Exhibit 1011

Disparate Impact and Unfairly Discriminatory Insurance Rates

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Abstract.

Historic actuarial literature, general insurance literature, and legislative histories reveal "unfairly discriminatory rates" to be a cost-based concept. A rate structure is unfairly discriminatory if the insurance premium differences between insureds do not reasonably correspond to differences in expected insurance costs. More recently a new rate concept has arisen in some court cases which is referred to as "disparate impact" (or "adverse impact"). Disparate impact has nothing to do with underlying insurance costs and is solely based on the disproportionate impact of the insurance rate structure on the insurance premiums paid by protected minority classes defined by race, color, religion, sex, or national origin. It would likely be a rare instance where the rate standard of unfairly discriminatory and the concept of disparate impact could be applied simultaneously to a risk classification plan without conflict. It is the author's opinion that if the standard of disparate impact eventually prevails over the historical rate standard of unfairly discriminatory, then accurate risk assessment will be destroyed, adverse selection will be widespread in the insurance marketplace, and coverage availability will suffer.

Keywords. Risk classification plans; risk assessment; credit scoring; insurance law; rate regulation; adverse selection; disparate impact; adverse impact.

1. INTRODUCTION

In today's society, the terms discrimination and disparate impact connote unfairness. Without any historical context as background, it would not be surprising for the average person to mistakenly conclude that the term unfairly discriminatory is redundant, and that the term disparate impact is just another form of unfair rate discrimination. However, a review of insurance literature, legislative histories, and court cases reveal that the terms disparate impact and unfair rate discrimination are fundamentally different. In insurance ratemaking there has always existed a form of rate discrimination which is considered to be fair if the rates are based on underlying insurance costs. On the other hand, disparate impact is defined without any reference to underlying insurance costs.

The origins of the common rate standards applied by actuaries (i.e., reasonable, adequate, not excessive, and not unfairly discriminatory) are discussed in this paper, with special emphasis on the rate standard of unfairly discriminatory. The insurance literature and legislative histories show the four common rate standards to have meanings based entirely on the underlying anticipated insurance costs. It is precisely because these rate standards are cost-based that actuaries have adopted these standards as terms of art, as set forth in Principle 4 of the Casualty

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Actuarial Society's Statement of Principles Regarding Property and Casualty Insurance Ratemaking (i.e., CAS Statement of Ratemaking Principles).

More recently, some courts have considered the application of a new standard of disparate impact (or adverse impact) to insurance rate structures. Thus far no court has actually applied the disparate impact standard to insurance rates, but it is only a matter of time before some court does so. The standard of disparate impact has its origins in federal civil rights laws and has been applied by the courts in a range of issues including employment, educational testing, housing, and age discrimination. Unlike unfairly discriminatory rates, disparate impact is not a cost-based concept. If applied to insurance, a risk/rate factor will potentially be said to have a disparate impact if it more adversely impacts a protected minority class than it does the majority class, regardless of its relationship to underlying costs.

It is reasonable to assume a priori that no protected minority class (i.e., race, religion, sex, etc.) will be uniformly distributed throughout any given insurance risk classification plan. This assumption implies that all risk factors used to measure and assess risk are potentially in violation of a disparate impact rate standard, even though each risk factor accurately reflects expected losses and expenses.

If a risk classification plan were changed to eliminate one or more risk factors found to have a disparate impact, the resulting rates would likely be unfairly discriminatory because the rate differences would no longer be based on the underlying insurance costs. Therein lies the inevitable and irreconcilable conflict between the two standards.

This paper concludes with a brief discussion of the potential role of an actuary with the various issues related to disparate impact. Even though disparate impact is not cost-based, and therefore not an actuarial term of art, actuaries do have expertise in measuring the statistical significance of any differences in rate impact between the majority class and a protected minority class. Actuaries could also provide expertise in defining the data needed to measure disparate impact and in establishing the business necessity of any risk factor in question.

2. THE DAWNING OF U.S. RATE REGULATION AND RATE STANDARDS

The origin of property/casualty insurance rate regulation in the U.S. is rooted primarily in the history of fire insurance. It was solvency concerns and destructive price competition in the fire insurance business in the 1800's that spurred the need for cost-based actuarial ratemaking procedures and the need for rate regulation by the states.

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In the early to mid-1800's local boards (i.e., voluntary associations of insurers) were organized to provide a means of sharing loss data and to enforce uniform rates among the insurers. Uniform rates were desired so that rates were adequate to protect against insolvencies and were not unfairly discriminatory. The primary concern with unfairly discriminatory rates, often stated at the time, was that rich and powerful insureds could unfairly negotiate lower rates than were being charged to less influential insureds, even though their degree of risk and underlying insurance costs did not warrant a lower rate.

In 1866 a national association of insurers, the National Board of Fire Underwriters (i.e., NBFU), was formed to gather industrywide data and to develop a uniform rate schedule. The NBFU decreased the need for local boards. During the ensuing profitable years the insurers regularly violated their NBFU membership agreements by engaging in destructive rate-cutting. On the verge of disbanding just prior to the 1871 Chicago fire, the insurer insolvencies which followed the Chicago fire gave new life to the need for rate discipline and new life to the NBFU. But profitability soon returned to fire insurers and destructive rate-cutting returned to the market. Rampant rate-cutting caused the NBFU to finally disband in 1887, thereby shifting "control" of fire insurance rates back to local boards and associations.

Federal legislation in the 1880's, which outlawed combinations of insurers in restraint of trade, led about half the states to adopt anti-compact laws between 1885 and 1907. The anti-compact laws sharply reduced the ability of local boards to maintain uniform, adequate, and fairly discriminatory rates. The pressing need for insurers to associate so as to create a combined, credible fire insurance database and the existing lack of discipline in fire insurance rating practices in the late 1800's led to many proposals for state regulation of rates.

3. UNFAIRLY DISCRIMINATORY RATES

3.1 Early Rate Regulatory Laws

The first modern-style rate regulation statute was enacted in Kansas in 1909. The Kansas law required fire insurance rates to be filed with the Insurance Commissioner and required the rates to be reasonable, not excessive, adequate to the safety and soundness of the insurer, and not unjustly discriminatory. Unjust discrimination was defined as charging different rates to persons with "risks of a like kind and hazard".

Soon after enactment of the Kansas law, although largely as the result of the insolvencies and the subsequent sharp fire insurance rate increases ensuing from the fires following the great San Francisco Earthquake of 1906, the New York legislature appointed the Merritt Committee and launched an investigation of fire insurance rates. The Merritt Committee Report led to New

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York's first rate regulatory law in 1911. This law permitted insurers to gather data and act in concert to set rates through rate bureaus. The New York law also required fire insurance rates to be filed with the Superintendent of Insurance and prohibited unfairly discriminatory rates. The law and the Merritt Committee Report made it clear that rates were considered to be unfairly discriminatory if different rates were charged to risks in the same class or of essentially the same hazard. Class rate differentials based on differences in risk and loss experience were expressly permitted by the New York legislation.

New York, working through the National Convention of Insurance Commissioners (i.e., NCIC), offered its new fire insurance rate law as a prototype for other states. Many states (e.g., New Jersey in 1913) did adopt similar rate regulatory laws which permitted collusive rate setting through rate bureaus and prohibited unfairly discriminatory rates. Consistently, the clear purposes of these early laws were to permit collusion in regard to data gathering and rate setting, and to ensure that rates were established commensurate with the degree of risk and hazard being insured. In a speech before the NCIC in 1915, the New Jersey Insurance Commissioner spoke about the need to base insurance rates on the degree of risk being insured and the unfair discrimination that arose when "some people were getting insurance for less than it was worth and others were paying for it."

3.2 McCarran-Ferguson and Modern Rate Regulation

The enactment of Public Law No. 15 (i.e., McCarran-Ferguson) on March 9, 1945 reaffirmed the right of the states to regulate insurance by providing an antitrust exemption for insurance to the extent that insurance was regulated by state laws. McCarran-Ferguson spurred a new and modern round of state rate regulatory laws throughout the United States. As a result of McCarran-Ferguson, the National Association of Insurance Commissioners (i.e., NAIC) immediately turned its attention to drafting model rate regulatory laws that could be considered for adoption by the majority of state legislatures which were scheduled to begin to meet next in 1947. The 1945 NAIC proceedings indicate that the model laws and the rate standards were based largely on existing state rate regulatory statutes, as witnessed by the following quote from the May 12, 1945 Report of the Subcommittee on Federal Legislation:

> "On the subject of rate regulation the Committee felt that there were well-defined patterns available based upon the actual experience of a number of states which could be used as a foundation for the drafting of rate regulatory statutes at this time. This fact was recognized by certain segments of the insurance industry which prepared so-called model rating bills based largely upon existing statutes

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> and which were used as guides for the enactment of rate regulatory laws recently in several states."

The NAIC's model fire/marine and casualty/surety rate regulatory bills of 1946 utilized the rate standards of not excessive, inadequate or unfairly discriminatory and required that rates be based on consideration of past and prospective loss and expense experience. These model bills specifically allowed for the grouping of risks by classifications for the establishment of rates. Classification rates could be modified for individual risks if, and only if, the modification was based on "variations in hazards or expense provisions, or both."

The NAIC model bills were a pervasive influence on individual state legislatures. It is not at all surprising that the rate regulatory laws throughout the U.S. today contain similar, if not the same, language as the 1946 NAIC model bills. As an example, the influence of the 1946 NAIC model bills on individual state rate regulatory laws can be found in the California McBride-Grunsky Act of 1947 (S.B.1572). This California statute prohibited rates that were unfairly discriminatory and specifically allowed for differences in rates between risk classifications, if the rate differences were based on the differences in the underlying hazard or expenses.

A new rate regulatory statute was established in California in 1988 with the passage of Proposition 103. Proposition 103 reestablished the unfairly discriminatory rate standard, as well as placed certain restrictions on some rate factors used in rating personal auto insurance. Subsequent to the passage of Proposition 103 new rate regulations were adopted and some lower courts addressed the definition of unfairly discriminatory rates in California. In this author's opinion thus far there have been no changes in California to the traditional concept that rates should be based on expected costs and not be arbitrary.

4. DISPARATE IMPACT ON INSURANCE RATES

4.1 History

The concept of disparate impact[1] has its roots in certain federal civil rights laws, including the Civil Rights Acts of 1866, 1964, and 1991 and the Fair Housing Act (42 U.S.C. Sec. 3604) (i.e., FHA). Broadly speaking, this category of federal laws prohibits discrimination based on race,

[1] Note: As in this paper, the terms disparate impact and adverse impact are generally used interchangeably to mean that a protected minority class is being adversely and disproportionately impacted as compared to the impact on the majority class. Disparate impact and adverse impact are both distinguished from disparate treatment, which involves intent to discriminate in a way that is prohibited by federal civil rights law.
In this paper the terms disparate impact and adverse impact are used with the recognition that the impact may occur in neutral processes without the specific intent to violate any civil rights prohibitions. Disparate treatment, based on the intent to violate discrimination prohibitions, is not related to actuarial considerations, is a mutually exclusive theory from disparate impact, and is not addressed in this paper.

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