

July 12, 2024

NYDFS Final Guidance on Use of AI in Insurance Underwriting and Pricing

Final Guidance Addresses Use of AI in Underwriting and Pricing and Is Largely Consistent with Draft Released in Early 2024

SUMMARY

On July 11, 2024, the New York State Department of Financial Services (the “NYDFS”) issued Circular Letter No. 2024-7, entitled “Use of Artificial Intelligence Systems and External Consumer Data and Information Sources in Insurance Underwriting and Pricing” (the “Circular Letter”), which sets forth guidance for insurers licensed in New York that use artificial intelligence systems (“AIS”) and external consumer data and information sources (“ECDIS”) for underwriting and pricing purposes.¹ While the Circular Letter is generally consistent with the initial draft circular letter that was released by the NYDFS in January 2024 (the “Draft Circular Letter”),² the NYDFS modified or clarified certain requirements in response to comments. This memorandum focuses on the most significant revisions and clarifications included in the Circular Letter.

BACKGROUND

The use of artificial intelligence in the insurance industry in connection with activities that affect consumers—such as underwriting, pricing, marketing, and claims adjusting—has become an area of significant focus for state insurance regulators and the National Association of Insurance Commissioners (“NAIC”). The NAIC’s December 2023 model bulletin (the “NAIC Model Bulletin”), which sets forth principles-based governance standards for licensed insurers that use artificial intelligence in their operations, has been adopted in over ten (10) states. Work on additional guidance governing insurers’ use of AIS and ECDIS is ongoing, both at the NAIC and by certain individual states.

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In line with these efforts, the Circular Letter further develops the NYDFS's approach to regulating the use of AIS and ECDIS by New York-licensed insurers, building upon Governor Hochul's statewide policy governing AI and her ongoing commitment to "mak[e] New York a leader in cutting-edge technology development."³

KEY REVISIONS AND CLARIFICATIONS

The most significant revisions and clarifications included in the Circular Letter include:

Scope and Applicability. The entities and activities in scope are largely unchanged; the Circular Letter applies to all insurers licensed in New York⁴ that use ECDIS⁵ or AIS⁶ in underwriting or pricing insurance policies, to supplement, or as a proxy for, traditional health, life,⁷ property or casualty underwriting or pricing, or to identify "lifestyle indicators" that may contribute to an underwriting or pricing assessment of an applicant for insurance coverage. The Circular Letter does not address, or include as in-scope activities, other insurer functions, such as marketing and claims adjusting. The Circular Letter clarifies that it is intended to apply to a licensed insurer's use of AIS even absent the use of ECDIS.

The Circular Letter also expressly states that it does not apply to Child Health Plus, Essential Plan, and Medicaid managed care coverage.

"Unlawful" or "Unfair" Discrimination. In response to comments asking that the terms "unfair" or "unlawful", which are used throughout, be defined in the guidance, the Circular Letter indicates that the definitions of these terms are those included in certain existing New York and federal statutes that address discrimination in other contexts.⁸

"Proxy" Assessment. Importantly, while leaving unchanged the requirement that insurers be able to demonstrate that the ECDIS they use for underwriting and pricing is not prohibited under the New York Insurance Law ("NYIL"), the Circular Letter no longer requires insurers to *demonstrate* that such use of ECDIS does not serve as a "proxy for any protected classes" that may result in unfair discrimination. Instead, the Circular Letter requires only that insurers *evaluate the extent* to which these ECDIS are correlated with (*i.e.*, "proxy" for) membership in any protected class that may result in unfair discrimination. The Circular Letter clarifies that such correlation may be determined using data available to or inferred by the insurer using accepted statistical methodologies. In the event a correlation between the ECDIS and protected class status is identified, the insurer is then required to "consider" whether the use of such ECDIS is "required by a legitimate business necessity". The Circular Letter does not expressly prescribe any further requirements that an insurer would have to follow after finding that a "legitimate business necessity" exists, and does not expressly state whether the insurer may continue to use the ECDIS upon a finding that its use is not required by a "legitimate business necessity".

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Comprehensive Assessment of Lack of Unfair Discrimination and Violations of the NYIL. The Circular Letter maintains the requirement that insurers conduct a “comprehensive assessment” for purposes of determining that their use of ECDIS or AIS would not result in, or “collect or use criteria that would constitute,” unfair discrimination or an unfair trade practice, or would otherwise violate the NYIL. This “comprehensive assessment” requires the insurer to: (i) assess whether the use of ECDIS or AIS produces “disproportionate adverse effects” on similarly situated insureds, or insureds of a protected class; (ii) if so, assess whether there is a “legitimate, lawful and fair” explanation or rationale for the differential effect on similarly situated insureds; if there is no such explanation or rationale, the insurer should modify its use of ECDIS or AIS; and (iii) if a “legitimate, lawful and fair” explanation or rationale can account for the differential effect, conduct and document a search and analysis for a less discriminatory alternative variable(s) or methodology that would “reasonably meet the insurer’s legitimate business needs”. The Circular Letter adds a requirement that, if the insurer has determined that a less discriminatory alternative variable(s) or methodology does not exist, the insurer should conduct ongoing model risk management and conduct a search for less discriminatory alternatives at least annually.

Quantitative Testing. The Circular Letter clarifies that quantitative testing to determine whether the use of AIS or ECDIS results in unfair or unlawful discrimination is only required in respect of protected classes for which data are available or may be reasonably imputed using statistical methodologies, and that there is “no expectation” that insurers would collect any additional data from or about individuals for purposes of performing quantitative assessments.

Governance and Risk Management Requirements. The Circular Letter notes that, unsurprisingly and “consistent with long-standing supervisory approaches in the insurance sector and other sectors,” the board of directors and senior management are responsible for the overall outcomes of the use of ECDIS and AIS, not the day-to-day implementation thereof.

Annual Testing of Model Output. The Circular Letter clarifies that the “periodic[]” testing to assess the output of AIS models must be conducted “at least annually”.

Third-Party Vendors. Further addressing a topic of keen interest to the industry, the Circular Letter clarifies that conducting the required “appropriate oversight” over third-party vendors developing or deploying the ECDIS, AIS or other tools that insurers use does not require insurers to understand their detailed inner workings, but insurers nevertheless: (i) should perform appropriate due diligence and oversight in connection with ECDIS or AIS developed or deployed by third-party vendors; and (ii) are ultimately responsible for the outcomes of the use of such ECDIS or AIS.

The Circular Letter also adds a requirement that, “where appropriate and available”, insurers include terms in their contracts with third-party vendors that: (i) provide audit rights to the insurer or entitle the insurer to receive reports of audits conducted by qualified auditing entities; and (ii) require the third-party vendor to cooperate with the insurer in connection with regulatory inquiries and investigations. This requirement

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mirrors that in the NAIC Model Bulletin, but further guidance in this area is anticipated, in particular as the NAIC has recently formed the Third-Party Data and Models (H) Task Force that has started its work on developing a framework for the regulatory oversight of third-party data and predictive models used by U.S. insurers.

Disclosures to Applicants. The Circular Letter expands on the disclosures required by the NYDFS's Circular Letter No. 2019-1 (Jan. 18, 2019) and expands its scope (which was limited to life insurers) by requiring:

- If the insurer has threshold criteria for utilizing ECDIS or AIS in underwriting (e.g., if underwriting using ECDIS or AIS is applicable only to certain ages, coverage amounts, or types of risk), the insurer should disclose such criteria in all advertisements, marketing materials and disclosures provided to consumers during an application process.
- If the insurer has determined that the applicant cannot be underwritten using ECDIS or AIS, the insurer should provide written notice to the applicant, within 15 days of such determination, setting forth the reason(s) for the determination.
- If an applicant will not be approved for coverage under an underwriting process utilizing ECDIS or AIS based on specific ECDIS data, the insurer should provide to the applicant, as part of the written notice described immediately above, a process to review the accuracy of ECDIS data.

Confidentiality. The Circular Letter confirms that, in supervising insurers' use of AIS and ECDIS, the NYDFS will carry on with its historical commitment to protect confidential information, intellectual property and trade secrets of insurers and third parties. While the NYDFS "cannot promise confidentiality in all cases" because it is required to comply with the New York Freedom of Information Law, the Circular Letter states that, if an insurer submitting information to the NYDFS deems such information to be a trade secret or other information that could be harmful if publicly disclosed, the insurer may request that the NYDFS except the information from disclosure pursuant to Section 89(5)(a)(1) of the New York Public Officers Law.

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ENDNOTES

- 1 The Circular Letter is *available at* <https://www.dfs.ny.gov/industry-guidance/circular-letters/cl2024-07>.
- 2 For our previous client memorandum describing the Draft Circular Letter, see Sullivan & Cromwell LLP, “NYDFS Draft Guidance on Use of AI in Insurance Underwriting and Pricing”, *available at* <https://www.sullcrom.com/SullivanCromwell/Assets/PDFs/Memos/NYDFS-Draft-Guidance-Use-AI-Insurance-Underwriting.pdf>.
- 3 See “Governor Hochul Unveils Fifth Proposal of 2024 State of the State: Empire AI Consortium to Make New York the National Leader in AI Research and Innovation” (Jan. 8, 2024), *available at* <https://www.governor.ny.gov/news/governor-hochul-unveils-fifth-proposal-2024-state-state-empire-ai-consortium-make-new-york>.
- 4 Like the Draft Circular Letter, the Circular Letter also applies to licensed fraternal benefit societies and the New York State Insurance Fund. In addition, the Circular Letter adds New York Article 43 corporations and health maintenance organizations to the list of regulated entities to which its provisions apply.
- 5 The definition of “ECDIS” has not materially changed from the corresponding definition that appeared in the Draft Circular Letter, except that the Circular Letter includes a new exclusion for prescription drug data from the definition of “ECDIS”.
- 6 The definition of “AIS” has not materially changed from the corresponding definition that appeared in the Draft Circular Letter, except that, as described in the immediately following footnote, the definition of “AIS” now refers to “traditional *health, life*, property or casualty underwriting” instead of “traditional *medical*, property or casualty underwriting or pricing”.
- 7 In the Draft Circular Letter, the definitions of “AIS” and “ECDIS” both referred to “traditional *medical*, property or casualty underwriting or pricing”. In the Circular Letter, this language was changed only in the definition of “AIS” to “traditional *health, life*, property or casualty underwriting or pricing”; the definition of “ECDIS”—possibly inadvertently—was not changed, and continues to refer to “medical” underwriting or pricing instead of “health” and “life”.
- 8 These statutes include Article 26 of the NYIL (which prohibits unfair claim settlement practices, unfair discrimination, and certain other practices), Sections 4224(a) and (b) of the NYIL (which prohibit rebates, inducements and discriminatory practices in life, accident and health insurance), Sections 3221(q)(3) and 4305(k)(3) of the NYIL (which prohibit discrimination based on health status-related factors), the provisions in Section 2303 of the NYIL prohibiting unfairly discriminatory rates for property and casualty insurance coverage, the New York Executive Law, the New York General Business Law, and the federal Civil Rights Act.

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