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RESPONSE OF THE AMERICAN PROPERTY CASUALTY INSURANCE ASSOCIATION TO THE PROPOSED RECOMMENDATIONS REGARDING DISPARATE IMPACT

FEDERAL ADVISORY COMMITTEE ON INSURANCE

SUBCOMMITTEE ON AVAILABILITY OF INSURANCE PRODUCTS

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INTRODUCTION

The American Property Casualty Insurance Association (APCIA) appreciates the opportunity to make this submission responding to the proposed Federal Advisory Committee on Insurance (FACI) recommendations to the Federal Insurance Office (FIO) regarding disparate impact liability contained in a paper circulated to members of the Subcommittee on May 22, 2020 (May 22 Paper). APCIA strongly opposes the proposed recommendations for the reasons set forth below and in APCIA's January 21, 2020 submission to this Subcommittee.

The first of the proposed recommendations conflicts with Supreme Court precedent and disregards the Treasury Department's settled view relating to the Department of Housing and Urban Development (HUD) proposed regulation addressing disparate impact liability under the Fair Housing Act (FHA). The second proposed recommendation, regarding state insurance regulation, conflicts with current state law, would undermine the business of insurance, and is contrary to Supreme Court precedent while resting on underdeveloped and untested statistical theories set forth in an informal paper that cites no authoritative statistical or actuarial analysis, economist, or statistician for support and makes unsupported assumptions regarding how risks are priced and underwritten.

THE PROPOSED RECOMMENDATIONS

The May 22 Paper contains two proposed recommendations:

1. "FACI recommends that FIO support disparate impact as unfair discrimination against protected classes in residential property insurance under the Fair Housing Act as currently recognized by the Department of Housing and Urban Development (HUD) and oppose the proposed revisions to HUD's disparate impact rules."

2. "FACI recommends that FIO encourage states to modernize insurance regulation by explicit recognition of disparate impact as unfair discrimination against protected classes and further encourage states to develop statutory or regulatory guidance for insurers to identify and minimize disparate impact against protected classes and for safe harbors for insurers to demonstrate compliance."

These proposed recommendations are addressed in turn below.

FIO SHOULD NOT OPPOSE HUD'S DISPARATE IMPACT REGULATION

Background

On August 19, 2019, HUD published a Notice of Proposed Rulemaking ("Proposed Rule") titled "HUD's Implementation of the Fair Housing Act's Disparate Impact Standard."[1] The Proposed Rule would modify a prior HUD regulation published in 2013 entitled "Implementation of the Fair Housing Act's Discriminatory Effects Standard" (the "Disparate Impact Rule").[2] The 2013 regulation provided "that liability under the Fair Housing Act may arise from a facially neutral practice that has a discriminatory effect" on a group of persons defined by race, color, religion, sex, handicap, familial status, or national origin—"regardless of whether there was an intent to discriminate"—and set forth a specific burden-shifting framework for applying that disparate-impact standard. [3] In 2014, a federal district court held that HUD's assertion that the Disparate Impact Rule applied to insurance was arbitrary and capricious. *See Property Cas. Insurers Ass'n of Am. v. Donovan*, 66 F. Supp. 3d 1018, 1047-1051 (N.D. Ill. 2014). In 2016, HUD adhered to its view that the Rule applied to insurance. *See* 81 Fed. Reg. 69,012 (Oct. 5, 2016). But in 2019, HUD proposed to impose important limitations and clarification. The 2019 Proposed Rule would "amend HUD's interpretation of the FHA's disparate-impact standard to better reflect the Supreme Court's 2015 ruling in *Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc.*, and to provide clarification regarding the application of the standard to State law governing the business of insurance."[4]

Comments on HUD's Proposed Rule were due October 18, 2019. Over 45,000 comments were submitted. *See* https://www.regulations.gov/docket?D=HUD-2019-0067. HUD appears to be poised to publish its Final Rule, which was submitted to the Office of Information and Regulatory Affairs for review on May 7, 2020. *See* https://www.reginfo.gov/public/do/eoDetails?rrid=130337.

The May 22 Paper opposes the more recent Proposed Rule's changes in the burden-shifting framework set forth in the original 2013 Disparate Impact Rule to ensure that disparate impact liability is applied only where appropriate under governing Supreme Court case law. *See Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc.*, 135 S. Ct. 2507 (2015); May 22 Paper at 5-6. The Paper also opposes a proposed defense that would apply "[w]here a plaintiff alleges that the cause of a discriminatory effect is a model used by the defendant, such as a risk assessment algorithm." 84 Fed. Reg. at 42,862; May 22 Paper at 6-7. The Subcommittee should reject both of these arguments as substantively at odds with *Inclusive Communities* and untimely as it relates to the rule-making process.

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[1] 43 Fed. Reg. 42,854 (Aug. 19, 2019).

[2] 78 Fed. Reg. 11,460 (Feb. 15, 2013); *see* 24 C.F.R. § 100.500.

[3] 78 Fed. Reg. at 11,460; *see also* 24 C.F.R. § 100.500.

[4] 43 Fed. Reg. 42,854.

Opposing the HUD Proposed Rule Would Conflict with Treasury's Position

In October 2017, Treasury issued a report entitled "A Financial System That Creates Economic Opportunities Asset Management and Insurance."[5] Among other things, that report urged HUD to reconsider the 2013 Disparate Impact Rule, stating:

> Treasury recommends that HUD reconsider its use of the disparate-impact rule. In particular, HUD should consider whether the disparate-impact rule, as applied, is consistent with McCarran-Ferguson and existing state law. HUD should also reconsider whether such a rule would have a disruptive effect on the availability of homeowners insurance and whether the rule is reconcilable with actuarially sound principles.[6]

The proposed recommendation—that FIO oppose HUD's efforts to revise the 2013 regulation—would thus conflict with Treasury's public position on the question. FIO may not disregard Treasury's views on this issue, and the FACI should not recommend that FIO do so.

HUD's Proposed Changes to the Burden-Shifting Framework Are Consistent with *Inclusive Communities*

APCIA supports HUD's proposal to modify the burden-shifting framework set forth in the 2013 Disparate Impact Rule and opposes any contrary recommendation by the FACI. The modifications HUD suggested are fully consistent with—and indeed mandated by—the Supreme Court's 2015 decision in *Inclusive Communities*, as well as the Supreme Court's prior decision in *Wards Cove Packing Co. v. Atonio*, 490 U.S. 642 (1989).

Although the Supreme Court in *Inclusive Communities* recognized that disparate-impact claims are cognizable under the FHA, the Court emphasized that they "must be limited so employers and other regulated entities are able to make the practical business choices and profit-related decisions that sustain a vibrant and dynamic free-enterprise system." *Inclusive Cmtys.*, 135 S. Ct. at 2518. Only "artificial, arbitrary, and unnecessary" practices that are causally linked to a racial imbalance by robust evidence, beyond a mere correlation, may be subject to liability. *Id.* at 2522-24. Legitimate business practices do not give rise to liability even if they happen to have differential impacts. These requirements ensure that defendants are not "held liable for racial disparities they did not create." *Id.* at 2523 (citing *Wards Cove*, 490 U.S. at 653). When a defendant articulates a "valid interest served by their policies," the plaintiff should not be allowed to "second-guess which of two reasonable approaches" a defendant should follow. *Id.* at 2522. The Court also cautioned against any disparate-impact framework that did not have "adequate safeguards at the prima facie stage" to prevent the use of race "in a pervasive way" or the injection of "racial considerations into every housing decision." *Id.* at 2523-24. The Court recognized that the absence of such safeguards would tend to "perpetuate race-based considerations rather than move beyond them." *Id.* at 2524.

[5] *See* U.S. Dep't of the Treasury, *A Financial System That Creates Economic Opportunities Asset Management and Insurance* (Oct. 2017), https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf.

[6] *Id.* at 110.

And fundamentally, the Court expressed concern that the "specter of disparate-impact litigation" could discourage businesses from undertaking activities essential to a well-functioning housing market. *Id.*

The requirements included in HUD's Proposed Rule (proposed 24 C.F.R. § 100.500(b))—that the May 22 Paper opposes—are consistent with the Supreme Court's guidelines:

- In section 100.500(b), the Proposed Rule would require that the plaintiff's claim focus on "a specific, identifiable policy." That requirement was set forth by the Court in *Wards Cove*. *See* 490 U.S. at 657 ("As a general matter, a plaintiff must demonstrate that it is the application of a specific or particular employment practice that has created the disparate impact under attack."). It also incorporates the Supreme Court's instruction in *Inclusive Communities* that "a disparate-impact claim that relies on a statistical disparity must fail if the plaintiff cannot point to *a defendant's policy or policies* causing that disparity." 135 S. Ct. at 2523 (emphasis added).

- In section 100.500(b)(1), the Proposed Rule requires a plaintiff to allege that the challenged policy or practice is "arbitrary, artificial, and unnecessary to achieve a valid interest or legitimate objective." This language tracks the Court's confirmation in *Inclusive Communities* that challenged policies are "not contrary to the disparate-impact requirement unless they are 'artificial, arbitrary, and unnecessary barriers.'" *Inclusive Cmtys.*, 135 S. Ct. at 2524; *see also id.* at 2522.

- Proposed § 100.500(b)(2) would require a "robust causal link" between the challenged practice and the alleged disparate impact. The Court in *Inclusive Communities* opined regarding the importance of a "robust causality requirement." *Id.* at 2523.

There is no basis for the FACI to recommend that the FIO oppose changes proposed by HUD that would merely conform HUD's regulations to binding Supreme Court precedent.

<u>Adopting An Algorithm Defense Would Be Appropriate</u>

The Proposed Rule would provide a defense "[w]here a plaintiff alleges that the cause of a discriminatory effect is a model used by the defendant, such as a risk assessment algorithm." 84 Fed. Reg. at 42,862 (proposed 24 C.F.R. § 100.500(c)(2)). This "algorithm defense" is available if the defendant:

- "(i) Provides the material factors that make up the inputs used in the challenged model and shows that these factors do not rely in any material part on factors that are substitutes or close proxies for protected classes under the Fair Housing Act and that the model is predictive of credit risk or other similar valid objective"; or

- "(ii) Shows that the challenged model is produced, maintained, or distributed by a recognized third party that determines industry standards, the inputs and methods within the model are not determined by the defendant, and the defendant is using the model as intended by the third party"; or

- “(iii) Shows that the model has been subjected to critical review and has been validated by an objective and unbiased neutral third party that has analyzed the challenged model and found that the model was empirically derived and is a demonstrably and statistically sound algorithm that accurately predicts risk or other valid objectives, and that none of the factors used in the algorithm rely in any material part on factors that are substitutes or close proxies for protected classes under the Fair Housing Act.”

Adopting a properly framed algorithm defense is important and appropriate. Each of the above variants HUD proposes contains a critical safeguard—ensuring that the model used is, in fact, predictive of risk. The first variant of the defense specifies that the model must be “predictive of credit risk or other similar valid objective.” The second variant is limited to models developed by an industry standards-setting entity. And the third variant requires that the model be shown to be “empirically derived” and to be a “demonstrably and statistically sound algorithm that accurately predicts risk or other valid objectives.” The algorithm defense thus applies only where an insurer is relying on an actuarially sound model that is predictive of risk. Such a practice is not subject to liability under the HUD regulation: As HUD has recognized, even if a plaintiff can show a possible disparate impact, an insurer can prevail under the burden-shifting framework by demonstrating that it is engaged in legitimate risk-based pricing. *See* 81 Fed. Reg. at 69,015 (recognizing “that risk-based decision making is an important aspect of sound insurance practice”); *id.* (conceding that “nothing in the Rule prohibits insurers from making decisions that are in fact risk-based”). The algorithm defenses merely reflect this settled aspect of disparate impact law—disparate impacts are not prohibited if they merely happen to result from legitimate business practices.

Where am insurer has relied on an algorithmic model, the insurer cannot be found to have directly caused any resulting disparate impact because the “robust causal link” (required by both *Inclusive Communities* and the Proposed Rule) is missing. Moreover, in this situation, the insurer has not adopted some arbitrary or irrational practice. It has relied, rather, on an algorithmic model designed to engage, for example, in “risk assessment.” 84 Fed. Reg. at 42,862. To oppose now (as the Proposed Recommendations do) this element of HUD’s Proposed Rule, which is grounded in *Inclusive Communities,* is substantively out of sync with Supreme Court guidance—not to mention untimely.

The May 22 Paper posits that variants (i) and (iii) of the algorithm defense are flawed because they allow parties to escape liability by relying on models that purport to use “neutral” factors but in fact result in disparate effects. As explained above, however, the algorithm defense is consistent with general disparate-impact theory, which precludes liability where a defendant shows at the second step of the analysis that it is relying on a legitimate business practice. The algorithm defense is also consistent with *Inclusive Communities’* safeguard against holding parties accountable for disparities that are the result of factors that are not within the parties’ control, as explained further at pages 10 and 13 *infra*. The May 22 Paper also asserts that variant (ii) is inconsistent with insurance industry practice, which holds insurers responsible for third-party tools the insurer may use and requires models to be subject to regulatory review. But nothing in the rule insulates insurers from challenge or precludes regulatory review of insurer pricing models that are developed by third parties in the first instance.

FIO SHOULD NOT URGE STATES TO REQUIRE INSURERS TO CONSIDER PROTECTED CHARACTERISTICS TO TRY TO PREVENT DISPARATE IMPACT

Background

As explained in APCIA's January 21 paper, insurers set prices according to risk, not protected characteristics. Excluding persons from participation in society, government, or markets based on protected characteristics is wrong. Intentional discrimination based on protected characteristics in the pricing of insurance is prohibited everywhere. APCIA fully supports existing state laws prohibiting discrimination. But APCIA strongly opposes any proposal to fundamentally modify the manner in which states regulate insurance by imposing novel disparate impact standards that are inconsistent with the business of insurance and conflict with state insurance laws.

Risk-based pricing is fundamental to the business of insurance. To predict losses and thereby set rates and underwriting guidelines, insurance actuaries and underwriters examine numerous risk factors that correlate with losses. Quantifying the impact of any risk factor is a purely mathematical statistical exercise. *Homeowners and commercial habitational insurance actuaries and underwriters do not consider protected characteristics when evaluating these factors.* As stated by the Casualty Actuarial Society, "[i]t is important that proper actuarial procedures be employed to derive rates that protect the insurance system's financial soundness and promote equity and availability for insurance consumers."[7]

Accurate pricing ensures the broad availability of insurance, by permitting insurers to cover the cost of the risks they agree to bear. It promotes fairness—insureds pay rates that reflect their individual risk—and provides incentives for insureds to properly mitigate risks. And, critically, it safeguards *the solvency* of insurers. If an insurer sets a price too low or fails to accurately account for the risks involved with policies, it may not have the funds to pay claims.[8] Rate regulation is an integral aspect of solvency regulation because it ensures that insurance companies charge premiums that are sufficient to cover current and future claims.[9] Insurers thus have clear incentives to engage in accurate risk assessment and state regulators have a clear incentive to ensure that they do.

State insurance codes and actuarial principles affirmatively permit risk-based pricing.[10] Insurance regulation in every state, including the District of Columbia, is designed to create and

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[7] Casualty Actuarial Society, *Statement of Principles Regarding Property and Casualty Insurance Ratemaking*, Principle 1 (May 1988), https://www.casact.org/professionalism/standards/princip/sppcrate.pdf.

[8] *See, e.g.*, Zain Mohey-Deen & Richard J. Rosen, *The Risks of Pricing New Insurance Products: The Case of Long-Term Care*, FEDERAL RESERVE BANK OF CHICAGO, https://www.chicagofed.org/publications/chicago-fed-letter/2018/397 ("Underpricing a new product was the major cause of the insolvency of Penn Treaty . . . at the time the tenth-largest [long-term] insurer.").

[9] Joshua Phares Ackerman, *The Unintended Federalism Consequences of the Affordable Care Act's Insurance Market Reforms*, 34 Pace L. Rev. 273, 283 (2014)

[10] As explained by the Actuarial Standards Board, "[t]he actuary should select risk characteristics that are related to expected outcomes. A relationship between a risk characteristic and an expected outcome, such as cost, is demonstrated if it can be shown that the variation in actual or reasonably anticipated experience correlates to the risk characteristic." Actuarial Standards Board, *Actuarial Standard of Practice No. 12*, Section 3.2.1. (2005), http://www.actuarialstandardsboard.org/asops/risk-classification-practice-areas/#321-relationship-of-risk-characteristics-and-expected-outcomes.

sustain heathy insurance markets by prohibiting rates that are "excessive, inadequate or unfairly discriminatory." As explained in the Casualty Actuarial Society Statement of Ratemaking Principles, "[a] rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer."[11] Rates are "unfairly discriminatory" if "premium differences . . . do not correspond to expected losses and average expenses or if there are expected average cost differences that are not reflected in the premium differences."[12] Indeed, the vast majority of states not only permit risk-based pricing but expressly *require* it. State laws make clear that failing to take risk into account results in unfair discrimination, which is described in state statutes and case law as treating insureds with similar risk profiles differently. State laws also mandate that insurers consider past losses and other relevant risk factors in developing insurance rates. See Appendix 1 entitled "State Insurance Laws".

The May 22 Paper's Proposal

The May 22 Paper proposes that insurers be required to somehow obtain detailed race and other demographic information about their customers, analyze that data, and then cease relying on any actuarial risk factor to the extent it correlates with any protected characteristic. *See* May 22 Paper at 3-4, 9-10. The paper urges FACI to encourage state regulators to require insurers to collect data on their insured's protected characteristics and then use that data in their pricing models. *See id.* at 4, 10. The paper appears to suggest that including insureds' protected characteristics in a pricing model will cause the model to re-weigh the predictive impact of traditional actuarial risk factors in a manner that excludes any predictive power of that risk factor to the extent the factor is correlated with a protected characteristic. *Id.* The paper argues that including protected characteristic variables in regression models will actually make the models *more* accurate because including them somehow "minimize[s]" the "correlation between" predictive risk factors and protected characteristics." *Id.* at 10. The paper proposes that insurers should be required to reduce their reliance on traditional actuarial risk factors based on this exercise. *Id.* at 4. Under this approach, insurers would be prohibited from relying on risk factors predictive of risk to the extent those factors may be correlated in any way with a protected characteristic, which would, thereby, reduce the accuracy of pricing models.

As explained below and in APCIA's prior submission, the proposed approach raises significant concerns by requiring insurers to collect race and other demographic data, in conflict with standard practices and state law in some instances. There are also significant statistical questions raised by the proposed approach, which cites no authority for its key statistical assertions and fails to undertake any rigorous discussion of the impact on a regression analysis of including non-risk demographic characteristics that are not expected to be predictive of risk and that insurers otherwise would not consider. Moreover, preventing insurers from fully relying on neutral factors that are, in fact, predictive of risk of loss—would fundamentally undermine the business of insurance, risk insurer insolvency, and conflict with existing insurance laws in every state as well as with *Inclusive Communities* without any evidence the proposed recommendation will not

[11] Casualty Actuarial Society, *Statement of Principles Regarding Property and Casualty Insurance Ratemaking*, Principle 4 (May 1988), https://www.casact.org/professionalism/standards/princip/sppcrate.pdf.

[12] Miller, *Disparate Impact and Unfairly Discriminatory Insurance Rates*, Casualty Actuarial Society E-Forum at 283 (internal quotation marks omitted).

adversely change a regulatory structure designed to help ensure economic viability while at the same time treating consumers fairly.

The May 22 Paper Does Not Provide Sufficient Justification for Mandating Insurers To Collect Sensitive Race and Other Demographic Data from their Customers

Mandating that insurers seek to obtain sensitive race and other demographic data from their customers would be a profound break from current practice and public policy objectives, which seek to ensure that insurance decisions are based on risk, not protected characteristics that bear no relationship to risk. The May 22 Paper fails to provide an adequate justification for such drastic action.

The foundation of the May 22 Paper's proposal—that FIO recommend states require insurers to fundamentally alter their pricing models to include protected characteristics—is based on a wholly unsupported statistical analysis. The May 22 Paper makes unsubstantiated assertions about the impacts on complex regression analyses of adding new variables for protected characteristics. Those characteristics are not expected themselves to impact risk of loss. But the May 22 Paper assumes that in at least some cases protected characteristics will be *correlated* with at least some legitimate actuarial risk factors. It then purports to explain the impact of including those correlated—but themselves unpredictive—variables in insurer regression models.

Notably, however, the May 22 Paper does not make a single reference to a textbook, journal article, scholarly work, or any other statistical analysis supporting its bare assertions. There is no indication that the May 22 Paper is based on any empirical, peer-reviewed analysis grounded in actual data. Indeed, the paper makes its predictions in a half a page of cursory analysis based on an unsupported opinion. In contrast, as noted above, Principle 4 of the Casualty Actuarial Society's Standards for Rate Making provide that "a rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer."[13] Actuarial Standards Board, Actuarial Standard of Practice No. 12 advises that actuaries "should select risk characteristics that are related to expected outcomes."[14]

It would be irresponsible to mandate application of the May 22 Paper's untested approach without fully understanding how it will impact the accuracy of the pricing of insurance and the solvency of insurers. Implementing this approach, will be highly burdensome and complicated—if not impossible—given the practical and legal limitations on collecting data regarding insured's protected characteristics. Accurately determining the effect of the May 22 Paper's approach on the predictive value of insurance pricing models would require extensive testing and gathering data over a lengthy period of time, including data on protected characteristics, which are not presently

[13] Casualty Actuarial Society, *Statement of Principles Regarding Property and Casualty Insurance Ratemaking*, Principle 4 (May 1988), https://www.casact.org/professionalism/standards/princip/sppcrate.pdf.

[14] Actuarial Standards Board, *Actuarial Standard of Practice No. 12*, Section 3.2.1. (2005), http://www.actuarialstandardsboard.org/asops/risk-classification-practice-areas/#321-relationship-of-risk-characteristics-and-expected-outcomes.

collected by insurers.[15] As a practical matter, insurers would be forced to ask each of their customers for sensitive information about their protected characteristics. Aside from the undesirability of this process from a privacy standpoint, it would violate state laws that prohibit consideration of protected class characteristics[16] and those that prohibit collecting such data in the first instance, such as MD. CODE ANN. INS. § 27-501.[17]

APCIA respectfully submits that the FACI and the FIO could not responsibly make recommendations to states and to HUD—that are grounded in purported impacts on complicated statistical regression analyses—without having a basis grounded in rigorous statistical analysis and peer-review consensus. Back of the envelope statistical musings and unjustified opinions should not be the basis for the significant policy positions suggested in the May 22 Paper.

Preventing Full Consideration of Risk Would Undermine the Business of Insurance

The May 22 Paper's proposal would—as it is intended—restrict insurers from fully taking into account risk characteristics, making their pricing less accurate. By reducing the accuracy of pricing, the proposal would lead to the following outcomes:

- Lower-risk homeowners would have to be overcharged for insurance, while others would not pay a rate commensurate with their risk of fire and other hazards.[18]
  - When individuals are overcharged relative to the risk they pose, it leads to some low-risk insureds opting out of the insurance market where possible, which in turn raises prices for everyone. That, in turn, leads to more opt outs, which drives prices even higher, thereby continuing the downward spiral and threatening insurer solvency.

[15] *See* A.R. 376, *PCI v. Carson*, No. 13-8564 (N.D. Ill. Feb. 12, 2014) (ECF No. 19); ECF No. 44-2 ¶ 6, *PCI v. Carson*, No. 13-8564 (N.D. Ill. May 16, 2014) (insurer does not collect information on race or ethnicity); ECF No. 44-3 ¶ 11, *PCI v. Carson*, No. 13-8564 (N.D. Ill. May 16, 2014) (insurer does not collect data on policyholders' race or ethnicity); ECF No. 44-4 ¶ 11, *PCI v. Carson*, No. 13-8564 (N.D. Ill. May 16, 2014) (insurer does not consider data related to race, color, religion, national origin, or disability relevant to determining rates for homeowners insurance and does not collect such information); ECF No. 44-5 ¶ 7, *PCI v. Carson*, No. 13-8564 (N.D. Ill. May 16, 2014) (insurer does not collect data concerning race, color, or national origin of its policyholders and does not use such information in determining rates); ECF No. 27-2 ¶ 4, *AIA v. Carson*, No. 13-966 (D.D.C. June 26, 2013) (insurer does not collect or retain electronic records of race, color, or national origin and does not have capabilities to store and use such information); ECF No. 27-3 ¶ 9, *AIA v. Carson*, No. 13-966 (D.D.C. June 26, 2013) (insurer does not collect or consider race, color, religion, or national origin in underwriting and rating homeowners' insurance); ECF No. 27-5 ¶ 5, *AIA v. Carson*, No. 13-966 (D.D.C. June 26, 2013) (prior to the Disparate Impact Rule, insurer did not collect date on race, color, religion, national origin, sex, familial status, or handicap of its policyholders).

[16] *See, e.g.*, CAL. INS. CODE § 679.71 (prohibiting insurers from denying insurance or providing insurance on less favorable terms due to an applicant's marital status, sex, race, color, religion, national origin, or ancestry).

[17] *See* MD. CODE ANN. INS. § 27-501(c)(1) (prohibiting insurers or insurance producers from inquiring about race, creed, color, or national origin in any manner of requesting general information related to an insurance application).

[18] *See* Miller, *Disparate Impact and Unfairly Discriminatory Insurance Rates*, Casualty Actuarial Society E-Forum at 284; Ronen Avraham, *The Economics of Insurance Law—A Primer*, 19 Conn. Ins. L.J. 29, 44 (2012).

- Where opting out is not possible, there are significant fairness concerns, as individuals posing lower risks are required, in effect, to subsidize more risky insureds.

- Insurer's in general, and those with smaller volumes (less data) and not very complex pricing models in particular, could suffer significant financial harm from incorporating variables that are not predictive of risk, resulting in threats to solvency and a less competitive insurance marketplace.

- The financial incentive for insureds to reduce risks, construct safer houses, and maintain existing houses would be reduced.[19] When insureds do not realize the benefit of reducing risk, they have less incentive to take actions to reduce risk.
- Without the ability to rate risks according to specific risk-profiles, insurance companies would likely withdraw from specific lines of business, leading to less availability of insurance and less competition in the market.
- If insurers were required to make their proprietary pricing models public, competition and innovation would be stifled, harming consumers.

<u>Preventing Full Consideration of Risk Would Conflict with Existing State Laws</u>

No state has adopted disparate impact as a standard for insurance ratemaking. But every state prohibits intentional discrimination based on protected characteristics. In addition, as noted above, every state prohibits rates that are *"excessive, inadequate, or unfairly discriminatory"* and ties all three elements to risk.

Rates may not be "excessive" relative to the risk that an insured presents. No rate may be "inadequate" for the solvency purpose previously described. And, no rate may be "unfairly discriminatory," which occurs when insureds presenting similar risk profiles are treated differently. In fact, as explained above, the vast majority of states *require* insurers to set rates based on past losses, anticipated future losses, related loss expenses, and other risk-related factors. These factors (taken together) form the foundation of risk-based pricing and underwriting.

Adopting the disparate impact approach suggested in the May 22 Paper and, thereby, preventing insurers from fully considering actuarial risks, would require amendments to laws in every state. Where, for reasons out of the control of insurers, there happen to be differential impacts from considering legitimate predictive risk factors, insurers would be compelled to charge unfairly discriminatory rates—rates that do not accurately reflect risk of loss.

The May 22 Paper's proposal finds no support in statements by the New York Financial Services Circular and the National Association of Insurance Commissioners (NAIC) Handbook it cites. *See* May 22 Paper at 8. The Circular states that its purpose is "to advise insurers authorized to write *life insurance* in New York of their statutory obligations regarding the *use of external consumer*

[19] Avraham, *The Economics of Insurance Law*, 19 Conn. Ins. L.J.at 66-67.

data and information sources in underwriting for life insurance."[20] And, it focuses exclusively on external "data or information sources not directly related to the medical condition of the applicant that is used . . . *as a proxy for traditional medical underwriting*, or to establish 'lifestyle indicators' that may contribute to an underwriting assessment of an applicant for life insurance coverage."[21] While confirming the appropriateness of external data sources, the Circular articulates the concern that "the accuracy and reliability of external data sources can vary greatly", many of these sources are "not subject to regulatory oversight and consumer protections," and they often "lack … transparency for customers"[22] The Circular's commentary on the potential that certain external data factors "mask …discrimination" does not call into question the fact that property and casualty insurers are mandated by state law and actuarial principles to consider *legitimate risk-based factors* (such as loss history, distance from a fire station, building material, etc.) to accurately price insurance.[23] In fact, the Circular affirms that the prohibition on "unfairly discriminatory" rates precludes pricing similar risk profiles differently, and it then recognizes an exception in general discrimination laws "where the refusal, limitation or rate differential is permitted by law or regulation and is based on sound actuarial principles or is related to actual or reasonably anticipated experience."[24] Similarly, the NAIC Handbook's general counsel against using underwriting variables that serve as proxies for protected characteristics, which may also lack "strong actuarial justification,"[25] does not undermine insurers' consideration of sound and neutral risk factors to adequately price insurance for various risk classifications.

In short, the May 22 Paper does nothing to dispute that the suggested approach would require fundamental changes in existing state laws.

The May 22 Paper's Proposed Approach Would Conflict with *Inclusive Communities*

As noted above, the Supreme Court's decision in *Inclusive Communities* put in place several "safeguards" to ensure that disparate-impact claims are properly limited.[26] Those safeguards include the following:

- Governmental or private policies are not subject to disparate-impact liability unless they are "artificial, arbitrary and unnecessary barriers."[27]

- Potential defendants must have "leeway to state and explain the valid interest served

[20] New York State Department of Financial Services, *RE: Use of External Consumer Data and Information Sources in Underwriting for Life Insurance*, Insurance Circular Letter No. 1 (2019) (emphasis added), https://www.dfs.ny.gov/industry_guidance/circular_letters/cl2019_01.

[21] *Id.* (emphasis added).

[22] *Id.*

[23] *Id.*

[24] *Id.* (emphasis added).

[25] *DRAFT Recommendations of the FACI Availability Subcommittee to FACI*, pg. 8 (citing NAIC Market Regulation Handbook, 2017 Edition at page 67).

[26] *Inclusive Cmtys.*, 135 S. Ct. at 2523.

[27] *Id.* at 2524.

by their policies."[28]

- Businesses "must be given latitude to consider market factors."[29]

- Claims must satisfy a "robust causality requirement," which "ensures that '[r]acial imbalance . . . does not, without more, establish a prima facie case of disparate impact' and thus *protects defendants from being held liable for racial disparities they did not create*."[30]

- Where another "law substantially limits the [defendant's] discretion," causation cannot be established.[31]

The Supreme Court cautioned that without these safeguards "disparate-impact liability might cause race to be used and considered in a pervasive way"[32] thereby tending to "perpetuate race-based considerations rather than move beyond them"[33] and to discourage businesses from undertaking the very activities that ensure a well-functioning market.[34]

Preventing insurers from fully considering actuarial risk, as set forth in the May 22 Paper, conflicts with these essential safeguards required by *Inclusive Communities*.

The "artificial, arbitrary, and unnecessary barriers" safeguard–

Relying on actuarially valid rate-setting models that do not consider any protected characteristics and are required by a state regulatory framework designed to ensure solvency for the benefit of the insurance-buying public cannot, by definition, be an "artificial, arbitrary, and unnecessary barrier" to participation in the insurance marketplace.

The "valid interest" safeguard–

A reliable assessment of risk over time and across a book of business is an essential component of achieving the solvency goals of individual insurers and the state regulatory framework guaranteeing the payment of covered claims.

The "leeway to consider market factors" safeguard–

Insurance markets function efficiently when insurance is priced in accord with risk-based factors. This sends appropriate and socially beneficial market signals about risk taking

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[28] *Id.* at 2522.

[29] *Id*. at 2523.

[30] *Id.* at 2523 (emphasis added).

[31] *Id.* at 2524.

[32] *Id.* at 2523.

[33] *Id.* at 2524.

[34] *Id.*

and risk mitigation, providing an incentive to guard against risk and, thereby, avoiding the societal consequences of moral hazard. The extensive state-law framework governing the pricing of insurance, including protections for insurer insolvency, is intended to promote such efficient operation, which encourages businesses to undertake the very activities that ensure a healthy insurance marketplace.

The "robust causality" safeguard–

Insurance companies do not consider, nor do they collect, data regarding their customers' race. An insurer's reliance on risk-based pricing is not, therefore, "the direct cause" of any resulting disparate impact. To the extent disparate impact arises from risk-related factors in this context, any alleged disparity is the result of factors that are not within the control of insurers. For example, the fact that a prospective insured under an auto policy is an urban versus rural dweller is highly correlated to future loss projections and factors into pricing as a result. Predicating alleged disparate-impact liability based on this factor would compromise an important tool for ensuring the solvency of insurers and their ability to pay current and future claims, while doing nothing to combat direct causes of discrimination.

The "limited discretion" safeguard–

State insurance laws uniformly prohibit "excessive, inadequate and unfairly discriminatory" rates and require an assessment of risk exclusively based on factors that are predictive of risk not only in the context of rate-setting but in the application of rates to individual insureds with similar risk profiles. These laws substantially limit insurers' discretion to depart from risk-based pricing and underwriting, which undermines causation.

Additionally, consistent with *Inclusive Communities*, as explained above, HUD itself has recognized that risk-based pricing is a legitimate business practice.[35] To prohibit insurers from fully considering actuarial risks, as the disparate impact proposal suggests, would ignore what HUD has already concluded and extend beyond what HUD initially proposed in its 2013 rule and now proposes to roll back in light of *Inclusive Communities*.

Finally, APCIA also has concerns that injecting disparate-impact analysis into insurance could lead to burdensome litigation. Disparate-impact claims are often asserted based only on alleged statistical discrepancies and can be costly to defend even when meritless. To the extent the suggested approach would go so far as to prevent insurers from raising their legitimate business interest in risk-based pricing as a defense (as HUD and *Inclusive Communities* have recognized is appropriate), the approach would impose even greater burdens.

[35] *See* 81 Fed. Reg. at 69,015 (recognizing "that risk-based decision making is an important aspect of sound insurance practice"); *id.* (conceding that "nothing in the Rule prohibits insurers from making decisions that are in fact risk-based").

CONCLUSION

FIO should not oppose HUD's Disparate Impact Rule because the proposed modifications are consistent with the Treasury's settled view and Supreme Court precedent and because they are wholly untimely given the status of HUD's Proposed Rule. Nor should FIO adopt the May 22 Paper's recommendation regarding state insurance regulation. Healthy and solvent insurance markets depend on accurate consideration of actuarial risk, consistent with the existing and long-standing state regulatory framework. Implementing the May 22 Paper's proposal would violate state laws prohibiting insurers from collecting data on customers' protected characteristics. Aside from this, preventing insurers from fully taking into account legitimate risk factors would have significant negative effects. Prices would rise, particularly for insureds presenting relatively lower risks, who would be required to subsidize risks they do not present. To the extent those low-risk insureds opt-out, they increase the current insurance gap while expecting state and or federal government support for homeowner losses, for example, in times of disaster. Insurers would make insurance less available in light of their inability to accurately price the risks they bear. Incentives for risk reduction—such as through safer building practices and loss prevention—would be diminished. Less accuracy in the rating structure and pricing may endanger the financial stability of some companies, creating a less competitive insurance marketplace. For all these reasons, and those set forth above, APCIA strongly opposes any effort to pursue the disparate impact approach that has been suggested to this Subcommittee in the May 22 Paper.