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Understanding Insurance Anti-Discrimination Laws*

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Abstract

Insurance companies are in the business of discrimination. Insurers attempt to segregate insureds into separate risk pools based on their differences in risk profiles, first, so that they can charge different premiums to the different groups based on their risk and, second, to incentivize risk reduction by insureds. This is why we let insurers discriminate. There are, however, limits to the types of discrimination we will allow insurers to engage in. But what exactly are those limits and how are they justified? To answer these questions, this Article articulates the leading fairness and efficiency arguments for and against limiting insurers' ability to discriminate in their underwriting; identifies on this basis a set of predictions as to what one would expect state anti-discrimination laws to look like; and evaluates some of those predictions against a unique hand-collected dataset consisting of the laws regulating insurer risk classification in all 51 U.S. jurisdictions. Among our findings is that contrary to the conventional wisdom state insurance anti-discrimination laws vary a great deal, in substance and in the intensity of regulation, across lines of insurance, across policyholder characteristics, and across states. The Article also finds that, contrary to our predictions, a surprising number of jurisdictions do not have any laws restricting insurers' ability to discriminate on the basis of race, national origin, or religion. It concludes by discussing whether this fact indicates that states have inadequately policed unfair discrimination in insurance or impacts the larger policy decision in this country to leave insurance anti-discrimination law to the states.

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INTRODUCTION

We discriminate when we draw distinctions between things. Individuals, corporations, and governments draw distinctions all the time, and in ways that are widely considered unobjectionable. However, the word "discrimination" has taken on a negative connotation, because of the various types of discrimination "against" particular groups of people based on particular characteristics, such as race or religion or gender. Such discrimination is often deemed immoral or illegal or both.¹ Much has been written by legal scholars and philosophers on the question of what distinguishes good discrimination from bad,² and there are whole fields of law, such as employment discrimination law, that are devoted to the question of when discrimination should be deemed illegal and when not.³

Insurance companies are in the business of a particular type of discrimination, not among their employees but among their insureds. That is how insurance works. Insurers attempt to classify insureds into separate risk pools based on differences in their risk profiles. Thus, insurers openly discriminate among individuals based on observable characteristics. Moreover, they do this, among other reasons, so that they can charge different premiums to different groups of insureds based on differences in their risks. Discrimination or risk classification⁴ by insurers can also create incentives for insureds to minimize risks: that is, if an insured will take care to reduce her risk level, a discriminating insurer will lower her premium. In a sense, these two reasons (accurate risk classification and incentivizing risk reduction) provide the primary justifications

¹ See Larry Alexander, *What Makes Wrongful Discrimination Wrong? Biases, Preferences, Stereotypes, and Proxies*, 141 U. Pa. L. Rev. 149, 151 (1992) ("We all know it is wrong to refuse to hire women as truck drivers, to refuse to let blacks practice law, to bar Moslems from basketball teams, or to refuse to sit next to Rastafarians at lunch counters. At the same time, we also know it is not wrong to refuse to hire the blind as truck drivers, to refuse to admit those who flunk the bar exam to the practice of law, to bar short, slow, uncoordinated persons from the basketball team, or to refuse to sit next to people who haven't bathed recently."); . and DEBORAH HELLMAN, *WHEN IS DISCRIMINATION WRONG?* 1 (2008) ("And we know that while it is okay for a school principal to ask students with last names beginning with A-M to sit on one side of the auditorium and students with last names beginning with A-Z to sit on the other, it is not okay for a local law to require black bus passengers to sit in the back and whites in the front.").

² See, e.g., Alexander, *supra* note 1 (addressing the question generally of how to distinguish morally acceptable from morally unacceptable, and legal from illegal, discrimination); SANDRA FRIEDMAN, *DISCRIMINATION LAW* (2d ed. 2011) (same); HELLMAN, *supra* note 1 (same); Deborah Hellman, *When Is Discrimination Wrong?*, BALKINIZATION (Jun. 20, 2008, 10:30 AM), <http://balkin.blogspot.com/2008/06/when-is-discrimination-wrong.html> (same); Richard Arneson, *What is Wrongful Discrimination?*, 43 San Diego L. Rev. 775 (2006) (same). There is a large literature also on the specific question whether discrimination of particular types, such as racial discrimination in the workplace, is efficient or not. See, e.g., GARY BECKER, *THE ECONOMICS OF DISCRIMINATION* (2d ed. 1971); John Donohue, *Is Title VII Efficient?*, 134 U. PA. L. REV. 1411 (1986); Richard A. Posner, *The Efficiency and the Efficacy of Title VII*, 136 PA. L. REV. 513 (1987). Any list of classic articles on the topic of what constitutes illegitimate discrimination should include Paul Brest, *Foreword: In Defense of the Antidiscrimination Principle*, 90 HARV. L. REV. 1 (1976); and Charles R. Lawrence III, *Id, the Ego, and Equal Protection: Reckoning with Unconscious Racism*, 39 STAN. L. REV. 317 (1987).

³ See, e.g., John J. Donohue III, *Prohibiting Sex Discrimination in the Workplace: An Economic Perspective*, 56 U. Chi. L. Rev. 1337, 1365-66 (1989); Gillian K. Hadfield, *Rational Women: A Test for Sex-Based Harassment*, 83 Cal. L. Rev. 1151, 1175-76, 1180 (1995) .

⁴ We use the terms "discrimination" and "risk classification" synonymously throughout this article when referring to insurers' efforts to sort insureds into different groups based on differences in risks.

for why we let insurers discriminate. Insurers provide a valuable social function—in risk shifting, risk spreading and risk reduction—at least in part because they are allowed to, are expected to, and do discriminate.

There are, however, limits on the discrimination that insurers are permitted to engage in. Some of these limits stem from federal laws. The Patient Protection and Affordable Care Act of 2010 [“PPACA”], together with the Health Insurance Portability and Accountability Act of 1996 [“HIPAA”], forbids insurers from considering pre-existing conditions in the underwriting process.⁵ PPACA also forbids health insurers from taking gender into account.⁶ Likewise, the Genetic Information Nondiscrimination Act of 2008 [“GINA”] prohibits all health insurers from denying coverage or charging different premiums to insureds based on genetic information.⁷ Finally, a recent rule issued by the U.S. Department of Housing and Urban Development provides that the Fair Housing Act (“FHA”) applies to insurance and prohibits housing practices that have an unjustified disparate impact on protected classes.⁸ Besides those four recent statutes, however, there are no federal laws expressly forbidding insurers from engaging in any form of discrimination in the underwriting process. There is therefore no federal law specifically forbidding insurance companies from taking into account, for example, race, religion, national origin, or gender, at least outside the context of homeowners insurance.

What all of this means is that discrimination by insurers in the underwriting process is largely unregulated at the federal level, leaving the states as the regulators of insurer discrimination. How this came to be has much to do with the history of the McCarran-Ferguson Act [“MFA”], which effectively delegated to the states the primary responsibility for regulating insurance in this country.⁹ Whether such an allocation of regulatory authority with respect to insurance discrimination has turned out well is an interesting and largely unstudied question, a question that this Article begins to answer.

More specifically, the Article addresses three general questions. First, as the country’s primary promulgators of insurance anti-discrimination law, what factors should state

⁵ The other two are HIPAA and PPACA. HIPAA prohibits groups health insurers from excluding an insured’s pre-existing condition from coverage for more than 12 months after the insured’s enrollment date, and the 12 month period was shortened or eliminated for people who were previously insured. HIPAA also prohibited group health insurers from excluding individuals on the basis of genetic predisposition to certain diseases. 15 U.S.C. § 1012(b) (2006). PPACA prohibits all health insurers from denying coverage on the basis of pre-existing conditions, and for health status generally, for children starting in 2010 for adults starting in 2014. ACA § 1201, 124 Stat. at 154–55 (adding § 2704 to the PHSa) (to be codified at 42 U.S.C. § 300gg-3) (preexisting conditions); ACA § 1201, 124 Stat. at 156–60 (adding § 2705 to the PHSa) (to be codified at 42 U.S.C. § 300gg-4) (prohibiting discrimination).

⁶ ACA § 1201, 124 Stat. at 156–60 (adding § 2705 to the PHSa) (to be codified at 42 U.S.C. § 300gg-4).

⁷ Genetic Information Nondiscrimination Act of 2008, Act, Pub. L. No. 110-223, 122 Stat. 881, 883, 888 (codified as amended at 29 U.S.C. § 1182(b) and 42 U.S.C. § 300gg-1(b)) (adding § 1182(b) to ERISA and adding § 300gg-1(b) to the PHSa)

⁸ See HUD Rule Imposes Disparate Impact Standard on Insurance, Insurance Compliance Insight.

⁹ Under the McCarran-Ferguson Act, federal laws that affect insurance are deemed “reverse preempted” by any conflicting state law, unless the federal law expressly provides that it is meant to apply to insurance. 15 U.S.C. § 1012(b) (2006).

governments take into account when deciding whether and to what extent to limit insurers' ability to discriminate? In answering this normative question, Part I provides the first systematic integration of the risk-classification scholarship that has been published in insurance economics journals with the risk-classification scholarship of legal academics. It distills from these literatures twelve different factors that may shape the normative case for laws restricting insurers' capacity to discriminate among different policyholders.

Second, taking into account the various normative considerations identified in Part I, Part II attempts to identify or predict what actual anti-discrimination laws state legislatures should be expected to enact. These predictions will depend not only on what laws reflect the best balance of normative concerns but also on various political considerations, such as which laws most help insurers to maximize their profits (since insurers as a group will sometimes be a relatively powerful lobbying force) and which laws are consistent and which in conflict with widely shared social norms (since legislatures can also on occasion be responsive to the masses). Part II, therefore, takes into account political economy concerns as well the normative considerations outlined in Part I.

Third, building on Parts I and II, Part III asks the surprisingly difficult and previously unexamined question: what laws dealing with risk classification have states actually adopted? The reason this question is both difficult to answer and has been largely ignored is that the exercise of merely identifying the laws in all the relevant jurisdictions requires hours of painstaking research and analysis. And that is what we, together with a team of research assistants, have done. We have developed a unique, hand-collected dataset of state statutes governing insurer risk classification. This task required us to identify and analyze the insurance statutes, and any related regulatory or judicial interpretations of those statutes, in all 50 states (and Washington DC) and then to code those laws and sometimes their judicial or administrative interpretations for five different lines of insurance—health, life, disability, auto, and property/casualty—and for nine different characteristics—race, national origin, religion, gender, age, credit score, genetics, sexual orientation, and zip code. The result is the first ever comprehensive database of insurance anti-discrimination laws in the U.S. dealing with those nine characteristics.

Part III summarizes some of the key results of our research and compares them with the predictions we developed in Part II.¹⁰ For example, Part II predicts that all jurisdictions would either forbid or strongly limit insurers' ability to discriminate among insureds on the basis of race, national origin, or religion. Indeed, based on our experience in the insurance law field over many years, it seems that the conventional wisdom among many if not most insurance law scholars, teachers, and students is that every state in the country forbids the use of such

¹⁰ In the interest of keeping this Article a manageable length, some of the empirical results will be explored in a subsequent paper.

characteristics, especially race, in insurance underwriting.¹¹ Surprisingly, this prediction is incorrect: more than half the states do not ban the use of race in life, health, and disability insurance, 23 states do not ban its use in auto insurance, and 18 do not ban its use for property/casualty insurance. Similar statements can be made about national origin and religion. We also find similar gaps in state laws for other policyholder characteristics: 37 states do not ban the use of sexual orientation in health insurance and 40 states do not ban the use of gender in auto insurance. As all this suggests, affirmative bans of insurer discrimination on the basis of potentially suspect policyholder traits are quite rare. Thus, only 9 states ban the use of age in auto insurance; only 5 states ban the use of genetic testing in disability insurance; and only 2 states ban the use of zip code in property/casualty insurance.

We conclude by offering a number of tentative theories that might explain these results. We also consider their normative implications. For instance, might the lack of uniformity in state insurance anti-discrimination regulation require a rethinking of this country's longstanding practice of generally leaving insurance issues to the states? To what extent does the fact that a substantial number of states have failed to even address core issues of unfair discrimination in their insurance laws indicate a failure in state unfair discrimination regulation writ large? And what should we make of the stark contrast between this reality, and recent federal efforts to address facially neutral insurance classification schemes that have a disparate impact on the capacity of protected groups to acquire housing?¹²

I. The Normative Framework

A. *Fairness v. Efficiency*

Laws limiting risk classification in insurance implicate a tradeoff between “efficiency” and “fairness” concerns.¹³ The efficiency costs of these laws stem principally from the fact that they attempt to force insurers to charge the same premiums to individuals who pose different predicted risks. This can generate the twin insurance harms of moral hazard and adverse selection.

First, regulatory restrictions on insurers' risk classifications can produce moral hazard by undermining feature rating and experience rating.¹⁴ Feature rating refers to insurer efforts to link

¹¹ See, e.g., Stephen Brobeck & J. Robert Hunter, *Consumer Federation of America, Lower-Income Households and the Auto Insurance Marketplace: Challenges and Opportunities*, CONSUMERFED.ORG, Jan. 30, 2012, <http://www.consumerfed.org/news/450> (“No states, for example, permit the use of race or income in rate-making.”); Jill Gaubling, *Race, Sex, and Genetic Discrimination in Insurance: What's Fair?*, 80 CORN. L. REV. 1646, 1646 (1994) (reporting that it would be illegal in every state for an insurer to charge more to African Americans because they have shorter expected life spans).

¹² See HUD Rule Imposes Disparate Impact Standard on Insurance, Insurance Compliance Insight.

¹³ See, e.g., Kenneth S. Abraham, *Efficiency and Fairness in Insurance Risk Classification*, 71 VA. L. REV. 403 (1985); Michael Hoy & Michael Ruse, *Regulating Genetic Information in Insurance Markets*, 8 RISK MGMT. & INS. REV. 211 (2005) (“Economists can contribute to the debate [about regulating genetic information in insurance markets] by casting the problem as a classic efficiency-equity trade-off.”).

¹⁴ KENNETH ABRAHAM, *DISTRIBUTING RISK* 71-72 (1986).

premiums to policyholder characteristics that correlate with risk. Experience rating, by contrast, refers to the linking of premiums with policyholders' actual loss experiences. Both mechanisms attempt to improve the accuracy of the premium calculation and to incentivize policyholder care (notwithstanding insurance coverage) by increasing the likelihood that a failure to take care will result in a future increase in premiums. These tools are undermined when risk classification restrictions limit the capacity of insurers to adjust their premiums.¹⁵

Second, regulatory restrictions on insurers' risk classifications can generate adverse selection. Adverse selection can occur when policyholders have private information about their own riskiness that insurers do not observe. If policyholders know they cannot be charged more for insurance coverage even if their riskiness is higher than average, they may be more likely to buy insurance coverage because they will not pay its full price.¹⁶ If this occurs, then insurers may respond by charging low-risk individuals premiums that are too high for their risk. Anticipating this sort of inaccuracy in pricing, low-risk individuals may exit the risk pool and opt not to purchase insurance coverage at all. To prevent this exit of low-risk policyholders, insurers can design policy coverage specifically to appeal to low-risks by offering incomplete coverage in return for a low premium.¹⁷

By contrast, defenders of laws limiting insurers' ability to classify risks typically rely on "fairness" based arguments. Frequently these arguments embrace a vision of insurance as solidarity – spreading risk within communities strengthens the fabric that connects individuals by having them cross-subsidize each other's risk. Risk classification undermines this vision, they claim, by splitting communities into ever smaller and more fragmented risk pools, particularly when it trades on preexisting social inequities and stereotypes.¹⁸ Even when actuarial correlations between characteristics and risk can be demonstrated, defenders of risk classification regulation emphasize that this correlation is socially constructed, reflecting existing norms, assumptions, and biases that frame both the collection and analysis of the data that produces risk assessments.¹⁹ By classifying risks, insurers consequently assign responsibility to individuals in a manner that is much less stable and objective than actuarial science suggests.²⁰

¹⁵ See discussion *infra* Part I.B.4

¹⁶ To be sure, insurers will classify risks even without the threat of adverse selection, because competition from other carriers will otherwise skim away the good risks. This does not represent a social cost, however, unless it causes at least some policyholders to purchase less insurance than they would like to purchase at actuarially fair rates.

¹⁷ Tom Baker, *Health Insurance, Risk, and Responsibility After the Patient Protection and Affordable Care Act*, 159 U. PA. L. REV. 1577, 1608-15 (2011); see also Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629, 634-38 (1976) (describing a theoretical model in which the design of the insurance market itself encourages individuals to self-sort into risk categories).

¹⁸ Wendy K. Mariner, *Social Solidarity and Personal Responsibility in Health Reform*, 14 CONN. INS. L.J. 199 (2008); Deborah Stone, *The Struggle for the Soul of Health Insurance*, 18 J. HEALTH POL. POL'Y & L. 287 (1993).

¹⁹ François Ewald, *Insurance and Risk*, in THE FOUCAULT EFFECT: STUDIES IN GOVERNMENTALITY 197, 206-10 (Graham Burchell, Colin Gordon, & Peter Miller, eds., 1991); Regina Austin, *The Insurance Classification Controversy*, 131 U. PA. L. REV. 517, 534-36 (1983) ("However much the [insurance] companies plead

While “fairness” is generally associated with opposition to risk classification, and “efficiency” is associated with defenses of the practice, neither side has a monopoly on fairness- or efficiency-based arguments, as described more fully below. Despite this complication, it is helpful to summarize the extant normative literature on risk-classification and insurance discrimination through the “efficiency vs. fairness” lens. Interestingly, each of these considerations is principally developed in a different academic literature. The efficiency implications of risk classifications restrictions are explored principally in the risk management and economics literature, whereas the fairness arguments concerning legal restrictions on risk classification are explored principally in the legal literature. The historical disconnect between these literatures²¹ means that their collective insights have not previously been integrated or even gathered together in a single place.²² The next two sections attempt this task.

B. Efficiency-Based Considerations

1. Adverse Selection

As noted above, the risk of adverse selection is one potential efficiency cost of legal restrictions on insurers’ risk-classification practices.²³ Indeed, the risk of adverse selection is so often associated with regulatory restrictions on risk classification that some refer to the phenomenon as “regulatory adverse selection.” The social cost of adverse selection is that some risk-averse individuals forego coverage that they would like to purchase at actuarially fair rates.²⁴ To the extent that adverse selection triggers undermines an insurance market entirely (a so-called “death spiral”) or leads to strategic insurer efforts to segregate low-risk and high-risk

happenstance, insurance ‘risk’ classifications correlate with a fairly simplistic and static notion of social stratification that is familiar to everyone.”)

²⁰ TOM BAKER, *INSURANCE LAW AND POLICY* (2007).

²¹ See *LAW AND ECONOMICS OF INSURANCE* (Daniel Schwarcz, ed., 2012).

²² The paper that comes closest to collecting all of these considerations is Seth J. Chandler, *Visualizing Adverse Selection: An Economic Approach to the Law of Insurance Underwriting*, 8 *CONN. INS. L.J.* 435 (2002). Much of Chandler’s paper, though, builds off of his own computer model, and it therefore misses some of the points that have been raised in other papers.

²³ Indeed, one of the primary writers on the topic refers to such rules as “regulatory adverse selection.” See Hoy, *supra* 15, at 245. The disadvantage of adverse selection can also be framed in fairness, rather than efficiency, terms. Indeed, some promote the notion of actuarial *fairness*, which suggests that insurers have a moral “responsibility to treat all [their] policyholders fairly by establishing premiums at a level consistent with the risk represented by each policyholder.” See, e.g., Karen A. Clifford & Russel P. Inculano, *Aids and Insurance: The Rationale for Aids-Related Testing*, 100 *HARV. L. REV.* 1806 (1987) (arguing that failing to screen insureds for AIDS would be unfair “because it results in the subsidization of high risk individuals by those at low risk”). Various industry-sponsored advertisements in the late 1980’s trumpeted a similar idea: that it is “unfair to pay for someone else’s risks.” See Stone, *supra* note 17.

²⁴ Jan Mossin, *Aspects of Rational Insurance Purchasing*, 76 *J. POL. ECON.* 553 (1968). These efficiency costs are particularly large in the rare situations where adverse selection produces a “death spiral.” A death spiral occurs when adverse selection becomes increasingly self-reinforcing; the lowest-risk policyholders opt out of the insurance pool, driving up premiums and causing the next lowest-risk policyholders to opt out, and so on. Eventually, only high-risk policyholders remain. Death spirals obviously generate substantial efficiency costs, as all but very high-risk individuals forego complete coverage. See Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 *YALE L.J.* 1223, 1224 (2004).

policyholders indirectly by offering multiple coverage options (a separating equilibrium), it can also undermine regulatory objectives to promote subsidization from low-risk to high-risk individuals.²⁵

Substantial empirical research has recently demonstrated that the threat of adverse selection is much more contingent on the characteristics of particular insurance markets than has traditionally been assumed.²⁶ Some insurance markets are quite susceptible to adverse selection, while others are resistant to adverse selection.²⁷ Relevant factors for determining whether a particular insurance market is at risk of adverse selection include: (1) the absence of useful private information, (2) the existence of private information for some but not all policyholders in a market, (3) policyholders' inability or failure to use the private information they have, (4) the presence of superior information or predictive power on the part of the insurer, (5) propitious selection resulting from interaction between risk and risk aversion or other policyholder characteristics associated with an increased tendency to purchase insurance, and (6) institutional arrangements.²⁸

Numerous additional factors are likely relevant to the more specific prospect that a regulatory risk classification restriction would trigger adverse selection. This would certainly include both the size and risk levels of the population with the "high risk" characteristic whose use is prohibited, as both factors would mediate the ultimate impact on rates of a risk classification restriction.²⁹ It would also include the elasticity of demand among the population of "low-risk" policyholders, as regulatory risk classification restrictions would cause them to face slightly higher prices for coverage. Elasticity of demand for insurance, in turn, would depend on factors such as the practical and legal necessity for the relevant type of insurance as well as the magnitude of potential policyholders' risk aversion.

Various more line-specific factors could also contribute to the risk of regulatory adverse selection. For instance, risk-classification restrictions are less likely to generate adverse

²⁵ Even ostensibly efficiency-oriented evaluations of risk-classification restrictions may reflect unstated normative commitments to individual responsibility. This may manifest itself in these evaluations ignoring alternative mechanisms to manage adverse selection risks, such as the mandated purchase of insurance or the provision of universal coverage. *See, e.g.,* Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification*, 9 CONN. INS. L.J. 371, 379-83 (2003) (cataloguing policy mechanisms for reducing adverse selection without resort to risk classification).

²⁶ Siegelman, *supra* note 8 at 1224 (showing that such death spirals are quite rare and that, in many cases, adverse selection is itself uncommon). In a recent update and extension of this article, Siegelman and Cohen find more mixed evidence of adverse selection in insurance markets, concluding that the phenomenon varies substantially across different lines of insurance and even within particular insurance lines. Alma Cohen & Peter Siegelman, *Testing for Adverse Selection in Insurance Markets*, 77 J. RISK & INS. 39 (2010).

²⁷ Chandler, *supra* note 21 (using computer modeling to show the extent to which adverse selection depends on numerous factors in the underlying insurance market).

²⁸ Alma Cohen & Peter Siegelman, *Testing for Adverse Selection in Insurance Markets*, 77 J. Risk & Ins. 39 (2010).

²⁹ *See* Hoy, *supra* note 15 at 249-69; *see also* Chandler, *supra* note 21, at 498 (making similar point by noting that homogeneity of risks in the underlying pool decreases the prospect of adverse selection, whereas heterogeneity increases this risk).

selection when high-risk policyholders cannot over-insure, and thus multiply the “advantage” of being high-risk in a setting where carriers are forbidden from taking this into account.³⁰ At least in life insurance, such over-insurance is possible because individuals can own multiple different policies, each of whose benefits are unaffected by the existence of other policies.³¹ The prospect of regulatory adverse selection might also be exacerbated by the existence of a secondary market for insurance policies, which is also a feature of life insurance and annuity markets.³² Secondary markets increase the risk of adverse selection by allowing high-risk individuals to purchase a policy with an immediate *guaranteed* profit.³³ They also allow high-risk individuals to benefit *personally* from their life insurance products. Finally, line-specific product features, such as the existence of an incontestability period after which insurers cannot deny coverage for misrepresentations or fraud, could also increase the risk of regulatory adverse selection.³⁴

2. Moral Hazard

Legal restrictions on insurers’ ability to classify risks can result in moral hazard, causing policyholders to take less than socially-optimal levels of care. For instance, some commentators have argued that rules prohibiting insurers from classifying policyholders on the basis of their health status may encourage individuals to eat less healthy foods or exercise less.³⁵ Others have claimed that rules prohibiting underwriting on the basis of geographic area can result in the over-development of homes in risk-prone regions, such as along the coast of a hurricane-prone state.³⁶

In order for moral hazard to potentially result from legal restrictions on risk classification, two conditions must be met. First, the regulated characteristic must be at least partially within policyholders’ control. A good example is a legal prohibition on insurers using health-related information of individuals in underwriting, as individuals clearly have some control over their likelihood of getting sick. By contrast, rules prohibiting classification on the basis of age or

³⁰ Hoy & Ruse, *supra* note 12; Chapter 6.

³¹ In most insurance contexts, policies contain coordination of benefits or “other insurance” provisions, which prevent a policyholder from recovering under multiple policies in a way that would improve the policyholder’s financial condition as a result of the loss.

³² *See generally* [Find cites]

³³ Risk classification rules that would prevent investors from asking about individuals’ genetic makeup, cannot prevent such transactions because these rules cannot prevent high-risk policyholders from volunteering information about their genetic predispositions to investors. While individuals have an incentive to hide their genetic defects from insurers, they have the opposite incentive when selling policies to third-party investors: the sooner the policyholder is to die, the more investors will be willing to pay for the policy.

³⁴ An insurer that sells individually underwritten auto or non-auto liability and property policies can cancel policies or decline to renew when the policy comes up for renewal. *See* ROBERT JERRY, UNDERSTANDING INSURANCE LAW.

³⁵ RICHARD EPSTEIN, MORTAL PERIL 125-126 (1997) (“Cross-subsidies necessarily allow everyone to pass off some part of the costs of their own risky behavior onto other persons.”); Jonathan Klick & Thomas Stratmann, *Diabetes Treatments and Moral Hazard*, 50 J.L. & Econ. 519 (2007) (finding that mandates for medical treatment for diabetes generate a moral hazard problem with diabetics exhibiting higher BMIs after the adoption of these mandates).

³⁶ HOWARD C. KUNREUTHER ET. AL., AT WAR WITH THE WEATHER: MANAGING LARGE-SCALE RISKS IN A NEW ERA OF CATASTROPHES (2009).

gender cannot produce moral hazard for the simple reason that individuals cannot change their age or gender in response to such rules. Second, there must be some “but for” causal link between the regulated characteristic and risk. Prohibitions on medical underwriting again provide a suitable example: an individual is more likely to incur substantial health expenses if he or she has a history of health-related expenses, and less likely to incur future expenses if she has no preexisting conditions or medical risks. By contrast, while individuals have some degree of control over their credit score (thus satisfying the first condition), it is unclear whether credit score enjoys a “but for” causal connection to risk of loss. Thus, while prohibitions on insurers’ use of credit scores in underwriting might conceivably cause people to safeguard their credit scores less effectively, it is not clear that this would actually lead to greater losses.

When these two pre-requisites are met, legal restrictions on risk classification may generate moral hazard because they effectively operate as state-provided insurance against classification risk.³⁷ In other words, by limiting the capacity of insurers to classify risks in the future, these rules undermine individuals’ incentives to take care by protecting them from the risk that their present behavior will impair their capacity to purchase affordable insurance in the future. Thus, prohibiting health insurers from charging more to smokers may increase the incidence of smoking and health risk because individuals will not worry that their decision to smoke will subject them to increased insurance premiums in the future. The magnitude of this effect likely depends substantially on the extent to which individuals appreciate the potential links between their behavior and future premiums.³⁸ Thus, individuals are unlikely to change their smoking habits in response to legal restrictions on insurers’ underwriting if they are unaware of the potential link, or lack thereof, between smoking and future premiums.³⁹

3. Socially Wasteful Expenditures

The efficiency of risk-classification regulations may also be impacted by the prospect that insurers’ classification efforts are socially wasteful. One of the primary ways that insurers compete in unregulated insurance markets is by attempting to classify risks more accurately in order to skim good risks from other companies and dump bad risks on those companies. These efforts *may* be socially beneficial to the extent that they increase the number of low-risk individuals who choose to purchase full insurance.⁴⁰ At the same time, though, these efforts produce no social benefit to the extent that they merely shift the composition of policyholders among different carriers, at least in those cases where moral hazard is not a possible outgrowth of risk classification. From a social welfare standpoint, the same individuals are insured and only the distribution of the resulting social benefits is at stake in the particular matching of

³⁷ See *supra* note 23 and accompanying text.

³⁸ Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996).

³⁹ On the difficulties of empirically estimating moral hazard and adverse selection see Ronen Avraham, *The Economics of Insurance Law—A Primer*, 18 CONN. INS. L.J. (forthcoming 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1822330.

⁴⁰ Whether they are in fact socially beneficial requires weighing the social benefit of increased coverage for low-risk individuals against the cost of less insurance coverage for high-risk individuals.

insurers and policyholders. By contrast, these efforts do indeed produce a social cost in the form of money spent on classifying policyholders, which may be passed on to policyholders through increased premiums.⁴¹

In these settings, risk-classification regulations can be justified as a means for preventing socially wasteful investments.⁴² The power of this rationale for regulation depends largely on the extent to which risk classification is costly. Thus, it is likely to be a more powerful consideration when classification requires medical tests, genetic tests, physical examinations of individuals or property, or extensive analysis of loss data and mitigation measures.⁴³ Indeed, this argument figured prominently in debates about health care reform's prohibition on medical underwriting precisely because of the cost of such underwriting.⁴⁴ Interestingly, this argument may also be persuasive when a carrier is legally or contractually required to investigate representations in insurance applications, as is the case with doctrines imposing a duty to underwrite or establishing a period of incontestability.

4. Private Acquisition of Information

Another relevant consideration in evaluating the efficiency of laws restricting risk classification by insurers is the extent to which insurers' classification efforts impact individuals' ex ante incentives to learn of their own risk characteristics. Individuals may be deterred from learning about their own risk profiles when insurers can use that information in underwriting. This is a particular problem when the relevant information is expensive for carriers to uncover on

⁴¹ Keith J. Crocker & Arthur Snow, *The Efficiency Effects of Categorical Discrimination in the Insurance Industry*, 94 J. POL. ECON. 321, 338 (1986) (“[F]or intermediate levels of cost the market still categorizes even though the winners from categorization could not compensate the losers.”). In this way, these private risk classification efforts are analogous to individual investments in protecting property that merely shift crime to neighbors rather than reducing aggregate crime levels; in both cases parties invest in protecting themselves only to shift costs on to others

⁴² Of course, risk-classification regulation may not be the optimal way to respond to this problem. For instance, one recent article argues that it is preferable for governments to adopt partial social insurance that induces firms to invest in classification only to the extent that doing so is socially efficient. Casey Rothschild, *The Efficiency of Categorical Discrimination in Insurance Markets*, 78 CONN. INS. L.J. 267 (2011). Of course, social insurance schemes raise their own set of efficiency problems and are often, as a practical matter, not politically feasible.

⁴³ See Crocker & Snow, *supra* note 41. Genetic rating has attracted a wildly disproportionate amount of scholarly attention, even while far more commonplace forms of risk classification have slipped by without much academic comment. See, e.g., John V. Jacobi, *Genetic Discrimination in a Time of False Hopes*, 30 FLA. ST. U. L. REV. 363 (2003); Nancy Kass & Amy Medley, *Genetic Screening and Disability Insurance: What Can We Learn from the Health Insurance Experience?*, 35 J. L. MED. & ETHICS 66 (2007); Robert Lowe, *Genetic Testing and Insurance: Apocalypse Now?*, 40 DRAKE L. REV. 507 (1991) Robert F. Rich & Julian Ziegler, *Genetic Discrimination in Health Insurance – Comprehensive Legal Solutions for a (Not So) Special Problem?*, 2 IND. HEALTH L. REV. 5 (2005); Mark A. Rothstein, *Predictive Genetic Testing for Alzheimer's Disease in Long-Term Care Insurance*, 35 GA. L. REV. 707 (2001); Richard H. Underwood & Ronald C. Cadle, *Genetics, Genetic Testing, and the Specter of Discrimination: A Discussion Using Hypothetical Cases*, 85 KY. L. J. 665.

⁴⁴ Paul Krugman, *Health Care Realities*, NYTIMES.COM, Jul. 30, 2009, <http://www.nytimes.com/2009/07/31/opinion/31krugman.html> (“And in their efforts to avoid “medical losses,” the industry term for paying medical bills, insurers spend much of the money taken in through premiums not on medical treatment, but on ‘underwriting’ — screening out people likely to make insurance claims.”).

a case-by-case basis. Such insurers will only be able to classify individuals through underwriting applications that ask applicants to represent their subjective knowledge of their risk levels, backed by the threat of rescission in the event a misrepresentation is subsequently discovered. In order to avoid this risk, individuals may simply refrain from learning about their risk status. This argument has gained particular salience in the context of genetic risk classification, with many commentators arguing that individuals are deterred from acquiring valuable information about their genetic makeup because of the potential insurance consequences of doing so.⁴⁵ The social costs associated with individuals not learning their own risk characteristics include denial of access to preventive medical care and decreased financial and family planning for a shorter expected life span.⁴⁶

5. Positive Externalities of Risky Behavior

In some cases, individuals become high risk as a result of behavior that is socially productive in the aggregate. For instance, doctors in high-risk specialties such as obstetrics provide necessary and socially valuable services, even though their decision to become a specialist exposes them to substantial risk that may not be fully compensated for through higher salaries. Similarly, individuals who decide to have children obviously generate substantial social benefits that may not be fully captured by the personal benefits of raising children. But they also expose themselves to large new risks. In both cases, one can argue that insurers should be prohibited from charging individuals more for their socially beneficial choices because this will drive the underlying activity below socially optimal levels.⁴⁷ On the other hand, it is not clear that the most efficient way to subsidize high risk socially productive behavior is via the insurance markets, and not, say, via the tax and transfer systems.⁴⁸

6. Efficient Redistribution

Efficiency-oriented legal scholarship typically assumes that income redistribution should generally be ignored in analyzing optimal legal rules, because such redistribution is most efficiently accomplished through the tax-and-transfer system.⁴⁹ However, laws restricting insurers' use of certain characteristics may provide a type of redistribution from the better off to the less well off that is preferable to redistribution within a tax-and-transfer system.⁵⁰ This is because such laws produce a transfer that naturally approximates the difference in well being associated with the characteristic. That is, assuming the characteristic in fact correlates with

⁴⁵ See, e.g., Susan M. Wolf & Jeffrey P. Kahn, *Genetic Testing and the Future of Disability Insurance: Ethics, Law & Policy*, 35 J.L. MED. & ETHICS 6, 15 (2007).

⁴⁶ Ronen Avraham, *supra* note 39, at 22.

⁴⁷ Daniel Wikler, *Personal and Social Responsibility for Health*, 16 ETHICS & INT'L AFF. 47, 53 (2002); Mark Geistfeld, AALS Annual Meeting Presentation.

⁴⁸ Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 TAX. L. REV. 157 (2003).

⁴⁹ LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* (2002).

⁵⁰ See Logue & Avraham, *supra* note 48.

differences in expected losses, forbidding the use of that characteristic results in a transfer to each insured who has the trait in an amount equal to the average expected losses associated with the trait. And this transfer is funded by slightly higher premiums charged to the insureds in the pool who do not have the trait. Moreover, assuming the risk-classification restrictions target only traits that are beyond the insured's control (such as race or gender or genes), they have an advantage over a redistributive income tax regime, which has the notorious effect of distorting individuals' work/leisure decisions.⁵¹

7. Collective Action Problems

Rules limiting insurers' ability to classify risks may theoretically encourage insurers to develop more efficient risk-classification schemes if these schemes have public good attributes.⁵² Risk-classification methods are at least partially non-rivalrous because multiple insurers can use them simultaneously.⁵³ Similarly, certain risk-classification frameworks may be non-excludable because carriers can mimic innovations developed by a competitor.⁵⁴ These characteristics suggest that individual insurers may have insufficient incentives to develop new risk classification technologies. Regulation that prohibited antiquated risk-classification schemes might be able to overcome this problem by encouraging insurers to develop alternative, and more accurate, approaches to risk classification.⁵⁵ Of course, a major weakness of this argument is that it assumes that insurers would respond to risk classification restrictions by developing more accurate classification schemes. Yet insurers may well opt for even less accurate proxies for risk in the face of restrictions on their classification practices. Thus, auto insurers prohibited from rating on the basis of age may instead rate based only on zip code, which can be a proxy for age.

8. Insurer Usage of Underlying Characteristic

⁵¹ The disadvantage of risk-classification restrictions as a form of redistribution is that, if the insurance pools are relatively small, it might be considered unfair that the additional costs associated with the particular trait are being subsidized by only a small portion of the population; whereas, a tax-and-transfer approach would spread these costs over the entire tax base. Logue & Avraham, *supra* note 48.

⁵² See Abraham, *supra* note 13, at 423.

⁵³ To be sure, the more rivals that use an improved risk-classification scheme, the less that each insurer can thereby gain a competitive advantage by skimming good risks from competitors.

⁵⁴ Even though insurers generally do not need to reveal the details of their risk-classification schemes under most state laws, and states provide trade secret protection to disclosed classification schemes, certain pricing strategies may be relatively easy for competitors to observe simply through market research.

⁵⁵ One potential example of this is the use of age in auto insurance. Age is a cheap, albeit imprecise, predictor of expected loss. Age may be predictive of expected loss because it proxies for characteristics such as (i) driving experience, (ii) likelihood of drunk driving, and (iii) attentiveness. By prohibiting insurers from relying on age, lawmakers may prod insurers to develop better ways of directly measuring these more casual contributors to risk.

Laws forbidding the use of a characteristic in underwriting may be hard to justify if insurers are not actually discriminating among policyholders on the basis of that characteristic.⁵⁶ To some extent, though, this depends on why insurers are not using the relevant characteristic.

First, if insurers do not use a rating characteristic because it has no apparent predictive value, then the case for legally restricting the use of this characteristic is extremely weak. Insurers are unlikely to ever use a characteristic with no predictive power in underwriting, meaning that the only social benefit such a law might provide is to articulate a moral commitment to a principle. But such a law could produce potentially meaningful social costs in the form of the public cost of legislating and the private cost of policing compliance.⁵⁷

Second, the case for regulation may be slightly stronger when the reason that carriers do not use a policyholder characteristic is because the cost of determining and verifying the characteristic outweighs the benefits of a more refined classification scheme.⁵⁸ Here, a plausible case can be made for laws restricting insurers' usage of characteristics that are predictive of risk, but nonetheless not used because of the cost to insurers of evaluating that characteristic: even though insurers are not currently employing the troubling characteristic in their underwriting, this may change as the composition of the population or cost of collecting accurate policyholder information changes. Legal prohibitions on risk classification can therefore be justified as a mechanism for preventing potentially problematic insurer behavior in the future.

Finally, the case for regulation is relatively strong if insurers are refraining from using problematic policyholder characteristics because they fear the potential reputational or regulatory consequences of doing so.⁵⁹ There is good evidence that this occurs. For instance, both auto and life insurers often do not take into account policyholder occupation or geographic location, even though both have been shown to predict claims and are relatively easy for insurers to determine.⁶⁰ Similarly, long term care insurers do not generally take into account gender, even though this has a substantial impact on claims experiences.⁶¹ Evidence that smaller and newer

⁵⁶ Evidence suggests that states often do pass coverage mandates that have no practical effect because all known insurance plans are consistent with those mandates. See Amy Monahan, *Fairness Versus Welfare in Health Insurance Content Regulation*, 2012 U. ILL. L. REV. 139 (2012).

⁵⁷ Compliance costs may exist even if insurers are not using the underlying risk characteristic, because the carrier must expend funds confirming that this is not the case.

⁵⁸ See generally Amy Finkelstein & James Porterba, *Testing for Adverse Selection with "Unused Observables"* (Nat'l Bureau of Econ. Research, Working Paper No. 12112, 2006) (noting that insurers often do not use policyholder characteristics in underwriting even though these characteristics have predictive value, and offering various potential explanations for this phenomenon).

⁵⁹ See Finkelstein & Porterba, *supra* note 58. Finkelstein and Porterba note a fourth potential explanation: that the predictive content of characteristics such as place of residence may be limited by the extent to which such characteristics are subject to change in response to characteristic-based pricing differentials. As they note, however, this is unlikely to be a substantial factor in most cases because the difficulty of changing the underlying characteristic will generally be larger than the potential insurance benefits of doing so.

⁶⁰ See Finkelstein & Porterba, *supra* note 58, at 21.

⁶¹ See Jeffrey Browne & Amy Finkelstein, *The Private Market for Long-Term Care Insurance In The United States: A Review of the Evidence*, 76 J. RISK & INS. 5 (2009).

firms have been more willing than established firms to introduce rating innovations suggests that this behavior is partially explained by the fear of public or regulatory backlash; newer and smaller firms are likely to be less deterred by the prospect of reputational or market backlash as a result of risk classification innovation.⁶² In these cases, laws explicitly limiting insurers' ability to employ the suspect characteristics have the benefit of reducing regulatory uncertainty. Of course, a coherent argument can be made that regulation in these settings is neither necessary or wise: when norms and reputation are sufficient to constrain private behavior, it may be best for law to avoid intervention because of the risk that it may "crowd out" those norms.⁶³

C. *Fairness-Related Considerations*⁶⁴

1. Control and Social Solidarity

Perhaps the most frequently invoked argument in favor of risk-classification regulation is that it is unfair to allow insurers to charge different rates based on characteristics that are beyond individuals' control.⁶⁵ This argument is typically grounded in a particular vision of insurance that emphasizes its capacity to promote social solidarity, or just egalitarian redistribution, by broadly distributing risks. From this perspective, many risks are the inevitable byproduct of the environment we all operate within, such as the political regime (modern capitalism vs socialism), technological and scientific advancements, and other features of the social landscape that are, from the individual's perspective, pure luck. The economic costs associated with these risks should be distributed in a morally-blind manner.⁶⁶ Insurance is a social and economic tool for counteracting this ethically unbound distribution of losses, allowing the collective to largely rid itself of undeserved risk. When insurers classify policyholders based on individual

⁶² See Finkelstein & Porterba, *supra* note 58.

⁶³ See, e.g., Uri Gneezy & Aldo Rustichini, *A Fine Is a Price*, 29 J. LEGAL STUD. 1, 3 (2000); Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 568-71 (2001).

⁶⁴ This Section draws heavily from Ken Abraham's path-breaking article, *Efficiency and Fairness in Risk Classification*. See Abraham, *supra* note 13.

⁶⁵ See, e.g., Larry Gostin, *Genetic Discrimination: The Use of Genetically Based Diagnostic and Prognostic Tests by Employers and Insurers*, 17 AM J.L. & MED. 109, 112-13 (1991) ("Discrimination based on actual or perceived genetic characteristics denies an individual equal opportunity because of a status over which she has no control."). Although typically framed in fairness language, this argument can be understood in economic terms to preserve the ability of individuals to purchase insurance against these risks, which is welfare enhancing. From this perspective, being born with unfavorable genes or permanent health problems is just like any other exogenous risk against which people desire insurance. Prohibiting insurers from classifying on this basis merely allows people to protect themselves against this risk even though they cannot purchase pre-birth insurance that specifically covers the risk of being born with an unfavorable genetic hand. See, e.g., Michael Hoy, *Risk Classification and Social Welfare*, 31 GENEVA PAPERS 245, 262-63 (2006) For a discussion of the possibility in the future of genetic endowment insurance, which would cover just this sort of risk, and the problems that such insurance might present, see Kyle Logue & Joel Slemrod, *Genes as Tags: The Tax Implications of Widely Available Genetic Information*, 61 NAT. TAX J. 843, 858-60 (2008) (discussing possibility of "genetic endowment insurance").

⁶⁶ EMBRACING RISK: THE CHANGING CULTURE OF INSURANCE AND RESPONSIBILITY 33-51, (Tom Baker & Jonathan Simon, eds., 2002); JACOB S. HACKER, *THE GREAT RISK SHIFT* 42 (2006); Ewald, *supra* note 19, at 197-210; Mariner, *supra* note 18; Stone, *supra* note 18.

characteristics, they undermine this feature of insurance by “fragmenting communities into ever-smaller, more homogenous groups.”⁶⁷

Although the strongest version of the social solidarity norm would prohibit all forms of risk classification, many proponents of the social solidarity view will still permit classification when policyholders have control over the relevant characteristic. In such cases, it is *fair* to charge higher premiums because people choose to lead their life in a risky way. However, defining what “control” means in this context is not always easy – or objective. Individuals are generally deemed to have control over a relevant characteristic when they *knowingly and voluntarily* make choices that determine their status as high-risk or low risk. For instance, automobile insurers are generally (though not always)⁶⁸ allowed to charge more to individuals who have been in an accident or received a speeding ticket: policyholders have a large degree of control over these factors because they can choose to drive more slowly or safely. Similarly, but on the other end of the spectrum, one reason commentators are often so opposed to genetic-underwriting is because people do not choose their genetic composition.

In many cases, though, it is hard to assess whether policyholders control their risk status. For instance, while individuals clearly exert some level of control over their health status, this control is obviously highly limited: fit people often get sick, and many obese individuals live until old age. Of course, it is theoretically possible to hold people responsible only for health features that involve choice, such as smoking, eating, and working out. But even in these domains, it is difficult to determine what choice means. Much behavior that seems voluntary may actually be the result of habit adopted in young age or addiction and, in any event, is highly correlated with numerous social factors, such as growing up in poverty or in a particular cultural setting.⁶⁹

2. Socially Suspect Classifications

A second fairness-based explanation for regulatory classification restrictions is that insurers should be prohibited from making classifications that are socially suspect. The concept of socially suspect classifications is difficult to define with perfect clarity. The term itself is a product of U.S. constitutional law. According to the Supreme Court’s interpretation of the equal protection clause of the 14th Amendment, laws that discriminate on the basis of certain characteristics are subject to a heightened degree of judicial review. Thus, while the vast majority of laws that discriminate among different groups will be upheld as valid so long as those laws have merely a “rational basis,” laws that discriminate on the basis of suspect classifications will be struck down unless they meet a higher standard of judicial review.

⁶⁷ Stone, *supra* note 18, at 290.

⁶⁸ See Massachusetts law that requires insurers to give drivers one free accident. [Find cites]

⁶⁹ See, e.g., Daniel Wikler, *Personal and Social Responsibility for Health*, 16 ETHICS & INT’L AFF. 47, 53 (2002).

According to the Court, suspect classifications can be identified by virtue of having three factors in common: (1) there is a history of discrimination against the group in question; (2) the characteristics that distinguish the group bear no relationship to the group members' ability to contribute to society; (3) the distinguishing characteristics are immutable; and (4) the subject class lacks political power.⁷⁰ Applying these criteria, the Court has identified three characteristics—race, religion, and national origin—that are considered suspect characteristics and thus receive the highest level of scrutiny, known as strict scrutiny.⁷¹ In addition, the Court has also identified a class of “quasi-suspect” characteristics (to date limited to gender and illegitimacy of birth) that receive an intermediate level of judicial scrutiny.⁷² Given the criteria cited above, these judicial categories appear to be meant to provide protection for groups who not only have been habitually and unjustifiably discriminated against, but who also lack the political power to do anything about it.⁷³

The Constitution and the courts are not the only sources of meaning for what constitutes a socially suspect classification. More generally, we might regard as socially suspect any classification that reinforces or perpetuates broader social inequalities, or that causes some sort of expressive harm by acknowledging and legitimating prior unfair treatment.⁷⁴ For instance, society might object to an insurer who announced that it was willing to sell annuities at better rates to African-Americans because they tend to have a shorter life span. This objection might persist even though the traditionally disadvantaged group is made better off as a result of the insurer classification scheme.⁷⁵

3. “Differential Inaccuracy”⁷⁶

A third fairness-based objection to risk classification arises out of the fact that all classification regimes are imperfect. Not only are predictions about the future inherently

⁷⁰ See, e.g., *Cleburne*, 473 U.S. at 442, 445, 454.

⁷¹ The *Caroline Products* case famously established strict scrutiny and the concept of suspect classifications. *United States v. Caroline Products*, 304 U.S. 144, 152 n.4 (1938). Subsequent cases identified race (*Loving v. Virginia*, 388 U.S. 1, 11 (1967)), national origin, (*Oyama v. California*, 332 U.S. 633, 644–46 (1948)) and religion (*Church of the Lukumi Babalu Aye, Inc. v. City of Hialeah*, 508 U.S. 520, 546 (1993)), as suspect classifications.

⁷² Intermediate scrutiny requires that the legal classification in question be “substantially related to an important governmental objective.” *Clark v. Jeter*, 486 U.S. 456, 461 (1988). For cases establishing the categories of quasi-suspect classifications, see *Craig v. Boren*, 429 U.S. 190, 197 (1976) (sex); and *Mills v. Habluetzel*, 456 U.S. 91, 98–99 (1982) (illegitimacy).

⁷³ See generally JOHN HART ELY, *DEMOCRACY AND DISTRUST: A THEORY OF JUDICIAL REVIEW* (1980).

⁷⁴ Abraham frames this category more broadly in his article, stating that a classification can be suspect for at least four reasons: (i) it is used improperly in other fields, (ii) it is not supported by sufficient data, (iii) it systematically works to the disadvantage of a particular group, or (iv) it perpetuates unfair disadvantages outside of the insurance system. In general, though, none of the first three explanations seem problematic unless they are coupled with the fourth. It is not, for instance, troubling that classification schemes systematically work to the disadvantage of individuals with bad driving records. Similarly, Abraham himself argues elsewhere in his article that mere inaccuracy is not, in itself, a basis for a fairness objection. See Abraham, *supra* note 13.

⁷⁵ Although often framed in terms of fairness, this argument can also be understood in economic terms as an externality argument: insurers impose harms on society at large by relying on certain suspect classifications.

⁷⁶ ABRAHAM, *supra* note 14 (coining this phrase).

uncertain, but classification is itself costly. Efficient insurance regimes will only invest in improving classification to the extent that the resulting benefits are larger than this cost. These imperfections arguably do not inherently raise fairness concerns, as all policyholders are better off when insurers choose not to invest beyond efficient levels in refining classification regimes.⁷⁷ However, inaccuracy in classification can raise fairness concerns when the burden of inaccuracy is differentially allocated among policyholders, so that some groups bear a larger share of the cost of such inaccuracy than other groups.⁷⁸ For instance, differential inaccuracy was a central concern in the substantial literature on the use of HIV/AIDS status in insurance underwriting. During the AIDS panic in the late 1980s, various life and health insurers began to include AIDS-based coverage exclusions in their policies.⁷⁹ Various commentators excoriated this practice, arguing that the HIV antibody test was too unreliable to support such testing because it created an unacceptably heterogeneous population of AIDS sufferers and false positives, forcing the latter to bear the financial burden of the former.⁸⁰

4. Correlation and Causation

Insurance classification schemes are based on correlations between observed policyholder characteristics and ultimate losses.⁸¹ Of course, a correlation between two data points does not necessarily imply a causal relationship. According to the American Academy of Actuaries, insurer classification may “be more acceptable to the public if there is a demonstrable cause and effect relationship between the risk characteristics and expected costs.”⁸² Often, though, objections to risk classification schemes that are articulated in terms of a lack of a causal connection seem to in fact be driven by the perceived lack of a strong enough correlational connection. For instance, detractors of gender-based insurance rating in life insurance often contrast gender with age, arguing that “the association between age and mortality is much stronger than that between sex and mortality.”⁸³ Similarly, at least some of the resistance to race-based life insurance rating “undoubtedly comes from the perception that it makes little factual sense, because... [t]he apparent differences are mostly environmental.”⁸⁴

⁷⁷ See ABRAHAM, *supra* note 14; Abraham, *supra* note 13, at 429-31.

⁷⁸ See ABRAHAM, *supra* note 14; Abraham, *supra* note 13, at 431-34.

⁷⁹ Karen A. Clifford & Russel P. Inculano, *Aids and Insurance: The Rationale for Aids-Related Testing*, 100 HARV. L. REV. 1806 (1987). Even after the AIDS panic had subsided, some suspected that insurers were continuing to discriminate against homosexuals as an at-risk group, by secretly targeting men in stereotypically gay occupations. Katy Chi-Wen Li, *The Private Insurance Industry's Tactics Against Suspected Homosexuals: Redlining Based on Occupation, Residence, and Marital Status*, 22 AM.J.L. & MED. 477 (1996).

⁸⁰ Judith A. Berman, Note, *AIDS Antibody Testing and Health Insurance Underwriting: A Paradigmatic Inquiry*, 49 OHIO ST. L. J. 1059 (1989).

⁸¹ Professor Robert Rhee, Remarks at the Insurance Law Section of the AALS Annual Meeting (Jan. 7, 2012).

⁸² See American Academy of Actuaries.

⁸³ Lea Brillmayer, Douglas Laycock & Teresa A. Sullivan, *The Efficient Use of Group Averages as Nondiscrimination: A Rejoinder to Professor Benston*, 50 U. CHI. L. REV. 250 (1983); see also Spencer L. Kimball, *Reverse Sex Discrimination: Manhart*, 4 AM. BAR FOUNDATION RESEARCH J. 83, 108 (1979) (“Age discrimination is so basic in life insurance and annuities that any serious challenge to it seems unlikely.”).

⁸⁴ Kimball, *supra* note 64.

What these quotations reveal is just how slippery the meaning of “causation” can be in this context.⁸⁵ Indeed, it is often not clear exactly what is meant by assertions that a relationship between an underwriting factor and risk is causal.⁸⁶ Perhaps the clearest answer is that there is a “but for” causal link, such that a change in the characteristic being underwritten would necessarily produce a change in loss experiences, holding all else equal. Thus, the causal link between credit scores and losses could be contested on the basis that credit scores decreased significantly in the wake of the Great Recession, but loss experiences did not adjust accordingly.⁸⁷ (Of course, if it is relative credit score—the score compared to others—that matters to insurers, then a general drop in the average credit score is not relevant to insurers’ risk analyses.)

But while “but for” causation may be necessary, it is likely not sufficient for a causal relationship to exist, as any first-year tort student can explain. Just as in tort law, causation inevitably also includes some notion of “proximate cause” to ensure that the relationship between a but-for characteristic and loss is not excessively attenuated. None of this means that the concept of causation cannot be operationalized in insurance: for instance, most would agree that the link between smoking and life expectancy is causal. Rather, it means that this link depends on factors such as the degree of correlation between policyholder characteristic and risk of loss as well as the ease with which one can construct stories connecting policyholder characteristics and risk.

To the extent that causal links between policyholder characteristics and risk can be meaningfully identified, they tend to play one of two roles in fairness-based critiques of risk-classification schemes and their regulation. First, whenever the link between a particular characteristic and risk is perceived to be non-causal, the use of the characteristic may be challenged on the grounds of differential inaccuracy, as described above. In such cases, it can always be argued that (i) the relevant characteristic is simply a proxy for some other causal contributor to risk, and (ii) the burden of this inaccuracy is only borne by the portion of the risk pool with the relevant characteristic. For instance, suppose that recent immigrants tend to get into more car accidents, but that is entirely attributable to the fact that many recent immigrants were trained to drive on the left side of the road. In these circumstances, charging recent immigrants more might be contested due to the lack of causation between the characteristic and risk. In fact, though, the fairness concern is better framed in terms of differential inaccuracy: the insurer practice has the effect of forcing all recent immigrants, including those who learned to drive on the right side of the road, to bear the burden associated with imperfect rating.

⁸⁵ Regina Austin, *supra* note 19, at 559-63 (“Causation cannot serve as a neutral basis Causal attribution is merely a subterfuge and cannot be a substitute for value judgment.”).

⁸⁶ Indeed, according to the American Academy of Actuaries, “in insurance it is often impossible to prove statistically any postulated cause and effect relationship.” American Academy of Actuaries (AAA), Committee on Risk Classification.

⁸⁷ See *supra* Part I.B.2

A second, logically distinct, objection to the use of characteristics that are not perceived to be causally connected to risk is that using such characteristics can have the effect of masking classification practices that are objectionable for reasons already noted, such as lack of policyholder control or because they trade on socially suspect characteristics. For instance, the primary objection to insurers' use of credit scores to rate individuals is that this simply proxies for other, more objectionable, policyholder characteristics, such as race and income.⁸⁸ This argument is logically distinct from the differential inaccuracy point because it is based on the notion that the lack of understanding of the connection between the characteristic and the risk masks some unfair result.

5. Privacy

A final fairness-based factor in evaluating the propriety of insurer risk-classification measures is policyholder privacy. Although the purchase of insurance is usually voluntary, insurance is often a practical pre-requisite to a wide range of modern necessities, such as driving and owning a home. Consequently, allowing insurers to demand certain highly personal pieces of information – such as HIV status, genetic information, or sexual orientation – is often viewed as unduly intrusive.⁸⁹ More recently, there are also concerns that insurers violate policyholder privacy when they acquire information for underwriting without meaningful cooperation or consent from policyholders. This might include information about consumers' browsing histories and purchasing patterns that individuals do not reasonably expect will be available to insurers in underwriting.

II. Predicting State Insurance Law and Regulation

This Part attempts to translate the broad range of normative factors discussed in Part I into specific predictions about the contours of state insurance anti-discrimination law. Because state insurance law and regulation is ultimately a political exercise, it attempts to balance the conflicting normative concerns discussed in Part I with the political realities of state insurance regulation. The principal goal of this Part is simply to provide a framework for analyzing the data regarding the actual pattern of state laws governing insurer risk classification, which are reviewed in Part III. Given the tentative nature of our hypotheses, and how easy it would be for the balance of concerns to be given slightly different weight in different contexts, we will not be shocked to find that the results diverge from our predictions.

A. Setting the Stage: Key Assumptions and the Political Economy of Insurance

⁸⁸ Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* (July 2007), available at <http://www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf>.

⁸⁹ See, e.g., Sandra E. Stone, *HIV Testing and Insurance Applicants: Exploring Constitutional Alternatives to Statutory Protections*, 19 *Hastings Const. L.Q.* 1163, 1181-83 (1992).

Drawing from two distinct literatures on insurance discrimination, Part I identified the efficiency and fairness considerations that a benevolent legislature might consider in deciding whether to restrict an insurer's ability to discriminate with respect to a particular characteristic in the underwriting process. But how might these various normative considerations affect which particular state laws get enacted? Making such predictions is fraught with difficulty, for two general reasons. First, fairness and efficiency concerns often, though not always, cut in opposite directions. Trading off efficiency and fairness concerns is what lawmakers are asked to do every day, but predicting the outcome of such balancing is no easy task.

The second difficulty arises from the fact that lawmaking is messy. There are of course many different theories of how law gets made. Interest group theories tend to view legal rules—statutes and regulations and even court decisions—as outputs of a market-like process in which interested parties use the lawmaking process to “purchase” legal outcomes that further their interests.⁹⁰ From this perspective, the arguments from Part I that are most likely to impact legislative outcomes are those that impact insurers' bottom lines. By contrast, public interest theories tend to be more optimistic about what motivates legislatures, agencies, and judges and thus more optimistic about the nature and quality of the laws they produce.⁹¹ On this more rosy view, all of the fairness and efficiency arguments developed in part I should carry actual weight with lawmakers, whether the mechanism for this result is the altruism of the legislators themselves or the existence of effective politicians who are able to convert good policy arguments into effective political leverage. The best theories of the lawmaking process, of course, adopt a blend of these competing approaches. Such blended theories take seriously the political influence of relatively small but well-organized and highly motivated interest groups, while simultaneously acknowledging the power of the diffuse majority with respect to issues that they care about—or are made to care about. We take a blended approach in this Article.

There is support for taking such an approach in the political science literature. The definitive study of the political economy of the insurance industry is *The Political Economy of Regulation: The Case of Insurance*, by Kenneth J. Meier.⁹² Meier concluded that no single theory could fully describe the landscape of insurance regulation. Rather, insurance regulation is a multi-faceted and complex activity that is influenced by a number of competing and often conflicting interests. To be sure, insurance companies often do get their way in the regulatory domain, even on occasion at the expense policyholders' best interests—or at least what some consumer interest group regards as their best interests.⁹³ At the same time, though, insurers are

⁹⁰ See, e.g., Jonathan R. Macey, Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model, [86 Colum. L. Rev. 223, 227-33 \(1986\)](#)

⁹¹ See JAMES Q. WILSON, *THE RISE OF THE BUREAUCRATIC STATE* (1975).

⁹² KENNETH J. MEIER, *THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE* (1988).

⁹³ Robert Hunter, *A Failure of Oversight in Need of Rescue: Insurance Regulation*, *13 NY Bar Association Journal of Government, Law and Policy* 2 (2011); Daniel Schwarcz, *Preventing Capture Through Consumer Empowerment Programs: Some Evidence from Insurance Regulation*, in *PREVENTING CAPTURE* (David Moss & Daniel Carpenter, eds.) (Cambridge, 2012).

not always able to completely capture state regulation. In part, this is because the insurance industry is heterogeneous with respect to many issues, as property/casualty insurers sometimes have different interests than life insurers and large companies sometimes have different interests than small insurers.⁹⁴ But it is also because consumer groups and political entrepreneurs can organize consumer opposition to certain industry-friendly positions, and, in many cases, highly motivated regulators or “bureaucrats” effectively advocate for their own vision of the public interest.⁹⁵ Additionally, scrutiny of insurance issues at the federal level can often trigger state regulatory reform.⁹⁶

B. Predictions

1. Efficiency based predictions

Adverse selection: As discussed in Part I, one major efficiency cost of disallowing insurers’ ability to classify according to certain characteristics is that it inhibits insurers’ ability to combat the problem of adverse selection. Adverse selection is not merely a problem of social efficiency; it threatens insurers’ ability to make a profit by insuring particular risks. Additionally, adverse selection can actually undermine fairness-based rationales for limiting discrimination, at least if it is sufficiently severe to produce a death spiral or if insurers can combat it by segregating risks indirectly by offering different levels of coverage. Thus, we predict that, for those line/characteristic combinations where adverse selection is especially problematic, state anti-discrimination laws will tend to be relatively weak on average because (i) some insurers will be strongly motivated to ensure this result, (ii) other industry players will have little reason to oppose this result, and (iii) this result is potentially consistent with fairness-based arguments.

Adverse selection is a bigger problem for some line/characteristic combinations than for others, and so we expect to see relatively weak risk-classification regulation in those lines of insurance in which adverse selection is an especially severe problem. For example, as discussed in Part I, there are reasons to believe that adverse selection may be an especially difficult problem for life insurers. First, life insurance is one area where there is a possibility of over-insurance that does not exist in the same way with other types of insurance, because, unlike other types of insurance, life insurance policies do not contain coordination-of-coverage or other insurance provisions.⁹⁷ Second, there is a strong secondary market in life insurance, but not in other types of insurance, which increases the value to insureds of successfully adversely selecting into life insurance pools in particular.⁹⁸ Third, life, and to a lesser extent health, insurers face substantial product design and legal restrictions in their ability to cancel or non-

⁹⁴ Meier, *supra* note 98, at at 167.

⁹⁵ *Id.*

⁹⁶ *Id.*; See also Daniel Schwarcz, *Transparently Opaque: Fixing the Lack of Transparency in Insurance Consumer Protection*, U.C.L.A. L. REV. (forthcoming, 2013).

⁹⁷ See *supra* text accompanying notes 34-36.

⁹⁸ See *supra* text accompanying notes 37-38.

renew policies, because they must generally do so within the statutory incontestability period.⁹⁹ Fourth, life insurance policyholders are often keenly aware of both their risk characteristics (such as age and gender) and how they effect mortality risk.¹⁰⁰ Finally, life insurance is generally not legally or practically required for policyholders.¹⁰¹ Moreover, there are various substitute financial products for many forms of life insurance and particularly annuity products. These factors will tend to increase the elasticity of demand and therefore the risk for adverse selection.¹⁰²

Moral hazard: Moral hazard also threatens insurers' profitability, and thus we would make a similar prediction here: for those line/characteristic combinations where moral hazard is especially problematic, state anti-discrimination laws will tend to be relatively weak. Because moral hazard is only an issue with respect to factors over which an insured has some control,¹⁰³ this moral-hazard prediction is consistent with a fairness-based prediction: for characteristics considered to be totally within an insured's control, state anti-discrimination laws will tend to be weaker on average than for characteristics that are considered totally outside of the insured's control. Likewise, since whether a characteristic is within a person's control can be considered a matter of degree, we would predict that the less within one's control a characteristic is the stronger will be the applicable anti-discrimination law.

Insurer use of underlying characteristic: For characteristics that do not provide any predictive value to insurers, like zip code in disability insurance, we predict that the average level of regulation will be very weak, unless there is some strong expressive or symbolic reason for regulation.¹⁰⁴ For characteristics that may have predictive value to insurers, but which insurers nonetheless have not historically used, we predict that the average level of regulation will still be weak, but less weak than above.

Other efficiency considerations: We predict that the other assorted efficiency arguments – including the socially wasteful expenditure of resources, the potential public good nature of risk classification, efficient redistribution, and positive externalities of risky behavior – will tend not to impact legislative and regulatory choices. All of these efficiency arguments would tend to *support* risk classification regulation (in contrast to those noted above) on the basis of broad social efficiency benefits.¹⁰⁵ But interest groups will tend not to coalesce around these social efficiency arguments because their benefits accrue not to small and easily identifiable groups, but

⁹⁹ See Part I, *supra*.

¹⁰⁰ See part I, *supra*. Whether policyholders fully understand the link between their mortality risk and their gender may be variable. See Howell Jackson & Allison Hoffman, *Retiree Out-of-Pocket Healthcare Spending: A Study of Consumer Expectations and Policy Implications*, 39 AM. J. LAW & MED. 1 (2013).

¹⁰¹ See part I, *supra*.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ See Part I, *supra*.

to the diffuse public.¹⁰⁶ Similarly, while we expect that state lawmakers will be publicly-oriented in some cases, we expect that none of the efficiency arguments in support of risk-classification regulation are sufficiently large or publicly salient to generate substantial momentum on this basis alone. This especially true these restrictions may limit insurers' potential profit, and thus face industry opposition.

2. Fairness based predictions

Control and social solidarity: As mentioned above, we predict that the greater the control an insured has over a characteristic, the weaker will be the average insurance anti-discrimination law, both for efficiency (moral hazard) and fairness reasons. The other reason why we expect this to be true is that, insofar as insurance anti-discrimination laws are about achieving some degree of social solidarity (or redistribution from better off to less well off), such arguments tend to be most persuasive, or easily accepted, in situations in which individuals lack control over their circumstances.¹⁰⁷

Socially suspect characteristics: Here we have two general predictions, the strong version and the weak version. The strong version is that, when there is general agreement that a characteristic is socially suspect (based for example on constitutional jurisprudence), *every jurisdiction* will have a law forbidding insurers from using that characteristic across all lines, even if the characteristic may not have any predictive value in a particular line. As a proxy for the strong-version prediction we use the Supreme Court's concept of suspect classifications, which includes race, religion, and national origin, and quasi-suspect classifications, which includes gender.¹⁰⁸ The weaker prediction is that, for such characteristics, at least the average level of anti-discrimination regulation will be stronger than the average level of regulation of other characteristics. Also, if there are characteristics that are well-known, or even widely suspected, proxies for socially suspect characteristics, such as zip code as a proxy for race, we expect similar results, although probably not as strong: that is, there will be fewer states with

¹⁰⁶ See Part II.A, *supra*.

¹⁰⁷ The social solidarity/redistribution idea also suggests a cross-state prediction, one that we do not yet have the data fully to test: Given that insurance anti-discrimination laws can be viewed as a form of redistribution from the better off (the ones without the high-risk characteristic) to the less well off (the ones with the high-risk characteristic), we predict that states in which voters are relatively hostile to government redistribution via the tax and transfer system will have relatively weak insurance anti-discrimination laws. We expect this effect to be strongest where the redistributive argument is strongest: for example, where there is relatively little control on the part of the insured. A simple albeit rough way of differentiating between redistribution-friendly and redistribution-hostile states would be to look at the blue state/red state divide in recent Presidential elections, where the issue of the appropriate degree of redistribution (through income tax progressivity and health care finance) has been a key component of the campaigns. Relatedly, states in which voters are relatively open to anti-discrimination law in other contexts (as shown in survey research or in the existence of state anti-discrimination laws of other types) will be relatively more likely to have strong insurance anti-discrimination laws. Perhaps the blue state/red state divide would work here as well.

¹⁰⁸ See *supra* discussion at note ___. Obviously, the equal protection clause has no binding effect on private insurance companies, but rather serves only as a limitation on state power. We use the concept only as a rough proxy for characteristics that are universally regarded as inappropriate bases for risk segregation.

outright bans, and the average strictness of the regulation will be less, than for the socially suspect classification itself.

Correlation and Causation: The correlation/causation concern from Part I suggests that stronger anti-discrimination laws will exist for characteristics that do not have a clear causal connection to risk. At the same time, insurers will presumably lobby extensively to use characteristics that provide useful risk-related information, irrespective of their causal link to loss. Our prediction then is that, there should be stronger restrictions on average for traits that are perceived not to have a causal relationship with the risk they are said to reflect.

Privacy: We predict that characteristics that are considered private and/or that require effort by the policyholder to acquire will be more highly regulated.

3. Applying the predictions to the nine characteristics

How will these general predictions play out for the various line/characteristic combinations that we examine below?

Race, national origin, and religion (the “big three”): Race, national origin, and religion have a special place in this country’s history; and, as discussed above, discrimination on the basis of these three characteristics has been subject to stricter scrutiny in American law than have other characteristics. Therefore, relying on the general predictions above with respect to socially suspect classifications, *we predict that race, national origin, and religion will be prohibited characteristics in every state across every line.* A weaker form of the prediction is that *these three characteristics will be more strictly regulated on average than will the other characteristics.* We make these predictions for all three of these characteristics, even though not all of them correlate in an obvious way with the risks associated with all five lines of insurance.

Gender: Gender-based discrimination in insurance has long been controversial.¹⁰⁹ And differential treatment on the basis of gender is, of course, in many contexts widely considered unacceptable or illegal.¹¹⁰ Nevertheless, there does not seem to be the same level of agreement—as there is for the race, religion, and national origin—that drawing gender-based distinctions is always wrong. As discussed above, federal constitutional law treats gender as only a quasi-suspect classification; as a result, laws that discriminate on the basis of gender are subject to an intermediate level of scrutiny. This means a more searching scrutiny for laws that discriminate

¹⁰⁹ Indeed, the question of the legality under the federal employment discrimination laws of gendered differences in insurance (or pension) premiums and payouts sparked one of the more important and interesting debates regarding what constitutes unfair or illicit discrimination in the insurance context and what constitutes merely a fair allocation of costs. Lea Brilmayer, Douglas Laycock & Teresa A. Sullivan, *The Efficient Use of Group Averages as Nondiscrimination: A Rejoinder to Professor Benston*, 50 U. CHI. L. REV. 250 (1983); see also Spencer L. Kimball, *Reverse Sex Discrimination: Manhart*, 4 AM. BAR FOUNDATION RESEARCH J. 83, 108 (1979) (“Age discrimination is so basic in life insurance and annuities that any serious challenge to it seems unlikely.”).

¹¹⁰ John J. Donohue III, *Prohibiting Sex Discrimination in the Workplace: An Economic Perspective*, 56 U. Chi. L. Rev. 1337, 1365-66 (1989).

on the basis of gender than for laws that discriminate on the basis of other characteristics, but less searching scrutiny than for race, national origin, or religion. Therefore, *we predict that there will be more variability across the states with respect to laws regulating insurance gender discrimination than with respect to laws restricting the use of the big three, perhaps with states clustering around either end of the spectrum.* In addition, because gender equity arguments tend to be used to improve the lot of women relative to men, and gender equity is a salient public issue that attracts various public interest groups, *we also predict that the gender discrimination will be more strictly regulated on average for health insurance (where gender-rated policies often result in higher premiums for women) than for auto insurance (where gender-rated policies result in higher premiums for men).* However, *with respect to life insurance, we predict that the laws regulating gender discrimination will be on average relatively weak,* since adverse selection in the life insurance market is especially problematic. Regarding property/casualty insurance, as there seems to be no conceivable correlation between those risks, we predict *either states will cluster around no regulation, or, alternatively, states will cluster around forbidding the use of gender in p/c insurance on symbolic or expressive grounds.* It is also possible that there will be a bi-modal distribution along those lines.

Sexual orientation: Unlike with race, national origin, religion, and gender, legal classifications on the basis of an individual's sexual orientation has not been identified by the Supreme Court as deserving special scrutiny. In addition, unlike race, national origin, and gender, there are no federal laws forbidding discrimination on the basis of sexual orientation in employment.¹¹¹ However, there are state laws that forbid discrimination on the basis sexual orientation,¹¹² and some lower courts have held that sexual orientation should be a suspect or quasi-suspect characteristic.¹¹³ It is safe to say that discrimination on the basis of sexual orientation is at least highly controversial. Moreover, discrimination in insurance on the basis of sexual orientation would also implicate substantial privacy concerns. *Thus, we predict that on average, with respect to life and health insurance, sexual orientation will be a moderately regulated characteristic, less regulated than big three and somewhat less regulated than gender, but more heavily regulated than age. Moreover, there may be some cross-state variation.* Because there is little reason to believe that sexual orientation correlates with property or liability risks, *we expect relatively little if any regulation of sexual orientation in the auto and property/casualty lines.*

Age: *We expect that age will have the lowest average regulatory score of all the risk characteristics we are studying.* First, age is not a suspect classification, at least not by constitutional standards. Second, age tends to correlate causally with several important areas of risk (mortality, health, and perhaps disability risks), thereby increasing the perceived fairness of

¹¹¹

¹¹² See, e.g., Sexual Orientation Non-Discrimination Act (NY 2002).

¹¹³ *Windsor v. United States*, 12-2335-CV, 2012 WL 4937310 (2d Cir. Oct. 18, 2012) (finding that sexual orientation is a quasi-suspect classification and, on that basis, striking down DOMA as applied to the federal estate tax).

rating on that basis.¹¹⁴ Third, age can present serious adverse selection problems for insurers, since individual insureds know their own age and the risks associated with their age.¹¹⁵ Fourth, social solidarity arguments with respect to age are relatively weak, since individuals can spread risk over their lifetime through various income smoothing products. These factors are likely most important with respect to life insurance, where the causal connection between age and risk is obvious and regulatory restrictions would create large adverse selection concerns. Therefore, *for life insurance, we predict that almost every state will either have no regulation or will explicitly permit the use of age.* Regulatory restrictions on age could also create adverse selection problems with disability and health insurance, though these may be less severe because these lines of coverage are often sold on a group basis. *As such, we expect more variation among the states for the use of age in health and disability, perhaps fewer with rules specifically permitting age-based classifications than with life insurance.* With respect to auto insurance, age is a relatively strong proxy for driving risks, meaning that insurers have an interest in lobbying against age-limitations. At the same time, the causal link between age and auto risk is contestable potentially complicating the fairness argument. Even if age is causally connected with auto risks, it is arguably unfair to group all similarly-aged drivers together.¹¹⁶ These concerns lead us to *expect variation across states with respect to whether, and how, insurers can use age in auto insurance underwriting.* Because we are unaware of any correlation between age and non-auto property/casualty risks, *we expect that most states will not regulate of the use of age with respect to property/casualty insurance.*

Credit score and zip code: Credit score and zip code are not, by themselves, socially suspect characteristics. However, as mentioned in Part I, some commentators have argued that credit score and zip code are used by auto and home insurers as proxies for socially suspect characteristics, such as race. By contrast, insurers argue that credit scores and zip codes are predictive of loss experience for reasons having nothing to do with these factors. Given the history of this debate, *we predict that there will be a substantial number of states that limit, though few outright prohibitions of, the use of credit score and zip code in auto insurance and for homeowners' insurance.* However, because insurers seem to have done a better job of public relations and of lobbying, *we expect to see a fair amount of variation among states, perhaps with a bi-modal distribution of some states clustering around no regulation and others clustering around limits. We expect little regulation with respect to credit score and zip code for disability, health, and life insurance,, since we are unaware of any correlation between risk in these lines and credit score or zip code.*¹¹⁷ *More generally, we expect the average regulatory score to be higher for zip code and credit score than for age, but lower than for race, national origin, and religion.*

¹¹⁴ See Part I.C, supra.

¹¹⁵ See Part I.B, supra.

¹¹⁶ This is the differential inaccuracy point discussed in Part I. See Part I.C, supra.

¹¹⁷ While it is true that some have argued that zip code and perhaps credit score are proxies for other factors that may correspond to health, disability, or life risks, we insurers do not appear to be interested in using zip code and credit score in those lines.

Genetics: Laws limiting the ability of insurers, especially health and life insurers, to use genetic tests in underwriting insurance can be defended on redistributive and privacy grounds, for reasons discussed above. They can also be defended on efficiency grounds, as insurer usage of this characteristic could deter individual knowledge acquisition. *Therefore, we would expect that anti-discrimination laws will on average tend to be more restrictive for genetic testing than for characteristics that do not present such an argument (such as age). We would expect no regulation of genetics for auto or p/c insurance, as there is no apparent connection to those risks. With respect to life insurance, we would predict that genetic testing would be permitted or not regulated in almost all states, for adverse selection reasons.* Given the federal law forbidding genetics in health insurance, *we predict that for health most states would prohibit. Because disability insurance presents greater moral hazard concerns, we expect more variation—more willingness to allow.*

All of our predictions are summarized in the following table. The columns represent the five lines of insurance, and the rows are for the nine characteristics we examined.

State Insurance Anti-Discrimination Laws: Predictions

	Auto	Disability	Health	Life	Property/ Casualty
Race	Prohibited across all states (highest average level of strictness)	Prohibited across all states (highest average level of strictness)	Prohibited across all states (highest average level of strictness)	Prohibited across all states (highest average level of strictness)	Prohibited across all states (highest average level of strictness)
National origin	Same as race	Same as race	Same as race	Same as race	Same as race
Religion	Same as race	Same as race	Same as race	Same as race	Same as race
Gender	Variation across states; with some states permitting and others prohibiting or limiting, possible bi-modal distribution (bmd)	Variation across states; some states permitting and others prohibiting or limiting	Variation across states; some states permitting and others prohibit or limit; fewer and weaker limitations than with auto insurance on average, because of AS concerns and because discrimination here tends to help women	No regulation or explicitly permitted in substantially all states, mainly because of adverse selection and discrimination here helps women	No regulation in substantially all states, because not relevant to risk, or prohibited on expressive grounds, possible bmd
Sexual Orient.	No regulation, because not relevant to risk	Variation across states (some states prohibiting; others not regulating; possible bmd)	Variation across states (some states prohibiting; others not regulating; possible bmd)	Variation across states (some states prohibiting; others not regulating; possible bmd)	No regulation, because not relevant to risk
Age	limited regulation, with some variation across states	limited regulation	limited regulation	no regulation or explicitly permit	No regulation
Credit Score	Variation across states; with some not regulating and others limiting on proxy grounds	No regulation	No regulation	No regulation	Variation across states; with some not regulating and others limiting on proxy grounds
Zip Code	Same as credit score	Same as credit score	Same as credit score	Same as credit score	Same as credit score
Genetics	No regulation	Relatively weak regulation on average, but with variation across states	Most states prohibiting, as in federal law; or no states prohibiting, because of federal law	No regulation or specifically permitted, because of adverse selection	No regulation

Part III. The Data

A. Empirical Methodology and Coding of State Laws

Although there has been considerable theorizing about the extent to which insurance companies should be allowed to discriminate among insureds in the underwriting process, there has been almost no research on the question what the law actually permits. It is a surprisingly complex and difficult issue. Because the governing law in this area is primarily state law, we first had to identify and analyze the relevant state statutes and regulations in all 50 states as well as the District of Columbia, as of 2012. To make the project manageable, we focused specifically on how states have regulated insurers' use of the nine characteristics – race, religion, national origin, gender, age, genetic testing, credit score, sexual orientation, and geographic location – and we focused on the five largest lines of insurance – life, health, disability, auto, and property/casualty.¹¹⁸ This exercise revealed statutes at all levels of generality: statutes that limited or prohibited all “unfair discrimination” in all lines of insurance with no mention of particular traits;¹¹⁹ statutes that limited or prohibited “unfair discrimination” generally within a particular line of insurance;¹²⁰ and statutes that limited or prohibited the use of one or more specific characteristics either for all lines¹²¹ or for a specific line of insurance.¹²²

¹¹⁸ With one large exception, the category of “property/casualty” insurance includes first-party property insurance and all liability insurance, including homeowners' insurance coverage. The exception is auto insurance, which includes both first party and liability components and is so large in terms of premium volume and the like that it was given its own category.

¹¹⁹ For example, Texas law provides that an insurer may not use a rate that is “unfairly discriminatory.” Tex. Ins. Code § 560.002(a)(2)(c). Oklahoma, by contrast, treats “unfair discrimination” as a type of prohibited “unfair or deceptive act or practice.” 36 Okl. St. § 1204(7). In total, 28 states have general statutes forbidding “unfair discrimination” or “unfairly discriminatory” rates by insurers or both across all (or multiple) lines of insurance. Those states are: Alabama, Alaska, Arizona, Arkansas, Colorado, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Minnesota, Missouri, North Carolina, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

¹²⁰ For example, North Carolina prohibits “unfair discrimination” in life insurance rates. N.C.G.S § 58-58-35; § 58-63-15(7)(a). Likewise, South Dakota. SDCL § 58-33-12. In fact, *every* state except Iowa, Utah, Vermont, Washington, and Wisconsin has a statute prohibiting “unfair discrimination” by insurers or “unfairly discriminatory” rates or both in connection with life insurance in particular. Another example of general anti-discrimination statutes that apply to specific lines would be property/casualty insurance. There are 27 states, and the District of Columbia, that such statutes. See, e.g., O.R.C. §3901.21(M) (Ohio); Gen.Laws 1956, § 27-44-5(Rhode Island); and MCL § 500.2403 (Michigan).

¹²¹ For example, Delaware has a general statute forbidding the use of race in connection with any type of insurance. 18 Del Code 2304(22) (“It shall be an unlawful practice for any insurance company licensed to do business in this State to discriminate in any way because of the insured's race, color, religion, sexual orientation or national origin”). Arkansas, by contrast, has a general statute that limits but does not outright prohibit the use of race in any area of insurance. Specifically, it forbids “refusing to insure or continue to insure an individual or risks *solely because* of the individual's race, color, creed, national origin, citizenship, status as a victim of domestic abuse, or sex.” A.C.A. § 23-66-206(14)(G)(i). This very common type of limitation statute, found in many states, seems to suggest that race, and other suspect categories, may be used, but only if they can be backed up by accurate and reliable actuarial data.

¹²² For example, Utah has a statute forbidding the use of race in insurance ratemaking for property/casualty insurance in particular. Utah Code Ann. § 31A-19a-202(3)(c). Ohio has an anti-discrimination provision that is particular both to race and to property/casualty insurance; however, that statute forbids the use of taking race into

Based on these state statutes, we assigned a code for each line/trait combination for each state. We ended up with six possible codes that we arranged along a continuum, from those that are least restrictive of insurers' underwriting decisions to those that are most restrictive. At one end of the continuum are statutes that expressly permit the use of a particular trait, and at the other end are outright prohibitions of particular traits. Between these two extremes, the "general restriction" statutes (that is, the general unfair discrimination statutes) were treated as being more restrictive than the absence of any relevant statute, but as being less restrictive than statutes that specifically mention the trait in question. The entire continuum is reproduced below:¹²³

Expressly Permit (-1) — The state has a statute expressly or impliedly permitting insurers to take the characteristic into account.

No Law on Point (0) — The state laws are silent with respect to the particular characteristic.

General Restriction (1) — The state has a statute that generally prohibits "unfair discrimination," either across all lines of insurance or in some lines of insurance, but that statute does not provide any explanation as to what constitutes unfair discrimination and does not single out any particular trait for limitation.

Characteristic-Specific Weak Limitation (2) — The state has a statute that limits the use of a particular characteristic in either issuance, renewal, or cancellation.

Characteristic-Specific Strong Limitation (3) — The state has a statute that prohibits the use of a particular characteristic when the policy is either issued, renewed, or cancelled, or the state has a statute that limits but does not completely prohibit the use of a particular characteristic in rate-setting.

Characteristic-Specific Prohibition (4) — The state has a statute that expressly prohibits insurers from taking into account a specific characteristic in setting rates.

After arriving at an initial code based upon the state statutes for every line of insurance, for every characteristic, in every state, we went back and examined judicial decisions and administrative rulings within each jurisdiction to determine if the initial code was changed by a decision. Surprisingly, out of the 2295 trait/line combinations (9 traits times 5 lines of insurance times 51 jurisdictions), only 16 total trait/line combinations were changed. In sum, judicial and

account in decisions regarding whether to issue or renew a policy. O.R.C. §4112.02(H)(4). In total, 33 states and the District of Columbia either limit or forbid the use of race by property/casualty insurers. Interestingly, only six states – Illinois, Massachusetts, Nebraska, New York, North Carolina, and Virginia – impose any limit on the use of gender in life insurance.

¹²³ We acknowledge that this continuum from permissive to stringent restrictions is neither perfectly continuous nor perfectly scaled, but it is the best that can be done given the nature of the data. It allows us to "see" the data in a way that makes it more accessible. As with any grading scale, the differences between immediately contiguous scores (e.g., the difference between B+ and an A-) can be slim in some cases. But the hope is that averages, across lots of measurements, will have some meaning; and the differences in the extremes (e.g., the A and the C) will likely reveal important differences.

administrative interpretation of the state statutes had very little effect on the final coding results.¹²⁴

Our approach to coding the various laws has an important limitation. First, our coding continuum, is, for simplicity, equidistant, even though the actual laws are not. That is, we assume that the distant between zero to one is similar to the distant between one and two. Second, and more importantly, many of the various intermediate limitations—which are, after all, laws requiring a showing of statistical correlation between the characteristic and the risks in question— may, in practice, be relatively simple for insurers to satisfy. In those cases, there will be little difference between strong limitations, weak limitations, general limitations, no mentions, and express permits. Instead, the important distinction will be between the states that have outright prohibitions with respect to a particular line/characteristic combination and those states that do not.

B. The results

In this section we discuss the extent to which the data are consistent with the hypotheses developed in part II. To do so, we report some basic summary statistics. In some cases we report average strictness scores. That is, we simply take the average of the codes for a given set of states for a particular characteristic or line/characteristic combination. We also examine the individual state scores that make up these averages, the variance in state laws and the extent to which distributions tend to be bi-modal. We ran various statistical tests on the data, but eyeballing the graphs proved to be just as revealing. Those graphs, for each line/characteristic combination, are included in the appendix.

1. Race, Religion, National origin (The “big three”)

Figures 1 to 3 present our finding regarding the “big three” for auto insurance, yet much of the analysis remains the same for other lines of insurance.

¹²⁴ Among the few but interesting exceptions to this conclusion is *Guidry v. Pellerin Life*, in which a federal court applying Louisiana’s general unfair discrimination statute holds that discrimination on the basis of race in life insurance is not unfair, discussed below.

Treatment of Religion in Auto Insurance

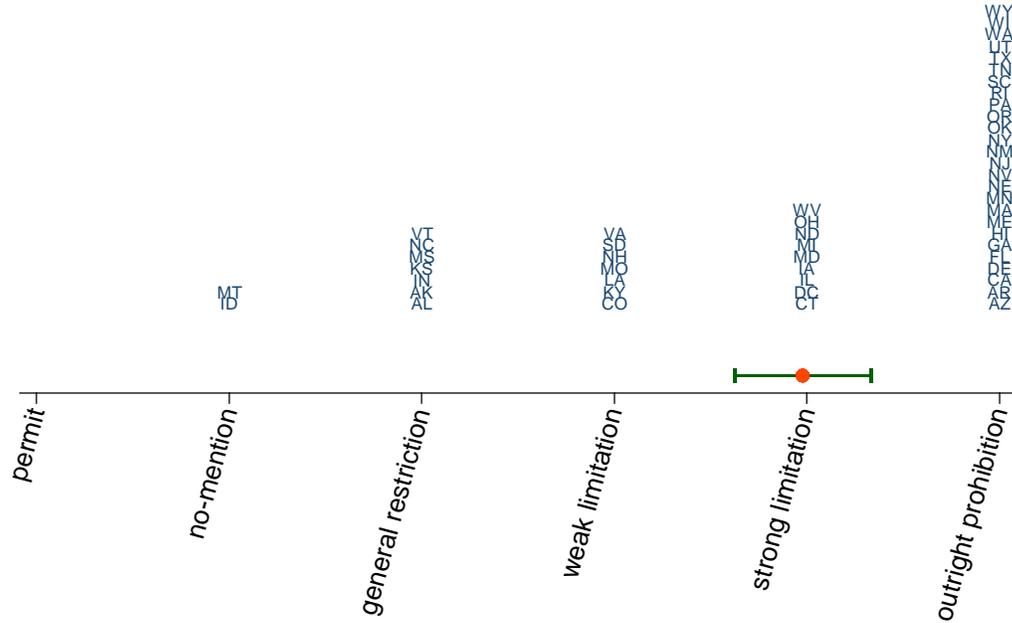


Figure 3- Distribution of States’ Scores for Religion, in Auto Insurance

Perhaps the most surprising finding was the fact that states do not uniformly prohibit insurers from using race, religion, and national origin—contradicting our strong prediction about the big three characteristics. Figure 4 below reveals that only seven states have forbidden the use of race, national origin, and religion across all lines of insurance. Those states are California, New Jersey, New Mexico, New York, Texas, Washington, and Wisconsin. Two additional states—Georgia and North Carolina—prohibit the use by insurers of race and national origin, but do not apply the same prohibition to religion. In contrast, only one state, Louisiana, explicitly permits the use of race in life insurance.

Characteristic	Number of Jurisdictions <i>Completely Prohibiting</i> Use of Characteristic in All Five Lines of Insurance	
Race	9	(CA,GA,NJ,NM,NY,NC,TX,WA,WI)
National Origin	9	(CA,GA,NJ,NM,NY,NC,TX,WA,WI)
Religion	7	(CA,NJ,NM,NY,TX,WA,WI)
Gender	1	(MT)
Age	0	
Credit Score	0	
Genetic Testing	0	
Sexual Orientation	5	(CA,DE,FL,KY,UT,VT,WA)

Zip Code	0
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Figure 4

The next finding observable in Figures 1 to 3 above is that regardless of the level of restrictiveness the treatment of the “big three” is highly correlated (with an average Spearman’s rho of 0.9) in all states. In fact, as these 3 graphs show, the scores per line of insurance are almost identical for these three characteristics with property/casualty insurance being the most restrictive line of insurance, then auto, health, life and lastly disability insurance.

Our weaker prediction of course was confirmed: As Figure 5 shows, more states forbid insurers from using race, national origin, and religion across all lines of coverage than for any of the other characteristics. In addition, the average level of regulation of the big three is significantly stricter (at less than 1% level), applying our strictness coding system described above, than for the other six characteristics we studied, as shown in Figure 5. Interestingly, the prohibition on using religious affiliation is stricter on average than the prohibition on using race or national origin.

Figure 5 also shows that at the most general level the regulation of the various characteristics follows the federal constitutional law principles where race, national origin and religion are suspect classifications, gender is quasi-suspect and sexual orientation is not far behind.

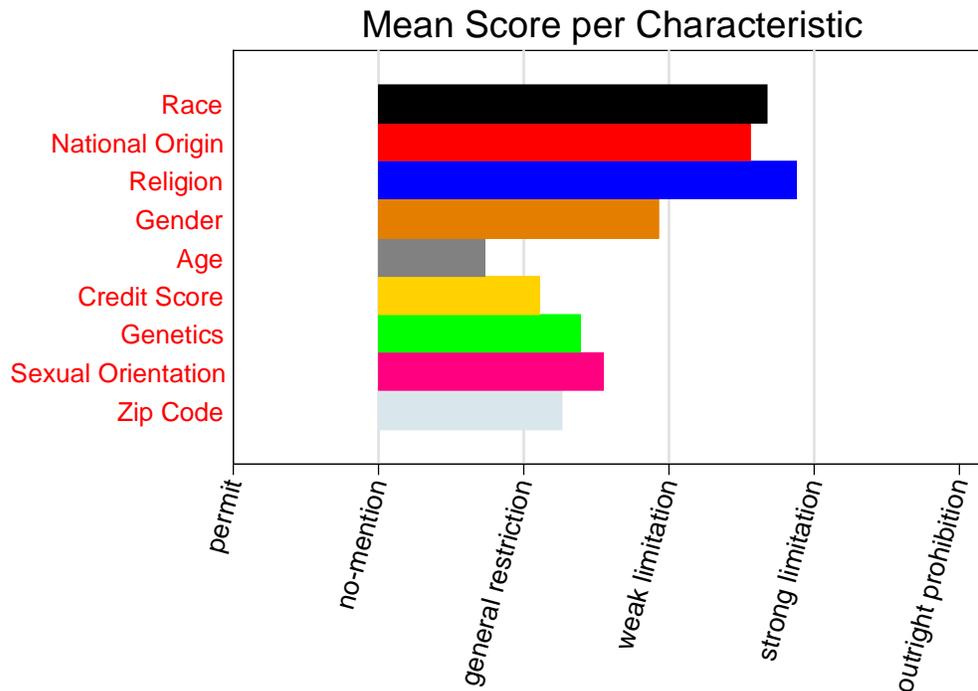


Figure 5

While these results confirm our hypothesis that the “big three” will be treated the same, there remains an interesting question: why is the use of race, national origin, and religion not prohibited in every state in the country? We have a number of theories.

First, perhaps state regulators and their constituents are under the impression that federal law already bans the use of these characteristics. At least two federal statutes could conceivably be interpreted to forbid discrimination on these bases by insurers. First, the Fair Housing Act [“FHA”] makes it unlawful “[t]o refuse to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or rental of, *or otherwise make unavailable or deny, a dwelling* to any person because of race, color, religion, sex, familial status, or national origin.”¹²⁵ Although federal courts were split about the FHA’s applicability to homeowners’ insurance,¹²⁶ new regulations now make clear that the statute does indeed apply in this domain, thus prohibiting racial discrimination in homeowners’ insurance.¹²⁷ Even so, however, the statute does not affect any other type of insurance.

The other federal antidiscrimination law that could conceivably be applied to limit insurer discrimination is 42 USC 1981, which forbids racial discrimination in the making of contracts. But no court has interpreted Section 1981 in this manner, and at least one federal district court has held that Section 1981 did not apply to a claim that life insurers in Louisiana charged higher premiums to African American insureds than to other insureds.¹²⁸ The court noted that Section 1981 requires proof of intentional discrimination on the basis of race, and the evidence in the case supported the defendant insurer’s claim that any race-based premium differential reflected differences in risks. That is the only case we found addressing the application of Section 1981 to insurance transactions; and it went in favor of the insurer.¹²⁹ Thus, if states have failed to enact

¹²⁵ 42 U.S.C. § 3604 (2000) (emphasis added).

¹²⁶ See, e.g., *Nationwide Mut. Ins. Co. v. Cisneros*, 52 F.3d 1351 (6th Cir. 1995) (holding that the McCarran-Ferguson Act does not reverse-preempt the application of the FHA to homeowners’ insurance), *NAACP v. Am. Family Mut. Ins. Co.*, 978 E2d 287 (7th Cir. 1992) (same), *Nat’l Fair Hous. Alliance, Inc. v. Prudential Ins. Co. of Am.*, 208 F. Supp. 2d 46 (D.D.C. 2002), *Toledo Fair Hous. Ctr. v. Nationwide Mut. Ins. Co.*, 94 Ohio Misc. 2d 151 (Ohio C.P. 1997), and *Dunn v. Midwestern Indem. Mid-Am. Fire & Cas. Co.*, 472 E Supp. 1106 (S.D. Ohio 1979).

¹²⁷ See HUD Rule Imposes Disparate Impact Standard on Insurance, Insurance Compliance Insight.

¹²⁸ *Guidry v. Pellerin Life Ins. Co.*, 364 F.Supp.2d 592 (2005).

¹²⁹ This case is the reason we code Louisiana as being the only state that expressly permits race to be used for a particular line of insurance, here life insurance. This coding, however, should be taken with a grain of salt. A close reading of the *Guidry* case leaves unclear whether the insurer in the case was using explicitly insurance premiums that had been calculated explicitly on the basis of race. It is clear from the opinion that the insurer was systematically and knowingly charging African Americans a higher rate than whites, owing to a higher average risk of mortality for African Americans. Indeed, the opinion says that, “up until April 1, 1982, Louisiana law mandated the use of separate published rates for whites and African-Americans.” But it is not clear from the opinion whether this dual-pricing resulted from insurers’ asking about race on their insurance applications or rather from insurers’ using proxies for race. Of course, even if proxies for race are used, if they are knowingly used in order to sort people according to race, which is clearly the implication of the opinion, then it would be the same as if race were

prohibitions because they assumed that federal law already did the job, that assumption may be mistaken.¹³⁰ In any event, this explanation would not explain the results for national origin and religion.

Second, state legislatures may not have banned insurer usage of the big three because they believe that insurers have stopped using race, national origin, and religion already and thus that a law prohibiting their use would simply be unnecessary. In other words, perhaps the anti-discrimination regulatory work is already being done by informal social norms. On this view, insurers understand that if they were to attempt to risk classify on the basis of race, for example, that fact might be discovered, producing serious reputational repercussions.¹³¹ There is probably some explanatory power to this story. We in fact rarely if ever hear of insurers using race, national origin or religion when underwriting individual insurance policies these days.¹³² However, even if explicit discrimination on the basis of the big three is a rarity in insurance, it does not follow that implicit forms of discrimination do not occur. Moreover, if social norms are already discouraging the use of these characteristics, why do so many states have laws forbidding their use? If the answer has to do with the expressive or symbolic effect of the laws, then it remains a puzzle why only some states care enough about this sort of expressive or symbolic benefit to enact the prohibitions?¹³³

Third, and related to the norms explanation, maybe the lack of a universal ban has something to do with timing. It could be that a number of states enacted prohibitions on the use of the big three characteristics and then those laws contributed to creating a norm against their use, at which point the other states did not need to adopt the same laws. The data for this paper do not allow us to examine timing issues, as we are looking only at the law as currently enacted. But we are in the process of doing research on how the laws have changed over time, in all 51 jurisdictions, which may permit us to look at this possibility.

2. Gender

Figure 6 presents the main finding for gender.

directly asked about on the application. The key fact seems to be an absence of evidence of racial animus on the part of the insurer, and there reason the court found no evidence was that the dual-pricing in fact correlated with actuarial risk.

¹³⁰ J. Gabriel McGlamery, *Raced Based Underwriting and the Death of Burial Insurance*, 15 Conn. Ins. L. J. 531 (2009) (suggesting a similar story to explain why life insurers stopped using race decades ago, despite the fact that it was technically legal to do so).

¹³¹ *Id.*.

¹³² There are insurers who ask about religious affiliation. [example: divorce insurance]

¹³³ In a subsequent study that looks more a cross-state variation, taking into account differences in state voters preferences for such things as fairness, we may be able to find some answers to these questions.

as we predicted, less strict than for race, religion, and national origin but more strict than age. This difference is statistically significant.¹³⁴ Figure six is also consistent with our prediction that there would be a large degree of variation across states. Finally, Figure six is somewhat consistent with our prediction that for gender discrimination in auto, disability, and health insurance, state would vary in the intensity of their regulation, with some states clustering around strong limitations and others around no limitations or specific permissions.

The results are more mixed for another of our predictions: that the average score for gender in auto and life insurance would be lower (less strict) than in health insurance because discrimination by insurers in auto and life insurance tends to help women whereas discrimination in health insurance tends to hurt them. Life insurance is indeed less regulated than health insurance, but auto insurance is more regulated on average, as shown in Figure 3.

Figure Seven shows that the results are also mixed for our prediction that states would tend to permit insurer discrimination for gender, with large number of “specifically permits.”¹³⁵

¹³⁴ A Wilcoxon sign-rank test as well as a simple student t-test show a difference which is significant at less than 1% between the “big three” and gender as well as between gender and sexual orientation, the closest characteristic from below. However, for disability insurance there is no significant difference between the way the “big three” and gender are treated. For life and health insurance, there is no significant difference between the way gender and sexual orientation are treated.

¹³⁵ Recall that this prediction was based on the adverse selection problems associated with individually underwritten life insurance and because such discrimination actually benefits women.

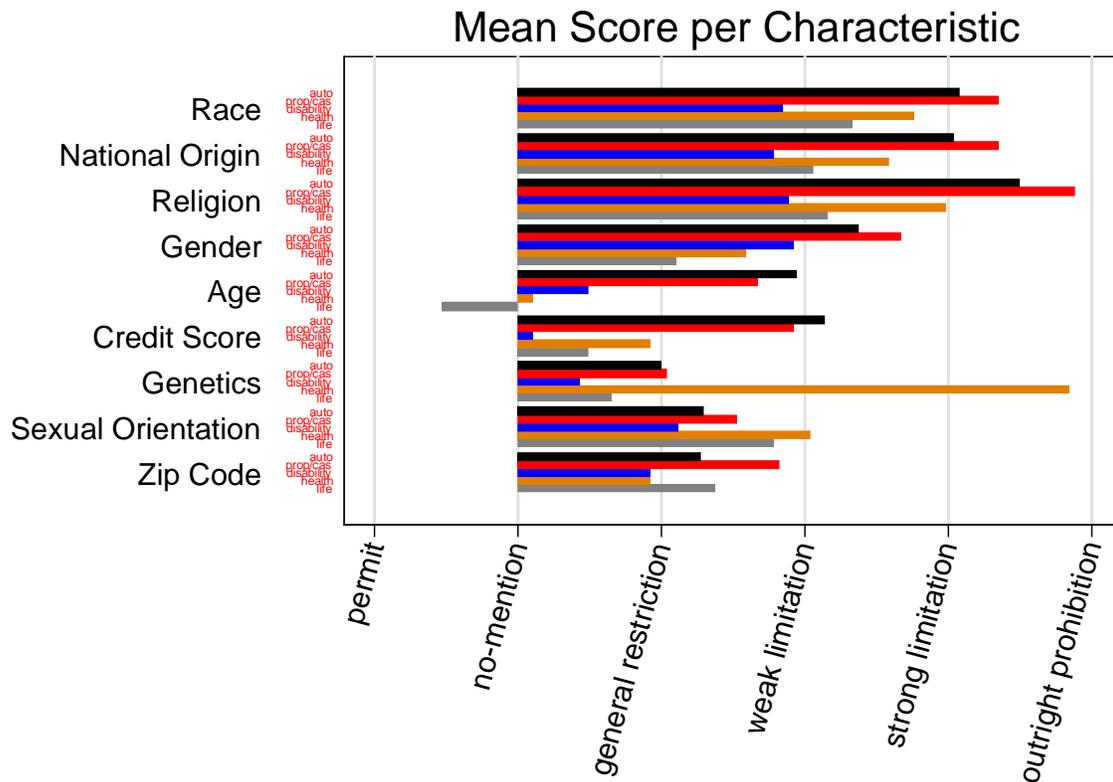


Figure 7

As Figure Seven shows, the average score for life insurance/gender is in fact lower than for the other line/gender combinations. This difference is statistically significant in all cases, except with respect to the difference between life and health.¹³⁶ Although there are a large number of states that specifically permit the use of gender with life insurance, there are also a large number that impose a strong limitation, which again generally means a requirement that the insurer be able to show that gender correlates with loss claims. More consistent with our prediction is the fact that only two states (Montana and North Carolina) forbid the use of gender in life insurance underwriting.

Figure seven is even more inconsistent with our prediction of a low average score and lots of “no mentions,” with respect to the use of gender in property/casualty insurance (excluding auto insurance).¹³⁷ As Figure 7 shows, gender (just like the “big three” above) is more heavily regulated in the property/casualty line than in any other line of insurance. Why is this? One answer is that property/casualty insurers are, in fact, using gender more than we assumed. That

¹³⁶ We use a Wilcoxon rank-sum test for unmatched data.

¹³⁷ Recall that this was due to the fact that we believed there was no obvious correlation between gender and non-auto liability and property risks. See Part II, *supra*. Figure four shows that our alternative prediction, that there may be a bi-modal distribution between states that have no statute on point and those that have outright prohibitions on other grounds was also not especially borne out, although there was a fair amount of variability.

explains why there are almost no “no-mention” in property/casualty for gender. But why restricting the use of gender and not permit it? Recall our discussion above that adverse selection is less of a problem with property/casualty insurance than with some other lines of insurance, such as life and health insurance. Alternatively, there is always the possibility that insurers work together to pass these bans in order to limit the competition among them.

Another possibility is that state legislatures pass laws such as this not because they believe they are needed to curb certain behavior on the part of insurers, but because the laws create the (in these cases, false) impression that they are doing something productive. One can see how such legislation could easily get passed. The insurers would not object, since the laws restrict them from doing something that they do not want to do anyway. Indeed, insurers may support such laws, whose passage may reduce the demand from voters for action on other fronts. The insuring public also would not object, because, as far as they know, these pointless laws are in fact constraining insurers from some socially harmful activity. Who pushes for such legislation? Again, the legislators themselves, who need to give the impression they are doing something, without offending an important constituency.¹³⁸

3. Sexual Orientation

For life/health insurance, we predicted a moderate level of average regulation for insurer usage of sexual orientation: less strict than for the big three but stricter than for age. This prediction is borne out in Figure 5. The difference is statistically significant.¹³⁹ Our prediction that state laws on this topic would be variable also found some limited support in the data. Five states have outright bans on the use of sexual orientation across all lines of insurance.¹⁴⁰ Sexual orientation is the only characteristic other than the “Big three” and gender about which that can be said in any state. This fits the federal constitutional law with respect to the role of sexual orientation as a suspect classification compared with the big three and gender.

Nevertheless, the dominant response among states with respect to sexual orientation is to have no specific regulation on sexual orientation at all, and this is true across all lines. With respect to health insurance, for example, eighteen states either prohibit or strongly limit the use of sexual orientation and all the other states have no specific regulation on sexual orientation, but

¹³⁸ Amy Monahan has done research that explores this hypothesis. In particular, she has an article showing that the health insurance mandates that states are most likely to pass are those that are already included in virtually every health insurance policy in the state. She explains this result as an example of the legislatures-trying-to-look-productive theory. Amy Monahan, *Fairness versus Welfare in Health Insurance Content Regulation* (working paper) (January 6, 2012), available online at <http://ssrn.com/abstract=1980764>.

¹³⁹ A Wilcoxon rank sum test shows the differences are significant at less than 1%

¹⁴⁰ See Figure 4. Those states are California, Delaware, Utah, Vermont and Washington. Colorado would have been the sixth, but for their failure to apply their prohibition on discrimination on the basis of sexual orientation to auto insurance.

have only general unfair discrimination laws.¹⁴¹ The treatment is similar with the other lines of insurance.

What does all of this mean? There are a number of possibilities. First, perhaps the large majority of states believe that their general unfair discrimination statues will be applied to sexual orientation as well. Second, maybe state lawmakers believe that insurers will not use sexual orientation in any event, for any of several reasons: (a) because insurers are constrained by social norms, as they seem to be with race, religion, and national origin; (b) because insurers do not see any strong correlation after all between insured risks and sexual orientation, and thus opt not to invite the controversy. Indeed, when most general restrictions laws were enacted, sexual orientation was probably not on states' legislatures' minds. It is an artifact of our coding that sexual orientation gets so many category ones. It can be reasonably interpreted as category zero-no law on point; (c) because insurers are skeptical of their ability to ascertain sexual orientation reliably; or (d) because insurers have discovered other, more direct ways of getting at the sources of risk in question (such as HIV tests).

¹⁴¹ The remaining line/characteristic specific charts are contained in the appendix.

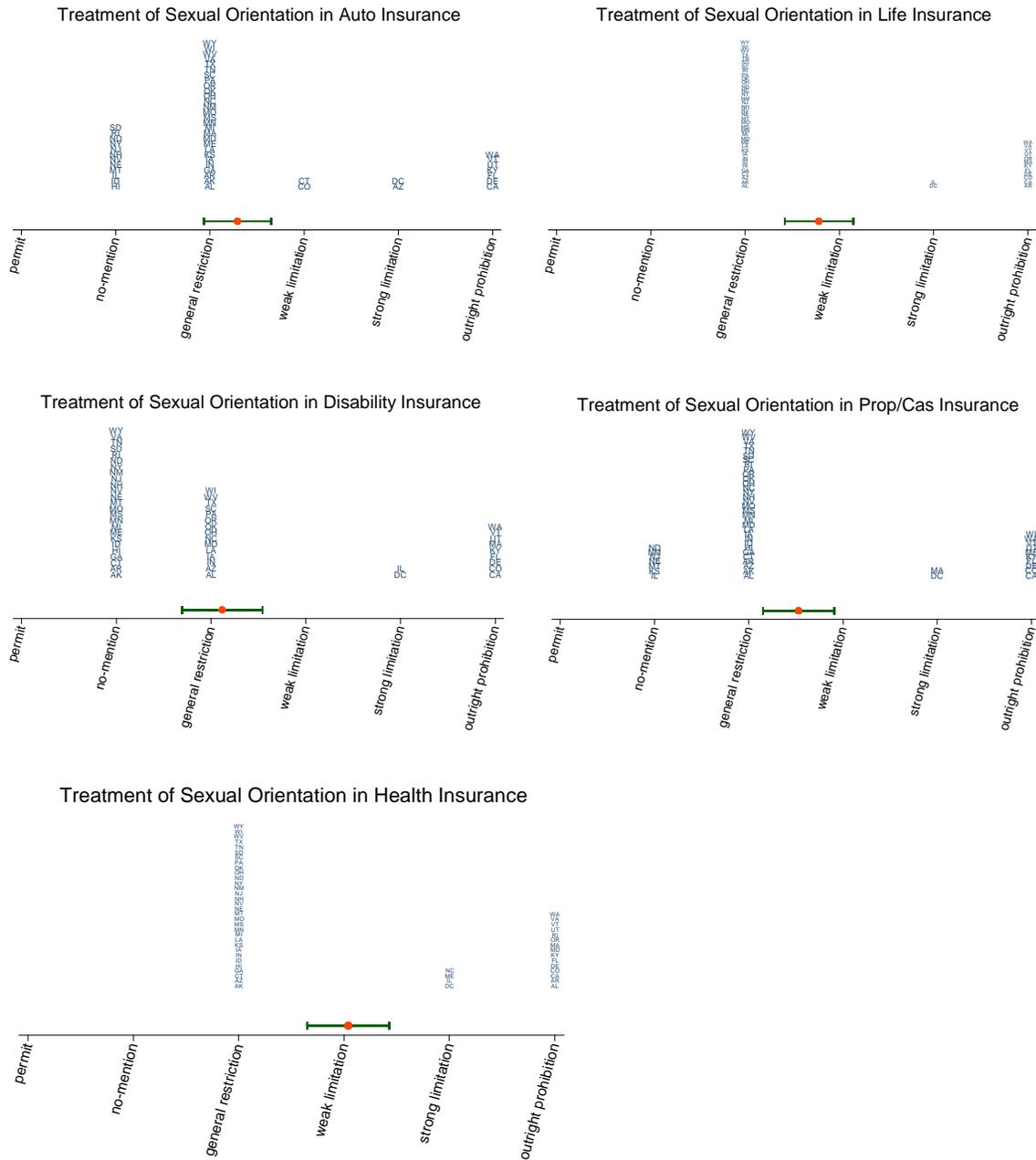
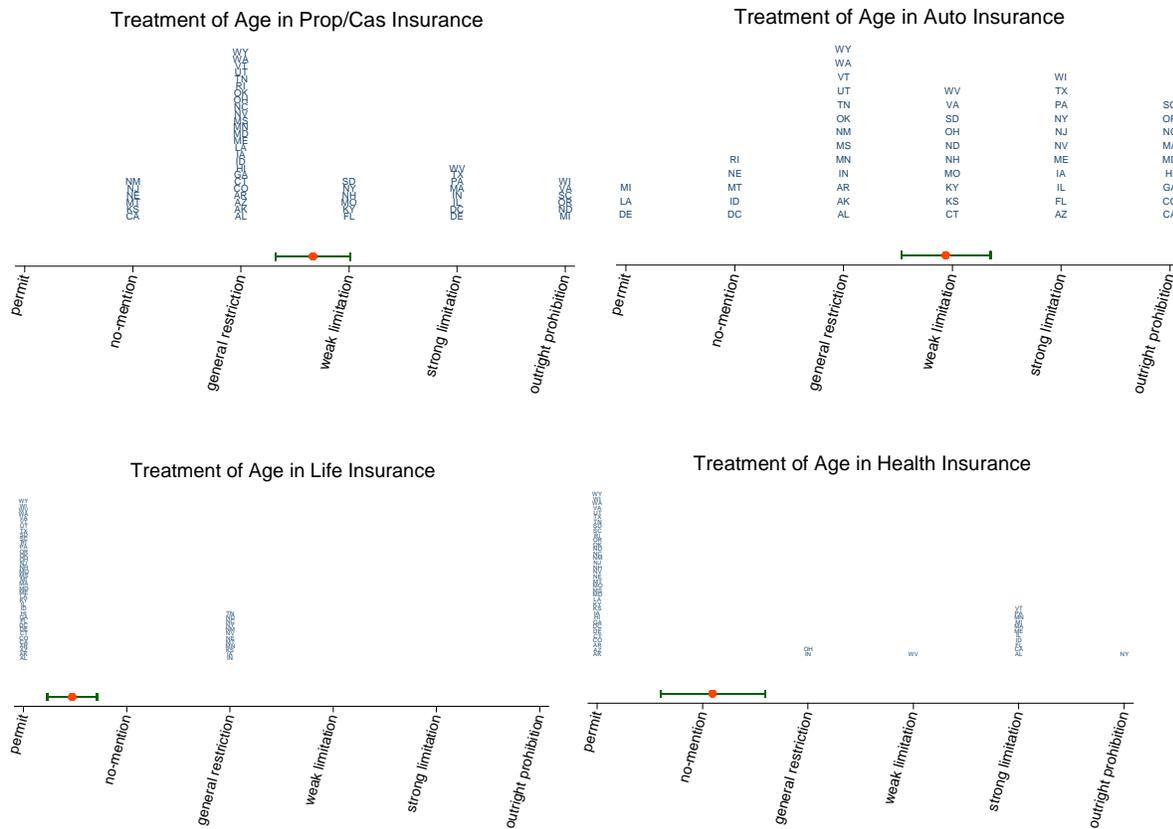


Figure 8 - Distribution of States' Scores for Sexual Orientation, by Line of Insurance

4. Age

Our general prediction that age would be the least regulated on average proved accurate, as reflected in Figure 5. The difference between age and credit score (the closest category) is significant in general at the 1% level, (although the difference is not significant for auto and property/casualty lines of insurance). Our specific prediction with respect to life insurance proved reasonably accurate as well: 39 states specifically permit the use of age in life insurance; and the remaining states merely impose a general unfair discrimination limitation. Health insurance is similar, but with less uniformity: 36 states permit the use of age in health insurance; and the rest impose specific regulations.¹⁴² Our predictions regarding the regulation of the use of age in the auto insurance markets (variability across states) was in the ballpark, though the amount of variation is somewhat more than we expected, as reflected in Figure 9, below.



¹⁴² Twelve states impose either a strong or weak limitation, and one state, NY, prohibits the use of age in health insurance.

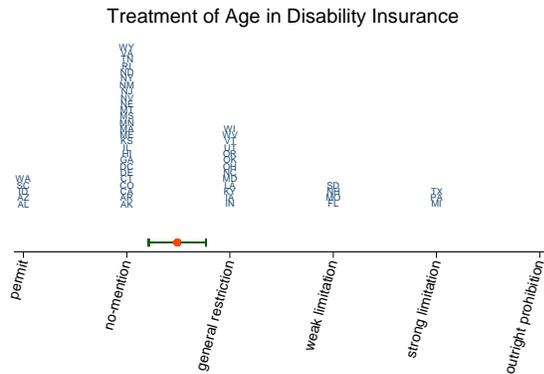


Figure 9 - Distribution of States' Scores for Age Orientation, by Line of Insurance

We predicted relatively few specific statutes would regulate property/casualty insurance with respect to age, only because of the seeming irrelevance of age. In fact, there were more than a few (twenty) that had some type of specific age-related restriction property/casualty insurers, six of which were outright prohibitions. What this suggests, of course, is that we may have been wrong about the risks of property/casualty insurance—especially homeowners' insurance—having no correlation with age. Indeed, when we subsequently looked into what kinds of questions insurers actually ask applicants for homeowners' insurance (as revealed in their rate filings, in which they seek approval from regulators to take various characteristics into account in their underwriting), age was specifically listed. Some insurers even give senior discounts. So apparently age correlates more with homeowners' risk, and thus with property/casualty risk, than we had thought.

5. Credit score and zip code

We predicted regulation of credit score and zip would on average be more restrictive than for age, but less than for the big three, and that prediction was borne out. Figure 5.(As was mentioned before the differences in general are statistically significant at the 1% level). We predicted variation across states, with some states limiting (though probably not prohibiting) and others either not mentioning or expressly permitting the use of credit score and zip code. The data are largely consistent with those predictions. For credit score in the property/casualty and auto insurance context, the distribution of states looks somewhat bi-modal, with states clustering either around some type of specific limitation, especially “strong limitation” (which is the modal response), and others, a smaller number, clustering around “expressly permit.” For zip code, there is less of a bi-modal split, but lots of variation. There are very few states that prohibit the use of credit score or zip code in p/c and auto insurance. For health, life, and disability insurance, there is a great deal of variation among the states about how they treat both zip code and credit score, with no discernible pattern. And again, there are very few states with absolute

prohibitions. Somewhat surprisingly, for health insurance, substantial numbers of jurisdictions explicitly permit the use of zip codes; and the same can be said health, life, and disability insurance and credit scores.

6. Genetics

Here again we predicted that the average level of regulation would be stricter than for age, but less than for the big three, and that is consistent with Figure 5. For life insurance in particular, we predicted that a substantial majority of states would either not regulate or specifically permit the use of genetic testing, because of adverse selection concerns. There are some states that have statutes specifically permitting the use of genetic testing by life insurers (16), but not as many as we expected—perhaps because regulators assumed that the absence of limitations or prohibitions would be sufficient to allow life insurers to use genetic testing when necessary. There were also a few specific limitations (6), and only one prohibition on the use of genetic testing by life insurers. The most common type of result was a general restriction on unfair discrimination, which we code as a 1 on the strictness continuum. As with sexual orientation that can reflect our coding system which allows general restriction laws (category one) to capture characteristics that were not contemplated by states' legislatures when they enacted these laws. With respect to health insurance, we predicted that, consistent with the recent federal law forbidding the use of genetic information, there would be similar laws at the state level, and that proved accurate. All but one state prohibits the use of genetic testing in health insurance. That result is even more uniform than we expected. For disability insurance, we predicted more variation than with health insurance, because of the greater moral hazard concern than there is with health insurance.¹⁴³ The result in fact shows variation, although there more states (20) expressly permitting the use of gender in disability insurance than we expected. Perhaps the moral hazard concern was larger than we imagined.

IV. Conclusion and Reflections

Anti-discrimination rules are a pervasive and fundamental feature of the American legal regime. Thousands of academic articles and judicial opinions have thus wrestled with the rules that govern permissible and impermissible discrimination in domains ranging from employment law to constitutional law to housing law. And yet, in the insurance domain – where discrimination is openly practiced and central to insurers' business models and economic functions – the precise rules that govern the line between permissible and impermissible discrimination has been almost entirely ignored, in large part because of the complexity and opacity of state law on the topic. This Article remedies this tremendous gap in the literature by systematically describing state insurance anti-discrimination law.

¹⁴³ Moral hazard is a big problem for disability coverage, since a nontrivial number of people prefer, when possible, not to work and still get paid.

Our findings reveal various discrepancies between the reality of state insurance anti-discrimination law and the largely theoretical literature on the topic. The most surprising, and potentially troubling, is that such laws often have little to say about the most important and divisive types of discrimination: distinctions based on race, national origin, or religion. This finding is normatively troubling on multiple fronts even if, as we suspect, virtually no carriers are explicitly taking into account these factors in their underwriting. This is because most forms of discrimination in these domains operate in subtle and often unconscious ways that may manifest themselves, for instance, in assumptions about risk in particular neighborhoods or for particular products. Even when actuarial support can be found for these assumptions, that does not mean that they are not intimately tied up with socially suspect characteristics. And, even in the absence of any impermissible motive, important and almost entirely unexamined questions remain about the extent to which insurers' use of particular characteristics that have disparate impacts on certain groups raise legal concerns.

Whatever the answers are to these difficult questions, the stunted development of state insurance law and regulation on the topic seems to suggest a deeper problem. In particular, it suggests that state law and regulation has largely ignored difficult and fundamental questions about how we allow insurers to discriminate – and thus spread risk across social boundaries that impact discrete minority groups. Indeed, this view is substantially confirmed by the insurance industry's outcry over recent federal regulations making clear that disparate impact analysis under the Fair Housing Act extends to the provision of the insurance that is required for housing.¹⁴⁴ It is also confirmed by the variability in state laws on zip code and credit score, two characteristics that have been specifically alleged to operate as proxies for suspect policyholder characteristics.

The states' lack of attention to these issues, combined with the recent federal rules on the FHA's applicability to insurance, suggests that it may be time for the federal government to play a larger role in regulating insurance discrimination impacting race, national origin, and religion. Indeed, federal law already pervasively regulates against discrimination on these bases, in both the constitution and in numerous federal statutes.¹⁴⁵ To be sure, this fact is in tension with traditional primacy of states in regulating insurance markets – an approach endorsed in the McCarran Ferguson Act. But that allocation of powers is not absolute, and is premised on the assumption that states are well-situated to regulate insurance markets effectively and, with the help of the National Association of Insurance Commissioners, consistently. Our results raise substantial questions along both domains.

¹⁴⁴ See HUD Rule Imposes Disparate Impact Standard on Insurance, Insurance Compliance Insight.

¹⁴⁵ E.g., Title VII of the Civil Rights Act of 1964, 42 U.S.C. 2000e-and following (prohibiting employers from discriminating against applicants and employees on the basis of race, color, religion, sex, and national origin, including membership in a Native American tribe); The Age Discrimination in Employment Act (ADEA), 29 U.S.C. 621-634 (prohibiting discrimination against 40-and-over employees based on age); and the Americans With Disabilities Act, 42 U.S.C. 12101-12213 (prohibiting employers from discriminating against people with disabilities in any aspect of employment).

Nor are the normative implications of this Article's findings limited to the "big three." For instance, this Article's findings expose a broad pattern of inconsistent and conflicting state laws on insurance anti-discrimination when it comes to gender. Across numerous lines of coverage – including life automobile and health – state law and regulation is highly variable and inconsistent, despite the centrality of the prominence of these issues in public policy circles for decades. Whatever our views are of the quality of state-level insurance regulation, it seems odd that the laws governing the circumstances in which a person may be discriminated against on the basis of their gender would be anything other than a national norm. People in Delaware should care about, and have a policy interest in, discrimination in New Mexico, and vice versa. In health insurance, at least, the Affordable Care Act preempted state law to articulate a principle that women should not be discriminated against even though they do indeed have higher medical costs, at least within certain age ranges. Perhaps a similar approach is warranted in other lines of coverage.

In addition to these normative implications, the Article also has the potential to reveal which theoretical arguments on risk classification in insurance have traction in state policymaking. For instance, one persistent finding is that life insurance is less regulated than other lines of insurance. This finding was consistent with our predictions, because life insurance seems more susceptible to adverse selection than other lines of insurance. But more analysis is needed to determine whether this suggests, as we initially predicted, that state lawmakers and regulators are responsive to the risk of regulatory adverse selection due to the lobbying power and influence of the industry. Similarly, consistent with our predictions, age is less regulated than other policyholder characteristics. But whether this reveals more about the fairness of discrimination on the basis of mutable characteristics like age, or the adverse selection risk of regulatory risk classification restrictions on that basis, requires further interrogation and analysis.

APPENDIX

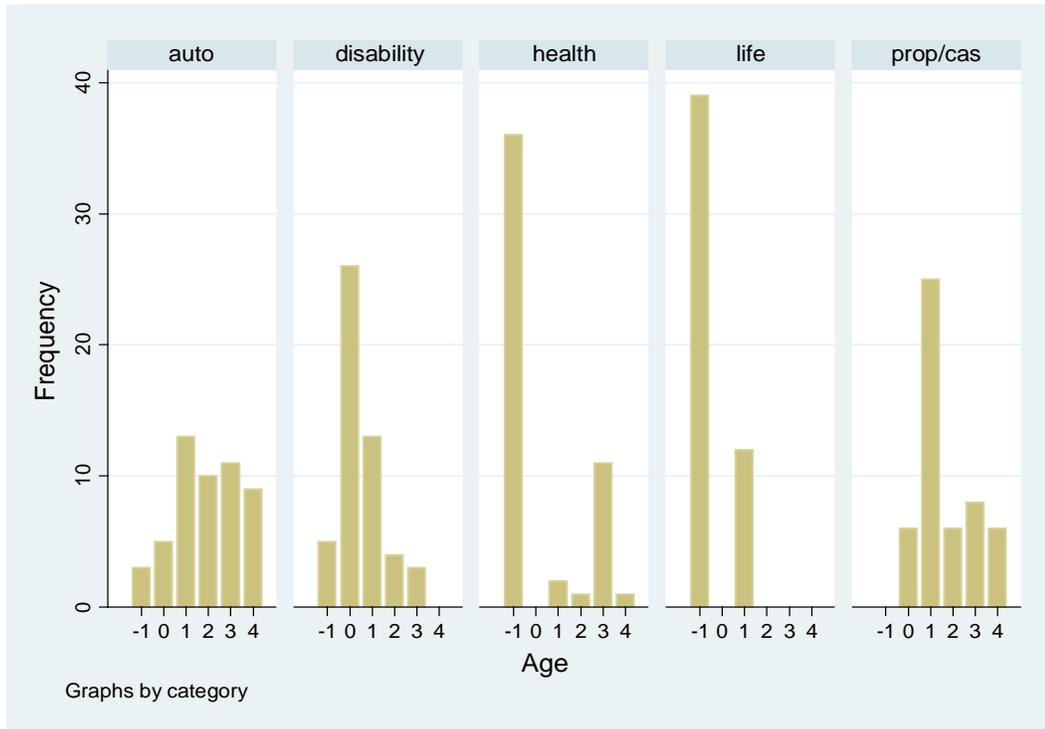


Figure - Distribution of States' Scores for Age, by Line of Insurance

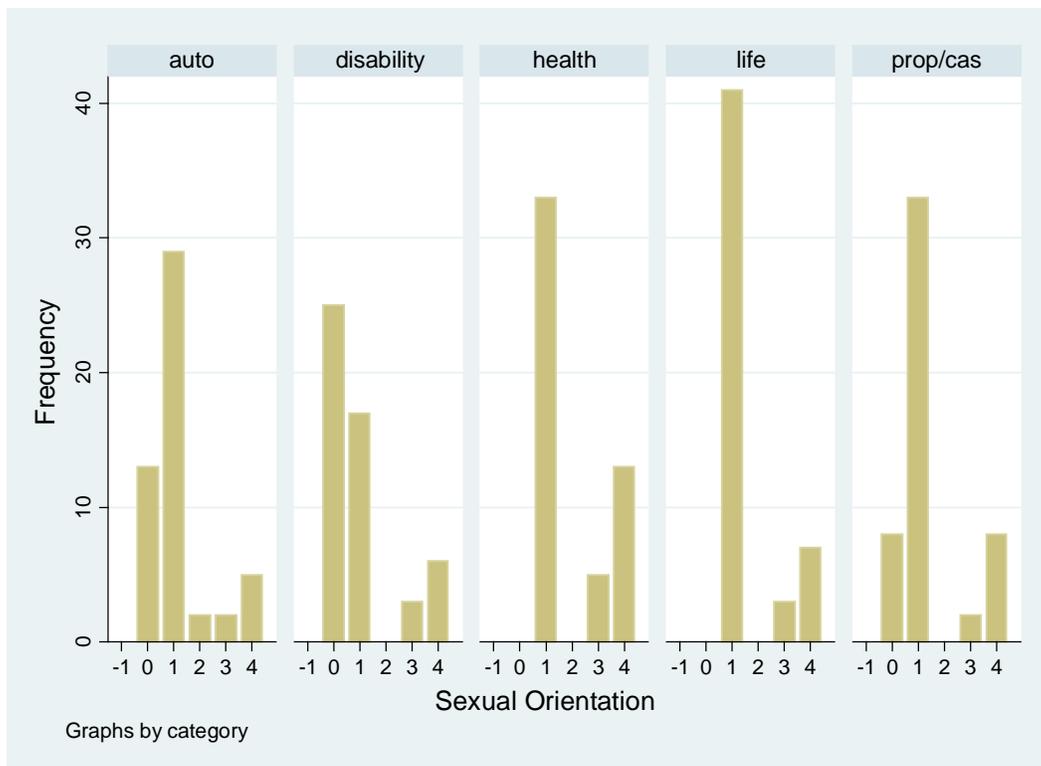


Figure - Distribution of States' Scores for Sexual Orientation, by Line of Insurance

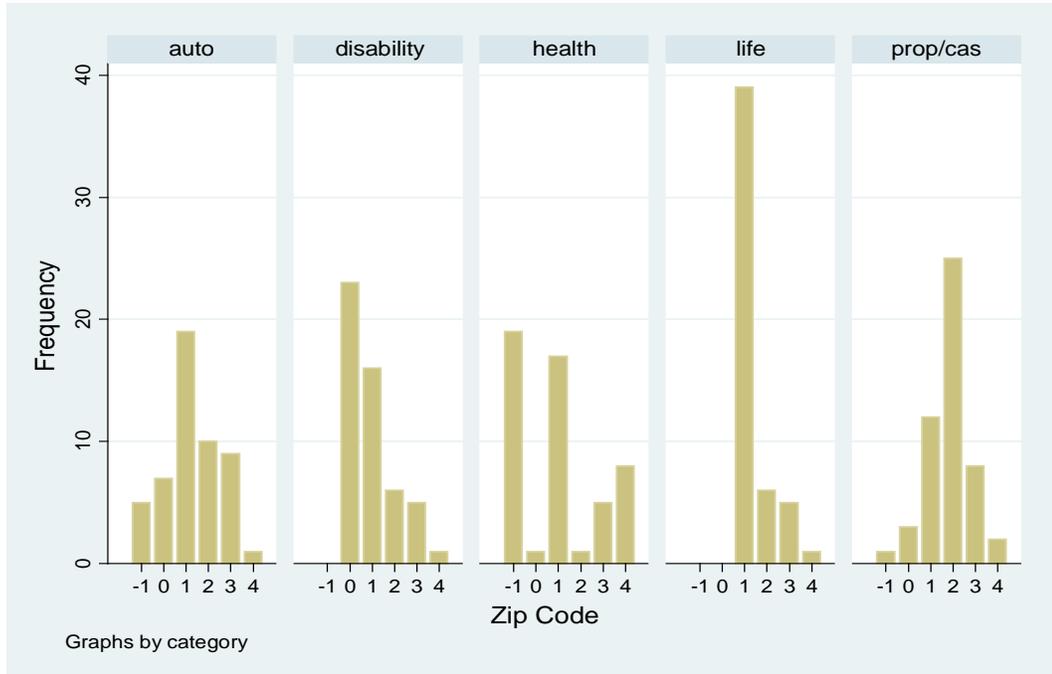


Figure - Distribution of States' Scores for Zip Code, by Line of Insurance

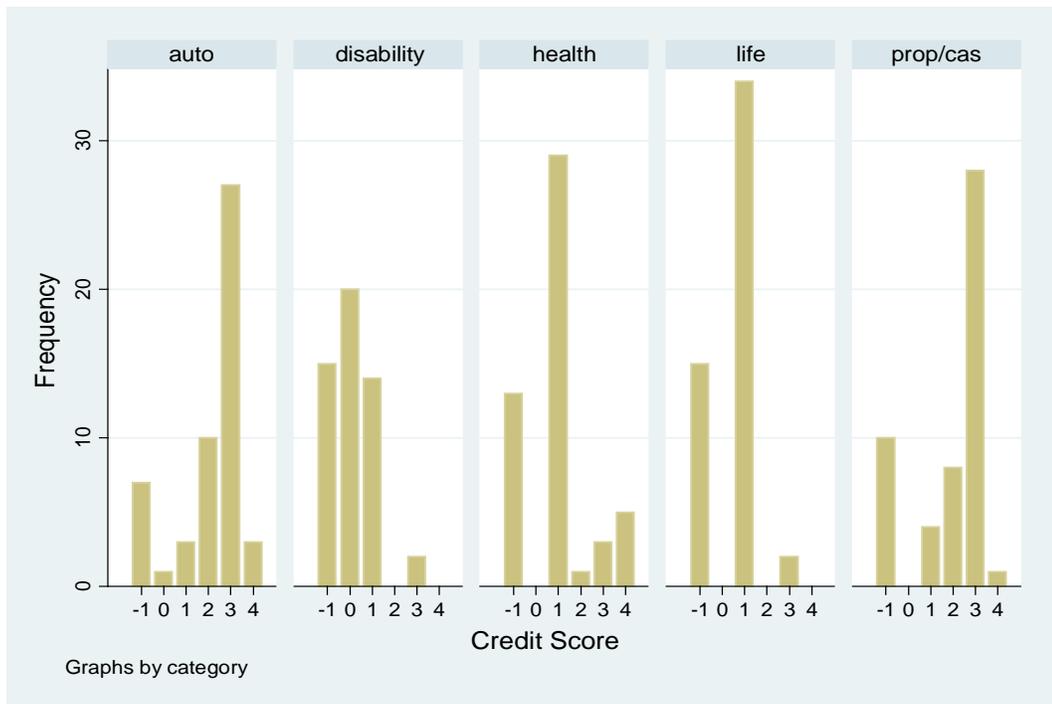


Figure - Distribution of States' Scores for Credit Score, by Line of Insurance

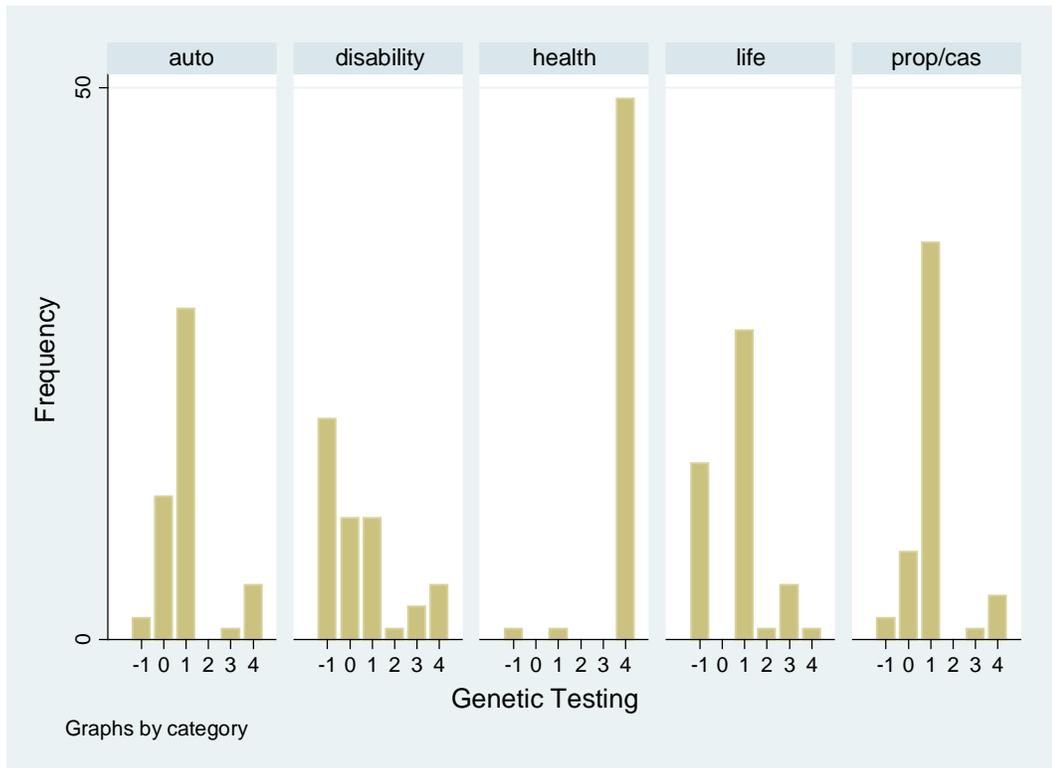


Figure - Distribution of States' Scores for Genetic Testing, by Line of Insurance