Legal Backgrounder

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State Insurance Commission's Assault on Risk-Based Auto Rates Both Unlawful and Ill-Advised

by Kirk Herath

The factors that property and casualty insurers can consider when determining an insurance applicant's risk have long been a topic of debate in state legislatures and insurance regulatory agencies. In recent years, that debate has focused intently on whether insurers' use of an applicant's credit history illegally discriminates against racial and ethnic minorities.

The very concept of private insurance requires insurers to "discriminate" between those who pose a high risk of insured losses and those who pose a lower risk. Insurers, like all financial services companies, can lawfully make such calculations based on broad, neutral factors that have been mathematically proven to predict an individual consumer's risk posture. Businesses use a variety of factors in determining a consumer's risk and premium. Depending on the insurance product, these include the applicant's age, driving record, claims record, value of the automobile/home, local crime statistics, among others. If an applicant poses more risk to an institution, that applicant pays more, be it through a higher interest rate for a bank loan or a higher premium for property or casualty insurance.

Four states—California, Hawai'i, Massachusetts, and Maine—prohibit the use of credit as a factor in underwiriting insurance products. Interestingly, those states insurance consumers tend to pay higher-than-normal insurance prices on average. Many insurers use credit-based insurance scores in states where it is legal to do so. The State of Washington currently permits consideration of an applicant's credit.

Washington's Rule and the Insurance Industry's Response

Washington's Insurance Commissioner, Mike Kreindler, disagrees with the state's approach to credit history. For years, Kreindler has unsuccessfully lobbied Washington's progressive legislature to grant him rulemaking authority over automobile insurers' use of credit scores.

After the legislature rejected Commissioner Kreindler's efforts in 2021, he acted unilaterally, adopting an Emergency Rule prohibiting auto insurers' use of credit history. He claimed that COVID-19 and the federal government's legislative response to the pandemic compelled his office's immediate action. Several insurance trade associations sued to enjoin the Emergency Rule in April 2021. On October 8, 2021, a state court held that the Commissioner could not establish the good cause required by statute to dispense with public notice-and-comment.

Rather than appeal, Commissioner Kreindler moved toward adopting a permanent rule that his office published for public comment on October 5, 2021. The proposal set a public-comment deadline of November 22, stated the Insurance Commission would hold a November 23 hearing on the rule, and declared that the rule would take effect on November 24. Commissioner Kreindler held off on finalizing the rule through December 2021 and January 2022. After he learned of a new legislative effort to prohibit the Commission from conducting rulemaking on credit scores, he swiftly published the final rule on February 1, 2022.

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Three trade associations representing over 100 insurance companies and thousands of agents and brokers (the Americans Property Casualty Insurance Association, the Professional Insurance Agents of Washington and the Independent Insurance Agents and Brokers of Washington) filed suit against the Insurance Commission and the Commissioner on February 2, arguing that the office lacks the statutory authority to issue the rule. A fourth association, the National Association of Mutual Insurance Companies, filed a separate suit. In addition to the lack of legal authority, the lawsuits argue, among other things:

- The Commissioner's Rule was arbitrary and not based in any facts or actuarial analysis.
- The Commissioner asserts, without facts or analysis, Congress's passage of the CARES Act as a justification for the ban. The law in part temporarily protects some in-debt consumers from the reporting of negative credit events. That action leads to "objectively inaccurate" and unreliable credit scores, the Commissioner asserts, which in turn undermines the predictive value of credit scoring and will lead insurers to discriminate against those who benefit from CARES.
- The Commissioner offers no evidence that creditors treated consumers who received credit accommodations under the CARES Act differently from those who have not. And even if the law permitted creditors to treat consumers experiencing negative credit events differently from others, insurers do not unfairly or unlawfully treat such consumers differently when pricing insurance and determining eligibility for coverage.
- Contrary to the Commissioner's claim about the effects of the CARES Act's expiration, credit scores have actually improved during the pandemic.
- Finally, the rule forces insurers to charge an inadequate rate in light of the risk posed by a consumer. Thus, the rates will either be too low or excessive and, as a result, will unfairly and unlawfully discriminate against consumers.

This last argument underscores one of the primary purposes of insurance regulation. Insurance regulation has two main components—financial and consumer protection. The financial component ensures that insurers remain solvent. This means that the risks they assume through insurance coverage obligations are offset by actuarially sound premiums. In other words, insurers have to charge rates that are going to provide them with enough premium to conservatively assure regulators that they will have sufficient funds, including investment income, to offset future losses.

By arbitrarily eliminating one important factor in determining risk, Commissioner Krindler's actions would result in a misalignment between the amount of money an insurer charges versus the risk that they are assuming for that money. The premium would either be too much, which is illegal under state law, or too little, which could lead to future insolvency and, thus, also illegal under Washington law.

On February 23, a Washington Superior Court judge combined the two separate suits and stayed the Insurance Commission's rule, which was set to take effect March 4. The rule will remain stayed until the court rules on the merits of the associations' claims.

Regulatory Oversight and Studies Affirm Insurers' Use of Credit History

The associations' legal challenges will turn on whether Commissioner Kreindler possesses independent authority to issue the permanent rule. But the Washington rule, as well as other state bans on insurers' use of credit, also fail as a matter of sound public policy.

The system of insurance regulation in the United States is often misunderstood. Given the vast authority the federal government possesses, the average consumer may logically believe insurance is regulated at the national level. On the contrary, the states, not the federal government (with some exceptions in the health insurance and securities arena), oversee the sale and underwriting of most insurance products, particularly the property and casualty coverage of home and automobile owners.

State insurance regulators' main membership organization is the National Association of Insurance Commissioners (NAIC). NAIC is in essence a trade association that represents the collective views of state regulators. The organization establishes standards and best practices, conducts peer reviews, and coordinates regulatory oversight.

The NAIC's primary focus is assuring insurance company solvency. Though its members have studied and debated the use of credit in underwriting insurance for several decades, the NAIC has never recommended that states prohibit the use of credit history as an underwriting factor, nor has any of the organization's studies shown it to illegally discriminate, even unintentionally. In fact, NAIC authored a consumer fact sheet in 2020, "Credit-Based Insurance Scores Aren't the Same as a Credit Score. Understand How Credit and Other Factors Determine Your Premiums."

While NAIC created the fact sheet primarily as a consumer information and protection guide, it effectively explains how one's credit score is an indicator of risk, why it is used as such, and in many respects endorses the activity. The fact sheet explains:

- How insurers can use one's credit-based insurance score to determine a premiums. It also explains how a consumer's credit-based insurance score is not the same as his or her regular credit score.
- How a credit-based insurance score cannot use any personal information to determine a score.
- How information that is not in one's credit report cannot be used as part of an insurance score, including race, color, and national origin.
- How an insurance company can only use a credit-based insurance score as *one* factor in its underwriting process.
- How credit information will be considered with several other factors that vary by insurance type. For example, auto insurers may utilize ZIP code (some locales have higher crime or driving accidents); other household drivers (some for whom may have poor driving history); the age of the operators; marital status (married people, particularly men, are less risky); gender (young men pose higher risks than young women); education; occupation; model and a auto's age (some cars are more expensive and more costly to repair than others); claims history; coverage selection (more coverage, more expensive potential losses); deductible; and the miles driven annually (a driver who drives more miles annually is statistically more likely to have an accident than a driver who drives few miles).

Other private and government research confirms the impact of credit scores on the setting of premiums. Forbes Advisor's analysis of auto insurance rates in the 46 states permitting credit as a pricing factor found "an average increase of 76% for drivers with poor credit. That amounts to about $1,180 more per year for drivers with poor credit, compared to drivers with good credit." Credit-score-use prohibition proponents such as Commissioner Kreindler don't dispute the factual link between premium amounts and low credit scores. What they argue is that the use of credit scores harms consumers overall and unfairly discriminate against racial minorities, even unintentionally.

Consider, however, a Federal Trade Commission (FTC) study of credit-based scores Congress mandated in the Fair and Accurate Credit Transactions Act. That study found, among other conclusions, the following:

- There was a clear correlation between a score that included credit and claims frequency and magnitude (*i.e.*, credit is a good indicator of how often and how big losses might be).
- Credit was not a good proxy for race, which undermined the main argument used by opponents of credit-based insurance underwriting, that the practice amounted to illegal discrimination based on race.

- Even within ethnic and minority groups, those with better credit paid lower premiums than those with worse credit score.

In essence, the FTC, while not overtly endorsing the practice, affirmed insurers' argument that the better one's credit-based score, the lower the risk that one will suffer a loss. Furthermore, the Commission also determined that use of credit scores actually benefited higher risk consumers. Insurers' reliance on credit scores improved risk-pricing accuracy, which in turn expands the availability of insurance. Since insurers' losses are a factor in overall pricing, lower losses amount to lower insurance prices for everyone.

In addition to the FTC study at the federal level, several state insurance departments have studied the use of credit to determine insurance rates and found most drivers pay less for car insurance when credit is used as a pricing factor. For example, a study conducted by the Vermont Department of Financial Regulation found that credit-based underwriting resulted in 66% of policyholders having lower premiums, 16% had higher, and 18% had no impact. Banning the use of credit would result in two-thirds of the state's drivers seeing their cost of insurance "increase" by spreading (*i.e.*, socializing) the cost of the higher risk drivers across all drivers. An Arkansas study found about the same distribution among its state's drivers (57% decrease, 23% increase, and 19% no impact).

Thus, no regulatory study has been able to prove that the use of credit harms insurers in general. On the contrary, studies have shown that the practice helps most consumers of all races with lower prices, and have failed to identify even a correlation between use of credit and race, even unintentionally.

Conclusion

Regardless of the outcome of the litigation and the legislative credit-use debate in Washington, national and state-based opponents of credit-score use will continue to pursue legislative and regulatory impediments. It is notable that NAIC has pledged to address alleged discrimination in the insurance industry by forming a special study committee. One of the committee's first tasks is to determine whether non-driving factors, such as the use of credit in underwriting potentially disadvantages minorities.

At the federal level, some Members of Congress have introduced legislation that would virtually socialize insurance. For example, Senator Cory Booker's 2020 Prohibit Auto Insurance Discrimination (PAID) Act prohibited both the use of credit scores in underwriting and more traditional factors, such as gender, ZIP code, marital status and employment status. The PAID Act failed to gain any traction, though.

As noted above, one of insurance regulators' primary goals is to maintain insurer solvency. Policies that prohibit or impede the use of proven risk calculation factors such as an applicant's credit history directly undermine that goal. Prohibition proponents argue in the name of fairness and call the credit history's use discriminatory. What they don't acknowledge, however, is that eliminating that factor, based on perception and little else, will increase the number of higher-risk policyholders whose likely losses will be paid for by less-risky policyholders paying more for their insurance than their individual risk warrants. Further, higher risks leading to higher premiums will reduce insurance opportunities for all consumers, but especially for those in lower-income brackets.

Elected officials and regulators need look no further than what cost shifting and overregulation have done to America's private health-insurance system over the past 30 years. More government involvement has driven up costs and driven down consumer access. Property and casualty insurers and their customers risk the same fate