Use of Credit-Scoring Factors in the Pricing of Homeowner's Insurance Under the FHA and the McCarran-Ferguson Act

Posted on April 14, 2010 by Gregory Eisenreich

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In a putative class action, *Ojo v. Farmers Group, Inc.*, et al., Case No. 06-55522 (9th Cir. April 9, 2010), an en banc panel of the Ninth Circuit Court of Appeals decided a case where the Plaintiff alleged that the use of credit-scoring factors in the pricing of homeowner's insurance in Texas had a disparate impact on minorities in violation of the federal Fair Housing Act ("FHA"), 42 U.S.C. sections 3601-19.

The Ninth Circuit held that the FHA prohibits discrimination in the denial and pricing of homeowner's insurance. In doing so, it joined the Sixth and Seventh Circuits and disagreed with the Fourth Circuit on the issue of whether the FHA applied to homeowner's insurance.

It should be noted that the Court did not reach the issue of whether the use of credit-scoring factors actually violates the FHA, noting that there could be a "legally sufficient, nondiscriminatory reason" causing a disparate impact and that the defendant is also entitled to rebut the facts of an alleged prima facie case.

After addressing whether the FHA applied to homeowner's insurance, the Court held that the McCarran-Ferguson Act may "reverse-preempt" claims under the FHA. However, the Ninth Circuit did not decide the critical question.

[B]ecause the issue's resolution will have pervasive implications for future claims brought against Texas insurers, we have concluded that the appropriate course of action is to certify the issue to the Supreme Court of Texas.

Under the McCarran-Ferguson Act, state law preempts a federal statute if:

1. the federal law does not specifically relate to insurance;
2. the state law is enacted for the purpose of regulating insurance; and
3. the application of federal law to the case might invalidate, impair, or supersede the state law.

Thus, a claim that would otherwise be viable under the FHA is preempted by state law if the conduct giving rise to the claim is legal under the state's insurance laws. The Ninth Circuit noted that the first two prongs of the three-part test were readily met in this case in favor of reverse-preemption. The debate will focus on the third prong and specifically, whether the FHA as applied to this case might "invalidate, impair, or supersede the state law."

With respect to this third prong, the Ninth Circuit offered its views on how the debate may unfold.

If Texas law permits insurance companies to use credit scores even if the factors used to compute scores may have a racially disparate impact, then allowing [plaintiff] to sue defendants under the FHA for this practice would impair Texas law.

On the other hand,

if Texas law prohibits the use of credit-score factors that would violate the FHA on the basis of a disparate impact theory, then the FHA would complement -- rather than displace and impair -- Texas law, and [plaintiff's] FHA disparate-impact suit would not be reverse-preempted by the McCarran-Ferguson Act.

Texas Insurance Statute sections 559.001-559.201 permits the use of credit scoring and credit information in the sale and rating of personal lines insurance policies issued in Texas. The statute, codified in 2005, was, and remains, the subject of heated debate in the Texas Legislature.

Proponents support the use of credit scoring as relevant to proper risk based pricing of insurance.

Opponents contend the use of credit scoring unfairly impacts minorities.

Prior to its codification, the Texas Legislature authorized the Texas Insurance Commissioner to conduct a two-phased analysis of the use of credit scoring in insurance. The first phase of the analysis was published December 31, 2004, and the second phase on January 31, 2005. Both supported the use of credit scoring in insurance.

In a letter to the then Governor and Speaker of the House, enclosing the second phase of the study, the Texas Insurance Commissioner addressed the question of disproportionate impact and credit scoring.

By the nature of risk-based pricing and underwriting, all factors used in insurance have a disproportionate impact to some extent. One could make a convincing argument to ban the use of all risk-related factors based solely on disproportionate impact. Effectively, we would ban risk-based pricing and underwriting and revert to a pricing system where we homogenize the risk and essentially charge everyone the same price--regardless of risk. . . .

As Commissioner, I have the authority to end a practice that is either unfairly or intentionally discriminatory. However, I do not have a legal basis to ban a practice that has a disproportionate impact if it produces an actuarially supported result and is not unfairly or intentionally discriminatory. . . .

The study, however, did not support those initial suspicions. Credit scoring, if continued, 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. . . . Further, its use is justified actuarially and it adds value to the insurance transaction.

(January 31, 2005 TX DOI Letter)

The Texas DOI studies were undoubtedly pivotal in enacting the credit scoring statute. Had the studies concluded otherwise, the Texas Legislature likely would have banned the use of credit scoring in the state. The studies, if admissible, should weigh in favor of reverse-preemption.