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Special Report: Insurance Law

Credit questions

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Consumers' credit histories can play a major part in their lives — from impacting credit card interest rates to securing a mortgage. For more than 40 years, the credit scoring system has enabled financial institutions to make decisions about doing business with consumers.



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Among insurers, credit scores have become an important underwriting tool they say allows them to more accurately categorize and rate insurance

risks. Automobile insurers, in particular, have long contended that the use of credit scoring benefits good drivers with lower rates.

They maintain that, much like a consumer's years of driving experience or accident history, credit history is a reliable predictor of the likelihood of future losses. Insurers argue that better accuracy in the underwriting and rating of risks can allow them to reliably match price with risk and lead to lower premiums for most consumers who fall into the middle and upper credit score tiers.

Recently, the use of credit scores in insurance underwriting has come under increased scrutiny and criticism in Florida and across the nation. Although federal laws, in particular the Fair Credit Reporting Act (FCRA), govern the use of credit scores by insurers, states also have enacted legislation and regulations addressing the use of credit scores by insurers.

This scrutiny has been strong in Florida, where efforts to tighten restrictions intensified in the wake of the catastrophic losses of the 2004 and 2005 hurricane seasons.

Consumer groups and regulators in numerous states are concerned that low income and minority groups are unfairly overrepresented in the lower credit score tiers. As a result, they argue, these groups often pay higher premiums for the same coverage as others.

Their opposition to the use of credit scores by insurers has begun to yield results. In June 2006, Allstate agreed to settle a federal class action lawsuit that alleged its use of credit scoring discriminated against Hispanics and blacks. As part of the settlement, Allstate refused to abandon credit scoring entirely but did agree to use a new methodology to set rates.

Under Florida law, insurers are prohibited from taking certain actions with respect to the use of credit scores involving insurance consumers. One of the law's chief provisions prohibits insurers from requesting credit scores based explicitly on criteria such as race, gender, age and marital status.

Proposed state rule blocked

In February 2005, the Florida Office of Insurance Regulation (OIR) proposed a new rule to prevent discrimination in the use of credit scores by insurers. This rule would have imposed an affirmative burden on insurers to establish with OIR that any credit scoring methodology utilized did not "disproportionately affect" consumers based on race, color, religion, marital status, age, gender, income, national origin or place of residence.

Some insurance industry trade associations challenged the proposed rule, arguing it would effectively ban the use of credit scores in the underwriting of insurance policies. Since insurers do not collect demographic information about applicants, insurers argued they would have no way to establish with OIR that the classes sought to be protected were not being "disproportionately" affected.

The industry associations also challenged the proposed rule's prohibition against an insurer's use of any credit scoring methodology that is "unfairly discriminatory." The proposed rule defined the term "unfairly discriminatory" to include the use of methodology that "disproportionately" affects persons belonging to certain protected classes, but it failed to define what a disproportionate effect was.

Last December, an administrative law judge sided with the industry associations and determined the rule's definition of "unfairly discriminatory" was impermissibly vague and that the rule could not be enforced by OIR.

Public hearing on new proposal

In response to this decision, the OIR recently issued two new proposed rules to overcome shortcomings in the prior proposed rule identified by the administrative law judge. They would require insurers to submit proof that the models, methods, programs and other processes are accurate predictors of risk.

They also would require insurers to detail the credit scoring methodologies used and the particular effect that certain credit scores will have on consumers. The changes also seek to define the terms "unfairly discriminatory" and "disproportionate impact."

OIR has scheduled a public hearing on the proposed rules for Thursday in Tallahassee. Industry associations are expected to again challenge the new rules to assure that insurers will be able to use credit scoring, which they say is a valid method to predict risk and, accordingly, set rates charged to insureds.

There is evidence to support their position in a 2004 study commissioned by the Texas Department of Insurance that concluded that credit scoring improves pricing accuracy by better predicting risk.

This month the Federal Trade Commission (FTC), the federal agency that enforces FCRA, released the results of a study that found credit information was an effective predictor of the number of claims insureds filed and the size of those claims.

The FTC concluded that credit scores may result in savings for consumers since they enable the insurers to make more efficient and reliable underwriting decisions. But the FTC study openly acknowledges the premiums paid by certain racial and ethnic minorities, on average, may be affected by their overrepresentation in the lower credit score tiers.

A consortium of consumer groups have attacked the FTC's report and are requesting that Congress ban credit scoring for insurance.

Battle over notice

In June, just before the OIR issued its new proposed rules on the use of credit scoring, the U.S. Supreme Court issued a significant decision on credit-scoring. The high court's decision in June in *Safeco Insurance Co. v. Burr* pertained to FCRA, which like Florida law, requires that insurers advise consumers when their credit scores result in higher premiums or coverage denials. This notice is known as an adverse decision notice.

One important point the Supreme Court addressed: What are the obligations of insurers to provide notice of an adverse decision to first-time applicants for insurance?

FCRA requires insurers provide notice to consumers when they make an adverse decision based on credit reports. Similar to Florida law, FCRA defines adverse actions to include situations in which an applicant is not offered the best rates or coverages available because of the applicant's credit score.

In *Safeco*, the insurers argued the mandatory adverse decision notice was not required for first-time applicants. They argued that any decision made by an insurer on a first-time applicant cannot be "adverse" since there is no baseline rate or coverage applicable to the applicant. The initial rating of an applicant cannot be adverse, it was argued, because there is no prior rating history of the applicant for comparison purposes.

The Supreme Court rejected the insurers' argument. The high court, in a 9-0 ruling, held that this notice requirement applies not only to existing customers who experience rate changes due to their credit score but also to new applicants who are being assigned rates and coverages for the first time. In both instances, notice is required if the rates or other policy terms offered based on the consumer's credit score are not the best available from the insurer.

The court's holding is significant because now every new applicant for insurance who does not receive the best rates or coverage terms available based on his or her credit scoring will be legally entitled to receive an adverse decision notice from the insurer.

The legal trend with respect to the use of credit scoring in insurance clearly shows a tightening of restrictions on insurers. This trend is apparent in Florida, where credit scoring is one industry practice the state is determined to carefully regulate. The impact of the FTC's recent report is yet to be determined. This promises to be a controversial and hotly debated issue on both the state and national levels.

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