2 (2006), <http://www.iii.org/media/hottopics/insurance/creditscoring/>.

⁹ BIRNY BIRNBAUM, INSURERS' USE OF CREDIT SCORING FOR HOMEOWNERS INS. IN OHIO: A REPORT TO THE OHIO CIVIL RIGHTS COMM'N 9 (2003) <http://www.cej-online.org/creditscoringmainpage.htm> (follow "report for the Ohio Civil Rights Commission" hyperlink) (last visited Oct 16, 2006).

¹⁰ *Id.* at 1.

loss reports, and driver characteristics such as age, marital status, and vehicle usage.¹¹

C. Statistical Correlations—How credit data correlates to claim risk

At the core of the use of insurance scores is a claim by insurers that credit performance closely correlates to the likelihood of filing an insurance claim.

A study by EPIC Actuaries used a nationwide sample of nearly 2.7 million auto insurance policies to identify a correlation between an individual's insurance score and the individual's propensity to file a claim on an auto insurance policy.¹² According to the EPIC Actuaries' study, credit-based insurance scores were among the top three most predictive risk factors for each of the six types of coverage included in the study.¹³ EPIC found that as insurance scores increased, the average dollar cost of insurance claims decreased.¹⁴ The average dollar cost decreased in proportion to the decreasing number of claims filed.¹⁵ Specifically, EPIC found that for consumers with lower credit ratings, the dollar cost of insurance losses was as high as 48% above average; in contrast, for consumers with high credit scores, the dollar cost of insurance losses dropped to as low as 24% below average.¹⁶

In November 2004, the Texas Department of Insurance released a study that examined claims performance in a sample of approximately 150,000 policies in Texas. The study found that the 10% of consumers with the worst credit histories filed twice as many claims as those with scores in the top 10%.¹⁷ Specifically, the study

¹¹ Fair and Accurate Credit Transactions Act, 15 U.S.C.S. § 1681 (LexisNexis 2006).

¹² EPIC ACTUARIES, THE RELATIONSHIP OF CREDIT-BASED INS. SCORES TO PRIVATE PASSENGER AUTO. INS. LOSS PROPENSITY 4, 29 (2003), www.ask-epic.com/Publications/Relationship%20of%20Credit%20Scores_062003.pdf (last visited May 1, 2006).

¹³ *Id.* at 39.

¹⁴ *Id.* at 32.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ TEX. DEPT. OF INS., A STUDY OF THE USE OF CREDIT-BASED SCORES BY INS. CARRIERS (2005), <http://www.tdi.state.tx.us/reports/pdf/credit05sup.pdf> (last visited Oct. 22, 2006).

found that the average loss per auto policy for consumers with a 'worse' credit score was \$325, while the average loss for consumers with a 'better' score was only \$175. For homeowners' insurance loss ratios, the difference was even more significant: the average loss ratio for consumers with a 'worse' score was more than 200% higher than that of consumers with a 'better' credit score.¹⁸ Dividing consumers into deciles by credit score, the Texas Department of Insurance found that consumers in the lowest decile generated losses that were more than double the losses generated by consumers in the top decile.¹⁹

A third study conducted by the Casualty Actuarial Society also identified a strong link between credit score performance and insurance losses.²⁰ The group's study separated consumers by credit rating into four categories, ranging from those with unacceptable credit (category A) to those with excellent credit (category D).²¹ Those with the lowest credit ratings incurred losses 33% higher than the average losses of all groups combined, while those with the highest credit ratings incurred losses 25% lower than the combined average.²²

The use of credit scores in the underwriting process is based on three intuitive claims. First, the insurance industry claims that credit scores are indicative of personal responsibility because "it is intuitive and reasonable to believe that the responsibility required to prudently manage one's finances is associated with other types of responsible and prudent behaviors, for example proper maintenance of homes and automobiles and safe operation of cars."²³ Second, "it is intuitive and reasonable to believe that financially stable individuals are likely to exhibit stability in other areas of their lives."²⁴ Finally, credit scores are claimed to be indicative of "financial stress [that]

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ Robert P. Hartwig, *The Use of Credit Information In Personal Lines Underwriting*, INS. ISSUES SERIES, Vol. 1, No. 2, at 6, 16, available at <http://www.iii.org/media/hottopics/insurance/creditscoring/> (follow "White Paper: The Use of Credit Information in Personal Lines Insurance Underwriting" hyperlink). (last visited May 2, 2006) (discussing James E. Monaghan, *The Impact of Personal Credit History on Loss Performance in Personal Lines*, Casualty Actuarial Society, 2000).

²¹ *Id.* at 16.

²² *Id.*

²³ *Id.* at 11.

²⁴ *Id.*

could lead to stress, distractions or other behaviors that produce more losses, such as deferral of car or home maintenance.”²⁵

D. 2005 – Credit Scoring Makes News

Several highly publicized data breaches made 2005 an eventful year for the financial data reporting industry. Between February 2005 and March 2006 more than 56 million consumer credit files were reported lost or stolen.²⁶ This resulted from more than 100 separate data breaches.²⁷ As a result, credit scoring, credit reporting, and data privacy became high-profile issues, both in terms of public awareness and legislative activity. Due in large part to the public outrage generated by these high-profile breaches, credit scoring, in all its forms, has come under increasing scrutiny.²⁸

Consumer groups have criticized the use of the scoring for insurance purposes. They argue that the practice constitutes an unnecessary risk to consumer privacy, and it is questionable whether credit scores are an actuarially sound predictor of consumer claim propensity.²⁹ By identifying insurance credit scoring as a particularly vulnerable area and using it as part of a wedge strategy, consumer groups have sought to introduce stricter laws prohibiting or restricting the use of credit scores at many levels. To understand these strategies, it is first necessary to set forth a brief map of the legal landscape that credit reporting and insurance companies must navigate and the relevant legal history.

²⁵ Hartwig, *supra* note 20, at 11.

²⁶ CHRONOLOGY OF DATA BREACHES REPORTED SINCE THE CHOICEPOINT INCIDENT (2006) <http://www.privacyrights.org/ar/ChronDataBreaches.htm> (last visited May 1, 2006).

²⁷ 2005 DATA SEC. BREACH STATISTICS, http://www.utimaco.us/secnews/data_breaches/2005.html (last visited Oct. 22, 2006).

²⁸ *Record-High ChoicePoint Settlement Emphasizes Need to Reassess Corporate Data-Security Programs*, http://www.bryancave.com/pubs/pub_detail.asp?id=1274 (last visited May 2, 2006).

²⁹ Model State Clean Credit and Identity Theft Protection Act, § 9, at 28 (2005), www.uspirg.org/consumer/archives/PIRGUCleanActnov05.pdf (last visited April 24, 2006).

III. A BRIEF HISTORY OF THE LEGAL LANDSCAPE: FEDERAL STATUTES, MODEL LAWS, STATE ACTION, AND CASES

A. The McCarran-Ferguson Act

Even though most insurance contracts transcend state lines and clearly constitute interstate commerce, Congress preserved the states' sovereign authority to regulate the business and taxation of insurance. This preservation of power dates back to 1945, when Congress enacted the McCarran-Ferguson Act ("MFA") "to insure that the states [could] regulate the business of insurance free from the inadvertent preemption by federal statutes of general applicability."³⁰ The McCarran-Ferguson Act created a general exemption for state laws that regulate insurance from federal preemption.³¹ The Supreme Court has repeatedly interpreted this as a broad exemption.³²

Just one year after Congress enacted the MFA, the Supreme Court issued a strong ruling in favor of state sovereignty.³³ The Court concluded that in enacting the MFA, Congress had "throw[n] the whole weight of its power behind the state systems" for regulat-

³⁰Standard Sec. Life Ins. Co. v. West, 127 F. Supp.2d 1064, 1067 (W.D. Mo. 2000) (*quoting* Autry v. Nw. Premium Serv., 144 F.3d 1037, 1040 (7th Cir. 1998)).

³¹ 15 U.S.C. § 1012(b) (2006).

§ 1012 Regulation by State law; Federal law relating specifically to insurance; applicability of certain Federal laws after June 30, 1948

State regulation. The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

Federal regulation. No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: Provided, That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act [15 USCS §§ 1 et seq.], and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended [15 USCS §§ 41 et seq.], shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

³² Knutson, J. Haakon, Note, *Credit Scoring in the Insurance Industry: Discrimination or Good Business*, 15 Loy. Consumer L. Rev. 315, 320-322, (2003).

³³ Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 430-31 (1946).

ing insurance.³⁴ The Court softened this position somewhat in 1999 when it ruled that the MFA does not preempt claims brought under the federal RICO statute.³⁵ In doing so, the Court articulated that the MFA does not preempt generally applicable federal statutes “if the federal law is applied in aid or enhancement of state regulation, and does not frustrate any declared state policy or disturb the State’s administrative regime.”³⁶

The Court has also emphasized that while “McCarran-Ferguson’s overall purpose is to protect ‘the business of insurance’ . . . that . . . does not necessarily include every activity in which an insurance company might engage.”³⁷ Specifically, to be exempt, the state law must be an integral part of allocating the policyholder’s risk. The actual policy relationship between parties and the state law must be limited to regulation of the insurance industry.³⁸ More specifically, the MFA is only intended to protect state insurance laws from inadvertent preemption by federal laws of general applicability. By its plain language, the MFA still allows for limited preemption by federal laws provided that the federal law “specifically relates to the business of insurance.”³⁹

B. The Fair Credit Reporting Act of 1970

The FCRA was enacted in 1970 and revised in 1996 to regulate the credit reporting industry.⁴⁰ Among other things, the FCRA authorizes the use of credit reports and scores by insurance compa-

³⁴ Knutson,, at 320.

³⁵ *Humana, Inc. v. Forsyth*, 525 U.S. 299, 311 (1999).

³⁶ Knutson, *supra* note 11, at 317(2003) (citing *Humana*, 525 U.S. at 303).

³⁷ Cynthia T. Andreason, *Federal Preemption and the McCarran-Ferguson Act: An Analytical Primer*, 5 MEALEY’S EMERGING INS. DISPUTES, 1 (2000), http://www.wrf.com/publication.cfm?publication_id=11997, at Section III (last visited Oct. 24, 2006).

³⁸ *Standard Sec. Life Ins. Co. v. West*, 127 F.Supp.2d at 1067.

³⁹ The McCarran-Ferguson Act of 1947, 15 U.S.C.A. § 1013(b) (2006).

(b) No Act shall be construed to invalidate, impair, or superseded any law enacted by any state for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, *unless such Act specifically relates to the business of insurance* . . . (emphasis added).

⁴⁰ 15 U.S.C.S. § 1681 (2006).

nies to determine whether to issue a new policy,⁴¹ to review rates for existing policies,⁴² and to take adverse action, such as canceling a policy or increasing rates.⁴³ Although credit reports have been available to insurance carriers as an underwriting factor since 1970, it is only within the past decade that insurers have really made use of them. The explosive growth in the use of credit scores by insurers “has been fueled by the introduction of more sophisticated analysis tools and additional research indicating a strong correlation between credit history and insurance risk.”⁴⁴ The FCRA included several limited areas in which it explicitly preempted state laws. None of these preemptions covered the use of insurance scores. In 2003, the FACTA amended the FCRA.⁴⁵

C. The Fair and Accurate Credit Transactions Act of 2003

The FACTA amended the FCRA in response to pressing concerns within the financial services and financial data industries. First, concerns about data security led to the introduction of several new consumer rights and more stringent requirements for data accuracy.⁴⁶ Second, the FCRA included a limited number of state law preemptions.⁴⁷ The FCRA also contained a “sunset provision” stating that these preemptions would expire January 1, 2004.⁴⁸ Congress enacted the FACTA “to make these preemptions permanent and to also add a

⁴¹15 U.S.C.S. § 1681(a).

⁴²15 U.S.C.S. § 1681(b)(a)(3)(E).

⁴³*Id.*

⁴⁴*Id.*

⁴⁵Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, 117 Stat. 1952 (amending 15 U.S.C. § 1681 (1996); 20 U.S.C. § § 9701-9708 (1992); and 31 U.S.C. § 5318 (2004)).

⁴⁶Gail Hillebrand, *After the FACTA: State Power to Prevent Identity Theft*, 17 LOY. CONSUMER L. REV. 53, 53 (2004) (describing the new consumer rights granted by the FACTA, including the right to receive a free copy of their credit report from each of the three national bureaus once per year).

⁴⁷15 U.S.C. § 1681(t) (2004). The FCRA specifically preempts state law in the following areas: uses of credit report of prescreen consumers for firm offers of insurance or credit, time and manner of resolving consumer disputes with regard of accuracy, and duties of companies providing the data to the bureaus.

⁴⁸*Id.* (stating that the preemptions contained in § 624(b) & (c) “do not apply to any provision of State law (including any provision of a State constitution) that (A) is enacted after January 1, 2004”).

long list of new preemptions that significantly limit states' abilities to regulate much of the FCRA's subject matter and conduct requirements."⁴⁹ The FACTA reauthorized the use of credit scores as an actuarial factor by insurance underwriters.⁵⁰ The FACTA did not include the use of insurance scores in its updated list of preemptions.⁵¹ "Notwithstanding these broad preemptions, the FACTA does not limit, annul or supersede state laws regulating the use of credit-based insurance scores in insurance activities by any person engaged in the business of insurance."⁵² The FACTA does leave the door open for future changes by specifically requiring that a government study be conducted into "the effects of the use of credit scores and credit-based insurance scores on the availability and affordability of financial products and services, including property and casualty insurance."⁵³

D. The NCOIL and PIRG Model Laws

The National Conference of Insurance Legislators ("NCOIL") is a national organization of state legislators with a stated mission of "helping state legislators interface and communicate effectively with each other and Congress."⁵⁴ In November 2002, NCOIL adopted a new model law regulating the insurance industry's use of credit information.⁵⁵ The NCOIL Model Law specifically authorizes the use

⁴⁹National Consumer Law Center, *Analysis of the Fair and Accurate Credit Transactions Act of 2003*, Pub. L. No. 108-159 (2003), http://www.nclc.org/initiatives/facta/nclc_analysis.shtml#7 (last visited Oct. 25, 2006).

⁵⁰ Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, 117 Stat. 1952 (amending 15 U.S.C. § 1681 (1996); 20 U.S.C. § 9701-9708 (1992); and 31 U.S.C. § 5318 (2004)).

⁵¹ Kevin Fitzgerald and Brian Kaas, *Fair and Accurate Credit Transactions Act of 2003: Getting to Know the Facts about the FACT Act*, Feb. 6, 2004, http://www.foley.com/news/event_detail.aspx?eventid=305 (last visited May 2, 2006).

⁵² *Id.*

⁵³ *Id.*

⁵⁴ THE NAT'L CONFERENCE OF INS. LEGISLATORS (NCOIL): HISTORY & PURPOSE, <http://www.ncoil.org>; then follow "History and Purpose" hyperlink (last visited May 3, 2006).

⁵⁵ Independent Insurance Agents and Brokers of America, *LB 487 – Model Act Regarding Use of Credit Information*, 2003 Legislative Session, http://ne.iaaa.org/credit_scoring_bill_analysis.htm (last visited, Oct. 26, 2006).

of insurance scores as an underwriting factor, provided it is not the *sole* factor and that it not be used at all in the limited circumstances of a “no hit,” which means that the consumer has no credit history at all.⁵⁶ Additionally, insurers are prohibited from using any insurance score that is calculated using income, gender, addresses or zip codes, ethnicity, religion, marital status, or nationality as a factor.⁵⁷ The NCOIL Model Law also requires notification in the event that credit information was the basis for an “adverse action.”⁵⁸ This notification must explain the reason for the adverse action and include a description of up to four factors that were the main influences of the action.⁵⁹

Ostensibly, NCOIL is an independent association that conducts impartial studies and reviews to help state legislators regulate insurance fairly and objectively.⁶⁰ At least one consumer group has asserted that NCOIL is unfairly biased in favor of the insurance companies, including a claim in a 2003 study by the Consumer Federation of America that twenty-three of the fifty-seven members of NCOIL have some form of affiliation with the insurance industry.⁶¹ Whether NCOIL is truly impartial or not, there can be no question as to its influence. Forty-two states have enacted legislation based on the NCOIL Model Law’s restrictions on the type of data that can be used to calculate an insurance score.⁶² Twenty-seven states have approved laws that follow the basic NCOIL model, and twenty-four states have “based the entirety of their current insurance scoring laws

⁵⁶ INS. INFO. INST, *supra* note 8.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ THE NAT’L CONFERENCE OF INS. LEGISLATORS (NCOIL): HISTORY & PURPOSE, *supra* note 54.

⁶¹ *NCOIL Stacked With Insurance Insiders, Says Consumer Group*, Aug. 13, 2003, <http://www.insurancejournal.com/news/national/2003/08/13/31443.htm?print=1>.

⁶² NAMIC’S STATE LAWS AND LEGISLATIVE TRENDS: STATE LAWS GOVERNING INS. SCORING PRACTICES, *supra* note 1 (listing states that have enacted legislation or regulatory provisions that follow the NCOIL Model Law as: Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, and Wisconsin).

on the NCOIL Model Act.”⁶³

For several years, the NCOIL Model Law was the only model law available on the issue. As a result, several prominent consumer groups accused the states of adopting NCOIL’s pro-industry stance by default rather than because it was good law.⁶⁴ In response to this, along with other perceived failings of the 2003 FACTA, the Public Interest Research Group and the Consumers Union of U.S., Inc., drafted an opposing model law: the CLEAN Credit and Identity Theft Protection Act (“CLEAN Act”).⁶⁵ In contrast to NCOIL’s position that insurance scoring should be permitted but regulated, the CLEAN Act proposes an absolute prohibition on the use of insurance scores.⁶⁶ In support of this strict position, the CLEAN Act argues that the NCOIL Model Act offers only sham protections.⁶⁷ Specifically, the CLEAN Act claims “the NCOIL model authorizes [insurance scoring] so long as the scoring is not the sole criterion used. Since scoring is *never* the sole criterion used in underwriting or pricing insurance, the bill offers consumers *virtually no protection*.”⁶⁸

Prior to 2005, only a handful of states had adopted similar provisions to those proposed by the CLEAN Act: Oregon, Maryland, and Hawaii. The publicity generated by the 2005 data breaches has, in part, prompted the introduction of bills in virtually every state that closely mirror the CLEAN Act.⁶⁹

E. State action regarding the use of credit scores for insurance purposes

A majority of states now permit the use of credit scores by insurance companies. Forty-two states allow insurers to use credit

⁶³ *Id.* (listing states that have replicated the NCOIL Model Law in its entirety as: Alabama, Arkansas, Colorado, Delaware, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Mississippi, Nebraska, Nevada, New York, North Carolina, North Dakota, Oklahoma, Rhode Island, Tennessee, Texas, Virginia and West Virginia).

⁶⁴ BIRNBAUM, *supra* note 9, at 4.

⁶⁵ Abigail Mierzwinski, *The CLEAN Credit and Identity Theft Protection Act: Model State Laws* (2004), <http://www.pirg.org/consumer/credit/model.htm#clean>.

⁶⁶ Model State Clean Credit and Identity Theft Protection Act, *supra* note 29, at § 9(A).

⁶⁷ *Id.*

⁶⁸ *Id.* (emphasis added).

⁶⁹ *Id.*

scores provided they adhere to specific, limited prohibitions on certain uses or the use of certain negative credit factors.⁷⁰ Thirty-five states require insurers to file insurance scoring methodologies with the state insurance department.⁷¹

Five states have enacted outright prohibitions on the use of credit scores by insurance companies: Georgia, Hawaii, Maryland, Oregon, and Utah. Additionally, legislation is pending in several states that would prohibit the use of credit scores as an insurance underwriting factor. In 2005, Michigan and Alaska both took steps to prohibit the use of insurance credit scores. In both states, the prohibitions were overturned by judicial action.⁷² The Michigan insurance department is currently appealing its judgment.⁷³ In Florida, “the Financial Services Commission has voted to adopt a credit scoring rule that would require insurers to prove, before they could use credit scores, that their use does not unfairly discriminate against specific groups.”⁷⁴

F. Pending State Bills

Between January 1, 2005 and March 2006, several states introduced and debated bills that would have prohibited or severely limited the use of insurance credit scores, including Arkansas, Ari-

⁷⁰NAMIC’S STATE LAWS AND LEGISLATIVE TRENDS: STATE LAWS GOVERNING INS. SCORING PRACTICES, *supra* note 1 (listing specific states that permit use of insurance scores subject to limitations on certain negative credit factors as Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, and Wisconsin).

⁷¹*Id.* (listing specific states requiring insurance scoring methods to be filed with state insurance department as: Alabama, Alaska, Arkansas, Colorado, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, Washington, and West Virginia).

⁷² *Mich. Judge Rules Insurance Scoring Ban Illegal*, INSURANCEJOURNAL.COM, April 26, 2005, <http://www.insurancejournal.com/news/midwest/2005/04/26/54272.htm>.

⁷³ CREDIT SCORING: THE TOPIC, *supra* note 8 (last visited Oct. 24, 2006).

⁷⁴ *Id.*

zona, California, Colorado, Delaware, Iowa, Illinois, Indiana, Kansas, Minnesota, Missouri, Mississippi, Montana, North Dakota, New Jersey, New York, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas, Washington, and West Virginia.⁷⁵ Delaware is particularly likely to pass prohibitions, as its commissioner is opposed to the use of credit scoring.⁷⁶ In December 2005, Minnesota Attorney General Mike Hatch supported a ban on the use of insurance scoring for auto and homeowners' insurance by announcing legislation prohibiting the use of credit histories for underwriting or rating by insurance companies.⁷⁷

G. Government studies into the use of credit scores in insurance underwriting

In recent years, several states have concluded extensive studies into the issue of the use of credit scores in insurance underwriting. . Studies in Washington and Texas were the most extensive. In keeping with the contentious nature of this debate, both proponents and opponents of the use of credit scores have seized upon the findings of these studies to provide support for their causes.

The Washington study was required as part of newly enacted state law ESHB 2544, restricting the use of credit scoring in personal lines insurance underwriting.⁷⁸ The study's purpose was to determine whether the use of credit scoring by insurers had an unequal impact on specific demographic groups.⁷⁹ According to the Insurance Information Institute, a pro-credit scoring industry association, the Washington Office of the Insurance Commissioner concluded "while there are statistically detectable patterns in the demographics of credit scoring, most of the variations were due to random chance or other

⁷⁵ NAMIC'S STATE LAWS AND LEGISLATIVE TRENDS: STATE LAWS GOVERNING INS. SCORING PRACTICES, *supra* note 1.

⁷⁶ CREDIT SCORING: THE TOPIC, *supra* note 8 (last visited Oct. 25, 2006).

⁷⁷ Press Release, State of Minnesota Office of the Attorney General, State Senator Larry Pogemiller, State Representative Joe Mullery and Attorney General Mike Hatch Propose Fairness in Insurance Pricing Bill, (Dec. 29, 2005), http://www.ag.state.mn.us/consumer/PR/PR_051229FairnessInsurancePricing.htm.

⁷⁸ MIKE KREIDLER, STATE OF WASH. INS. COMM'R, A REPORT TO THE LEGISLATURE: EFFECT OF CREDIT SCORING ON AUTO. INS. UNDERWRITING AND PRICING (2003), www.insurance.wa.gov/publications/news/Final_SESRC_Report.pdf.

⁷⁹ Hartwig, *supra* note 20, at 7 (discussing state law ESHB 2544).

facts.”⁸⁰ The study also revealed that Asian Americans, the state’s largest minority group, *clearly benefited from credit scoring*.⁸¹ In contrast, the Professional Insurance Agents of Ohio (“PIA”) interpreted the study as showing a disparate impact on minority groups, and argued that the results “indicate that the use of credit scores to evaluate auto insurance risks can have an unequal impact on persons who are younger, poorer and members of a racial minority group.”⁸² According to the PIA, “the Commissioner said the study found that unequal effects of insurance scoring were too common to be random events . . . credit scoring is not blind to income and the jury is still out on how it impacts race.”⁸³

The Texas Department of Justice completed its own study in 2004 and issued its findings in a report in December of that year, which it updated in January 2005.⁸⁴ The Texas study found that the use of credit scores “significantly increased pricing accuracy in predicting risk when combined with other ratings variables.”⁸⁵ The study also found that while blacks and Hispanics generally had lower credit scores than whites and Asians, the results were not unfairly discriminatory.⁸⁶ As a result, Texas Department of Insurance Commissioner Jose Montemayor recommended the continued use of credit scoring to determine risk and insurance premiums.⁸⁷ In a January 31, 2005 letter to Texas Governor Rick Perry, Montemayor stated that while the use of credit scoring may have a “disproportionate im-

⁸⁰ KREIDLER, *supra* note 78.

⁸¹ Hartwig, *supra* note 20.

⁸² Professional Insurance Agents Association of Ohio, *Credit Study Indicates Disparate Impact* (Feb. 28, 2003), http://www.ohiopia.com/legislation/proaction/proaction03/pa2_28_03.htm.

⁸³ *Id.*

⁸⁴ TEX. DEP’T OF INS., REPORT TO THE 79TH LEGISLATURE: USE OF CREDIT INFO. BY INSURERS IN TEX. (Dec. 2004), <http://www.tdi.state.tx.us/reports/credit3.html>; then follow “Use of Credit Information by Insurers” hyperlink, *see also* TEX. DEP’T OF INS., SUPPLEMENTAL REPORT TO THE 79TH LEGISLATURE: USE OF CREDIT INFO. BY INSURERS IN TEX.: THE MULTIVARIATE ANALYSIS (Jan. 2005), <http://www.tdi.state.tx.us/reports/credit3.html>; then follow “Supplemental Report” hyperlink.

⁸⁵ CREDIT SCORING: THE TOPIC, *supra* note 8.

⁸⁶ *Id.*

⁸⁷ Jordan Smith, *Insurance Commish Says Credit Scoring OK*, AUSTIN CHRONICLE, Feb. 11, 2005, *available at* http://www.austinchronicle.com/issues/dispatch/2005-02-11/pols_naked3.html.

fact” on some groups, the practice does have an “actuarially supported result” and as such is not “unfairly or intentionally discriminatory.” Additionally, “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. Ending the practice without a corresponding change in law would likely lead to a prolonged court battle.”⁸⁸ In contrast to Montemayor’s interpretation, a coalition of organizations, including Texas Watch, League of United Latin American Citizens (“LULAC”), Mexican-American Legal Defense and Education Fund (“MALDEF”), NAACP, Texas Public Interest Research Group (“TexPIRG”), Center for Economic Justice, Public Citizen, Consumers Union, and Common Cause, took the position that the reports established “that the use of credit scoring disproportionately impacts minorities and middle class Texans and that other established rating factors are more predictive than credit scoring.”⁸⁹

Finally, the Federal State Commission (“FSC”) is currently conducting its own study examining the impact of credit scores upon the availability and affordability of insurance, as required by the FACTA.⁹⁰ The FSC was scheduled to complete its study by the end of 2005 and publish the results sometime in 2006.

H. Navigating the statutory landscape—relevant case law

To understand the contours of the debate surrounding the use of credit scores by insurance companies, it is necessary to first understand two distinct lines of case law: the concept of disparate impact and the circumstances in which federal law can preempt the MFA.

i. Disparate impact

The U.S. Supreme Court first established the concept of disparate impact in 1970 in response to a claim that an employer’s requirement of a high school diploma or aptitude test for all but the

⁸⁸ *Id.*

⁸⁹ TexPIRG, *House Committee Considers Legislation to Ban Insurance Credit Scoring*, Feb. 21, 2005, <http://www.texpirg.org/TX.asp?id2=16077&id3=TX&>.

⁹⁰ Robert Detlefsen, *Disparate Impact Theory Provides No Support For Banning Credit Scoring In Insurance*, LEGAL BACKGROUNDER, Vol. 20, No. 17 (Washington Legal Foundation), Apr. 2005, <http://www.namic.org/pdf/050408WLF CreditScoringDispImpact.pdf>.

lowest paying jobs violated Title VII of the Civil Rights Act.⁹¹ The plaintiffs alleged that this requirement disqualified black applicants at a far higher rate than white applicants.⁹² The Court ruled “[t]he Act proscribes not only overt discrimination but also practices that are fair in form, but discriminatory in operation.”⁹³ In doing so, the Court established a threshold requirement of “business necessity.”⁹⁴ Thus, the Court prohibited employment practices having an exclusionary effect if the employer could not show that the practices were related to job performance.⁹⁵ One year later, the Court elaborated, naming it “the business necessity test.”⁹⁶ Under the business necessity test, “the business purpose must be sufficiently compelling to override any racial impact, the challenged practice must effectively carry out the business purpose it is alleged to serve, and there must be no available acceptable alternative policies or practices which would better accomplish the business purpose advanced, or accomplish it equally well with a less differential racial impact.”⁹⁷ The business necessity test migrated out of case law and was granted statutory authority in 1991 when it was codified in the 1990 Amendments to the Civil Rights Act.⁹⁸

Courts have generally been reluctant to apply the doctrine of disparate impact to areas other than employment law.⁹⁹ In non-employment cases where courts have distinguished from Title VII disparate impact claims, courts have replaced the business necessity test with “a much looser ‘legitimate business justification’ stan-

⁹¹ *Griggs v. Duke Power Co.*, 401 U.S. 424, 425-26 (1970).

⁹² *Id.* at 424.

⁹³ *Id.* at 431.

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Robinson v. Lorillard Corp.*, 444 F.2d 791, 796-97, (4th Cir. 1971).

⁹⁷ *Id.* at 798.

⁹⁸ Civil Rights Act of 1991, Pub.L. No. 102-166, 105 Stat 1071 (1991) (amending 42 U.S.C. § 1981).

“The purposes of this Act are...

(2) to codify the concepts of “business necessity” and “job related” enunciated by the Supreme Court in *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971), and in the other Supreme Court decisions prior to *Wards Cove Packing Co. v. Atonio*, 490 U.S. 642 (1989).”

⁹⁹ Detlefsen, *supra* note 90, at 1.

dard.”¹⁰⁰ In applying the disparate impact doctrine to the question of whether a housing community’s rule limiting the number of people that could reside in a single dwelling violated the Fair Housing Act, the U.S. Court of Appeals for the Tenth Circuit stated that while “mere insubstantial justifications” are not sufficient to satisfy the test, “compelling need or necessity” is too high a bar because such a “degree of scrutiny would be almost impossible to satisfy.”¹⁰¹

At least one court has outright rejected the argument that credit scoring causes a disparate impact when used as a factor in underwriting insurance policies. In *Owens v. Nationwide Mutual Insurance Co.*, the U.S. District Court for the Northern District of Texas rejected the plaintiff’s claim that the insurance company used credit information to intentionally discriminate against minorities.¹⁰² The court determined that the “[d]efendant’s use of credit information was ‘predictive of or significantly correlated with important elements’ of underwriting and that absent its ability to determine risk using credit, its position in the market would suffer from competitive adverse selection.”¹⁰³ In addition, there were no other means by which the insurer “could reduce risk of loss and maintain competitiveness in a less discriminatory way.”¹⁰⁴

ii. Federal law claims and the MFA

In 1946, one year after Congress passed the MFA, the Supreme Court affirmed that Congress intended to throw “the whole weight of its power behind the state systems for regulating the business of insurance.”¹⁰⁵ This did not mean that state insurance laws were completely unassailable to federal claims. In 1999, the Supreme Court, in the contest of determining whether the MFA barred a federal RICO claim, established that to be barred by the MFA, the federal statute must not be one that “specifically relate[s] to the busi-

¹⁰⁰ *Id.* at 3.

¹⁰¹ *Mountain Side Mobile Estates P’ship v. Sec’y of Hous. & Urban Dev.*, 56 F.3d 1243, 1254-55 (10th Cir. 1995).

¹⁰² *Owens v. Nationwide Mut. Ins. Co.*, 2005 U.S. Dist. LEXIS 15701 (N.D. Tex. 2005).

¹⁰³ *Id.* at *14.

¹⁰⁴ *Id.* at *15.

¹⁰⁵ *Prudential Ins. Co. v. Benjamin*, 328 U.S. at 430.

ness of insurance,”¹⁰⁶ Thus if the federal statute at issue is not specifically related to the business of insurance, then application of that statute is complementary to state regulation and does not frustrate any declared state policy or disturb the State’s administrative regime.

In *Dehoyos v. Allstate*, the U.S. Court of Appeals for the Fifth Circuit specifically addressed whether the MFA preempted federal discrimination claims in relation to the practice of insurance credit scoring.¹⁰⁷ Using the test established in *Humana*, the court ruled that the MFA did not preempt a claim that the use of credit scores by the Allstate Indemnity Company violated the anti-discrimination measures of the federal Fair Housing Act (“FHA”).¹⁰⁸ The court ruled that while the FHA was not directly related to the business of insurance, application of the FHA’s provisions did not frustrate or conflict with any articulated state policy or law.¹⁰⁹ Although the central claim was based on a disparate impact theory, the court dismissed as “fanciful” Allstate’s claim that courts would be required to act as “super actuaries” in deciding each disparate impact claim on a case-by-case basis.¹¹⁰ Instead, the court focused its analysis exclusively on whether the FHA was compatible, or at least did not conflict with, an articulated state policy or law.¹¹¹

Finally, the United States Court of Appeals for the Ninth Circuit addressed the use of credit scores by insurance companies in 2005 in the consolidated cases of *Reynolds v. Hartford Financial Services* and *Edo v. GEICO*.¹¹² Specifically, the court was asked to determine whether a failure to offer the best rate possible constituted an adverse action, triggering the notice requirements of § 1681 et seq. of the FCRA.¹¹³ The court ruled that providing anything other than the best rate at the time of writing a policy as a result of credit data was an adverse action and failure to provide an adverse action notice

¹⁰⁶ *Humana Inc. v. Forsyth*, 525 U.S. at 307.

¹⁰⁷ *Dehoyos v. Allstate Indem. Co.*, 345 F.3d 290, 292 (5th Cir. 2003) (Plaintiffs alleged that Allstate’s practice of using credit scores to underwrite insurance policies violated the anti-discrimination measures of the federal Fair Housing Act).

¹⁰⁸ *Id.* at 297–99.

¹⁰⁹ *Id.* at 299.

¹¹⁰ *Id.* at 298.

¹¹¹ *Id.* at 299.

¹¹² *Reynolds v. Hartford Fin. Serv. Group*, 435 F.3d. 1081, 1084 (9th Cir. 2006).

¹¹³ *Id.* at 1085.

in such circumstances constituted a willful violation of the FCRA.¹¹⁴ The determination of “willfulness” prompted immediate response from industry commentators who claimed it “could open up personal lines carriers to near limitless civil liability . . . [because] . . . any person who willfully fails to comply with the adverse action requirements is liable to each consumer for damages of not less than \$100 and not more than \$1,000” in each instance.¹¹⁵ However, the court issued a revised opinion in January 2006 that “essentially backed away from an across-the-board finding of ‘willfulness’ and said that individual cases need to be reviewed by lower courts that have reviewed the specific actions of the insurers.”¹¹⁶ The *Reynolds* court did not address the conflict raised by bringing a federal claim under the FCRA against a practice that is central to the business of insurance. In doing so, there is a strong presumption that the MFA does not necessarily preempt federal claims brought under the FCRA, at least not in the Ninth Circuit.

IV. Understanding the debate—business and policy arguments

Opponents of credit scoring raise several theories as to why it is an inappropriate tool for pricing and underwriting insurance rates. First, they allege that the link between credit history and insurance claims is spurious at best. Second, credit scores purportedly enable discriminatory practices that disproportionately target certain ethnic groups. Third, the need for businesses to protect their proprietary scoring models and techniques fosters secrecy and a lack of accountability. Fourth, it is alleged that insurance companies increase rates to compensate for the discounts offered for good credit scores, making those discounts a bait-and-switch tactic. Finally, detractors point to potential inaccuracies or omissions contained in the underlying data from which the scores are calculated. Few, if any, of these arguments withstand scrutiny.

¹¹⁴ *Id.* at 1083.

¹¹⁵ Wes Bissett, *Carriers Face Credit Score Setback: Ninth Circuit decision on Insurance Scoring and Adverse Action Requirements*, INDEP. AGENT MAGAZINE, Aug. 18, 2005, available at <http://www.iiaba.net/IAMag/NewsViews/081805.html>.

¹¹⁶ Wes Bissett, *Carriers Receive Potential Credit Scoring Reprieve: Ninth Circuit Revises Decision on Insurance Scoring and Adverse Action Requirements*, INDEP. AGENT MAGAZINE, Feb. 2, 2006, <http://www.iiaba.net/IAMag/NewsViews/020206.html>.

Several opponents have argued that the link between credit performance and insurance claims is spurious at best and fraudulent at worst. In 2004, Michigan Governor Jennifer Granholm claimed “[t]here is no correlation between how well you drive and how well you use your credit.”¹¹⁷ Sara Lapham claims credit scores merely measure “claims consciousness,” which is simply an assumption that people with good credit scores are more likely to settle an accident out of their own pocket rather than file a claim with the insurance company.¹¹⁸ Such allegations have been disproved by study after study. In addition to the studies discussed above, a 1996 study by international actuarial consulting firm Tillinghast Towers-Perrin examined claim records from several insurance companies and found that the probability of a statistically significant correlation existing between insurance scores and insurance loss ratios exceeded 92% and was as high as 99%.¹¹⁹

The claim that credit scores promote discrimination is based on the theory of disparate impact and redlining. The disparate impact theory holds that a standard or practice is presumptively illegal if it has the effect of disproportionately excluding members of legally protected groups even though the challenged practice makes no reference to race or ethnicity, and even though the resulting adverse group impact was inadvertent.¹²⁰ The underlying premise of the disparate impact theory is that credit scores may neither intentionally target any groups for exclusion, nor use the methodologies to calculate those credit scores that are inherently unfair to low-income and minority consumers. Allegedly, insurance credit scores penalize even the most fiscally responsible low-income consumers because “the absence of positive credit information [such as a home mortgage] may lower a score just as much as the presence of negative information.”¹²¹ In addition, it is alleged that insurance credit scores potentially penalize the use of cash or money orders to pay bills, a practice

¹¹⁷ GOAPPLY.COM, *supra* note 5.

¹¹⁸ Sara Lapham, *The Truth Behind Credit Scoring*, <http://www.insurancescored.com/industryvsconsumer.htm>.

¹¹⁹ Hartwig, *supra* note 20, at 5. (last visited May 2, 2006) (citing Tillinghast Towers-Perrin, *Insurance Bureau Scores vs. Loss Ratio Relativities*, Dec. 1996).

¹²⁰ Detlefsen, *supra* note 90.

¹²¹ Massachusetts Consumers’ Coalition, *How Insurance Credit Scoring Harms Consumers: Penalizes Good Financial Management*, <http://www.massconsumers.org/insurancescoring/problems.html> (last visited May 5, 2006).

more common in low-income groups.¹²²

Redlining is a practice whereby insurers “would literally or figuratively draw a red line around certain geographic areas, and decline to [service] those areas on the basis of the racial composition, age of the housing stock, or other factors, regardless of the creditworthiness of the individual loan applicants.”¹²³ This quote from the Congressional record illustrates the absurdity of the redlining argument. While it makes for evocative and rousing rhetoric, the proposition that individual credit scoring is tantamount to redlining because it affects minorities as a group regardless of their individual creditworthiness constitutes circular logic at best.

Credit scores are based on complex and highly proprietary mathematical models. Because it is necessary to protect these models as trade secrets, opponents of credit scoring argue that it is effectively “a ‘black box’ because almost nobody knows how it works except the people who invent it.”¹²⁴ Opponents also “point out that there is no uniform, industry-wide standard mathematical model for use in insurance credit scoring which makes it impossible for consumers to know how a given insurance company will determine their credit score.”¹²⁵ The first point of this argument is unsupportable. A full *in camera* inspection would be available to any litigant wishing to examine the model. Many states have followed the NCOIL model law in this regard. While these states are required to protect these filings as trade secrets against disclosure to competitors, regulators have full access to any scoring model they wish to examine.¹²⁶ The second assertion that no uniform standard model for credit scoring exists was largely eviscerated by the introduction of a new, shared scoring

¹²² *Id.*

¹²³ Cassity, Wendy, Article, *The Case for a Credit Union Community Reinvestment Act*, 100 *Columb. L. Rev.* 331, 364 (2000) (quoting 123 CONG. REC. 17630(1977) (statement of Sen. Proxmire)).

¹²⁴ Kathleen Pender, *Insurance Credit Scoring Rankles*, SAN FRAN. CHRON., May 12, 2002, available at <http://www.consumerwatchdog.org/nw/?postId=1457&pageTitle=Insurers'+credit+scoring+rankles> (last visited May 1, 2006).

¹²⁵ Press Release, Office of The Governor, *Governor, OFIS Commissioner Propose Rule to Cut Base Insurance Rates by Banning the Use of Credit Scoring*, (April 26, 2004) (on file with author and available at <http://www.cej-online.org/granholm%20press%20release%20cr%20sc%20ban%20040426.pdf> (last visited Oct. 19, 2006)).

¹²⁶ NAMIC'S STATE LAWS AND LEGISLATIVE TRENDS: STATE LAWS GOVERNING INS. SCORING PRACTICES, *supra* note 1.

model called VantageScore. According to TransUnion, one of the three national credit bureaus, “VantageScore is the first—and only—industry model to be jointly developed by all three national credit reporting companies.”¹²⁷ The three bureaus collaboratively developed the new model to create a uniform, consistent industry standard: “VantageScore scores will be calculated the same way for each credit bureau or lender.”¹²⁸ It has even been argued that by using credit information in different ways, insurance companies are only competing amongst each other, which creates more choices for the consumer.¹²⁹

The discounts offered to those with good credit have been attacked as illusory. The allegation is that insurance companies increased their overall base rates to recoup the cost of offering credit score discounts.¹³⁰ According to Granholm, “the use of credit scoring . . . has caused base rates to rise beyond what’s affordable . . . especially those who do not qualify for any kind of discount.”¹³¹ Even assuming *in arguendo* that Governor Granholm’s hypothesis is true, more than 50% of consumers receive a discount as a result of having good credit.¹³² According to the Fair Isaac Company, 76% of consumers have “good” or “fair” credit.¹³³ Supporters of insurance credit scores also argue that “[w]ithout insurance scoring, many good drivers and homeowners would pay more—sometimes much more—for coverage.”¹³⁴ The rationale is that the more information insurers have at their disposal to assess risk, the more accurately they can set rates and distribute the risk of loss. “If information is insufficient, applicants for insurance may be placed in the wrong category. That means good drivers will pay more for coverage . . . subsidizing the bad.”¹³⁵ Without credit scores to help insurers make more accurate assessments of risk, policies would “not be priced according to the

¹²⁷ *Make Better Decisions with VantageScore*, <http://www.transunion.com/vantagescore/#benefits> (last visited May 5, 2006).

¹²⁸ Holden Lewis, *Credit Bureaus Create Alternative to FICO*, bankrate.com, <http://www.bankrate.com/brm/news/credit-scoring/20060315a1.asp> (last visited May 4, 2006).

¹²⁹ CREDIT SCORING: THE TOPIC, *supra* note 8.

¹³⁰ Press Release, Office of The Governor, *supra* note 126.

¹³¹ *Id.*

¹³² CREDIT SCORING: THE TOPIC, *supra* note 8..

¹³³ Hartwig, *supra* note 20, at 2. (last visited May 2, 2006).

¹³⁴ *Id.* at 8.

¹³⁵ CREDIT SCORING: THE TOPIC, *supra* note 8.

risk of the individual . . . but to average risk.”¹³⁶ As a result, insurance “would be too expensive for low-risk [customers] and very cheap for high-risk [customers].”¹³⁷

The accuracy of credit data is another area from which opponents of insurance credit scores draw ammunition. Michigan’s insurance regulator, Linda Watters, claimed that 70% of credit reports contain errors, of which 29% are so egregiously incorrect as to be unfair to consumers.¹³⁸ A 2004 survey by the Public Interest Research Group (“PIRG”) alleged that 79% of reports contained some error.¹³⁹ Of these errors, PIRG alleged that 25% were “serious.”¹⁴⁰ Upon closer analysis, it is apparent that such allegations are exaggerated. Of the 79% of reports containing errors, more than two thirds were minor, non-credit or confidential demographic information, such as publicly known address or name, “that was misspelled, long outdated or belonged to a stranger.”¹⁴¹ Consumers can dispute errors under the FCRA and FACTA. Once a consumer files a dispute, “eighty percent . . . have their mistakes fixed within ten working days.”¹⁴² Also, without the use of credit information to supplement motor vehicle records (“MVRs”), it is much more likely that insurance rates would be inaccurate. According to a 2002 study, more than 20% of convictions for traffic violations in Connecticut and Florida are missed by MVRs.¹⁴³ In some states, omissions more than doubled to 47% for out-of-state convictions.¹⁴⁴ In addition, different states follow different rules for recording offenses, creating an unreliable patchwork of

¹³⁶ Robin Varghese & Michael Turner, THE BENEFITS OF WIDER PARTICIPATION IN FULL-FILE CREDIT REPORTING IN LATIN AMERICA AND THE COSTS OF THE STATUS QUO, Information Policy Institute, March 27, 2006 (on file with author).

¹³⁷ *Id.*

¹³⁸ *How Can Credit Scoring Affect Your Insurance?*, *supra* note 5.

¹³⁹ TexPIRG, *supra* note 89.

¹⁴⁰ Candace Heckman, *Study Assails Accuracy of Credit Reports*, SEATTLE POST, June 21, 2004.

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ INS. RESEARCH COUNCIL, ACCURACY OF MOTOR VEHICLE RECORDS, 2002, available for order <http://www.ircweb.org/IRCProducts/order.htm>

¹⁴⁴ Insurance Research Council, *Motor Vehicle Records May Not Provide an Accurate or Complete Account of Driving Histories*, <http://www.ircweb.org/news/20020626.htm>.

data.

V. ANALYSIS

The use of credit scoring is an important practice that affects virtually every person in the United States on some level. Despite this, it remains an area of inconsistent application, with two primary areas of unresolved tensions—federal versus state authority and consumer protection.

A. Federal and state authority

The FACTA and the FCRA explicitly permit insurance companies to use credit scores for the purpose of assessing risk and pricing insurance policies. The FACTA, however, does not necessarily preempt state laws in this area. As a result, states currently use the following argument to show that they are free to enact their own rules, be it endorsing, limiting or outright prohibiting the practice. First, they argue that the MFA specifically prohibits federal preemption of state insurance laws unless the federal law *specifically relates to the business of insurance*.¹⁴⁵ Consumer groups have argued that the FCRA and FACTA are strictly intended to regulate credit reporting companies and that any regulation of insurers is incidental.¹⁴⁶ Despite the certainty of consumer groups, the language of the FCRA itself is not so clear. The purpose of the FCRA is “to require that consumer reporting agencies adopt reasonable procedures for meeting the needs of commerce for consumer credit, personnel, *insurance*, and other information in a manner which is fair and equitable to the consumer”¹⁴⁷

A second argument raised by states is that the FCRA, as amended by the FACTA, includes several explicit preemptions of state law. It is argued that under “the doctrine of *expression unius est exclusio alterius* . . . the mention of some items in a list implies the exclusion of other items not mentioned.”¹⁴⁸ Therefore, if Congress did not explicitly include a state law preemption covering insurance

¹⁴⁵ 15 U.S.C. § 1012 (2005).

¹⁴⁶ Memorandum from D.J. Powers, attorney for the Center for Economic Justice, *Preemption Questions Regarding Credit Scoring*, (March 31, 2003), <http://www.cej-online.org/creditscoringmainpage.htm> (last visited May 3, 2006).

¹⁴⁷ Fair and Accurate Credit Transactions Act, *supra* note 11. (emphasis added).

¹⁴⁸ Memorandum from D.J. Powers, *supra* note 147, at 4.

credit scoring, one cannot be implied. Several federal courts have recognized claims based on the FCRA for the use of credit scoring. In addition to *Reynolds*, as discussed earlier, the Fifth Circuit held that the FCRA gives insurers the right to use credit scores.¹⁴⁹ The court did not address whether a state can take away this right under its own laws. *Reynolds* notwithstanding, as the FCRA is currently written, even with the FACTA amendments, an insurance carrier would be in a weak position if it were to attempt to sustain a defense based solely on federal preemption. To prevail on such an argument, an insurance carrier would need a sympathetic court to make several novel and controversial decisions with regard to multiple issues.

i. Consumer protection

The second argument is that of consumer protection and benefit. Opponents of credit scoring argue that it adversely impacts certain groups of consumers. This argument ignores the overwhelming wealth of studies establishing that the majority of consumers benefit from the use of credit scores, and that “while banning the use of credit scoring might lower the cost of insurance for some, it would most certainly increase the cost for many.”¹⁵⁰ Credit scoring is facially neutral and is alleged to impact minority groups only because they generally have lower credit scores. To compensate for this practice would mean penalizing the vast majority of consumers, including the large numbers of minority policyholders who benefit from having a good credit history. Prohibiting the use of credit scores would not change the overall amount of claims an insurer receives; it will only change the manner in which the insurer could apportion that cost between customers. The effect of prohibiting credit scoring would be to handicap an insurer’s ability to allocate risk, forcing it to make more sweeping, and less fair, assumptions. Credit scoring is inherently focused on the individual, not on group generalizations.

Transparency is central to the use of credit scores. Any type of “black box” is inherently unfair and also inaccurate. The NCOIL Model Act requires that all insurers file a description of any credit model they use with the state department of insurance. The majority of state laws follow the NCOIL Model Act. The problem is that insurance credit scoring is currently in limbo between the outer limits of the FCRA and the individual whims of various state laws. The re-

¹⁴⁹ *Wilting v. Progressive County Mut. Ins. Co.*, 227 F.3d 474 (5th Cir. Tex. 2000).

¹⁵⁰ *How Can Credit Scoring Affect Your Insurance?*, *supra* note 5.

sult is a confusing patchwork of standards that obfuscates the issue and hinders transparency.

To demonstrate this, consider the following hypothetical. Policyholder, who has good credit, resides in Illinois, which for the purpose of this scenario allows insurers to use credit scoring. As a result, Policyholder receives multiple discounts. Policyholder happens to reside within a few miles of the Indiana state border, which for the purposes of this scenario prohibits credit scoring. Policyholder moves to a comparable town just across the border in Indiana. Policyholder's new town has identical crime statistics and demographics. Policyholder drives the exact same number of miles each day and commutes to Chicago. Policyholder keeps the same insurance policies with the same insurer but Policyholder's rates increase significantly. Virtually nothing has changed between the two locations; the only cause for the increase is that Policyholder is no longer entitled to any discounts. This hypothesis can also be reversed, and Policyholder may pay higher rates because of a poor credit rating and receive lower rates upon moving to a state where credit rating information is prohibited. Unless Policyholder is educated in methods of legal research and familiar with both the state insurance laws and the means to access Department of Insurance records, the reason for the disparity of rates naturally appears to be capricious and arbitrary.

ii. Conclusion

Credit scoring for purposes of pricing and underwriting insurance products will remain a contentious issue so long as the practice is inconsistently applied among the varying states. The use of insurance credit scores provides underwriters with a valuable tool for more fairly allocating risk and apportioning costs. The fact that it has a disproportionate impact on certain groups is not equal to disparate impact. Transparency issues are also compounded by the confusing patchwork of state laws. The FCRA does not preempt the MFA in this area as currently written. It will be necessary within the near future for Congress to address this shortcoming and specifically to extend the FCRA's preemptions of state law to this practice. Only by enforcing uniform, national standards can the "black box" be opened and the benefits of the practice be fully realized by the majority of American consumers. The recent movement by the three national credit reporting companies to standardize the scoring models they offer is a significant step toward uniformity, but ultimately Congress will need to act to resolve this issue. The completion of an independent study of the issue by the FTC, as required by the FACTA, should

go a long way toward validating the actuarial soundness of this practice.