



National Association of Insurance Commissioners

**AGENDA**  
**PROPERTY AND CASUALTY INSURANCE (C) COMMITTEE**  
**MARKET REGULATION AND CONSUMER AFFAIRS (D) COMMITTEE**  
**THE USE OF CREDIT-BASED INSURANCE SCORES**  
**PUBLIC FACT-FINDING HEARING AGENDA**

<b>TIME</b>	<b>TOPIC</b>
8:45 am-9:00 am	<b>Introductory Remarks from the Chairs</b>
9:00 am-9:40 am	<b>How Credit Scores are Developed and Used</b> <b>Panel Discussion with the Credit Reporting Agencies</b> <b>Panelists</b>
	<ul style="list-style-type: none"> <li>• Chet Wiermanski, TransUnion</li> <li>• Eric J. Ellman, Consumer Data Industry Association</li> <li>• Jon Burton, LexisNexis</li> <li>• Lamont Boyd, FICO CBIS</li> <li>• Birny Birnbaum, Center for Economic Justice</li> </ul>
9:40 am-10:30 am	<b>Member Questions to Credit Reporting Agencies</b>
10:30 am-10:45 am	Break
10:45 am-11:15 am	<b>Data Quality in Credit Reports and Actuarial Standards</b> <b>Panel Discussion with Actuarial Representatives</b> <b>Panelists</b>
	<ul style="list-style-type: none"> <li>• Jeff Kucera, American Academy of Actuaries</li> <li>• Robert P. Hartwig, Insurance Information Institute</li> <li>• Mike Miller, Actuary</li> <li>• Birny Birnbaum, Center for Economic Justice</li> <li>• J. Robert Hunter, Consumer Federation of America</li> </ul>
11:15 am-12:00 pm	<b>Member Questions to Actuarial Representatives</b>
12:00 pm-12:45 pm	<b>Lunch</b>
12:45 pm-1:15 pm	<b>How Insurers Develop and Use Credit-Based Insurance Scores</b> <b>Panel Discussion with Insurer Representatives and Insurance Producers</b> <b>Panelists</b>
	<ul style="list-style-type: none"> <li>• Dave Snyder, American Insurance Association;</li> <li>• Alex Hageli, Property Casualty Insurers Association of America</li> <li>• Neil Alldredge, National Association of Mutual Insurance Companies</li> <li>• Charles Neeson, Westfield Insurance</li> <li>• Wesley Bissett, Independent Insurance Agents and Brokers of America</li> </ul>
1:15 pm-2:00 pm	<b>Member Questions to Insurer Representatives and Insurance Producers</b>
2:00 pm-2:30 pm	<b>Consumer Perspectives on the Use of Credit-Based Insurance Scores</b> <b>Panel Discussion with Consumer Representatives</b>
	<ul style="list-style-type: none"> <li>• J Robert Hunter, Consumer Federation of America</li> <li>• Birny Birnbaum, Center for Economic Justice</li> <li>• Pat Butler, NOW</li> <li>• Gregory Squires, George Washington University</li> </ul>
2:30 pm-3:15 pm	<b>Member Questions to Consumer Representatives</b>
3:15 pm-3:30 pm	Break
3:30 pm-4:30 pm	<b>Open Discussion on Various Issues</b> <b>Impact of the Current Economy on Credit Scores</b> <b>Reliability of Credit Reports</b> <b>Fairness to Consumers</b> <b>Correlation v. Causation</b>
4:30 pm-5:00 pm	<b>Concluding Remarks and Next Steps</b>

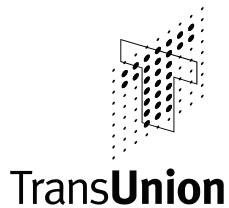


**THE USE OF CREDIT-BASED INSURANCE SCORES**  
**PUBLIC FACT-FINDING HEARING**  
**April 30, 2009**  
**Arlington, Virginia**

Written Testimony Submitted April 27, 2009:

- Chet Wiermanski, TransUnion
- Eric J. Ellman, Consumer Data Industry Association
- Jon Burton, LexisNexis
- Lamont Boyd, FICO CBIS
- Birny Birnbaum, Center for Economic Justice
- Jeff Kucera, American Academy of Actuaries
- Robert P. Hartwig, Insurance Information Institute
- Mike Miller, Actuary
- Birny Birnbaum, Center for Economic Justice
- J. Robert Hunter, Consumer Federation of America
- Dave Snyder, American Insurance Association
- Alex Hageli, Property Casualty Insurers Association of America
- Neil Alldredge, National Association of Mutual Insurance Companies
- Charles Neeson, Westfield Insurance
- Wesley Bissett, Independent Insurance Agents and Brokers of America
- J Robert Hunter, Consumer Federation of America
- Pat Butler, NOW
- Gregory Squires, George Washington University
- Commissioner Karen Weldin Stewart, Delaware Department of Insurance
- Senator James Seward, NCOIL





Testimony of  
Chet Wiermanski, Group Vice President, Analytical Services, TransUnion LLC  
On The Use of Credit-Based Insurance Scores

Before The  
National Association of Insurance Commissioners  
Property and Casualty Insurance (C) Committee  
Market Regulation and Consumer Affairs (D) Committee

April 30, 2009

Director McRaith, Commissioner Holland and distinguished committee members, thank you for providing TransUnion with the opportunity to speak with you today at this important hearing on credit-based insurance scores. We appreciate your leadership on the insurance scoring issue, this open forum, and your objectivity surrounding the often studied, but frequently misunderstood topic of credit-based insurance scores. I hope to shed some light on two of your objectives for this hearing: to understand the development of credit-based insurance scores and the trending of these scores in light of the current economic recession.

By way of background, TransUnion is a global leader in credit and information management and one of three global consumer credit reporting companies (CRAs). Headquartered in Chicago, TransUnion provides objective credit reports and credit-based insurance scores to insurers. As such, we do not determine rates or premiums, nor do we accept or reject applicants or policyholders. Our credit-based TransUnion Insurance Risk Scores (TUIRS) are used by insurers across the country. The security and accuracy of our information are our highest priorities.

TransUnion Insurance Risk Scores are developed to be completely transparent at all levels of the policy cycle. Thus, agents and consumers have a clear understanding of the credit characteristics impacting each score and how scores may potentially be improved. With each TUIRS adverse action reason code message, we provide an explanation detailing why the score is less than ideal. All characteristics and algorithms used to create TUIRS are available upon request, providing a clearer understanding of all the credit elements that impact a consumer's insurance score.

TransUnion Insurance Risk Scores are based exclusively on objective, factual, accurate credit report information, including consumer accounts such as credit cards, retail store cards, mortgages, and auto loans. Also included in our scores is public record information, including bankruptcies, liens and judgments, and collection accounts. Additionally, TUIRS takes into consideration consumer initiated inquiries associated with their request for new credit accounts. Multiple consumer generated credit inquiries associated with the shopping for a mortgage or auto loan are deduplicated to minimize the impact on their score. All of this factual credit information is received from tens of thousands of financial institutions, retailers, and court houses on a monthly basis. I should also note what is not included in the credit report and or in the calculation of a consumer's TUIRS: medical history and records, consumer buying habits, checking and savings information, income, or any prohibited basis characteristics identified by the Comptroller of the Currency, which includes information regarding marital status, race, age, religion, family status, color, receipt of public assistance, disability, gender or national origin.

It is important to note that while the term credit score is often used interchangeably by many for credit and insurance decisioning, credit-based insurance scores and credit risk scores are not synonymous. Credit-based risk scores are designed to predict the likelihood that an individual will satisfactorily repay their credit obligations, while insurance scores are designed to predict claims loss ratio. TransUnion Insurance Risk Scores were developed to meet the needs of our insurance customers who seek a transparent, objective, and accurate predictor of consumer insurance risk. TUIRS was developed from a pool of insurance policies collected directly from many different insurance companies. Approximately 1.1 million consumers were analyzed, accounting for about \$741 million in premiums, with claim amounts totaling \$539 million from 127,000 claims. The average loss ratio was 73% and the average premium was \$650. Claims frequency totaled .11 per consumer and the average claim was \$4200.

When developing the TransUnion Insurance Risk Score, TransUnion looked at approximately 2000 predictor candidate credit characteristics derived from consumer credit reports obtained one year prior to establishing each consumer's loss ratio. Using logistic regression we selected the credit characteristics that best predicted consumer loss ratios and based upon statistical analysis assigned the appropriate weights to each characteristic value to optimize the model's ability to estimate a consumer's loss ratio. Thus, our insurance scoring models are highly interpretable, multidimensional, consistent and objective.

TUIRS contains over seventy unique credit characteristics. Some of the credit characteristics used in TUIRS include the number of collections within five years, percentage of all accounts with balances greater than 50% of limit, months since oldest bankcard account has been opened, average balance of financial installment accounts, number of previous bankruptcies, and ratio of total balance to credit limit for all credit accounts. What is important to note is that each credit characteristic is highly correlated to loss ratio, and this correlation has been studied and verified by our customers, independent actuaries, state departments of insurance and federal regulators.

TransUnion continues to study our models and their performance in light of changes in the economic landscape. Thus, for this hearing, I will provide our perspective on two major questions, including, the trend and volatility of credit-based insurance risk scores and how actions taken by lenders to minimize their risk exposure are impacting credit-based insurance risk scores.

To better understand how recent economic conditions and changes in lending practices affect credit-based insurance scores, TransUnion analyzed a random sample of approximately 28 million consumers from each of the twelve most recent quarterly archived credit files. Each of the different consumers sampled was scored by all three TransUnion developed credit-based insurance risk models. In addition to appending a score from each TransUnion developed credit-based insurance risk model, thousands of credit characteristics were also appended to the approximately 340 million unique consumer credit reports in this analysis.

Between the fourth quarter of 2005 and the fourth quarter of 2008 the national average TransUnion Insurance Risk Score for each of the three proprietary TransUnion developed insurance models exhibited a very small fluctuation. As an example, during this time period the national average TransUnion Auto Insurance Risk Score, which ranges on a scale of 150 to 950, shifted from a low of 840.7 in the first quarter of 2006 to a high of 843.7 in the first quarter of 2008. The most recent national average TransUnion Auto Insurance Risk Score, as reflected of the fourth quarter of 2008, is 842.7. The national average scores for TransUnion's Property and combined Auto/Property Insurance Risk Scores showed similar fluctuations.

In general, the national average TransUnion Insurance Risk Scores exhibit far less fluctuation than the national average for credit risk scores. Credit risk scores are generally more volatile because they tend to rely more upon various forms of revolving credit utilization, recent new account openings and recent delinquency, than TransUnion Insurance Risk Scores. Although different aspects of utilization, account openings, and delinquency are contained within TransUnion's Insurance Risk Scores, these credit characteristics are defined differently and are not weighted as heavily as TransUnion's credit risk scores. Generally speaking TransUnion's Insurance Risk Scores, when compared to TransUnion's credit risk scores, tend to place more emphasis on credit characteristics that demonstrate a consumer's depth of credit history as reflected by the number and type of accounts maintained over time and a longer term view towards account delinquency.

A recent concern regarding credit-based scoring systems, in particular insurance risk models, is that proactive actions taken by lenders to reduce potential losses by lowering revolving credit limits may artificially lower a consumer's insurance score, which penalizes consumers in the form of higher premiums and less favorable terms to the consumer. Based upon TransUnion's analysis it appears that from an insurance risk score perspective, the action of lowering revolving credit limits has not played a significant role in the small fluctuations observed in the national average for TransUnion Insurance Risk Scores. This is attributed to the manner in which credit utilization credit characteristics are designed and weighted within TransUnion's Insurance Risk Scores. For example, revolving credit utilization credit characteristics are included in credit risk models, but by themselves, they are not included in the calculation of TransUnion Insurance Risk Scores. Based upon empirical evidence uncovered when developing TransUnion's Insurance Risk Scores, only a relatively few credit utilization characteristics, of the dozens tested, were highly correlated to insurance loss ratio and



subsequently included within the models. In addition, a majority of the credit characteristics calculate credit utilization as a function of a consumer's revolving credit limits combined with original installment loan amounts. This different approach dilutes the potential impact associated with the lowering of revolving credit limits.

As you continue to review the subject of insurance scores in this hearing and beyond, we ask you to consider a few points:

- Credit-based TransUnion Insurance Risk Scores are completely transparent.
- TransUnion Insurance Risk scores do not use any variables that unfairly discriminate against classes of consumers.
- A number of valid studies show a high correlation between credit data and future insurance losses, and that credit data are highly predictive of such losses.
- Analysis of credit-based TransUnion Insurance Risk Scores shows that they are not volatile; rather, scores are stable.

Once again, thank you for the opportunity to speak with you regarding the topic of credit and insurance, and I stand open for any questions you may have.





Writer's Direct Dial: 202-408-7407

Writer's Email: [cellman@cdiaonline.org](mailto:cellman@cdiaonline.org)

April 27, 2009

The Honorable Michael McRaith  
Chair, NAIC Property and Casualty Insurance Committee  
The Honorable Kim Holland  
Chair, NAIC Market Regulation and Consumer Affairs Committee

Dear Commissioners McRaith and Holland:

I write on behalf of the Consumer Data Industry Association (CDIA) to offer comments in connection with your review of credit-based insurance scores.

CDIA was founded in 1906 and is the international trade association that represents over 200 consumer data companies. CDIA members represent the nation's leading institutions in credit reporting, mortgage reporting, check verification, fraud prevention, risk management, employment reporting, tenant screening and collection services. Our members help their customers more effectively manage risk using precise, current, and reliable information.

We note that the call for the April 30, hearing did not specifically seek information concerning the underlying credit data that goes in to a credit-based insurance score. Since credit information is the building block of a credit-based insurance score, you might be interested in CDIA's comment.

Credit report information is heavily regulated by federal and state law, the credit report information is proven to be reliable by those that use consumer reports, those that regulate consumer reports, and consumers themselves. Credit information sets a solid foundation upon which credit-based insurance scores are built.

## **I. Background on Insurance Scoring**

Sometimes confused with credit scores that determine creditworthiness, an insurance score is designed to measure risk of loss. Insurance scores often, but not always, contain credit information. In a credit-based insurance score, credit information is one just one part of an overall score that also may include information like application information, MVA/DMV data, claims history, home or auto information, and more. Credit histories by themselves, or as part of insurance scores, are used by insurers because they are highly predictive of risk of loss. We will let others speak more directly and greater length to the actuarial predictiveness of insurance scores. For this comment CDIA will focus on the credit data.

## II. Building a Credit Report

A credit report is like a financial biography of a consumer and for most consumers the story is extraordinarily positive. Equifax, Experian, and TransUnion receive three billion updates every month from 18,000 data furnishers on 200 million Americans. More than 90% of all consumers have no adverse information on their files. For those consumers with information that is likely to be viewed as negative, in general that information cannot stay on a credit report beyond seven years.

Credit reports will contain credit information, like car loans, credit cards, and similar items. Consumers may also find preapproved offers of credit or insurance on their credit reports. By law, only that consumer sees such offers, better known as inquiries. No other lender, insurer, or other user is allowed to see such non-consumer initiated offers of credit or insurance.

Just as important as what is on a credit report is what is not on a credit report. Credit reports do not contain information about gender, race, religion, creed, color, national origin, or income.<sup>1</sup> Credit reports also do not contain medical histories.

## III. Credit Information and the Law

The federal Fair Credit Reporting Act (FCRA), 15 U.S.C. § 1681 *et seq.* heavily regulates the consumer reporting industry, including those that furnish data to and use data from consumer reporting agencies. The most comprehensive changes to the FCRA were in 2003 when Congress passed the Fair and Accurate Credit Transactions Act of 2003 (FACTA or FACT Act). The FCRA, which now has over 23,000 words, substantially controls the intake and output of consumer reporting data. Many states also have their own credit reporting laws.

The touchstone of the FCRA is the accuracy obligation of consumer reporting agencies. The law requires that consumer reporting agencies maintain reasonable procedures to assure maximum possible accuracy. 15 U.S.C. § 1681e(b). Determining what is accurate may sometimes be a challenge and may mean different things to different people, but it is important to note that even the Federal Trade Commission believes that credit reports cannot be completely error free.<sup>2</sup> A more thorough review of accuracy is found in Appendix I.

In addition to the accuracy obligations imposed upon consumer reporting agencies by federal and state law, federal law imposes restrictions on those that furnish data to consumer reporting agencies. For example, furnishers cannot provide data they know or have reasonable cause to believe is inaccurate. Furnishers are required to correct and update information. *Id.*, § 1681s-2(a).

---

<sup>1</sup> The committees should be aware of two studies in 2007 on credit scoring by the Federal Reserve Board and the Federal Trade Commission. Among the Fed's conclusions was this: "credit characteristics included in credit history scoring models do not serve as substitutes, or proxies, for race, ethnicity, or sex". In fact, "[c]redit scoring likely increases the consistency and objectivity of credit evaluation and thus may help diminish the possibility that credit decisions will be influenced by personal characteristics or other factors prohibited by law, including race or ethnicity." While the FTC's study was focused on credit-based insurance scores, it too found that "[c]redit-based insurance scores appear to have little effect as a 'proxy' for membership in racial and ethnic groups in decisions related to insurance."

<sup>2</sup> 16 C.F.R. Part 600 App. (2000). The Federal Trade Commission acknowledges that the law does not contemplate

error free consumer reports. If a consumer reporting agency accurately transcribes, stores and communicates consumer information received from a source that it reasonably believes to be reputable and which is credible on its face, the agency does not violate this section simply by reporting an item of information that turns out to be inaccurate.

Consumers have a right to dispute information on their credit reports with consumer reporting agencies and the laws require dispute resolution in not more than 30 days (45 days in certain circumstances). If a dispute cannot be verified then the information must be removed in the consumer's favor. *Id.*, § 1681i. Under the FACT Act, consumers will soon be able to file disputes directly with the data furnisher. *Id.*, § 1681s-2(a)(8).

In 2004 the FTC reported to Congress that the FACT Act “imposed a host of new requirements that, when fully implemented, should further enhance the accuracy and completeness of credit reports.”<sup>3</sup> A summary of all of the new FACTA consumer protections, consumer reporting agency obligations, and data furnisher obligations is available at Appendix II.

#### **IV. Accessibility of Credit Reports**

##### *A. Credit Reports are Accessible to All Consumers*

Credit reports are easy to obtain and are usually free. Consumers who wish to access their free annual credit reports can do so by going to [www.annualcreditreport.com](http://www.annualcreditreport.com). In addition to the one free report per year, per nationwide consumer reporting agency, consumers are entitled to a free credit report if they believe they might be a fraud victim, are unemployed and seeking employment, on public assistance, or have been denied credit or insurance on the basis of a credit report. As noted below in more detail between 2004 and 2006, more than 52 million free credit reports were provided to consumers who exercised their free credit report rights under the FACT Act.<sup>4</sup>

##### *B. Dispute Resolution is Fast and Efficient*

Dispute resolution is treated uniformly and electronically via the Online Solution for Complete and Accurate Reporting (e-OSCAR) system. This system works to resolve disputes in an even faster, more efficient, user-friendly, and accurate manner than ever before. A majority of all disputes are resolved within seven days or less and an additional 18% are resolved between days 8 and 14.

Consumers who disagree with the result of the dispute process are entitled by the FCRA to place a 100-word statement on their files explaining the dispute. The GAO found that 18% of consumers disputed information in their file and just 30% of that 18%, or 1% of those surveyed, submitted a dispute statement to the consumer reporting agency.<sup>5</sup>

It is important to remember that a dispute is not synonymous with an error that will lead to an adverse result. The General Accountability Office found in 2005 that 10% of consumers who disputed information on their credit reports disputed personal information like their name and address.<sup>6</sup> A dispute must always be viewed in the context of whether that item, had it been correct, would have led to a different credit or insurance result.

---

<sup>3</sup> Federal Trade Commission, *Report to Congress Under Sections 318 and 319 of the Fair and Accurate Credit Transactions Act of 2003*, Dec. 2004, vii.

<sup>4</sup> The GAO undertook a study of financial literacy and issued a report in March 2005. The GAO found that 79% of consumers who looked at their credit reports “felt that the information on their reports was very or somewhat easy to understand.” *General Accounting Office, Credit Reporting Literacy; Consumers Understood the Basics but Could Benefit from Targeted Educational Efforts Child Support Enforcement; Better Data and More information on Undistributed Collections are Needed*, GAO-05-223 (March 2005), 22. Hereinafter, “2005 GAO Report”.

<sup>5</sup> *Federal Trade Commission, Board of Governors of the Federal Reserve System, Report to Congress on the Fair Credit Reporting Act Dispute Process*, (Aug. 2006), 22, 24.

<sup>6</sup> 2005 GAO Report, 30.

Another reason for consumer disputes are attempts to “credit repair” a file. Although the FTC tells consumers that “[n]o one can remove accurate negative information from your credit report”<sup>7</sup>, tens of thousands try each year to flood consumer reporting agencies through credit repair operators who promise to assist consumers by disputing inaccurate or “unverifiable” information and trying to have accurate, predictive derogatory data removed. Our nationwide consumer reporting agency members estimate that on average approximately 30% of disputes filed are tied to credit repair.

## **V. Reliability of Credit Reports**

### *A. Industry Standards to Ensure Maximum Accuracy*

Federal law imposes accuracy standards on consumer reporting agencies and data furnishers. In addition to legal standards, there are operational standards in place to ensure reliability. The Metro 2 data reporting format is the data standard used by thousands of furnishers to report information to consumer reporting agencies. Approximately 82% of all data furnished to consumer reporting agencies is sent using the Metro 2 format; a 63% increase since 2005.

### *B. Economic Incentives to Ensure Maximum Reliability*

In addition to legal obligations and industry standards, there is an even bigger incentive for credit reports to be reliable. Simply put, there is a “market incentive[] to maintain and improve the accuracy and completeness of [credit] reports.”<sup>8</sup> There are approximately 200 million Americans with credit reports and credit reports are requested from Equifax, Experian, and TransUnion 27.4 million times each day. If credit reports were not reliable they would not be used by banks, insurance companies, or others. Furthermore, the American economy is a credit-based economy. The consumer reporting industry is the foundation upon which that economy is built and because of that importance, credit reports *must* be reliable and predictable.

### *C. Debunking the Public Interest Reports*

Often cited to perpetuate the myth of inaccuracies are reports issued by the U.S. Public Interest Research Group (PIRG) and Consumers Union (CU). The first PIRG report, issued in 1998, reviewed 133 files of 88 people (out of 200 million Americans with credit histories). The second PIRG report in 2004 reviewed the credit reports of 154 people, most of whom were PIRG members or staffers. The sample sizes were not representative of the population nor were the conclusions drawn statistically sound. For example, PIRG did not seek the input of creditors with regard to likelihood of an adverse credit decision, and based its conclusions on its own staffs’ opinions as to who would or would not receive credit. Consumers Union’s report was based on its asking 57 employees and their relatives to obtain their credit reports and identify anything they thought was wrong, regardless of whether it might actually impact the credit decision and again based on the consumers’ own conclusions.

The Federal Trade Commission reviewed the PIRG and CU reports and found that not only have “questions...been raised about the sample size and representativeness of the samples”, but neither of these “relied on the participation of all of the...key stakeholders in the credit reporting process.”<sup>9</sup>

---

<sup>7</sup> “Credit Repair: How to Help Yourself” <http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre13.shtm> (viewed April 20, 2009).

<sup>8</sup> Federal Trade Commission, *Report to Congress Under Sections 318 and 319 of the Fair and Accurate Credit Transactions Act of 2003*, Dec. 2004, 7.

<sup>9</sup> Federal Trade Commission, *Report to Congress Under Sections 318 and 319 of the Fair and Accurate Credit Transactions Act of 2003*, Dec. 2004, iii.

The General Accounting Office reviewed available literature on perceived inaccuracies in consumer reports and concluded that

the studies did not use a statistically representative methodology, examining on the credit files of their employees who verified the accuracy of the information, and counted any error as an inaccuracy regardless of the potential impact. Similarly, these studies use varying definitions in identifying errors, and providing some obscure explanations of how they carried out their work.<sup>10</sup>

#### *D. What the Regulators Say About Reliability*

The Federal Reserve has reviewed the reliability of consumer reports and made several observations. First, the Federal Reserve, which looked at over 300,000 credit reports, noted that

Overall, research and creditor experience has consistently indicated that credit reporting company information, despite any limitations that it may have, generally provides an effective measure of the relative credit risk posed by prospective borrowers.<sup>11</sup>

The report also noted that

Available evidence indicates that these data and the credit-scoring models derived from them have substantially improved the overall quality of credit decisions and have reduced the costs of such decision-making. Almost certainly, consumers would receive less credit and the price of the credit they received would be higher, if not for the information provided by credit reporting companies.<sup>12</sup>

In the context of the use of credit for insurance purposes, the 1997 NAIC White Paper *Credit Reports and Insurance Underwriting* cited the FTC. While the White Paper stated that "...various studies have indicated different results of the accuracy of credit reports," it went on to state that

[a] representative of the FTC, speaking to regulators on October 26, 1995, stated that the FTC is only able to estimate the accuracy of credit reports based upon the volume of complaints it receives. The number of complaints has been decreasing, thus the FTC assumes that the accuracy of credit report information is improving.

Indeed. Between 2004 and 2006, more than 52 million free credit reports were provided to consumers who exercised their free credit report rights under the FACT Act. Just 10% (520,000) of consumers had questions about that report or filed a dispute. Of the 10% who filed a dispute, just 1.98% (102,960) of disputes resulted in a deletion of data.

According to the Wall Street Journal of July 26, 2002: "The Federal Trade Commission, responsible for monitoring the activities of both the bureaus and data providers under the Fair Credit Reporting Act, says the different players in the credit-reporting process overall do a good job of making sure credit reports are accurate."

---

<sup>10</sup> *General Accounting Office, Consumer Credit – Limited Information Exists on Extent of Credit Report Errors and Their Implications for Consumers*, GAO-03-1036T (July 31, 2003), 9-10.

<sup>11</sup> *An Overview of Consumer Data and Consumer Reporting, Federal Reserve Bulletin, Feb. 2003, 50-51* (citations omitted); *See also, Credit Reporting Accuracy and Access to Credit, Federal Reserve Bulletin, Summer 2004, 320.*

<sup>12</sup> *Id.*, 70 (citations omitted); *See also, Credit Reporting Accuracy and Access to Credit, Federal Reserve Bulletin, Summer 2004, 320.*

*E. What the Users of Consumer Reports Say About Reliability.*

In 2001, Allstate ordered over 17 million credit reports. The number of written requests from consumers disputing information on their credit report totaled less than 3,000, or .017 percent of the total number of reports ordered. Of that small number, only some of the disputes were legitimate. Of the number of legitimate disputes, only some would have any bearing on the insurance score because we only look at certain characteristics. Of the number affecting the insurance score, only some would affect the discount amount because the score must change by a certain amount to move into another discount category. Thus, the number of inaccurate credit reports that affect the premium charged is at most a subset of a subset of a subset of .017%.<sup>13</sup>

**Conclusion**

The use of credit report information for insurance purposes is lawful and heavily regulated, commercially accepted by businesses and consumers, and statistically proven. Credit reports are reliable because the law requires it, industry tests it, and the economy demands it. Credit information sets a solid foundation upon which credit-based insurance scores are built.

Sincerely,

Eric J. Ellman  
Vice President, Public Policy and Legal Affairs

Attachments

---

<sup>13</sup> Allstate Insurance Company's Additional Written Testimony: Allstate's Use of Credit Scoring, before the Michigan Office of Financial and Insurance Services, July 23, 2002.



## How has the Economy Impacted Credit Models in Insurance

1



---

---

---

---

---

---

---

---

## Agenda

- Credit Models 101
- Do We See a Shift in Credit Score Changes?
- Credit Trends

2



---

---

---

---

---

---

---

---

## Credit Models 101

- Insurance Models ≠ Financial Models

<input type="checkbox"/> Insurance Models are developed on <b>historical insurance losses</b>	<input type="checkbox"/> Financial Models are developed on <b>bad debt/delinquencies</b>
<input type="checkbox"/> Insurance Score rank <b>order loss propensity</b>	<input type="checkbox"/> Financial Scores rank order <b>credit "bads"</b>

3



---

---

---

---

---

---

---

---

## Credit Models 101

❑ Insurance Models use attributes to rank order loss propensity

- ❖ Credit Seeking Behavior-*inquiries*
- ❖ Account Age-*length of time account is open*
- ❖ Credit Utilization-*ratio of balance to limit*
- ❖ Payment Behavior-*delinquencies*
- ❖ Derogatory Public Records- *# of bankruptcies/foreclosures*

4



---

---

---

---

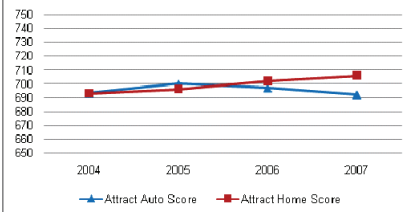
---

---

---

---

### National Insurance Score Trends



- ❑ Higher Scores indicate better risks
- ❑ Credit Score Naturally shift over time
- ❑ Average scores shifted between -1.0% and 1.0% annually between 2004 and 2007

5



---

---

---

---

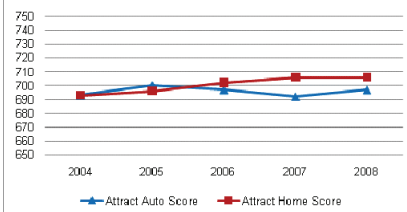
---

---

---

---

### National Insurance Score Trends



- ❑ The average Attract Home Score was flat from 2007 to 2008
- ❑ The average Attract Auto Score actually *rose* between 2007 and 2008

6



---

---

---

---

---

---

---

---



## Summary

- ❑ Insurance credit based scores continue to remain stable over time
  - ❖ Carriers do not use credit in isolation of other factors when setting rates
  - ❖ The current credit crisis is affecting consumer credit positively and negatively
    - Increased delinquency, foreclosures and bankruptcies
    - Decreased inquiries, balances and overall debt burden
  
- ❑ Insurance credit based scores continue to rank order loss propensity
  - ❖ Reducing the information available to insurance companies for measuring risk
  - ❖ Forces carriers to loosen their underwriting standards
  - ❖ Run the very real risk of not properly pricing their products
    - The end result is deficient capital for paying claims.

10



---

---

---

---

---

---

---

---

- **Contact:** Jon Burton  
Senior Director, Government Relations  
[Jon.Burton@LexisNexis.com](mailto:Jon.Burton@LexisNexis.com)  
678-694-3383

11



---

---

---

---

---

---

---

---



Fair Isaac Corporation  
901 Marquette Avenue, Suite 3200  
Minneapolis, MN 55402 USA  
T 612 758 5200  
F 612 758 5201  
www.fico.com

Make every decision count.™

April 24, 2009

Director Michael McRaith, (IL) Chair  
The Property and Casualty Insurance (C) Committee  
Commissioner Kim Holland (OK) Chair  
The Market Regulation and Consumer Affairs (D) Committee  
National Association of Insurance Commissioners  
444 N. Capitol Street, NW, Suite 701  
Washington, DC 20001-1509

*(Via Email – Eric Nordman, [enordman@naic.org](mailto:enordman@naic.org) and Pam Simpson, [psimpson@naic.org](mailto:psimpson@naic.org))*

**RE: NAIC Public Hearing on Credit-Based Insurance Scores – April 30, 2009**

Dear Director McRaith, Commissioner Holland,

Fair Isaac Corporation (FICO™) is pleased to offer the following comments in response to two questions asked by your Committees in their hearing announcement:

- What constitutes a credit-based insurance score?
- How have current economic conditions affected credit-based insurance scores?

### **What is a credit-based insurance score?**

FICO® Credit-Based Insurance Score models, introduced in 1993, evaluate credit data available on a consumer's credit report to produce a score that indicates the risk of an auto or home loss (measured by loss ratio relativity) for new applicants and existing policyholders. These models are mathematical algorithms that use legally acceptable data to predict future behavior. FICO CBIS models are updated as required to meet statutory and/or regulatory requirements in each state and are evaluated regularly to ensure continuing predictive value.

It is important to understand the difference between FICO® Credit-Based Insurance Scores and FICO® Credit Risk Scores. FICO CBIS scores predict likely future insurance loss ratio relativities, while FICO Credit Risk Scores predict the likelihood of future serious delinquencies or defaults on credit obligations. While our analytic and model development techniques are similar, the models are developed to predict completely different outcomes and, as such, the influence of different credit variables can vary greatly.

FICO CBIS scores generally range from the 100s to the 900s, with the higher the score, the lower the likely loss ratio relativity and the better the risk performance. We believe our CBIS scores are effectively used by insurers in combination with other relevant factors for underwriting and pricing decisions. Each insurer determines how best to implement its use of CBIS scores to match its market objectives, based on the competitive environment as well as state statutes and regulations.

As was revealed by the Federal Trade Commission Report to Congress on Credit-Based Insurance Scores (July 2007), among many other independent studies, insurers using CBIS scores are able to

effectively offer premium discounting to the majority of consumers. By relying on predictive, objective and consistent risk segmentation provided by CBIS scores, in concert with other key risk variables, the industry has expanded the availability and affordability of auto and home insurance coverage to consumers in all markets.

While FICO develops and maintains our CBIS models, the models are programmed into the processing systems of our partners, the consumer reporting agencies (CRAs), where the consumer credit data resides. FICO CBIS models are regularly audited by FICO and the CBIS scores are available to insurers from the CRAs as:

- InScore® via Equifax
- Experian/Fair Isaac Insurance Scores via Experian (delivered by ChoicePoint)
- Fair Isaac® Insurance Risk Scores (formerly known as ASSIST) via TransUnion

To develop our CBIS models, FICO follows rigorous statistical methodology and gathers depersonalized credit data on millions of consumers and multi-millions of dollars in insurance premiums and losses. In the model development process, advanced proprietary technology is used to empirically determine the correlation of hundreds of credit variables with subsequent claim performance. Those credit variables found to be most predictive of future losses are used to build the models.

As the FTC's 2007 Report to Congress and several independent studies have shown, the CBIS models are demonstrably efficient and accurate in predicting insurance losses. Without credit-based insurance scores, the risk selection process would likely be less objective, less consistent, and less accurate and we believe a majority of consumers—most of whom are good insurance risks—would have to subsidize those consumers whose greater level of risk is not able to be fully and effectively considered.

### **How have current economic conditions affected credit-based insurance scores?**

In spite of the current economic climate, recent analysis of FICO CBIS scoring models shows that average CBIS scores have remained virtually the same over time for the general population (see attachments). This is especially noteworthy when the number of people who are delinquent in repaying creditors has grown in recent months. We believe the overall stability of FICO CBIS scores may be caused by a greater number of consumers becoming even more credit conscious—making certain to pay all bills on time, paying down outstanding balances, and perhaps not seeking additional credit obligations.

While a small but growing number of consumers have experienced recent financial hardships, such as mortgage foreclosures, it is impossible to generalize about the impact of such an event on an individual's credit-based insurance score. FICO CBIS models consider the interrelationship of all credit information in a consumer's credit report, including any foreclosure information. Scores may change when lenders reduce credit limits, but FICO CBIS scores assess a wide variety of data on credit reports, so the impact from a single factor like credit limit reductions will depend on what other data is on the credit report and the amount of line reduction taken by a lender. While, in many cases, credit cardholders don't control their credit limits, they can control their account balances. Recent data shows that a notable number of consumers have reduced their revolving credit usage, helping to minimize any effect from lenders reducing their account limits.

FICO research will continue as the economic climate continues to change and as FICO CBIS score stability is important in helping insurers make objective, consistent and accurate underwriting and pricing decisions.

Director Michael McRaith (IL) Chair and Commissioner Kim Holland (OK) Chair

April 24, 2009

Page 3

Thank you for the opportunity to present this information. I look forward to responding to questions from your Committees.

Sincerely,

A handwritten signature in black ink that reads "Lamont D. Boyd". The signature is written in a cursive, flowing style.

Lamont D. Boyd, CPCU, AIM  
Director, Product Management  
Insurance Scoring Solutions  
[lamontboyd@fairisaac.com](mailto:lamontboyd@fairisaac.com)  
602-485-9858

Attachments





**Birny Birnbaum  
Center for Economic Justice**

**NAIC Hearing on Insurance Credit Scoring**

**April 30, 2009**

**Credit Reports**

**Issues Presented**

1. What Is And Is Not In A Credit Report
2. Non-Traditional Credit Information
3. Merged Reports For Mortgage Lending, Not For Insurance
4. Errors In Credit Reports -- Errors Of Commission And Omission
5. Missing Information -- Lender Choices
6. Variation Among Credit Bureaus And Resulting Score Impacts
7. Problems/Difficulties With Fixing Errors In Credit Reports
8. Problems With Adverse Action Notices And Explanations To Consumers
9. Credit Reports Reflect And Perpetuate Historical Inequities





# AMERICAN ACADEMY *of* ACTUARIES

---

## NAIC PUBLIC HEARING ON CREDIT-BASED INSURANCE SCORES

APRIL 30, 2009

My name is Jeff Kucera. I am here today representing the Casualty Practice Council of the American Academy of Actuaries.<sup>1</sup> I am employed as a senior consultant with EMB America LLC, an actuarial consulting firm. I am a fellow of the Casualty Actuarial Society and a member of the American Academy of Actuaries. I will be addressing actuarial practice applicable to risk classification and specifically, the use of credit-based insurance scores for rating and underwriting purposes. I am also here to offer the assistance of the Casualty Practice Council in your continued exploration of credit-based insurance scores.

In particular, my comments will demonstrate that the use of credit-based insurance scores allows the insurer to better segment insurance risks for the purpose of charging appropriate rates. I will address the following items:

- Current economic circumstances;
- Definition of what constitutes a credit-based insurance score;
- Evaluation of how insurers use credit-based insurance scores; and
- Discussion of how current economic conditions have affected policyholder premiums related to credit-based insurance scores.

Most companies now use credit-based insurance scores in the rating of personal lines such as private-passenger automobile or homeowners' insurance. The use of credit-based insurance scores helps insurance companies charge those risks that are likely to generate greater costs higher premiums, while those likely to generate lower costs get lower premiums. The removal of such insurance scores will not lower overall insurance premium; rather, it will redistribute the premium charges so that those risks with lower expected costs will pay more than is actuarially fair, while those with greater expected costs will pay less than is actuarially fair.

---

<sup>1</sup> The American Academy of Actuaries is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

## **Current Economic Circumstances**

As we are all aware, the United States is suffering from a major economic crisis, which has imposed considerable hardship on both individuals and businesses. A significant aspect of the current economic crisis is the severe tightening of the credit markets. This may suggest that credit standards are being tightened by banks and other sources of commercial credit. This comes at a time when increasing numbers of Americans are experiencing loss of income, including decreases in the value of many of their assets and unemployment. These problems are significant and ongoing, and they raise questions regarding the use of credit rating in insurance. These issues span multiple lines of insurance, but for individuals, they have the greatest impact on private-passenger auto and homeowners' insurance.

The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the voice of the profession on public policy issues. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

The purpose of my presentation on behalf of the Casualty Practice Council today is to assist the NAIC in its analysis of these questions and to offer to work with the NAIC in its continuing study of these issues. The Casualty Practice Council has a history of working with the NAIC on this and many other topics. In fact, the Risk Classification Subcommittee of the Academy's Products, Pricing, and Market Committee presented the NAIC with a report, "The Use of Credit History for Personal Lines of Insurance,"<sup>2</sup> in November 2002, which is still relevant today.

The NAIC has identified three issues to serve as a basis for discussion. Our comments will provide an actuarial context for each of these issues.

## **Definition of What Constitutes a Credit-Based Insurance Score**

An insurance score is a numerical score or ranking assigned to an insurance risk (i.e., a prospective insured) based on that risk's underlying characteristics. A common purpose of insurance scoring is to generate useful information in underwriting and pricing insurance for the individual risk being scored. The score provides a relative measure of the expected cost to the insurance company associated with the risk.

A credit-based insurance score utilizes various attributes found in a typical individual's credit report. There are several different scoring models currently in use to calculate credit-based insurance scores, including models developed by third-party vendors and proprietary models built by individual insurance companies. The type of credit attributes generally having the

---

<sup>2</sup> [http://www.actuary.org/pdf/casualty/credit\\_dec02.pdf](http://www.actuary.org/pdf/casualty/credit_dec02.pdf) (last visited on Apr. 24, 2009).

greatest effect on an individual's insurance score include: number of inquiries into opening new accounts, accounts 30 days or more past due. While the attributes and relative values are not identical for all companies, generally the higher the credit-based insurance score, the better an individual's credit rating.

The importance of credit-based insurance scores is that there is a strong correlation between them and the expected costs associated with the risk. In other words, in a group of insureds who are identical in every other way, insureds with favorable insurance scores are significantly more likely to have better loss experience than insureds with unfavorable insurance scores.

Consequently, credit-based insurance scores are a statistically reliable tool for segmenting risks into different groups with different expected cost levels. This has been demonstrated in a number of studies and reports, some of which we have listed in Appendix A.

### **Evaluation of How Insurers Use Credit-Based Insurance Scores**

Most state insurance laws prohibit the use of insurance rates that are excessive, inadequate, or unfairly discriminatory. Principle 4 of the Casualty Actuarial Society's *Statement of Principles Regarding Property and Casualty Insurance Ratemaking* states that, "A rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer."<sup>3</sup> Thus, the overall average rate level should be set so that the total premium collected from all risks is sufficient to cover the total expected costs. Additionally, the individuals' rates should be set such that the premium collected from each individual risk, or group of similar risks, reflects the expected costs for that individual risk (or group of similar risks).

In a 2001 survey, 90 percent of the responding insurers (from the top 100 personal lines companies) indicated that they were using credit data.<sup>4</sup> According to the survey, the use of credit data is a relatively recent trend; more than half of the responding insurers using credit said that they began using credit in 1998 or later. Today, the number of companies using credit is likely even greater. Some insurers use insurance scores simply to determine whether a prospective insured qualifies to be written by the company. More typically, insurers also use insurance scores to help segment risks into different groups with similar expected costs for the purpose of rating. In such cases, the insurer may use the insurance score directly as a rating factor, also called a "risk classification factor," similar to an amount of insurance for homeowners' insurance or prior violations for private-passenger auto insurance. Alternatively, an insurer with multiple "tiers" representing different levels of expected cost may use the insurance score to help assign risks to the appropriate tier. Whether insurance scores are being used as a risk classification or

---

<sup>3</sup> <http://www.casact.org/standards/princip/sppcrate.pdf> (last visited on Apr. 22, 2009), *Statement of Principles Regarding Property and Casualty Insurance Ratemaking*, Casualty Actuarial Society, May 1988.

<sup>4</sup> "Insurance Scoring in Personal Automobile Insurance—Breaking the Silence," Conning & Company, 2001.

tiering factor, the impact is the same: insurance scores are being used to segment risks into homogenous groups so that appropriate premiums can be charged.

With respect to insurance scores as a risk classification or tiering factor, the actuary is guided by Actuarial Standard of Practice (ASOP) No. 12, *Risk Classification*.<sup>5</sup> Rating plans for individual lines of insurance generally include several different risk classifications. For example, private-passenger auto lines use such risk classifications as the make and model of the car, age of the driver, prior traffic violations and accidents, etc. For homeowners' insurance, examples of risk classification include amount of insurance, type of home construction, prior loss history, etc. The key section of ASOP No. 12 that is applicable to the use of insurance scores is section 3.2.1., which reads in part as follows:

Relationship of Risk Characteristics and Expected Outcomes—The actuary should select risk characteristics that are related to expected outcomes. A relationship between a risk characteristic and an expected outcome, such as cost, is demonstrated if it can be shown that the variation in actual or reasonably anticipated experience correlates to the risk characteristic. In demonstrating a relationship, the actuary may use relevant information from any reliable source, including statistical or other mathematical analysis of available data. The actuary may also use clinical experience and expert opinion.

Rates within a risk classification system would be considered equitable if differences in rates reflect material differences in expected cost for risk characteristics. In the context of rates, the word *fair* is often used in place of the word *equitable*.

The actuary should consider the interdependence of risk characteristics. To the extent the actuary expects the interdependence to have a material impact on the operation of the risk classification system, the actuary should make appropriate adjustments.

The summary of articles on credit in Appendix A includes several studies that have shown that credit scores reflect significant differences in expected loss costs. Thus, credit scores are appropriate tools for risk differentiation. Rates based on groups differentiated by insurance score are not excessive, inadequate, or unfairly discriminatory.

The removal of such insurance scores will not lower overall premium collected; it will only redistribute the premium collected such that risks with lower expected costs will pay more, and those with greater expected costs will pay less.

While the evidence may only be anecdotal, most companies report that the use of insurance scores, along with multivariate rating and other new rating factors, have allowed them to write more risks from the general population than before these features were introduced.

---

<sup>5</sup> [http://www.actuarialstandardsboard.org/pdf/asops/asop012\\_101.pdf](http://www.actuarialstandardsboard.org/pdf/asops/asop012_101.pdf) (last visited on Apr. 22, 2009), Actuarial Standard of Practice No. 12, *Risk Classification (for All Practice Areas)*, adopted by the Actuarial Standards Board, Dec. 2005.

If the NAIC determines that further studies may be appropriate, the Casualty Practice Council would be pleased to assist the NAIC in such studies.

### **Discussion of How Current Economic Conditions Have Affected Policyholder Premiums Related to Credit-Based Insurance Scores**

While our current economic condition is certainly on everyone's mind, it is still uncertain exactly how this will affect overall insurance costs and, therefore, overall insurance prices. Some regulators or other public officials may be concerned that if the current economic crisis causes insurance scores to worsen, it will lead to unwarranted premium increases. It is important to consider both the impact on the aggregate premium and on individuals' premium.

First, it is important to consider the impact on the aggregate premium. Insurers use insurance scores to determine appropriate rate relationships between risk classes, not to determine overall premium need. Assume for a moment that insurers continue to maintain the same rate relationships for different insurance score ranges, and that the current economic crisis causes every insureds' insurance score to worsen. The actuary would observe this distributional shift or change and adjust overall rate levels so that the total premium collected by the insurance company remains the same and the integrity of the rate relationships among risks remains intact.

This is no different than any other distributional shift, such as an increase in the average value of homes, which an actuary has to consider when setting the overall rate level. Part of a typical actuarial rate review is an analysis of any shifts in distributions that affect the premium level. The actuary would adjust for these shifts in determining appropriate future rates. As a result of this standard ratemaking practice, any shift in insurance scores due to the current adverse economic conditions will not result in any long-term impact on overall premium collected.

Second, it is important to consider the impact on the individuals' premium.<sup>6</sup> As stated earlier, studies have demonstrated that insurance scores are an effective means of segmenting risks. Because of this, many companies now vary the rates charged to risks with different insurance scores. Some regulators or other public officials may be concerned that a dramatic shift in credit scores could disrupt the current relative rates among risks with insurance scores; in other words, perhaps the difference in expected cost levels among insureds with favorable and unfavorable scores will be less significant.

This, too, is not a problem that is unique to insurance scores. The gender and age of drivers have long been recognized as important rating characteristics for personal automobile insurance. There have been, and still are, very significant differences between the rates charged to young

---

<sup>6</sup> It is important to remember that any distribution shift is likely to have a smaller effect on renewal business than on new business, because some states and/or companies only permit the use of such scores for renewals if it results in a more favorable rate for the individual insured.

males and young females, reflecting the higher cost of auto insurance for young male drivers compared to young female drivers. However, over time, the driving habits of young males and young females have become more similar, and while the difference in risk is still significant, it is not nearly as large as it was in the past. As this trend has developed, insurers adjusted classification plans to reduce the rate differentials to reflect it. If the actuary regularly analyzes the indicated rate differentials for different insurance score ranges, the rate differentials will be changed if more recent data suggests it. This potential shift in group differentials, and motivation or intent to be competitive, provide incentives for companies to regularly review their rate differences.

One of the other roles of an actuary is to regularly review the data to decide whether the overall average rate level is appropriate and whether the rate differentials for risks with different insurance scores need to be adjusted. By doing this, the actuary can ensure that the rates are actuarially sound,<sup>7</sup> regardless of the effect the current economic crisis has on personal insurance scores.

It is possible that a sudden or immediate distribution shift could result from the current economic conditions, and that, by the time it works its way into the actuary's data, many insureds will have already been harmed. While we have been suffering through the current economic conditions for approximately six months, we are unaware of any quantifiable evidence that has surfaced to demonstrate that such a dramatic shift has been occurring. It is our opinion, based on anecdotal evidence, that any shift thus far has been minor. This could be because renewal business, which makes up the majority of any company's business, is less likely to be affected by a shift. Ascertaining whether an actual shift of any significance has occurred would require a study to look at the distribution of insurance scores of several companies over a period of time. The Casualty Practice Council is willing to assist the NAIC should it decide to pursue such a study.

On behalf of the Academy and the Casualty Practice Council, I thank you for the opportunity to speak to you today. To the extent that we can further assist the NAIC in its endeavors on this topic, the Casualty Practice Council volunteers its services. We look forward to working with you.

If time permits, I am happy to answer any questions you may have.

---

<sup>7</sup> <http://www.casact.org/standards/princip/sppcrate.pdf> (last visited on Apr. 22, 2009), *Statement of Principles Regarding Property and Casualty Insurance Ratemaking*, Casualty Actuarial Society, May 1988.



## Appendix A – Summary of Additional Articles on Credit Scoring

Several studies have already been conducted on the use of credit for rating and underwriting for both homeowners' and private-passenger auto insurance. In particular, the following studies may warrant review:

- *Predictiveness of Credit History for Insurance Loss Ratio Relativities* by Isaac Fair, (1999).
- *Use of Credit Reports in Underwriting* by the Commonwealth of Virginia, State Corporation Committee, Bureau of Insurance (1999).
- *The Impact of Personal Insurance Credit History on Loss Performance in Personal Lines* by James D. Monaghan (2000).
- *Insurance Scoring in Personal Automobile Insurance – Breaking the Silence* by Conning & Company (2001).
- *Use of Credit Information by Insurers in Texas* by the Texas Department of Insurance (December 2004).
- *Use of Credit Information by Insurers in Texas – the Multivariate Analysis* by the Texas Department of Insurance (January 2005).
- *Credit-Based Insurance Scores: Impact on Consumers of Automobile Insurance* by the Federal Trade Commission (July 2007).
- *Report to the Congress on Credit Scoring* by the Board of Governors of the Federal Reserve System (2007).



**PUBLIC HEARING ON CREDIT-BASED  
INSURANCE SCORES**

**Testimony as Delivered**

**by**

**Robert P. Hartwig, Ph.D., CPCU**

**President & Economist**

**Insurance Information Institute**

**New York, NY**

**National Association of Insurance Commissioners**

**Property and Casualty Committee**

**Market Regulation and Consumer Affairs Committee**

April 30, 2009

Arlington, VA



Thank you, Director McGraith, Commissioner Holland and members of the Committee.

Good morning. My name is Robert Hartwig and I am President and Economist for the Insurance Information Institute, a national property/casualty insurance trade association based in New York City.<sup>1</sup> I am also a Chartered Property Casualty Underwriter (CPCU) and have worked on a wide variety of insurance issues during my 16 years in the property/casualty insurance and reinsurance industries. Over the past decade I have devoted considerable time and attention to various questions arising from the use of credit information in the underwriting of personal lines insurance. I have authored reports on the issue, made presentations before insurance, real estate and mortgage lending groups, testified in several states, conducted agent and management training seminars and conducted hundreds of media interviews.

The Committee has asked today's witnesses to address three fundamental issues:

- (i) An explanation of what constitute a credit-based insurance score;
- (ii) An explanation of how insurers use credit-based insurance scores; and
- (iii) A discussion of how current economic conditions have affected policyholder premiums related to credit-based insurance scores.

All three are important issues. In my capacity as a professional economist with many years of experience in the property/casualty insurance industry, I will focus my comments today on item (iii), providing a detailed discussion on the relationship between current economic conditions, credit scores and the cost of insurance.

### **Current Economic Conditions**

The United States economy is currently in the midst of a deep recession which began in December 2007. During the fourth quarter of 2008, the nation's real gross domestic product (GDP) declined by 6.3 percent, the largest drop in nearly 27 years (FIGURE 1). In March 2009, the unemployment rate reached 8.5 percent, its highest level since January 1984 and more than 4 points above the cyclical trough of 4.4 percent in March

---

<sup>1</sup> Contact information: Tel: (212) 346-5520; Email: [bobh@iii.org](mailto:bobh@iii.org).

2007 [FIGURE 2]. Current projections call for the economy to continue to contract through the first half of 2009 with a modest recovery beginning in the second half of the year and continuing into 2010. Unemployment is expected to peak at approximately 9.6 percent in early 2010 and begin to decline thereafter.

Recessions are not uncommon, unusual or unexpected. They are an unpleasant but unavoidable part of the business cycle, correcting many of the excesses that occur during the expansionary phase of the cycle (such as the recent housing and credit bubbles). Since the end of World War II, the United States economy has experienced 11 recessions lasting an average of 6.4 months, followed by extended periods of economic growth lasting 60.5 months on average—nearly 5 times longer than the preceding contraction [FIGURE 3]. Thus recessions are recurrent but temporary phenomena. Growth, jobs and incomes that are diminished during recessions always recover once the economy resumes its long-term expansionary trajectory.

### **What's Different About This Recession: Credit Market Conditions**

Most recessions are triggered by a build-up of excess capacity and inventories in the economy. Firms seek to correct these imbalances by reducing production and investment, trimming expenses and cutting jobs. Layoffs (actual, anticipated or fear of) cause consumer confidence to wane. As consumers—who account for two-thirds of all spending in the economy—reduce spending, the overall economy suffers with recession being the likely result.

This same sequence of events is present in the current recession. However, the precipitating event was a collapse in the credit markets, which had experienced a massive and unsustainable expansion during the middle part of this decade. This credit “bubble” was most pronounced in the mortgage sector which grew by an astonishing 58 percent from \$9.35 trillion at year-end 2003 before peaking at \$14.74 trillion in mid-2008 [FIGURE 4]. Mortgage debt outstanding began to decline during the second half of 2008. The decline in mortgage debt is part of a much broader pullback in the credit markets.

## **The Economic Crisis and Consumer Credit Profiles**

As the average American consumer pulls back on spending, contributing to the current deep recession, they will also pull back on their use of credit financing of purchases. Indeed, recent data from the Federal Reserve indicate that the process of consumer “deleveraging” or debt reduction is already well underway [FIGURE 5]. Mortgage debt, which increased at a 12.8 percent average annual pace between the first quarter of 2004 and mid-2006, declined at an average annual rate of 1.4 percent during the final three quarters of 2008. Likewise, consumer credit fell at an average annual rate of 3.2 percent during the fourth quarter of last year after expanding at nearly 5 percent per year on average from 2004 through mid-2007.

The retrenchment of the American consumer is a principal contributor to the current recession. At the same time, there is little disagreement that millions of Americans were overextended in terms of their use of credit, especially with respect to mortgage debt. Thus a silver lining of the current financial crisis is a change in the credit profile of the average American household whereby outstanding debt is reduced to more manageable levels. This should lead to an improvement in the health of the typical consumer’s (and family’s) balance sheet. Indeed, this change is clearly already underway, as illustrated in Figure 5. This also implies that credit scores (and credit-based insurance scores), contrary to popular belief, are not headed uniformly downwards despite the current recession. Likewise, credit scores do not head uniformly upwards during boom times.

### *Can Consumer Deleveraging and Better Credit Management Lead to Higher Scores?*

The fact that many households are becoming more conservative in their use of debt and are better managing the debt that they already have is reflected in a recent report by the credit monitoring and management service Credit Karma [FIGURE 6]. Among their clients, 43 percent saw their credit score rise in March 2009, 27 percent saw their scores fall while the scores of the remaining 30 percent remained unchanged. The report clearly illustrates that a large proportion of consumers are benefiting from rising credit scores even in the current economic. It is also interesting to note that the 30 percent whose

score remained unchanged also had the highest average score, suggesting significant stability within this group.

### **Does Scoring Work When the Economy is in Recession?**

Credit-based insurance scores are highly accurate predictors of risk (expected loss) irrespective of the economic environment. Over the past 10 to 15 years during which the use of insurance scoring has become nearly universal, the economy has experienced two recessions and enormous variations in economic growth and unemployment across states. Insurance scores have been proven to remain highly accurate predictors throughout the entirety of this period.

The reality is that that US economy and the economies of individual states are in a constant state of flux. Insurance scores are robust in the sense that they remain predictive of future loss across the entire economic cycle. Specifically, since 1995 (near the beginning of the period when insurance scoring became more commonplace), the national unemployment rate has ranged from a low of 3.8 percent in April 2000 to a high of 8.5 percent in March 2009. In that month (March 2009), state unemployment rates ranged from 4.2 percent in North Dakota to 12.8 percent in Michigan. In 2000, when the US unemployment rate reached its low, state unemployment rates ranged from 2.3 percent in Connecticut and Virginia to 6.2 percent in Alaska. Scoring remained continuously and highly predictive before, during and after these two cyclical extremes for both auto and home insurance in every state in which it is used.

It should be noted that no study has *ever* shown insurance scores to be anything other than highly predictive of future loss. Studies recently conducted by the Federal Reserve and Federal Trade Commission as well as several state insurance departments confirm the predictive accuracy across states and over time. There are no exceptions to this finding. This implies that insurance remains strongly predictive irrespective of economic circumstances.

### **Why Does Insurance Scoring Work Even When the Economy is in Recession?**

The fact that insurance scoring is predictive of future loss irrespective of the state of the economy is enormously critical. It underscores the fact that insurance companies consider only those items from credit reports that have been shown to correlate with future insurance loss potential. Unlike a lender, an insurance company is not assessing a customer's ability to repay a loan. Insurers are interested exclusively in those factors that relate to future loss. Consideration of superfluous factors—factors that do not statistically correlate with expected future loss—would be a costly waste of time. Moreover, research conducted by credit bureau TransUnion indicates that actions taken by lenders appear to have little impact on insurance risk scores or insurance risk indices.

### **Wouldn't a Recession Push Everyone's Credit and Insurance Score Down?**

It is a common misconception that during a recession virtually consumer's credit score and hence insurance score will fall. As discussed previously, some credit scores rise even during a recession, some fall and others stay the same. The same is true with insurance scores. Examining this extreme situation is nevertheless instructive in that it reveals how the predictive ability of credit-based insurance scores is preserved even in the case when 100 percent of the population experiences a decline in their credit score. Statistically, such a shift in the entire population would likely have little impact on insurance rates (except to the extent that actual loss performance deteriorates). This is because credit-based insurance scores are used to help differentiate risk among groups with varying degrees of loss expectancy. These groupings would still exist as would the ability of insurers to differentiate between them statistically even if a bad economy pushed down every member of the population's credit and insurance scores. The argument also works in reverse. If an improving economy raises all credit and insurance scores, the insurer's ability to distinguish among groups is not in any way diminished.

### **Credit-Based Insurance Scores: Just One of Many Factors Considered by Insurers**

With so much focus on the potential impact of the economy on credit standing, it is important to recall that insurance scores are just one of *many* factors insurers consider when assessing the risk associated with a potential (or existing) policyholder. Credit-based insurance scores are never used as the sole underwriting criterion. Auto insurance



premiums, for example, are based on a myriad of factors such as driving record, previous losses, the type of car driven, miles driven and where the consumer lives. A homeowners insurance policy premium is based on where the consumer lives, previous losses, the type of home, and the cost to replace it, type of construction, proximity to a fire department, among other factors.

### **What Are the Consequences of Bans or Severe Restrictions on the Use of Credit-Based Insurance Scores?**

#### *Higher Premiums and Unfair Subsidies*

Prohibiting insurers from using credit-based insurance scores would instantaneously result in inherently unfair outcomes: higher rates for people with lower risk, and lower rates for those with a higher likelihood of submitting claims. In other words, bans or severe restrictions on insurer use of credit-based insurance scores would lead to massive subsidies for people who impose greater costs on the system. A 2007 study by the Federal Trade Commission found that two-thirds of consumers receive lower premiums than they otherwise would when credit-based insurance scoring is included as a rating factor.

Prohibiting the use of credit-based insurance score would exact a steep toll on the typical American family. A family owning a single home and two cars and currently earning a 10 percent discount related to a strong credit would have to pay approximately \$259 more per year in the event that a ban on the use of insurance scoring forced them to forfeit their discount.<sup>2</sup>

It gets worse. The hard-earned \$259 lost by the family with good credit and few, if any, insurance claims will go straight into the pockets of people who file more claims and impose greater costs on the insurance system in the form of a subsidy.

---

<sup>2</sup> Based on estimated 2009 auto insurance expenditures of \$875 per vehicle and average homeowners insurance premiums of \$841. Estimates are based on historical NAIC data and projected to 2009 using Consumer Price Index data from the US Bureau of Labor Statistics.

There is no question that bans or severe restrictions on the use of insurance scoring lead directly higher costs for people who impose few costs on the system and subsidies for those impose greater costs. The aggregate subsidy is potentially very large. Focusing on auto insurance and using Illinois as an example, a loss of an average 10 percent credit discount on two-thirds of the 7.7 million insured vehicles on the road in that state would result in a subsidy from good drivers to bad drivers of some \$382 million. Even if the average discount is just 5 percent, the subsidy is still \$191 million.<sup>3</sup>

### *Less Insurance*

In addition to millions of drivers and homeowners paying more for their coverage, insurers in some cases may simply back away from some risks. That is because the additional predictive power of insurance scoring increases insurers' understanding of risk and enables them to write certain risks that in the absence of scoring would be too uncertain to accurately price. Indeed, the same 2007 Federal Trade Commission study that affirmed the predictive value of insurance scores as well as the economic value they bring to consumers through discounts also concluded that the use of credit-based insurance scores enables insurance companies to offer coverage to more consumers than they had in the past. This effect is most pronounced for high-risk drivers, many of whom in the era before the use of insurance scores had no other option but to seek coverage through state-run auto plans for the highest risk drivers. Insurance scoring is one of the primary reasons for the 60 percent drop in the number of cars insured through these costly markets of last resort between 1996 (when 2.9 percent of drivers were insured in these plans) and 2006 (when just 1.2 percent of drivers obtained coverage through state-run plans). It's not that there are fewer bad drivers today; it's simply that insurance scoring has helped insurers understand how to price high-risk drivers more accurately than they could in the past.

### **Lessons to Be Learned from the Banking Sector's Experience in Ignoring Risk?**

It is ironic that calls to ban or severely restrict the use of credit-based insurance scores are being voiced during the current financial crisis. Insurers use credit-based insurance

---

<sup>3</sup> The estimated subsidy of \$382 million is based on 7.7 million insured vehicles in Illinois (2006 figure from AIPSO), two-thirds of which are assumed to be eligible for credit-related discounts (per 2007 Federal Trade Commission study) and an average auto insurance expenditure of \$740 (2006 figure from NAIC).

scores to help them quantify and price the risk inherent in the products they sell. It is a proven risk management tool. Property/casualty insurers' adherence to the basic principles of risk management (which include risk-based pricing) has allowed them to weather the crisis better than almost any other segment of the financial services industry. Legislation and regulation that would remove or compromise the ability to thoroughly assess, quantify and price risk is tantamount to an endorsement of the disastrous risk management strategies employed by many banks, whose willful ignorance of risk is at the very core of the current financial crisis.

The experience of property/casualty insurers compared with that of banks since the beginning of the financial crisis in 2007 could not be more stark. Whereas 50 banks have failed (including the largest bank failure in US history), not a single property/casualty insurance company has failed as a result of the crisis. Hundreds of those banks that remain have had to seek billions of dollars in government bailout funds. Not a single property/casualty insurance company has received bailout money. Throughout the entirety of the financial crisis, not a single valid claim has gone unpaid. Moreover, insurers continue to write new coverage, renew existing policies and roll out new products. Banks, on the other hand, are turning away families and businesses that need access to credit, are scaling back their product offerings and are raising fees. The property/casualty insurance industry even managed to earn a small profit in 2008, despite the crisis and near-record catastrophe losses of \$26 billion—the fourth highest total in history.

### **Summary**

Insurance scoring is a proven, accurate, objective and consistent risk assessment tool used widely in the underwriting of auto and homeowners insurance. The data supporting its use are statistically irrefutable, and the benefits to consumers are significant. Moreover, the use of credit information leads directly to a fairer and equitable premium charge for all policyholders because scoring allows premiums to be more closely matched to risk.

The current economic recession has created hardships for many American families, but there is no evidence to suggest that insurer use of credit-based insurance scores has in any

systematic way increased costs for policyholders. Insurance scores have repeatedly been proven to remain highly predictive of future loss over the course of the entire economic cycle—recessions and expansions alike—as well as across the very diverse range of economic environments and experiences found among the states. Importantly, insurance scores incorporate use only those elements from credit reports that correlate with future loss.

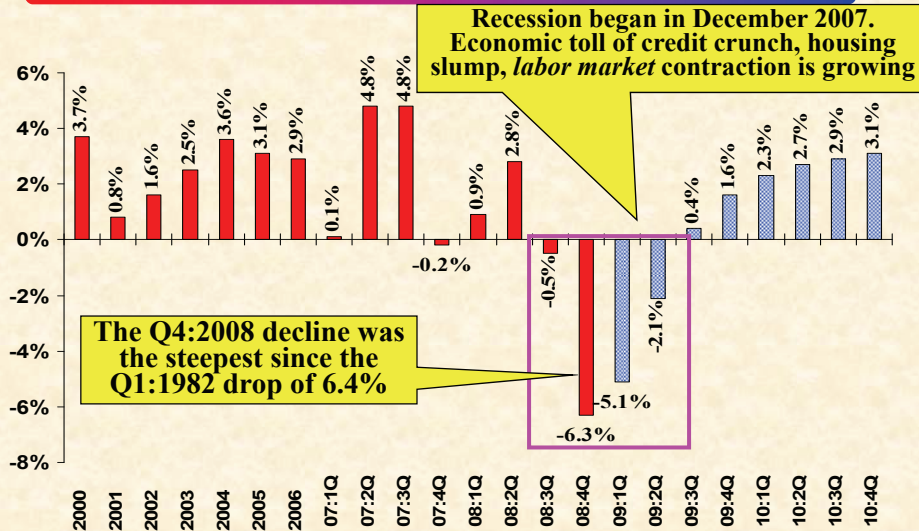
Finally, calls to ban, severely restrict or suspend the use of credit-based insurance scores during the current financial crisis are misguided, distortionary and unfair to the millions of policyholders who impose few costs on the system. Insurance scoring is a proven risk management tool. Property/casualty insurers' adherence to the basic principles of risk management has allowed them to weather the financial crisis far better than the banks, whose inattention to risk was nothing short of a colossal failure of risk management so profound that global financial chaos ensued. Legislation and/or regulation that would remove or compromise the ability to thoroughly assess, quantify and price insurance risk is tantamount to an endorsement of the disastrous risk management strategies employed by many banks, whose willful ignorance of risk is at the very core of the current financial crisis.

Thank you for the opportunity to appear at today's hearing. I would be happy to answer any questions you may have.

Figure 1.



## Real GDP Growth\*

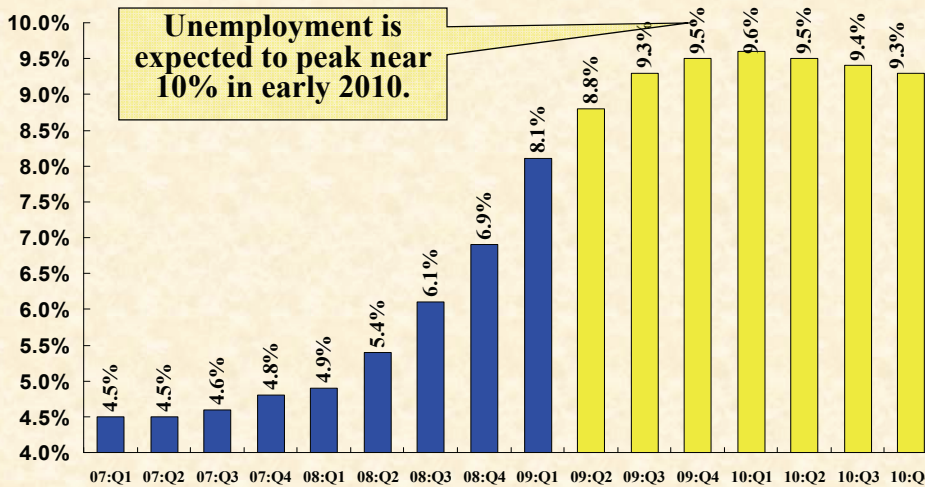


\*Yellow bars are Estimates/Forecasts from Blue Chip Economic Indicators.  
Source: US Department of Commerce, Blue Economic Indicators 4/09; Insurance Information Institute.

Figure 2.

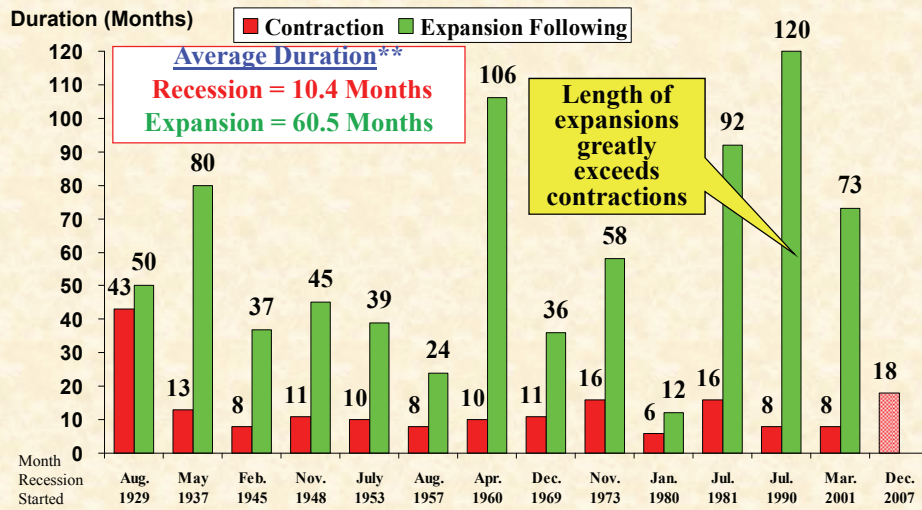


## U.S. Unemployment Rate, (2007:Q1 to 2010:Q4F)\*



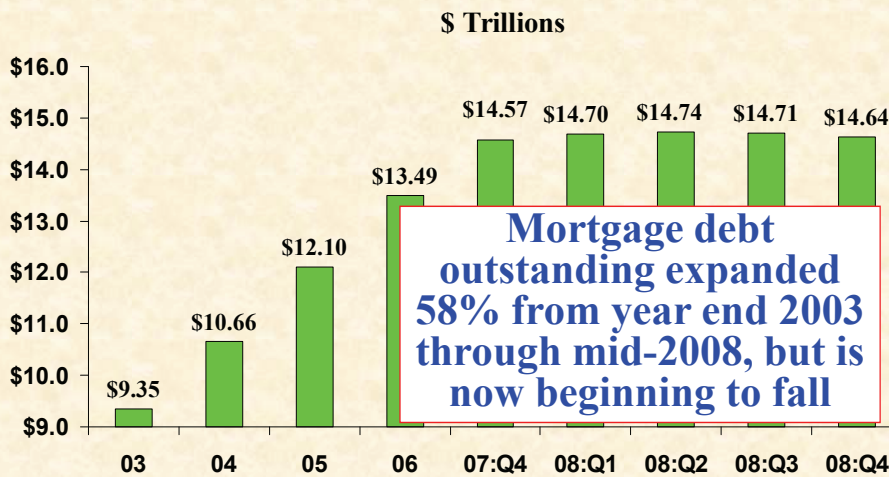
\* Blue bars are actual; Yellow bars are forecasts  
Sources: US Bureau of Labor Statistics; Blue Chip Economic Indicators (4/09); Insurance Info. Inst.

Figure 3. *Length of U.S. Business Cycles, 1929-Present\**



\* As of May 2009, inclusive; \*\*Post-WW II period through end of most recent expansion.  
 Sources: National Bureau of Economic Research; Insurance Information Institute.

Figure 4. *Mortgage Debt Outstanding: 2004- 2008<sup>1</sup>*



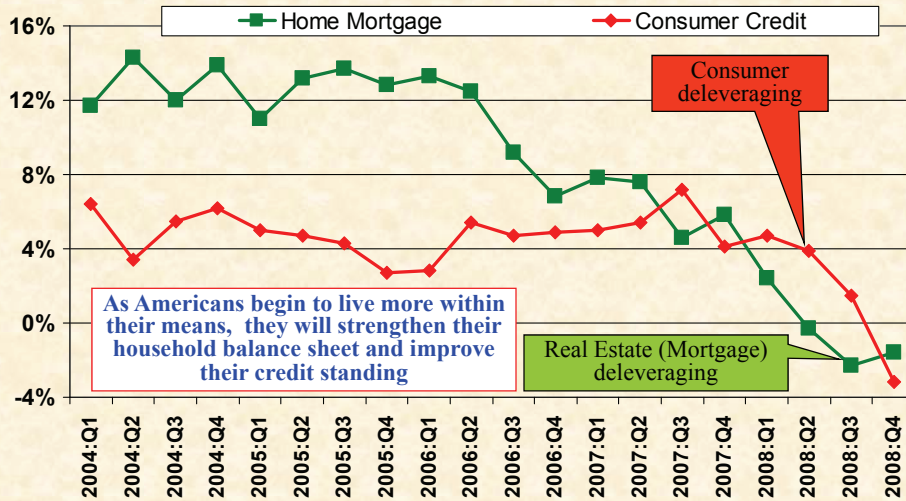
<sup>1</sup>End of period.  
 Sources: Board of Governors of the Federal Reserve, <http://www.federalreserve.gov/econresdata/releases/mortoutstand/>; Insurance Information Institute.

Figure 5.

## Households Are Now Rapidly “Deleveraging” (Shedding Debt)



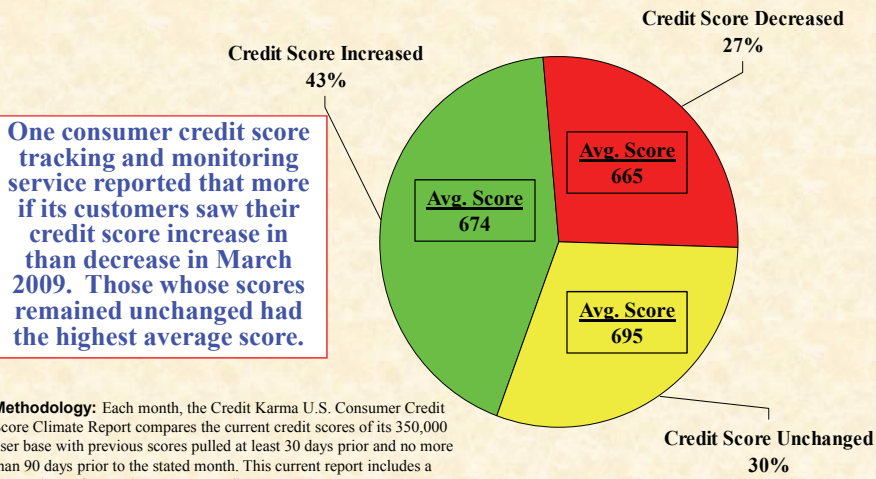
Percent Change in Debt Growth (Quarterly since 2004 at Annualized Rate)



Source: Federal Reserve Board, at <http://www.federalreserve.gov/releases/z1/Current/z1r-2.pdf>

Figure 6.

## Credit Monitoring Service Report: Many Scores Rose in March 2009



One consumer credit score tracking and monitoring service reported that more if its customers saw their credit score increase in than decrease in March 2009. Those whose scores remained unchanged had the highest average score.

**Methodology:** Each month, the Credit Karma U.S. Consumer Credit Score Climate Report compares the current credit scores of its 350,000 user base with previous scores pulled at least 30 days prior and no more than 90 days prior to the stated month. This current report includes a comparison of more than 30,000 Credit Karma user scores.

**Source:** Credit Karma U.S. Consumer Credit Score Climate Report (Press Release dated April 15, 2009) and reported in *Insurance Journal*. Credit Karma is a San Francisco-based consumer credit score tracking and monitoring service.







**Credit-Based Insurance Scores**

**As Currently Used by Personal Auto and Homeowners Insurers,  
Insurance Scores Are Actuarially Sound,  
Lead to More Accurate Risk Assessment,  
Fairly Discriminate Between Risks,  
And Work to the Advantage of a Majority of Insureds**

**Statement of Michael J. Miller, FCAS  
Actuarial Consultant, EPIC Consulting, LLC**

**The Use of Credit-Based Insurance Scores  
Public Hearing of NAIC Property and Casualty Insurance (C) Committee  
and Market Regulation and Consumer Affairs (D) Committee**

**April 30, 2009**

## **Introduction**

My name is Michael J. Miller. I am a Fellow of the Casualty Actuarial Society and a Member of the American Academy of Actuaries. My business address is 21253 N. 825 East Road, Carlock, Illinois.

In order to offer a public actuarial opinion, the actuarial profession requires more of an actuary than professional credentials. An actuary must also be experienced with the specific subject matter and be in compliance with the profession's continuing education requirements. I fully comply with the actuarial profession's experience and continuing education requirements.

I have practiced as a professional actuary for over thirty years with a special emphasis in ratemaking for auto and homeowners insurance. I co-authored in 2003 a major study pertaining to credit-based insurance scores entitled "The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity" (i.e., EPIC Study). A more complete summary of my education, training, and experience is set forth in the attached curriculum vitae (Exhibit I).

## **Overview**

Accurate risk assessment and risk differentiation are essential when insurance is being provided by multiple, competing insurers and the insureds are free to choose from among the multiple providers. Reliable studies have consistently shown that credit-based insurance scores enhance the accuracy of the risk assessment process. If the use of credit-based insurance scores were banned the result would be insurance rates that are inadequate for some insureds, excessive for other insureds, and unfairly discriminatory for all.

In July 2007 the Federal Trade Commission released a study of credit-based insurance scores as used for personal automobile insurance (i.e., FTC Study). The FTC study estimated that 59% of the national auto insured households benefit from reduced premiums due to the use of credit-based insurance scores. According to the FTC data, credit-based

insurance scores benefit nearly one-half the Hispanic racial group of insureds, approximately two-thirds of the Asian group, and over one-third of the African American group.

Although the percentage of insureds benefiting from the use of credit-based insurance scores is lowest among African Americans, the number of African Americans that do benefit is significant. Whether viewed as individual groups or viewed as a whole, it is clear that a banning of credit-based insurance scores would work to the disadvantage of many minority households throughout this country.

Concerns over the use of credit-based insurance scores arose several years ago before the facts were fully known. We now know with certainty that credit-based insurance scores enhance risk assessment and have a legitimate business purpose. We know that credit-based insurance scores cannot be used to accurately predict an insured's race or income. We know that the use of credit-based insurance scores works to the advantage of a significant number of racial minority households throughout this country.

What is not apparent is why, in the face of these facts, the use of credit-based insurance scores continues to be a political issue.

### **Ratemaking and Estimating Loss Propensity**

The essence of insurance is the transfer of risk. A commercial insurance enterprise does not involve a sharing of losses with other insureds, unless the insurance policy includes a post-assessment provision. An insurance consumer eliminates risk by choosing the certainty of the insurance premium versus the uncertainty of suffering a severe financial loss.

An insurance premium is a combination of the insured's expected loss, a provision for the insurer's expected operational/administrative expenses, and a provision for profit. An insured's expected loss is a function of the probability of a claim occurring (i.e., claim frequency or likelihood) and the average cost of the claim once it occurs (i.e., claim severity). For example, if an insured's likelihood of an auto collision claim is 10% per year and the average cost of a collision claim is expected to be \$1,000, the insured's expected loss is \$100 per year (i.e., 10% x \$1,000). Another insured with a claim likelihood of 12% and an

expected claim cost of \$1,000 would have an expected loss of \$120 per year (i.e., 12% x \$1,000). Since the expected loss is part of the calculated rate, the insurance premium charge for this second insured would be higher than the premium charge for the first insured because the expected loss for the second insured is higher.

An insured's expected loss is estimated based on a combination of several risk characteristics, or risk factors. Each risk factor has been found to measure and predict at least a portion of the total risk associated with each insured. For private passenger auto insurance, where the car is garaged and principally operated has been statistically shown to affect both the likelihood of claim occurrence and the cost of claims. Other important risk factors that are statistically correlated to the risk of auto insurance claims include age, gender, marital status, and driving record of the drivers; annual mileage and how the car is used (i.e., pleasure, commuting, or business); and the make and model of the car.

For homeowners insurance, the risk factors that are commonly used to estimate the expected loss include the estimated replacement cost of the house, the construction type of the house, the geographical location, and the age of the utilities.

No single risk factor has been found that measures or predicts the total risk. Typically, insurers rely on twenty or more risk factors to accurately estimate an insured's likelihood of a claim and the expected loss. All risk factors work in combination to measure and predict the total risk.

The EPIC Study of 2003 which I co-authored showed, and the FTC Study of 2007 confirmed, that credit-based insurance scores for personal auto insurance are strongly related to an insured's likelihood of claim occurrence and add significant accuracy to the risk assessment process. In other words, credit-based insurance scores measure risk not previously measured by other known rate factors. The strength of the statistical correlation is such that a credit-based insurance score is among the most important risk factors used by insurers to accurately estimate the probability of claim occurrence.

The EPIC Study found that a credit-based insurance score was among the top three most important risk factors for each of the four major auto insurance coverages. No researcher has yet been able to find an alternative risk factor that could replace a credit-based insurance

score as a predictor of claim likelihood without sacrificing a great deal of accuracy in the risk assessment process.

### **Causation**

Sometimes critics of the insurance industry complain that it is inappropriate to use a risk factor, such as a credit-based insurance score, because it does not “cause” an insured to have an auto accident or “cause” a homeowners insurance claim. If causation were a standard for the use of any specific risk factor, there would be no risk factors that could be used to predict and measure risk.

While understanding the causes of auto claim losses (e.g., inattention to driving, driving too fast, following too closely, etc.) and understanding the causes of homeowners claim losses (e.g., lightning strikes, wind storms, faulty wiring, ruptured washer supply hoses, etc.) may be of interest when attempting to reduce losses, non-causal factors are the more practical and powerful predictors of the probability of an insurance loss.

The classical example of a relationship to loss that is not a cause-and-effect relationship is a home built in a river valley. Living in a river valley does not “cause” a flood. But there is a predictive relationship between the risk of a flood loss and the construction of a home in a flood plain. It would be foolish to presume there is no risk of a flood loss merely because the location of the home does not “cause” the flood.

Many other examples of risk factors can be cited that do not cause accidents to occur. Neither past traffic violations nor past accidents “cause” future insurance losses, but there is a predictive relationship between past driving records and future losses. An age of the driver is not the cause of an accident, but it is predictive of the likelihood of a future accident. No predictive risk factor used in the risk assessment process can be said to actually cause an auto accident.

Causality should not be the basis for allowing or disallowing the use of credit-based insurance scores, just as it should not be the basis for allowing or disallowing all other risk factors. The basis for allowing the use of any risk factor should be the ability of the risk factor

to significantly contribute to the accurate measurement of the propensity for insurance losses.

It has long been a tenet of risk assessment that financial stability/responsibility was related to risk for private passenger automobile insurance. However, the concepts of financial stability and responsibility have been heretofore difficult to translate into objective, measurable risk factors. Credit-based insurance scores offer, for the first time, the means of objectively measuring the relationship between financial prudence and the propensity for insurance losses.

While it would be inconsistent with sound actuarial principles to require credit-based insurance scores to demonstrate a causal relationship, we could reasonably speculate that there are psychological factors that likely affect our adversity to risk and how we manage our personal lives. We could reasonably speculate that the results of these psychological tendencies can be observed in many aspects of our personal lives, including our credit history and insurance losses. Insurance scores may be providing an objective means of measuring personal responsibility and its effect on insurance losses, even though we may never fully understand the psychology involved.

Rather than speculate on what credit-based insurance scores are actually measuring, I would prefer to rely on the statistics. I fully recognize that statistical correlations can be spurious. Math statistical textbooks typically include warnings to math students that statistical correlations can be spurious. However, in the case of insurance scores there have been several studies published with analysts working independently, using different databases. All of the studies indicate the same conclusion. Credit-based insurance scores enhance the risk assessment process. It is highly unlikely that the statistically indicated correlation between credit-based insurance scores and insurance loss propensity is a spurious statistical relationship.

## **Unfairly Discriminatory Rates and Proxy Effect**

Rate regulatory laws throughout the United States consistently require that insurance rates not be unfairly discriminatory. This rate standard has a history in insurance literature and rate regulation that goes back in time over 150 years.

Traditionally, insurance rates have been considered to be unfairly discriminatory if there are premium differences that do not correspond to differences in expected losses and expenses, or if there are differences in expected losses and expenses that are not reflected in premium differences. Because credit-based insurance scores provide an important and accurate measurement of risk, it would be unfairly discriminatory to charge insurance premiums that ignored the differences in risk measured by these scores. Two insureds with significantly different insurance scores represent a significantly different risk of loss and as such it would be unfairly discriminatory to charge these two very different insureds the same premium.

In addition to studying the relationship of insurance scores and risk, the FTC also studied the relationship between credit-based insurance scores and race, ethnicity, national origin, and income. The FTC attempted to determine if differences in credit-based insurance scores were correlated to differences in insurance risk or whether the scores were merely a proxy for race or household income.

The FTC concluded:

- a. Credit-based insurance scores are effective predictors of risk under automobile policies.
- b. Credit-based insurance scores appear to have little effect as a proxy for membership in racial and ethnic groups in decisions related to insurance (emphasis added).

The FTC's use of the term "little effect" left the door open for the possibility that credit-based insurance scores did have some proxy effect, no matter how small, with respect to race and ethnicity. Based on its analysis the FTC estimated the proxy effect for African Americans to be +1.1% and for Hispanics to be +0.7%.

The FTC measured this purported proxy effect by comparing the average predicted risk derived from a model without controls for race to the average predicted risk for each racial group derived from a model with controls for race. In order to have any confidence that the small 1.1% and 0.7% proxy effects on risk are accurate and have any significance, the FTC needed to precisely control its analyses for all known risk factors other than race. Unfortunately, the FTC simply did not have a database that was refined enough to accurately identify such a small proxy effect of 1.0% or less.

The FTC acknowledged “that the large differences in average risk on comprehensive coverage for Hispanics and African Americans should be treated with some caution, as the geographic risk variable in the FTC database is not a very effective control for geographic variation in risk on comprehensive coverage” (emphasis added). I was directly involved in designing the database used by the FTC, exclusive of data concerning credit-based insurance scores, race, and household income. I advised the FTC that the geographic risk data were less than an ideal control for geographic variation in risk for the bodily injury coverage, as well as for the comprehensive coverage.

The way that the FTC grouped the data by age/gender/marital status, by tenure, by mileage, and by geography reduced the FTC’s ability to accurately control its statistical analysis for all known risk factors. The FTC’s problems with the traffic violations data also limited its ability to accurately measure a proxy effect. It is highly likely that the 1% and less proxy effect which the FTC ascribes to race would have disappeared entirely had the FTC been able to more accurately control the analysis for all known risk factors, especially the geographic risk factor.

To support this contention I would draw attention to the calculation of the proxy effect for the property damage liability coverage. The data used by the FTC to control for geographic risk for the property damage liability coverage was not ideal, but it was better geographic data than for any other coverage. Where the FTC could adequately control for geographic risk the FTC found “very little difference in the impact of credit-based insurance scores on predicted risk based on whether the model included controls for membership in a protected class”. In fact, the FTC found some evidence that inclusion of race in its model may be having an effect that was opposite a proxy effect for the property damage coverage (see FTC Study page 68). I suspect that if the FTC had been able to control for geographic risk as accurately



for all coverages as it did for the property damage liability coverage, all hints of a proxy effect would have disappeared, as was the case for the property damage coverage.

My primary criticism of the FTC Study is that readers were not properly warned as to the limitations of the data. The database was sufficiently refined to allow for general conclusions as to the ability of credit-based insurance scores to predict risk, both on an overall basis and within racial and income groups. The database was not sufficiently refined to allow for the measurement of a proxy effect that is as small as 1% or less.

In my opinion, the proper conclusion to be drawn from the FTC Study is that credit-based insurance scores are not proxies for race or income. Knowing someone's score provides no information, or even the basis for an educated guess, as to their race or income. If a small proxy effect does exist it is so small as to be unmeasurable by the FTC database. Surely the very small proxy effect hypothesized by the FTC, but not statistically proven, cannot invalidate an important risk factor that contributes significantly to the measurement of risk and benefits everyone by making insurance coverage more readily available.

### **California Rate Regulation**

Ratemaking regulations implemented in California subsequent to the passage in 1989 of Proposition 103 have limited insurers' abilities to implement accurate rate factors, thereby creating hidden cross-subsidies within the insured population. In California these hidden subsidies primarily benefit urban insureds and disadvantage rural insureds. California rate regulations also result in the disallowance of legitimate and necessary business expenses and limit the underwriting profit factors to amounts that are well below most insurers' true cost of equity capital.

California has imposed a ban on the use of credit-based insurance scores, apparently based on the mistaken notion that it is "protecting" low-income insureds and racial minority insureds. This ban actually creates significant and undesirable cross-subsidies. Many low-income insureds with better than average insurance scores are currently being required to subsidize relatively rich insureds with poor scores. Also, as shown by the FTC Study,

significant numbers of insureds within every racial minority group are being required to subsidize the cost of insurance for those of all races with below-average scores.

This arbitrary ban in California on insurance scores potentially creates, in my opinion, an undesirable change in the nature of competition. Rather than competing on price and competing to write as much business as is financially prudent, insurers will likely tend to turn to pre-screening marketing techniques and insurance will not be readily available for some insureds with above-average risk.

Critics of the insurance industry often contend that any restrictions on the risk assessment process, or arbitrary limits on rates, are justified as long as the insurance market has not completely collapsed through insurer withdrawals or insolvencies. In my career, I have seen rate regulation push the New Jersey personal insurance market towards collapse during the 1970's and 1980's. We may be seeing the same thing recurring now in the Florida homeowners insurance market. In my opinion, there is little in the California "experiment" with rate regulation that should be transported to other states. If all states copied California there would be no states left to provide subsidization and create the capital necessary for this industry to remain financially healthy for the benefit of every insured.

### **Federal Reserve Board Study**

In August 2007 the Federal Reserve Board (i.e., FRB) released its study of the impact of credit scoring on the availability and affordability of credit. There were both similarities and striking differences in the FRB's findings and the FTC's findings with regard to credit-based insurance scores.

The FRB found the mean credit score for Asians and non-Hispanic whites to be slightly above average. The mean score for Hispanics was 38% of the average and for African Americans it was 26% of the average. The FTC's findings with respect to the median insurance scores by racial group were strikingly similar to the FRB's findings.

Both the FRB and the FTC conducted multi-variant analyses of other known risk factors. In order to determine if the apparent differences in average scores by racial group were due to

race or due to other known risk factors, both the FRB and the FTC conducted a multi-variant analysis within each racial group. When the race is the same for all participants in the study, the FRB found that credit scores were predictive of credit risk and the FTC found that credit-based insurance scores were predictive of auto insurance losses. These findings prove that credit scores and credit-based insurance scores are not surrogates for race.

Unlike the FTC, the FRB recognized and discussed the fact that a practice applied uniformly to all applicants may not have a precisely uniform impact on all sub-groups. The FRB recognized that “courts and federal regulators of credit discrimination” have traditionally accepted some degree of differential impact if there is a “sufficient business justification” for the practice in question.

Unlike the FRB, the FTC mistakenly suggested that a small portion of the total risk being measured may be ascribed to race. The portion of risk mistakenly ascribed to race was the portion of the risk the FTC was unable to explain with other known risk factors. I have previously discussed in this testimony how the FTC failed to adequately control for geographic risk on three of the four major auto insurance coverages, and why what the FTC labeled as a “proxy for race” was nothing more than unexplained geographic risk.

***CURRICULUM VITAE***

**NAME:** Michael J. Miller

**BUSINESS ADDRESS:** 21253 N 825 East Road  
Carlock, IL 61725  
E-Mail: [mmiller@ask-epic.com](mailto:mmiller@ask-epic.com)

**EDUCATION:** ILLINOIS STATE UNIVERSITY  
Bachelor of Science – 1968  
Major – Mathematics  
Minor – Accounting

**CONTINUING EDUCATION:** Estimated study time exceeding 3,000 hours necessary for completion of 10 qualifying exams for membership in Casualty Actuarial Society (CAS).

Participation as an attendee and on the faculty of the CAS Loss Reserve Seminar, the CAS Ratemaking Seminar, and other CAS educational seminars on special topics, such as rate of return and underwriting practices.

Meet all continuing education requirements of the American Academy of Actuaries necessary to sign a public actuarial opinion.

**MEMBERSHIP IN PROFESSIONAL ORGANIZATIONS:**

Casualty Actuarial Society (CAS)	
Associate Member	1971
Fellow	1981
American Academy of Actuaries (AAA)	1975
Conference of Consulting Actuaries	2002-2004
Fellow	
International Actuarial Association	
Midwestern Actuarial Forum	
Chartered Life Underwriter (CLU)	

**PROFESSIONAL  
ACTIVITIES:**

CAS Committee on Risk Classification, Member	1982-1984
Chairman	1983-1984
CAS Committee on Principles of Ratemaking Member	1985-1987
Chairman	1991-1992
CAS Examination Consultant	1987-1990
CAS Long-Range Planning Committee	1993-1994 1997-2000
CAS Board of Directors	1992-1993 2001-2003
CAS Officer, Vice President – Research and Development	1993-1996
CAS Task Force on Non-Traditional Practice Areas Chairman	1998-2000
CAS/SOA Joint Task Force on Financial Engineers	1998-2001
AAA, Liaison Committee to the National Association of Insurance Commissioners	1985-1988
Actuarial Education and Research Fund Board of Directors	1994-1996
AAA, Casualty Practice Council	1990-1993
Property Casualty Committee of Actuarial Standards Board, Member	1987-1993
Chairman of Ratemaking Subcommittee	1987-1988
Chairman of Property/Casualty Committee	1989-1993
Midwestern Actuarial Forum Education Officer	1986-1987
President	1988

**EMPLOYMENT  
HISTORY:**

State Farm Insurance	1967-1984
M. J. Miller and Company	1984
Tillinghast	1984-1993
Miller, Herbers, Lehmann, & Associates, Inc.	1994-2002
EPIC Consulting, LLC	2003-Present

**PROFESSIONAL PUBLICATIONS:**

“Private Passenger Automobile Insurance Ratemaking”, Proceedings of CAS, Volume LXVI.

“Review – Risk Classification Standards by Walters”, Proceedings of CAS, Volume LXVIII.

“A History of the Rating and Regulation of Personal Car Insurance in the United States”, The Institute of Actuaries of Australia, February, 1990.

“An Evaluation of Surplus Allocation Methods Underlying Risk Based Capital Applications”, CAS Discussion Paper Program, Volume I, 1992.

“How to Successfully Manage the Pricing Decision Process”, CAS Discussion Paper Program, 1993.

“Building a Public Access PC-Based DFA Model”, CAS Forum, Summer 1997, Volume 2.

“Auto Choice: Whose Fault Is It Anyway”, Contingencies, January/February 1998

“Actuarial Implications of Texas Tort Reform”, CAS Forum, Spring 1998.

“The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity”, June 2003.

“Disparate Impact and Unfairly Discriminatory Insurance Rates”, CAS Call Paper Program, February 2009.

**PRESENTATIONS:**

Faculty member on National Association of Insurance Commissioners’ orientation program for new insurance commissioners, 1987-1994.

Faculty member on National Association of Independent Insurers’ seminars on ratemaking and loss reserving.

“Key Provision in Rate Filings”, Society of State Filers.

Numerous presentations at educational seminars and meetings conducted by the Casualty Actuarial Society on topics including ratemaking, loss reserving, underwriting, risk classification and rate of return.

**EXPERT TESTIMONY:**

Rate Regulatory Hearings in Alberta, California, Florida, Georgia, Louisiana, Maryland, Massachusetts, Michigan, Mississippi, New Brunswick, New Jersey, New York, North Carolina, Ohio, Oklahoma, Ontario, Pennsylvania, Texas, Vermont, West Virginia, and Wyoming.

Courts in Alabama, California, Florida, Minnesota, Mississippi, New Hampshire, Pennsylvania.

**Birny Birnbaum  
Center for Economic Justice**

**NAIC Hearing on Insurance Credit Scoring**

**April 30, 2009**

**Actuarial Considerations**

**The Role of Risk Classifications in the Insurance System**

Risk classifications are any factor used by an insurer to segment the population for purposes of determining whether to offer insurance, what terms and products to offer and what price to offer, whether that is called underwriting, tier placement or rating.

What is role of risk classification? Why not one average rate for everyone -- why not average rates for everyone?

1. Protect insurer financial condition by preventing or limiting adverse selection
2. Promote loss prevention / loss mitigation
3. Fairness in pricing -- group consumers of similar risk for purposes of assigning premium
4. Fairness in pricing -- rates based on characteristics society deems fair

Some risk classification is essential to prevent adverse selection, to provide incentives for loss prevention and meet basic **societal** standards of fairness and equity..

**Revolution in Risk Classification**

In recent years, risk classification has become more and more detailed, with more and more rate levels, more rating factors and more categories within rating factors. As risk classification becomes more and more detailed, the spread of prices increase as the cost for the most desirable policyholder goes down and the cost for the most undesirable policyholder goes up.

This has profound implication for the affordability of insurance because, inevitably, those consumers least able to afford insurance are the least desirable consumers for insurers and the ones facing higher and higher prices because of ultra risk classification.

Risk classification taken to the extreme is the end of insurance – a pay-as-you-go system in which those who pose no risk pay little or nothing and those who have a claim pay the cost of the claim.

Insurance credit scoring was the beginning of this revolution in risk classification because it was a massive database on a huge number of consumers that lent itself to the data mining necessary for refined risk classifications. That data mining / risk classification process has moved on to other consumer databases and other questionable risk classifications: education, occupation, prior liability limits, household composition, property-specific catastrophe and geographic rating, policy inquiries and surely others we do not know about.

### **Correlation Necessary, But Not Sufficient to Justify a Risk Classification**

The fact that a characteristic of the consumer, vehicle or property is associated with a difference in expenses or expected losses is a necessary, **but not sufficient**, justification for use as a risk classification.

For actuaries, the definition of fair or equitable is simply a difference in expected costs: Rates within a risk classification system would be considered equitable if differences in rates reflect material differences in expected cost for risk characteristics. In the context of rates, the word *fair* is often used in place of the word *equitable*.<sup>1</sup>

While this may be a sufficient definition of fair for insurers and actuaries, it is not sufficient for meeting public policy goals of insurance.

Just because insurers can find a characteristic that is correlated with expenses or expected losses does not mean that characteristic should or must be used.

Insurers themselves ignore or downplay risk factors demonstrably related to expected losses for their own business purposes – miles driven is a prime example – and yet the insurance system has not collapsed.

Insurers argue that failure to use insurance scoring will result in “low risk” consumers subsidizing “high risk” consumers.

**The purpose of insurance is to pool risks** – those with claims are subsidized by those without claims. The purpose of insurance is not to allocate costs to those who generate the costs, but to spread the risk and the costs across a pool of consumers. This is what makes it insurance and not a pay-as-you-go system.

---

<sup>1</sup> ASOP 12, 2005 Edition, Section 3.2.1. The original ASOP on Risk Classification, issued in 1989, Section 2.4, defined “Equitable or Fair—Appropriately reflecting differences among the costs of identifiable risk characteristics. The two terms are used interchangeably in this standard.”



Certain characteristics are not permitted – race, religion, national origin and in some states, marital status, credit information or being an elected official. They are not permitted because society does not believe these are proper bases for charging different insurance premiums – regardless of whether these characteristics are correlated with claims. We don't allow race-based life insurance premiums even though there is evidence that African Americans have shorter life expectancies than White Americans.

While we will argue that insurance scoring violates public policy and should be banned for that reason, it is clear that insurers' use of insurance scoring is not necessary, one, to protect insurer financial condition by preventing adverse selection, and two, to create a fair risk classification system.

It is not necessary because sufficient risk classification exists to protect insurer financial condition and prevent adverse selection. Insurance scoring not only does not prevent adverse selection – most consumers do not know that their credit information is used for underwriting or rating insurance – insurance scoring lends itself to adverse selection because it invites consumers to manipulate their credit score. The evidence of this is that there are no problems associated with the absence of credit scoring to be found in those states which ban credit scoring. In fact, insurers tout the new Massachusetts auto insurance regulatory regime – Progressive and GEICO have recently entered the market – despite a ban on insurance scoring. There are no problems in the California auto or Maryland homeowners markets attributable to these states' prohibition on insurance scoring.

Insurance scoring is not necessary to create a fair insurance system. A ban on insurance scoring does not prohibit insurers from using risk classifications that consumers understand and respond to for purpose of loss mitigation, like driving record, anti-theft devices, type of vehicle, catastrophe-resistant construction and many others.

Further, insurance scoring should be banned because it undermines the vital loss mitigation role of insurance. Insurance scoring provides no economic incentives for changing risky behavior; only economic signals to manipulate a credit report.

But beyond this, insurance scoring should be prohibited on purely actuarial grounds as unfairly discriminatory in the actuarial sense and in violation of actuarial standards of practice.

### **Insurance Scoring is Unfairly Discriminatory within Traditional Actuarial Standards and Should Be Prohibited by Regulators Using Existing Regulatory Authority**

First, it is important to state that actuarial standards are generally developed by actuaries who work for insurance companies and the effect of the standards is broaden the acceptable practices of actuaries rather than limit them.

Yet, even the actuaries, within the Actuarial Standard Of Practice (ASOP) 12 on Risk Classification, acknowledge the obvious – that a risk classification must be objectively and specifically identified:

3.2.3 Objectivity—The actuary should select risk characteristics that are capable of being objectively determined. A risk characteristic is objectively determinable if it is based on readily verifiable observable facts that cannot be easily manipulated. For example, a risk classification of “blindness” is not objective, whereas a risk classification of “vision corrected to no better than 20/100” is objective.

There is also a document called the “Risk Classification Statement of Principles,” which contains much the same guidance as the ASOP, but also includes a section on **controllability**.

Controllability refers to the ability of a risk to control its own characteristics as used in the risk classification system. While controllability is in many cases a desirable quality for a characteristic in a risk classification system to have, because of its close association with an effort to reduce hazards and the resulting general acceptability by the public, it can easily be associated with undesirable qualities, such as manipulation, impracticality and irrelevance to predictability of future costs.

Clearly, a risk classification that can be manipulated by the consumer is not objective or specifically identifiable. Further, if, for example, there are five categories of a particular risk classification, a consumer should be identified with one, and only one, category. If the categories for miles driven are 0 to 5,000; 5,001 to 7,500; 7,501 to 10,000; 10,001 to 12,500 and greater than 12,500, a consumer is eligible for one category only.

The risk classification categories must be mutually exclusive else the risk classification will be unfairly discriminatory in the actuarial sense – it will cause consumers of similar expected risk to be treated differently or cause consumers of different expected risk to be treated the same.

For example, a risk classification based on hair – length, color, thickness – would not be actuarially sound because a consumer could manipulate his or her hair – by cutting it, coloring it, treating it, having hair transplants, putting on a wig. And the hair could change over time – brown one day, grey a few weeks later.

Insurance scoring violates actuarial standards of practice because the risk classification is not objectively and specifically determinable and because it is subject to manipulation. Insurance scoring is unfairly discriminatory for the following specific reasons and should be prohibited by regulators under existing statutory authority.

#### Not Objective

1. Differences across credit bureaus
2. Differences within a credit bureau due to lender choices
3. Changes in definitions of credit report items – bankruptcy law change
4. Public policy initiatives changing credit scores – moratorium on foreclosures
5. Lack of information – 25% of reports contain insufficient information for scoring, clearly that 25% of population have a variety of risk characteristics
6. Timing of report – balance to limits varies by time of the month
7. Decisions of lenders – not reporting limits, changing limits

#### Manipulation

1. Invitations/Solicitations for Manipulation
2. Piggy-Back on another consumer
3. Shift balances from one car to multiple cards

#### Penalize Consumer for Rational Behavior

1. Shop around for best rates
2. Cancel a card when lender acts unfairly
3. Get a card to get 10% first visit discount

#### Impact of Economic Conditions / Model Versions

1. Miles driven: fewer miles driven means less exposure regardless of economic conditions
2. Delinquency: means something different in 2008 than in 2004 – FICO has updated its credit scoring model (FICO 08) to address the fact that its scoring model did not work well in predicting defaults and subprime crisis.

#### Multiple Models

1. Modelers produce multiple auto and homeowners models: Preferred Auto Minimum Limits; Preferred Auto Greater Than Minimum Limits, Standard Auto Minimum Limits, Standard Auto Greater Than Minimum Limits, Non-Standard Auto.
2. Consumer outcomes can vary based on which model the consumer is channeled into.

### **Accident Frequencies Decline as Credit Scores Worsen**

There is strong evidence that insurance scoring itself is not a predictor of risk or insurance claims, but, rather, that insurance scoring is a proxy for some other factor or factors that are truly related to claim experience.

If a risk classification is truly related to claims, we expect to see that relationship hold over time and as the incidence of the risk classification in the population increases or decreases. For example, we know that fewer miles driven means, on average, less exposure to accidents and claims, while more miles driven means more exposure. If there is a significant increase or decrease in miles driven, we expect to see fewer claims.

We know that youthful drivers are more likely to be in auto accidents than drivers with greater experience. This insight has led to graduated licensing programs and a resulting reduction in youthful driver accidents. But, if the percentage of youthful drivers in the population were, for example, to double from 10% to 20% with a couple of years, there is no doubt that the overall population frequency of accidents would increase.

With insurance scoring, we do not see the relationship between credit scores and claims hold over time. Over the past two years, credit scores have suffered because of:

- an increase in loan delinquencies
- an increase in mortgage defaults
- an increase in foreclosures
- an increase in bankruptcies
- an increase in debt to limits ratios because of lenders slashing credit limits and unemployment
- an inability to tap home equity due to negative equity and tightened lending standards

All these economic results impact credit scores – payment history, public records, balance to limits ratios.

If credit scoring were truly related to the likelihood of filing a claim, then during this unprecedented period of financial stress on consumers, we would expect to see an increase in claims. Stated differently, just as we would expect an increase in claims if the percentage of youthful drivers in the population increased rapidly, we would expect an increase in claims if the percentage of consumers in the population with poor credit scores increased.

Yet, during this period of worsening credit scores, auto claim frequency has declined. The Insurance Services Office reports the following changes in claim frequency from first quarter 2006 through fourth quarter 2008:

Bodily Injury Total Limits	-10%
Property Damage Liability	-5%
Personal Injury Protection	-15%
Collision	-2%
Comprehensive	-13%

## **The Missouri, Texas and FTC Studies**

### The Missouri Department of Insurance Study

The Missouri Department of Insurance released a study that specifically examined the impact of insurance credit scoring on the availability of insurance coverage in poor and minority communities. This was the first independent study based on detailed insurance credit scoring data using rigorous statistical analysis. The Department collected credit score data aggregated at the ZIP Code level from 12 insurers for the study period of 1999 to 2001. For each Missouri ZIP Code, the Department obtained:

- Mean credit score
- The number of exposures for each of five equal credit score intervals

The Department then utilized a variety of multi-variate statistical techniques to isolate the relationship of income and race to insurance credit scoring, independent of other factors. The study found:

- ***The insurance credit-scoring system produces significantly worse scores for residents of high-minority ZIP Codes.*** The average credit score rank in “all minority” areas stood at 18.4 (of a possible 100) compared to 57.3 in “no minority” neighborhoods – a gap of 38.9 points. This study also examined the percentage of minority and white policyholders in the lower three quintiles of credit score ranges; minorities were overrepresented in this worst credit score group by 26.2 percentage points.
- ***The insurance credit-scoring systems produces [sic] significantly worse scores for residents of low-income ZIP Code.*** The gap in average credit scores between communities with \$10,953 and \$25,924 in *per capita* income (representing the poorest and wealthiest 5 percent of communities) was 12.8 percentiles. Policyholders in low-income communities were overrepresented in the worst credit score group by 7.4 percentage points compared to higher income neighborhoods.

- ***The relationship between minority concentration in a ZIP Code and credit scores remained after eliminating a broad array of socioeconomic variables, such as income, educational attainment, marital status and unemployment rates, as possible causes.*** Indeed, minority concentration proved to be the single most reliable predictor of credit scores.
- ***Minority and low-income individuals were significantly more likely to have worse credit scores than wealthier individuals and non-minorities.*** The average gap between minorities and non-minorities with poor scores was 28.9 percentage points. The gap between individuals whose family income was below the statewide median versus those with family incomes above the median was 29.2 percentage points.

Based upon the results of this study, the former Governor of Missouri has called for a ban on insurance credit scoring.

#### The Texas Department of Insurance Preliminary Report

The Texas Department of Insurance (TDI) reviewed over 2 million policyholder records and obtained policyholder-specific information on race. The TDI report, issued in the beginning of January 2005, states unequivocally that insurance credit scoring discriminates against minority consumers:

The individual policyholder data shows a consistent pattern of differences in credit scores among the different racial/ethnic groups. The average credit scores for Whites and Asians are better than those for Blacks and Hispanics. In addition, Blacks and Hispanics tend to be over-represented in the worse credit score categories and under-represented in the better credit score categories.<sup>2</sup>

The TDI study confirms and validates the Missouri Department of Insurance (MDI) study. Insurers complained about the Missouri study because it inferred socio-economic characteristics from ZIP Codes to average credit scores. But the MDI methodology is well accepted in the field of fair lending analysis. The TDI study not only confirms the MDI study results – it validates the MDI methodology.

---

<sup>2</sup> Texas Department of Insurance, “Report to the 79<sup>th</sup> Legislature: Use of Credit Information in Texas,” December 30, 2004, page 3.

### The FTC Study

Mandated by Congress, the Federal Trade Commission conducted a study of insurance credit scoring for auto insurance. The study was flawed, biased and unreliable for many reasons, some of which are listed below. But even this flawed report on insurance scoring – despite relying upon data hand-picked by the insurance industry – found insurance scores were worse on average for African-Americans and Hispanics and that insurance scoring was a proxy for race. And had the FTC actually used an independent and comprehensive set of insurance data, the measured racial discrimination would have been much greater.

The FTC used only data on policies secretly selected by insurers. No data on applications that did not result in policies were obtained or analyzed. Consequently, consumers who were priced out of the market for the handful of insurers included in the study because of insurance scoring did not get counted or analyzed. It is certain that this population was disproportionately minority.

The FTC analysis of insurance scoring is deeply flawed and the report is unresponsive to its Congressional mandate. The problems include:

1. The failure to obtain a comprehensive and independent data set for analysis and the reliance upon a data set hand-picked by the insurance industry. The insurance industry effectively controlled the study by dictating the data that would be used in the study.
2. No substantive analysis of the impact of insurance scoring on the availability and affordability of insurance products as requested by Congress. Because of its reliance on industry-selected data, the FTC performed no analysis of how consumers actually fared from insurers' use of credit scoring.
3. Regurgitating insurer claims about credit scoring despite evidence that contradicts these claims. The FTC ignored evidence indicating that the correlation between insurance scores and claims was a spurious correlation – that insurance scoring was a proxy for some other factor actually related to claims.
4. The failure to analyze the "blaming-the-victim" strategy used by insurers to justify insurance scoring -- the bogus claim that people who manage their finances well are likely to manage their risks well and that's why credit scoring works. The fact is that, by the credit modelers own admission, fully 20% of the population is unscorable with tradition credit reports because of little or no information in the files. These folks are disproportionately low income and minority consumers who get charged higher rates through no fault

of their own. And even a cursory examination of actual scoring models reveals that most of the factors determining an insurance score have nothing to do with whether a consumer pays her bill on time, but with factors related to socio-economic status. Yet, the FTC report dutifully repeats this desperate rationalization for insurance scoring with no critical analysis.

5. The failure to examine any alternatives to insurance scoring that are predictive of claims but are not based on any consumer credit information. The FTC ignored research indicating that insurers could eliminate the use of credit information but obtain the same ability to predict claims with advanced modeling and data mining of traditional rating factors. Consequently, the FTC ignored an obvious alternative to insurance scoring that could reduce the impact on low income and minority consumers.





## Consumer Federation of America

1620 I Street, N.W., Suite 200 \* Washington, DC 20006

### **Comments by J. Robert Hunter, FCAS, MAAA<sup>1</sup> on “Some of the Reasons Why Credit Scoring is Actuarially Unsound”**

I am Bob Hunter, Director of Insurance for the Consumer Federation of America.

Actuaries who, for the most part, work directly or indirectly for insurance companies developed the actuarial standards published by the actuarial associations. While most of the people who participate on actuarial committees are fine people, they have a point of view that is very much reflective of their training and their employers' point of view. Few of the developers of the standards have experience thinking about insurance issues from the consumer point of view. Thus, the standards have an insurer-bias and minimize restrictions on freedom of action of both the actuary and their employers.

Because of this “flexibility” I have been in many rate and other public hearings where the actuaries, all claiming to fully adhere to the standards, come out with wildly different recommendations.

Regulators should develop their own impartial standards to define “actuarial soundness.”

But even with this bias toward allowing everything to pass muster, Credit Scoring is Actuarially Unsound for Several Reasons.

Here are a few of the reasons:

- Credit scores are subject to manipulation, for example by services promising vast improvements in a person's score
- Credit scores are not based on a plausible (logical) relationship to risk and is thus obscure and irrelevant to the insurance provided.
- Credit scores are not objective because of how scores vary between credit bureaus, how lender decisions impact a score, how definitions of such key items as “bankruptcy” vary over time and other reasons.
- Credit scores are not supportive of the hazard reduction incentives of a sound class system; indeed, it undermines such incentives

---

<sup>1</sup> Mr. Hunter is Director of Insurance for Consumer Federation of America and formerly served as Texas Insurance Commissioner and Administrator of the Federal Insurance Administration.

- Credit scores are a proxy for income and race, which actuaries know are prohibited criteria that should not be used, even in a back-door fashion.

To expand a bit:

Credit scoring is not objective because:

1. There are sharp differences for the same insured across the three credit bureaus. CFA's study of 500,000 credit reports for individuals found that consistent results (within 20 points) for all three repositories only happened 21 percent of the time. Errors were widespread, with 22 percent of people getting too low a score and the same percentage, 22 percent, receiving too high a score, which represents a 44 percent error rate. This research involved only one price break regarding the score needed to obtain the best credit terms, not the 50 rate tiers that some insurers use. Obviously it is likely that a large number of insurance applicants are not properly rated for insurance using credit score.
2. There are differences within a credit bureau due to lender choices of how to report and if to report information.
3. There are changes in definitions of key credit report items – bankruptcy law change is an example.
4. There are public policy initiatives changing credit scores – for example, a moratorium on foreclosures
5. There is a lack of information for many people – 25% of reports contain insufficient information for scoring, clearly that 25% of population have a variety of risk characteristics and are not the same from a risk standpoint.
6. The timing of report can change the result – the balance to limits item varies by time of the month
7. Decisions of lenders can impact the result – not reporting high limits to not alert competitors that a person is a good credit risk is an example.

Credit scores can be manipulated. Here is a couple of ways that happens:

1. A consumer receives a solicitation for manipulation from a service offering to raise your score by 100 points in 24 hours.
2. One consumer Piggy-Backs on another consumer
3. The consumer shifts balances from one card to multiple cards

Credit scores can penalize a consumer for rational behavior, for example:

1. When a consumer shops around for best rates
2. When a consumer cancels a card when lender acts unfairly

In my testimony, I comment on several excerpts from the American Academy of Actuaries “Risk Classification Statement of Principles,” showing some of the reasons that

credit scoring is actuarially unsound, even using a document developed by industry-oriented actuaries.

The Statement of Principles says an actuarially sound class system groups “risks with similar risk characteristics” together based on “relevant” factors. The statement goes on to say that “Risk classification characteristics should be neither obscure nor irrelevant to the insurance provided...” and that there must be a “plausible relationship between the characteristics of a class and the hazard insured against.”

The problem is that insurers cannot tell us what it is about a credit score that is linked with risk. They have merely a correlation to lean on, not a logical thesis underpinning the correlation. This is data mining at its worst and, because of the lack of any underlying rationale; the use of credit scoring in insurance is obscure to the insurance provided and therefore actuarially unsound.

Some actuaries have said that a thesis is not required because actuarial principles state that a cause and effect relationship is not required. While this is true, the principles also say that a “plausible relationship between the characteristics of a class and the hazard insured against.”—a logical underpinning for the use of the information -- is required.

Here is the key quote from the Causation Section of the Principles:

Often causality is not used in its rigorous sense of cause and effect but in a general sense, implying the existence of a plausible relationship between the characteristics of a class and the hazard insured against... Risk classification characteristics should be neither obscure nor irrelevant to the insurance provided; but they need not always exhibit a cause and effect relationship.<sup>2</sup>

Credit scoring is at best obscure relative to auto and home insurance, and probably is downright irrelevant.

Since there is no plausible logical basis underlying credit scoring, since it can be manipulated and since it is not objective the classification violates actuarial principles.

The rest of this testimony shows selected excerpts from the Statement of Principles along with comments as to why credit scoring violates the quoted material.

**EXCERPTS FROM “RISK CLASSIFICATION STATEMENT OF PRINCIPLES”  
of the American Academy of Actuaries Committee on Risk Classification<sup>3</sup>**

---

<sup>2</sup> Risk Classification Statement of Principles, American Academy of Actuaries Committee on Risk Classification, at <http://actuarialstandardsboard.org/pdf/appendices/risk.pdf>.

<sup>3</sup> Risk Classification Statement of Principles, American Academy of Actuaries Committee on Risk Classification, at <http://actuarialstandardsboard.org/pdf/appendices/risk.pdf>.

### Statement from the “Summary” Section of the Statement of Principles

*The grouping of risks with similar risk characteristics for the purpose of setting prices is a fundamental precept of any workable private, voluntary insurance system. This process, called risk classification, is necessary to maintain a financially sound and equitable system.*

*The following basic principles should be present in any sound risk classification system in order to achieve the above purposes:*

- \* The system should reflect expected cost differences.*
- \* The system should distinguish among risks on the basis of relevant cost-related factors.*
- \* The system should be applied objectively.*
- \* The system should be practical and cost-effective.*
- \* The system should be acceptable to the public.*

### CFA Comment

There is no reason to believe that a person’s credit score is a “relevant” factor in measuring risk. Nor does the use of credit scores place “risks of similar risk characteristics” into each class slot. Grouping people by credit score is arbitrary and not based upon any logical connection between credit score and insurance risk. I will discuss the lack of a logical basis or “thesis” for credit scoring at some length under “Causation” below. Credit scores are not “relevant cost related factors.”

Credit scoring is not objective since, as I discuss below, credit scores are error-laden and subject to manipulation.

There is serious question about the acceptability to the public of the use of insurance scoring as discussed below. The rash of state legislative attempts to ban or otherwise control the practice measures the concern of the public.

### Statement from the “Considerations in Designing a Risk Classification System” Section of the Statement of Principles

#### *Program Design*

1. *Degree of Choice Available to the Buyer*  
*The design of a risk classification system is affected by the degree to which the insurance program is compulsory or voluntary. For programs which are largely or entirely compulsory and where there is no voluntary choice among competing institutions, broad classifications are sometimes used, the extreme being a single class.*

### CFA Comment

Credit scoring is used particularly in home and auto insurance, which are not voluntary purchases for consumers given lender and state purchase requirements. This creates many tiers of prices, sometimes more than 50 tiers, resulting in very narrow classes, with some slots having few or even no people in the class.

*Program Design – Cont'd*

#### *5. Absence of Ambiguity*

*The definition of classes should be clear and objective. Once a factual assessment of an individual risk has been made, no ambiguity should exist concerning the class to which that risk belongs. The classes should be collectively exhaustive and mutually exclusive.*

#### *6. Manipulation*

*The system should minimize the ability to manipulate or misrepresent a risk's characteristics so as to affect the class to which it is assigned.*

#### CFA Comment

Credit scoring is not clear and objective and, thus, ambiguous. Scores vary between the three repositories, for instance, so an insurance price could depend on which credit repository the insurer chooses. Errors in the credit score abound, as CFA's research into 500,000 credit scores showed. Consistent results (within 20 points) for all three repositories only happened 21 percent of the time in our research. Errors were widespread, with 22 percent of credit reports surveyed receiving a score that was lower than they should have received and the same percentage, 22 percent, receiving too high a score, which represents a 44 percent error rate. This research was involved only one price break regarding the score needed to obtain the best credit terms, not the 50 rate tiers that some insurers use. Obviously it is likely that a large number of insurance applicants are not properly rated using credit scores.

As to manipulation, just type "Service to Improve Credit Score" into Google and you get over 27 million results. Some services promise such results as these promises:

Don't be surprised if you save 27% on your auto insurance alone!  
(RepairYourBadCredit.com)

Increase your credit score 61 pts. in 30 days? (YourCreditAttorney.com)

Legally Raise Credit Score 100 pts. in 30 days. (ecreditattorney.com)

How I raised my credit score 40 pts. in 24 hrs. and saved \$8,000!  
(thebestever/credit)

Statement from the "Hazard Reduction Incentives" Section of the Statement of Principles

*Risk classification systems can be designed to provide incentive for insureds to act to reduce expected losses and thus operate to reduce the overall costs of insurance in total. For example, recognizing sprinklers for classifying risks for fire insurance coverages may encourage their installation and thereby reduce expected losses. Or reduced life insurance prices for non-smokers may encourage people not to smoke, thus reducing the hazard of premature death caused by diseases linked to smoking.*

*Such incentives are desirable, but not necessary, features of a risk classification system. Although worth pursuing, it must be recognized there are limits to which a risk classification system can be extended in an attempt to solve society's problems and still serve the necessary and useful purposes for which such a system is designed.*

CFA Comment

Use of credit scoring not only does not advance the goal of hazard reduction, it actively undermines it. Credit scoring has a major impact on price, often more impact than classes with a clear hazard reduction incentive, such as driving record or miles driven. Consumers do not understand what credit scoring has to do with their ability to drive well or be a safe homeowner. (In fact, neither do the designers and users of credit scoring in insurance) When consumers realize that their good driving does not mean as much as credit scoring, it frustrates them and undermines safety efforts.

Statement from the "Public Acceptability" Section of the Statement of Principles

*Any risk classification system must recognize the values of the society in which it is to operate. This is a particularly difficult principle to apply in practice, because social values:*

- \* are difficult to ascertain;*
- \* vary among segments of the society; and*
- \* change over time.*

*The following are some major public acceptability considerations affecting risk classification systems:*

*They should not differentiate unfairly among risks.*

*\* They should be based upon clearly relevant data.*

*\* They should respect personal privacy.*

*\* They should be structured so that the risks tend to identify naturally with their*

*classification.*

*Laws, regulations and public opinion all constrain risk classification systems within broad social acceptability guidelines. Legislative and regulatory restrictions on risk classification systems must balance a desire for increased public acceptability with potential economic side effects of adverse selection or market dislocation.*

### CFA Comment

Credit scores fail miserably in meeting the cited “public acceptability considerations.” Credit scores differentiate unfairly between risks because of errors placing at least 50% of applicants in the wrong tier and because richer people are less likely to be in credit difficulty and, if they are, are more likely to be able to afford a service to manipulate the results in their favor. Further, credit score is a proxy for income and race, as many studies, cited in the NAIC draft report, make clear.

Credit scores as a class are not based on relevant data. A credit score has nothing to do with insurance risk. A credit score has to do with financial history and fortunate or unfortunate circumstances. A specific score has nothing to do with driving capacity or ability to be safe in a home.

Using credit information to price insurance violates privacy. The intent seems more to find rich people than safe people.

It is laughable to think that credit scores are “structured so that risks tend to identify naturally with their classification.” If I have a score of 600, what does that say about my identification with another person with a 600 score? Do I feel a kinship with the 600 score people? Think of the myriad ways one can build such a score. How does that number create an identity?

The statement requires actuaries to follow the law. All state laws disapprove of classes that are unfair. Credit scoring is unfair for insurance purposes and questionable even for some credit purposes. People with a certain credit score may be in the category because of vastly different reasons. Consider these facts:

- A person’s credit report can vary dramatically among the three major credit bureaus, so a credit score can vary significantly depending upon which bureau provided the insurer with information.
- A credit score can vary depending on what time in the month your credit report was ordered.

- A credit score depends on the type of credit you have, meaning that a person can have a low score even with a perfect payment record. A credit card with some companies, obtaining a loan from a consumer finance company, or having an installment plan from a car dealer, may lead to a lower score regardless of your payment record.
- A credit score depends on the presence of loan information, so a person will receive a lower score for paying in cash.
- A lower score can occur if a person does not borrow much or uses lenders that don't report to credit bureaus.
- Because the ratio of the amount of debt relative to a credit card limit, a consumer who uses one of her four credit cards to maximize frequent flier miles gets a lower score than another consumer who charges the same amount but does it over all four cards.

These oddities put people with different credit risks into the same credit score categories, making credit scoring questionable even for some credit purposes. Relying on this information to make decisions about granting or rating insurance coverage compounds the unfairness.

Statement from the "Causality" Section of the Statement of Principles

*Scientists seek to infer some cause and effect relationship in natural phenomena, in order to attempt to understand and to predict. It is philosophically satisfying to some when data exhibit such a cause and effect relationship.*

*Risk classification systems provide a framework of information which can be used to understand and predict future insurance costs. If a cause and effect relationship can be established, this tends to boost confidence that such information is useful in predicting the future and will produce some stability of results. Thus classification characteristics may be more acceptable to the public if there is a demonstrable cause and effect relationship between the risk characteristics and expected costs.*

*However, in insurance it is often impossible to prove statistically any postulated cause and effect relationship. Causality cannot, therefore, be made a requirement for risk classification systems.*

*Often causality is not used in its rigorous sense of cause and effect but in a general sense, implying the existence of a plausible relationship between the characteristics of a class and the hazard insured against. Living in a river valley would not seem to cause a flood insurance claim, but it does bear a reasonable*



*relationship to the hazard insured against and thus would be a reasonable basis for classification.*

*Risk classification characteristics should be neither obscure nor irrelevant to the insurance provided; but they need not always exhibit a cause and effect relationship.*

### CFA Comment

This may be the most important reason why the use of credit scoring is actuarially unsound. I call the insurer argument the “Causation Myth” – that asking for a “plausible relationship between the class and the hazard insured against” is not required because asking for such a relationship is akin to asking for a cause and effect test.

Obviously, the Actuarial Standards discriminate between a plausible relationship and cause and effect. The Standards thus require that there be a plausible relationship and that the relationship be “neither obscure nor irrelevant to the insurance provided.”

The problem is that insurers cannot tell us what it is about a credit score that is linked with risk. I have asked the proponents of the use of credit scoring to explain to the world why a person who suffered a decline in credit as a result of being in Hurricane Katrina or lost her job because of outsourcing or lost his job in the current economic downturn is suddenly a worse auto or home insurance risk? They do not have a credible response or they guess that maybe it is in the human genome. Often they say the person with a poor credit score might be sloppy and that this carries over into driving or housekeeping. But they only guess, they have no real logical, plausible basis for use of credit score in insurance. What they have is merely a correlation to lean on, not a logical thesis underpinning the correlation. This is data mining at its worst, which means that the use of credit scoring in insurance is actuarially unsound.

Unlike insurance classifications that were in use before credit scoring was adopted, this classifier is not based on an appropriate thesis, confirmed by a statistical analysis. In fact, there is no legitimate thesis for the use of credit scoring. There is only an alleged correlation based on proprietary information not open to public scrutiny.<sup>4</sup> However, a correlation in search of an appropriate thesis raises serious questions about the classification that is being used.

---

<sup>4</sup> This is another difference from all previous classes where the data are public and part of rate filings made with insurance departments. Previously, an insurer would propound a thesis and test it with the data. If a thesis was confirmed, the insurer would file for a new class with the commissioner showing the thesis and the data in the rate filing. An example was the use of accidents and tickets. The thesis was that people with more accidents and tickets would be worse drivers in the future because their historic driving record indicated less care in driving. The thesis was confirmed by data that can be viewed in its' entirety in rate filings.

The lack of a thesis means that credit scoring violates actuarial principles. Some actuaries say that a thesis is not required because actuarial principles state that a cause and effect relationship is not required. Although this is true, the principles, which were developed by a group of excellent but mostly industry-employed actuaries and therefore holding an overwhelmingly industry-oriented point of view, also say that a thesis -- a logical underpinning for the use of the information -- is required.

Let me repeat the key part of the “Causation” Section of the Principles:

Often causality is not used in its rigorous sense of cause and effect but in a general sense, implying the existence of a plausible relationship between the characteristics of a class and the hazard insured against... Risk classification characteristics should be neither obscure nor irrelevant to the insurance provided; but they need not always exhibit a cause and effect relationship.<sup>5</sup>

Credit scoring is at best obscure relative to auto and home insurance, and probably is downright irrelevant. Since there is no clear relationship, no thesis, underlying credit scoring, the classification violates actuarial principles.<sup>6</sup>

*Statement from the “Controllability” Section of the Statement of Principles*

*Controllability refers to the ability of a risk to control its own characteristics as used in the risk classification system. While controllability is in many cases a desirable quality for a characteristic in a risk classification system to have, because of its close association with an effort to reduce hazards and the resulting general acceptability by the public, it can easily be associated with undesirable qualities, such as manipulation, impracticality and irrelevance to predictability of future costs.*

**CFA Comment**

We have already pointed out the easy manipulation possible in the use of credit scores in insurance and the irrelevance of the class. So, it is clear that the downside of controllability exists in credit scoring.

The upside, the incentive of a class to reduce hazard is wholly missing in the use of credit scores. Indeed, as noted above, its use undermines safety incentives by making driving record, miles driven, alarm systems, deadbolts and other safety-related classes less important in the development of the final price.

---

<sup>5</sup> Risk Classification Statement of Principles, American Academy of Actuaries Committee on Risk Classification, at <http://actuarialstandardsboard.org/pdf/appendices/risk.pdf>.

<sup>6</sup> There are other actuarial principles that credit scoring violates as well, including the fact that it is not socially acceptable, is subject to manipulation (there are firms that offer, for a fee, to sharply improve your score) and is ambiguous.

**STATEMENT  
OF  
AMERICAN INSURANCE ASSOCIATION  
ON  
CREDIT-BASED INSURANCE SCORING  
NAIC HEARING**

**APRIL 30, 2009**

**David F. Snyder  
Vice President & Associate General Counsel  
Public Policy  
American Insurance Association  
2101 L Street, NW Suite 400  
Washington, DC 20036  
dsnyder@aiadc.org**

# STATEMENT OF AMERICAN INSURANCE ASSOCIATION ON CREDIT-BASED INSURANCE SCORING

**NAIC HEARING  
APRIL 30, 2009**

Personal lines of insurance are performing very well by objective measures, whether you are a consumer, company or producer. Prices are largely stable, even down in many states. Companies are well capitalized and aggressively marketing their products. Residual markets have shrunk to historic lows. In most areas there are dozens of companies offering personal insurance through a wide variety of distribution channels, including independent and captive agents, the internet and telephone.

This favorable personal lines experience for all concerned has resulted from insurers pricing insurance based on risk, instead of ignoring it, a major cause of the financial turmoil among lenders. Credit-based insurance scoring (CBIS) has played a key role in maintaining this risk based pricing and in producing the favorable – for all parties – competitive personal lines market conditions we see today. As compared to the millions of annual personal lines underwriting and rating transactions, CBIS complaints are scant. Over-regulating, or worse yet banning, insurance scoring, would disrupt the property and casualty insurance market in the US, severing, as it would the link between risk and pricing of personal insurance and eliminating a cost/effective tool that has enabled competition.

## **Today's Personal Lines Market Is Performing Well By Every Measure.**

### Automobile Insurance.

Voluntary insurance has kept up with consumer demand and the residual markets have dropped, all good signs of a healthy competitive market. From 1995-2005, the total number of new cars insured increased 32%, the voluntary car years increased 36% while the residual market car years dropped 60% and the residual market as a percentage of the total market declined 70%.

From 1994 to 2008, the auto insurance CPI increase of 49.1% is only slightly above food and beverages, electricity and all items. It was significantly below energy (126.3%), medical care (72.5%) professional services (61.5%) and housing (49.4%). Auto insurance costs actually declined as a percentage of personal income from 1995 to 2006, a long term trend that we expect continued through 2008.

Finally, according to a widely used measure of market concentration, the Herfindahl-Hirschman Index (HHI) where a "not concentrated" market is a rating under 1000, the auto insurance market is quite competitive at 651, with 326 insurers writing in 2007.

### Homeowners Insurance

The performance of homeowners insurance is still by and large quite favorable for consumers. It increased marginally as a percentage of family income from .81% to 1.09%. However, this small increase can be explained by increases in catastrophe prone areas and other factors such as increases in insured values. Despite recent real estate declines,

housing prices and insured values are still significantly higher than a decade ago. Even with the marginal shift of less than two-tenths of one percent, renters and household insurance increased, from 1999-2008, at a rate far lower than energy, medical care, professional services, and for “all consumer items” measured by the CPI. The property insurance residual markets in many states are less than 1%, but the overall averages are skewed by a few catastrophe-prone states. In fact, 4 states have 82% of the nationwide FAIR Plan exposures.

Homeowners insurance is also quite competitive. Using the HHI, homeowners scores 759 (again, anything under 1000 is “not concentrated”). Nationally there were 369 companies writing this business.

### **Competition Made Possible By CBIS Helps Promote Availability and Affordability.**

The emergence of CBIS, an objective rating and underwriting tool, has enhanced both availability and affordability. Many government studies demonstrate that the factor is a good predictor of risk and has assisted with affordability. The percentages range from the FTC’s estimate that 59% of policyholders save as a result of CBIS use, to much higher percentages for some companies.

Beyond affordability, the existence of a highly cost effective tool has allowed companies to continue to write coverage and to increase their writings. This has improved availability. For some companies, this means they can write virtually every risk with confidence that they have more accurately identified and priced for risk. The resulting competition helps put pressure on lowering prices and offers consumers more choices.

### **Credible Evidence That Widespread Harm To Consumers Resulting From CBIS Use In The Current Economic Conditions Is Lacking—Indeed There Is Evidence That Such Harm Is Not Occurring.**

One of the questions the NAIC is asked as it framed this hearing was whether the current economic conditions have caused widespread consumer difficulties due to insurers’ use of CBIS. Fortunately, it does not appear that they have.

Credit scores do not seem to be declining en masse despite the current down economy. Fair Isaac Corp. (now known formally as FICO) has reported that in their recent studies, CBIS “have remained virtually the same for the general population” and “more and more consumers appear to be realizing the value of prudent financial and credit management practices.”<sup>1</sup> Additionally, FICO found in an analysis of impact on consumer scores due to lenders’ decisions to decrease some customers credit limits that “[T]he median FICO score for the national population did not change between April 2008 and October 2008 (based on Equifax data alone, the national median FICO score remained 713).”<sup>2</sup> Experian’s “National Score Index” report from September 2008 showed that 58 percent of Americans have credit scores above 700 and the national average is 680. A “good” credit scores is considered anything over 700.<sup>3</sup>

The vast majority of states, NCOIL and the NAIC have all acted responsibly in balancing the market value of CBIS with the need to assure the factor is not over-used. The industry, as

---

<sup>1</sup> “Fair Isaac Credit-Based Insurance Scores” message document, January 2009

<sup>2</sup> “Study: How Credit Line Decreases Can Affect FICO® Scores”; see: <http://www.fico.com/en/Company/News/Pages/study-findings.aspx> for more information

<sup>3</sup> See: <http://www.nationalscoreindex.com/> for more information

well, has used it responsibly. Today, this combination of factors has resulted in a very low level of complaints that belies the charges of critics. In most states that we know, they amount to a few dozen compared to millions of business transactions using CBIS and state and federal regulatory systems that require upfront disclosures and adverse action notices, to encourage the filing of complaints.

There are several reasons for the lack of complaints. The first is that the evidence is that credit scores are not deteriorating as speculated. Representatives from that industry will share their findings. Next, the insurance scores contain other factors that would tend to dampen the effect of lowered credit scores, if that were happening. In addition, most states have a version of the NCOIL model law with sole basis restrictions and restrictions on the use of certain information. In addition, some states have “extraordinary life circumstances” language that encourages individual reviews. Finally, insurers maintain review systems that allow agents and their policyholders to reconsider cases upon a foreclosure or loss of a job, for example. Attached to this statement is a case in point of how one multi-line insurer uses credit scoring and prevents complaints. See Exhibit 1.

All of these factors combine, we believe, to explain why the system is working despite the broader economic concerns outside the insurance context. Under these circumstances, banning or over-regulating CBIS is not only not called for but such a move would actually inconvenience and harm the majority of all policyholders, including people of all ethnic backgrounds and income levels.

### **CBIS Is Subject to Extensive Federal and State Regulation.**

The federal Fair Credit Reporting Act, as amended, expressly allows insurers to use credit information. That use, however, is subject to many federal regulatory provisions, including that adverse action notices be provided as required by law. In addition, the sources of credit information insurers use are heavily regulated.

States have added specific laws relating to CBIS to their pre-existing insurance statutes and regulations. Generally, the new laws follow the NCOIL model which requires upfront disclosures and adverse action notices, prohibits the use of certain information, requires prompt remedy in case of incorrect information and provides sole basis restrictions.

There are established anti-discrimination protections that apply to CBIS use, with well understood legal standards. No court has found CBIS to be unfairly discriminatory. This is the appropriate legal and actuarial standard, as indicated in an exhibit to this testimony. CBIS have been found to be predictive of risk across different demographic groups. Even if average scores were to differ as well, the predictive nature remains and “disproportionate impact” is not a standard under any law for any rating factor. See Exhibit 2.

### **Companies Are Taking Proactive Steps To Prevent Problems.**

Based on public statements, insurers have in place various mechanisms for themselves and for their agents to address customers’ unique or extraordinary circumstances that merit review. Some insurers may do this in states as mandated. Others may extend this option more broadly. See Exhibit 1, a profile of one such company.

Companies also have the ability to adjust rating tiers so as to take into account over-all changes in the economy. This would be an additional safety valve, while still maintaining the comparative value of CBIS.

Finally, insurers assist the public by making information available on CBIS. We believe this helps prevent problems, as well. And when fully informed, the public has accepted the validity of CBIS. See Exhibit 3. Attached as Exhibit 4 are some examples of public information that AIA has made available in English and Spanish and to agents.

### **Government And Private Studies Have Consistently Shown That CBIS Improves Risk Assessment and Most People Benefit From Its Use.**

In recent years, there have been many public and private studies of CBIS. One of the largest and most sophisticated, is the 2007 Federal Trade Commission report that made the following findings:

- CBIS helps assess risk;
- CBIS may improve availability;
- Ethnicity is not used by insurers;
- CBIS does not serve as a proxy for race; and
- The majority of policyholders benefit from its use through lower costs.

These findings are consistent many other public and private reports. See Exhibit 5 for the highlights of these studies.

### **Conclusion**

The hearing notice indicates that it will focus on three areas: (1) definition of what constitutes CBIS; (2) evaluation of how insurers use CBIS; and (3) discussion of how current economic conditions have affected policyholder premiums related to CBIS. Over the years, AIA has submitted detailed information to the NAIC on the first two items; AIA is ready to assist the NAIC and individual insurance Commissioners further on this topic.

There is no evidence to support claims that there is widespread harm to insurance consumers as a result of CBIS, even in today's poor economic conditions. Instead, the evidence is to the contrary: most people continue to benefit from the use of CBIS. There are very few CBIS complaints, even though the regulatory systems encourage them, because of responsible business practices and existing regulation. On the other hand, banning or over-regulating CBIS may disrupt and weaken markets and harm far more consumers than it helps.

## EXHIBIT 1

### COMPANY PROFILE

Commissioner Holland presented a question at the NAIC Spring Meeting - what are insurers doing with respect to credit-based insurance scores (CBIS) in light of current economic challenges? Given antitrust concerns and practical considerations, AIA tapped one member company to get an up close look at its efforts.

### BACKGROUND

#### Lines of Business

This insurer uses CBIS for auto and homeowners business.

#### Duration

It has used credit information in many states for over 10 years.

### DATA REVIEW

#### Consider Whether CBIS Have Been Changing

In light of the current economic climate, the insurer has been reviewing its personal lines business to see if there have been notable changes.

This insurer has not noticed any significant downward trend for its book of business.

This insurer is in the process of pulling an archive study to compare and understand score distributions.

Given the press on foreclosures, it dug into its database to investigate whether there were changes in scores and loss history in high foreclosure areas. Its preliminary findings show that deterioration has not occurred.

#### Consider Impact of CBIS Ban

This insurer pulls sample states and looks at one of its programs to gauge the possible **rating impact** if it were to be required to remove CBIS. Current information shows that the following disruption could occur:

	COMBINED PL		PERSONAL AUTO					PERSONAL PROPERTY			
	Growth in PL policies from 2005 to present		Overall impact - % getting rate increase	Drivers 60 + have increase %	Drivers owning home to get increase	Families w/ teen drivers to get increase		Overall impact - % getting rate increase	Customers 60 + average increase %	Customers w/ renter's ins to get increase	Customers w/ loss in past 3 yrs to get increase and average %
Illinois (C)	24%		62%	83% / 10%	67%	64%		60%	79% / 13%	71%	63% / 5%
Maryland (D)	n/a							n/a	n/a	n/a	n/a
Wisconsin (D)	4%		64%	82% / 8%	68%	64%		61%	83% / 17%	69%	64% / 5%

NOTE: We may update the chart with more information, as we receive it.



This insurer also considers that eliminating CBIS could impact its underwriting and eligibility. With the advent of CBIS, the insurer has expanded its eligibility base—writing more risks in underserved areas countrywide, regardless of where one lived. This insurer is better able to identify and provide the most appropriate price for each risk. Without the use of CBIS, those benefits will be gone.

## **CONSUMER-ORIENTED EFFORTS**

### Notice - Expanded Reasons

Some states and the NCOIL Model require that insurers provide credit-related reasons for taking an adverse action. A few states require that these reasons be more expansive.

This insurer has opted to use expanded reasons countrywide.

### Extraordinary Life Circumstances

Some states require an insurer to offer to reconsider an applicant who has experienced certain extraordinary life circumstances.

This insurer has opted to make its extraordinary life circumstances procedures available countrywide. Indeed, thousands of people have benefitted from their procedures.

This insurer's list goes beyond the state-enumerated items to consider additional hardship situations.

This insurer's agents are aware of this procedure to use the company's Insurance Score Helpline. Information about the Helpline is available on their intranet.

This insurer's adverse action notices (and their consumer report notice) includes an 800 number for consumers to access the Insurance Score Helpline directly.

This insurer has reviewed whether their Insurance Score Helpline has experienced a recent increase in volume. It has not noticed much recent change. In fact, fewer than ½ of 1% of applicants and policyholders use call the Helpline.

### Consumer Complaints

This insurer has tracked credit complaints – those directly to the company and those via the insurance departments – since the late 1990s. In those years, it has gotten 69 complaints.

### Education

This insurer informs its agents of the availability of consumer brochures.

This insurer has information about their use of CBIS available on their website.

## EXHIBIT 2

### UNFAIR DISCRIMINATION AS ACTUARIAL STANDARD

State insurance laws, and indeed the principles underpinning property and casualty insurance pricing, rely on actuarial science to determine rates that most accurately measure loss potential. Actuarial science accomplishes this task by finding relationships between factors and risk of loss and then allocating costs accordingly. This is the essence of risk-based pricing. Importantly, to disregard the predictive value of a factor (1) ignores actuarial support; (2) results in better risks subsidizing worse risks; and (3) moves closer to a one-size-fits-all approach in direct conflict with risk classification standards.

Pricing programs of most insurers depend on making distinctions based upon a number of different factors. All things being equal, the one who reflects a worse risk based on this difference will pay more. To explain, the process of risk classification involves segmenting groups of individuals expected to have similar costs. The use of more segments makes for a more granular approach in which actuaries can more finely hone review of an individual in order to more accurately create class plans and measure risk potential. When there are a greater number of risk levels and pricing variations, insureds are placed with others with a more similar risk profile, which results in a fairer price and insurers are better able to offer coverage to people they might have otherwise declined.

Most insurers' pricing or risk classification programs depend on making distinctions based upon several factors (or rating variables). Common homeowners insurance factors include claim history of applicant, construction material(s), distance from fire station, dog/breed of dog owned, fire suppression devices, home-based business presence and type, lead paint potential (constructed pre-1978), loss history of property, roofing material, trampoline use, slab versus basement, security system. Common personal automobile insurance factors include age, coverage limits desired, deductibles selected, driving record/at-fault crashes, gender, marital status, miles driven, territory, vehicle age, vehicle make, and vehicle model. Credit-based insurance scores, like these other factors, are predictive of loss. Neither race nor ethnicity is ever collected or considered by property and casualty insurers.

The insurer is typically required have experience justifying its rates and in some states it must supply this information to state insurance regulators for approval. Restricting rates, when contrary to actuarial indications, violates the prohibition against rates that are "excessive, inadequate, unreasonable or unfairly discriminatory." The definition of "unfairly discriminatory" is tied to accurately measuring risk, meaning that rates must be cost-based and treat policyholders with equal risks equally. Consider laws that state that a rate is "unfairly discriminatory" if it "(A) is not based on sound actuarial principles; (B) does not bear a reasonable relationship to the expected loss and expense experience among risks; or (C) is based in whole or in part on the race, creed, color, ethnicity, or national origin of the policyholder or an insured." To dismiss for political or personal reasons the predictive value of a valid factor is to ignore actuarial science, which then risks violating state prohibitions against insurance rates that are "unfairly discriminatory."

To come full circle in our description of the background of the regulatory context, the "unfairly discriminatory" is the very foundation for insurance regulation. It consumes the field in areas where a state legislature does not otherwise deem a particular factor to be "unfairly discriminatory" via a public policy mandate.

### **EXHIBIT 3**

#### **CONSUMERS HAVE SPOKEN – OREGON**

During the November 2006 elections, Oregon voters were asked to consider a statewide ballot initiative (Measure 42) that would have banned insurer use of credit. The measure was defeated with citizens voting more than 2-1 (65.6% to 34.4%) against it, rejecting “mass subsidization.”

That fall, a study was commissioned to examine the potential impact on consumers if the ballot measure was successful and the results spoke volumes about the consumer benefits of credit-based insurance scoring. The study indicated that nearly 60 percent of personal auto policyholders paid lower rates than they would if credit information was not used and that many insurers were writing policies that they would not have otherwise were it not for access to credit information.

Oregon voters understood the harm Measure 42 would have caused – higher insurance rates for 60 to 70 percent of residents – and illustrates the voting public’s support for insurance pricing that accurately reflects individual risk.

AIA’s Ken Gibson, vice president, Western Region, summed it up well at the time saying: “voters said yes to personal responsibility, yes to risk-based pricing and no to mass subsidization.”

## EXHIBIT 4

### EXAMPLES OF CONSUMER INFORMATION

AIA has consumer brochures available to the public – in both English and Spanish - in hard copy and on its website. Applicable URLs follow:

<http://www.aiadc.org/AIAdotNET/docHandler.aspx?DocID=290558>

<http://www.aiadc.org/AIAdotNET/docHandler.aspx?DocID=290559>

## EXHIBIT 5

### CONCLUSIONS FROM MAJOR CREDIT-BASED INSURANCE SCORING STUDIES

- **“...91% of consumers either received a discount for credit or it had no effect on their premium” and “for those policies in which credit played some role in determining the final premium, those receiving a decrease outnumbered those who received an increase by 3.44 to 1.”**  
Source: “Use and Impact of Credit in Personal Lines Insurance Premiums Pursuant to Ark. Code Ann. §23-67-415”; A report to the Legislative Council and the Senate and House Committees on Insurance & Commerce of the Arkansas General Assembly by the Arkansas Insurance Dept. July 2008. The Arkansas Insurance Dept. examined approximately 2 million auto and over 620,000 homeowners policies. Arkansas enacted the National Conference of Insurance Legislators Model Act on Credit in 2003.
- **“Credit-based insurance scores are effective predictors of risk under automobile policies. They are predictive of the number of claims consumers file and the total cost of those claims.” and “Scores also may make the process of granting and pricing insurance quicker and cheaper, cost savings that many be passed on to consumers in the form of lower premiums.”** Also, when scoring is used **“...more consumers (59%) would be predicted to have a decrease in their premiums than an increase (41%).”**  
Source: “Credit-based Insurance Scores: Impacts on Consumers of Automobile Insurance,” A Report to Congress by the Federal Trade Commission, July 2007. The FTC examined more than two million insurance policies.
- **“A survey of Oregon insurers indicates that nearly 60 percent of personal auto policyholders...pay lower rates than they would if credit information was not used. In addition, many insurers report writing policies that they would not have written had they not had access to credit information.”**  
Source: “The Use of Credit Information by Insurers,” ECONorthwest, October 2006. This study was commissioned during the November 2006 elections when Oregon voters were asked to consider a statewide ballot initiative (Measure 42) that would have banned insurer use of credit. The measure was defeated with citizens voting more than 2-1 (65.6% to 34.4%) against it, rejecting “mass subsidization.”
- **“These results [impact of using credit information] corroborate the insurance industry’s contention that the majority of policyholders benefit from the use of credit scoring.”**  
Source: “Report on the Use of Consumer Credit and Loss Underwriting Systems,” Nevada Dept. of Business & Industry, Division of Insurance, July 2005. Insurers representing 60% of the auto and homeowners market were surveyed for this report.
- **As part of the Michigan insurance industry’s successful legal efforts to stop a regulatory ban on credit, multiple companies reported in lawsuit filings that a ban would produce premium increases up to 68% for both auto and homeowner policies, with individual rates rising hundreds of dollars.**  
Source: In the case of *Insurance Institute of Mich., et. al. v Commissioner of the Office of Financial and Insurance Services*, (2005) Case #05-156-CZ, Barry County (MI) Circuit Court. There the Judge issued a clear and definitive opinion saying in part credit “clearly shows an actual effect on losses and expenses” (Judge’s emphasis). The case is now on appeal (#262385).
- **“For both personal auto liability and homeowners, credit score was related to claim experience even after considering other commonly used rating variables. This means that credit score provides insurers with additional predictive information distinct from other**

**rating variables. By using credit score, insurers can better classify and rate risks based on differences in claim experience.” Also, “[C]redit scoring...is not unfairly discriminatory...because credit scoring is not based on race, nor is it a precise indicator of one’s race.”**

Source: “Use of Credit Information by Insurers in Texas: The Multivariate Analysis,” Supplemental Report to the 79<sup>th</sup> Legislature by Texas Department of Insurance (TDI), January 2005. The study analyzed scores and rating factors for over two million auto and homeowners insurance policies in Texas.

- **“...the lowest range of insurance scores produce indicated pure premiums 33% above average and the highest range of insurance scores produce indicated pure premiums 19% below average.”; and “...insurance scores significantly increase the accuracy of the risk assessment process.”**

Source: “The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity,” EPIC Actuaries, LLC, June 2003. The EPIC study reviewed more than 2.7 million auto policies.

- **“The correlation between credit score and relative loss ratio is .95, which is extremely high and statistically significant. The lower a named insured’s credit score, the higher the probability that the insured will incur losses on an automobile insurance policy, and the higher the expected loss on the policy.”**

Source: “A Statistical Analysis of the Relationship Between Credit History and Insurance Losses,” University of Texas Bureau of Business Research at the McCombs School of Business, March 2003.



**Property Casualty Insurers  
Association of America**

Shaping the Future of American Insurance

ALEX M. HAGELI  
MANAGER, PERSONAL LINES

April 30, 2009

The Honorable Michael McRaith  
Chair, The Property and Casualty Insurance (C) Committee  
National Association of Insurance Commissioners  
2301 McGee Street  
Kansas City, MO 64108

The Honorable Kim Holland  
Chair, The Market Regulation and Consumer Affairs (D) Committee  
National Association of Insurance Commissioners  
2301 McGee Street  
Kansas City, MO 64108

**RE: The Use of Credit-Based Insurance Scores**

Dear Director McRaith and Commissioner Holland:

Thank you for this opportunity to comment on insurers' use of credit-based insurance scores. My name is Alex Hageli and I represent the Property Casualty Insurers Association of America (PCI). PCI is a national property casualty trade association comprised of more than 1,000 member companies, representing the broadest cross-section of insurers of any national trade association. PCI members write 39.6 percent of all personal lines insurance sold in the United States.

While PCI does not endorse the use of any particular rating factor, we do support the right of insurers to use actuarially justified rating factors. As such, we believe they should have the ability to use credit-based insurance scores.

The federal Fair Credit Reporting Act first authorized insurers to consider credit information nearly 40 years ago. Within the past 15 years, however, the use of credit information in insurance has grown substantially as insurers continue to perfect its use and appreciate its accuracy. Credit-based insurance scoring, alternatively referred to simply as insurance scoring, is an objective and accurate method for assessing the likelihood of insurance losses. Insurers that consider credit information in their underwriting and pricing decisions do so for only one reason – insurance scoring allows them to rate and price business with a greater degree of accuracy and certainty. Sound underwriting and rating, in turn, allows insurers to write more business – a direct benefit for consumers.

It is important to understand how insurers use credit information and to note that there are significant differences between the credit scores used by lenders and the credit-based insurance scores used by many insurers. Although both are derived from information found on credit reports, the information is measured differently. Insurers use credit information in developing insurance scores to predict the likelihood of future insurance loss. Credit-based insurance scores provide an objective measurement of how one manages the risk of credit. Lending institutions, on the other hand, use credit scores to determine the availability, amount and price of credit products offered to the consumer. Lending institutions use credit to determine the likelihood of repayment. The most significant difference between insurers and lending institutions is that insurers never consider income. Insurers measure “how,” not “how much.”

In addition to income level, one’s address, ethnicity, religion, gender, familial status, nationality, age and marital status are also not considered within a credit score calculation. Further, there is no reliable evidence that points to insurance scoring resulting in higher insurance rates for any specific class of individual, or that higher scores correlate with higher incomes. In fact, Federal Housing Administration Commissioner Brian Montgomery declared in speech last year that the administration’s data, if anything, tended to show that families with lower incomes actually have *higher* credit scores.

A 2003 study by EPIC Actuaries (now part of Tillinghast), the largest and most comprehensive study ever undertaken on the connection between credit history and insurance risk, found that a consumer's credit-based insurance score is unquestionably correlated to that consumer's propensity for auto insurance loss. Even more significantly, the study found that insurance scores are consistently among the most important rating variables used by insurers. The EPIC researchers used a multivariate analysis technique to determine indicated risk factors. After fully accounting for all overlap and relationship with other risk factors, such as age/gender, territory, model year, driving record and coverage limit – credit was found to clearly be an independent and significant tool for predicting insurance loss. The propensity for loss was found to decrease as the insurance score increases. For example, after adjusting for other variables, individuals with the lowest insurance scores were found to incur 33 percent higher losses than average, while those with the highest scores incurred 19 percent lower losses than average.

Every serious and reputable actuarial study on the issue, including a 2007 study by the Federal Trade Commission, has reached the same conclusion: there is a very high correlation between insurance scores and the likelihood of filing insurance claims. Without the ability to consider credit, many insurers would be less aggressive in their marketing, and far more cautious in accepting new business. Thus, consumers would quickly have fewer choices in the marketplace.

That consumers do in fact enjoy more choices in the marketplace is borne out by the massive double-digit percentage declines in the population of state residual markets over the past 10 years. While no definitive study of this phenomenon is available, it is the general consensus of the industry that the decrease is directly attributable to the increased accuracy afforded by the use of insurance scoring.

Not only do credit-based insurance scores allow insurers to offer more coverage, it also allows them to offer coverage at lower rates. The majority of consumers have good credit-based insurance



Honorable Michael McRaith and Kim Holland  
The Use of Credit-Based Insurance Scores  
April 30, 2009

scores and benefit accordingly – with rates refined to reduce disproportionate subsidies of higher risk individuals. An annual survey issued by the Arkansas Insurance Department consistently finds approximately 32 percent of policyholders enjoy a decrease in premium while approximately nine percent of policyholders pay more because of insurance scoring (the remainder being otherwise unaffected), a ratio of 3.44 to 1.

Credit-based insurance scoring is an effective tool for insurers - and a fair one for consumers. To protect competition and consumer choice, it is imperative that insurers be permitted to fully price risks using nondiscriminatory and statistically valid tools available to them.

PCI appreciates the opportunity to provide our comments on this bill, and would be happy to address any questions you may have on this subject.

Sincerely,

A handwritten signature in black ink, appearing to read 'A. Hageli', with a long horizontal stroke extending to the right.

Alex M. Hageli



**Testimony of Neil Alldredge**  
**On Behalf of the National Association of Mutual Insurance Companies**  
**Joint NAIC C/D Committee Hearing on Credit-Based Insurance Scores**  
**April 30, 2009**

Good afternoon Director McRaith and Commissioner Holland, I'm Neil Alldredge, Vice President – State & Policy Affairs for the National Association of Mutual Insurance Companies (NAMIC). NAMIC represents 1,300 member companies that underwrite over 40 percent of the insurance market in the United States.

Before I begin, I will note that NAMIC has submitted several documents for the record. In particular, I draw your attention to our Issue Analysis public policy paper that examines the issue of disparate impact, unfair discrimination and the use of insurance scoring. We have also submitted an Issue Brief titled: *Credit-Based Insurance Scoring, Separating Facts from Fallacies*. This policy briefing does a good job (in 4 pages) summarizing most of the points you have heard today.

**Introduction**

Credit-based insurance scores have been used by insurance company underwriters and actuaries for nearly two decades to more accurately assess risk and price coverage for automobile and homeowners' insurance policies.

The use of insurance scores encourages competition and enables insurers to offer coverage to more consumers at a fairer price. Furthermore, consumers benefit from insurance scoring because it keeps the insurance marketplace competitive, resulting in lower prices, better service, and more product choices.

Insurance scores provide an objective, fair, and consistent tool that insurers use with other information to better predict the likelihood of future claims and the cost of those claims. During the late 1990s, lawmakers and regulators in several states began enacting laws and regulations that established procedures for insurers to follow in using an individual's credit information. In 2002, the National Conference of Insurance Legislators (NCOIL) created a "Model Act Regarding Use of Credit Information in Personal Insurance," which became the basis for additional legislation in other states. Today, 47 states have laws or regulations pertaining to credit-based insurance scoring.

In spite of an apparent consensus on this issue, some public officials and advocacy groups have continued to press for further restrictions on the use of insurance scores, or to prohibit the practice entirely. We believe this course of action is not warranted and would be harmful to the vast majority of policyholders.

## **Studies**

The focus of my testimony today is to review the various studies conducted on insurance scoring. To date, 17 industry, state or federal agency studies have been conducted. Typically these studies have examined the correlation between credit-based insurance scores and the propensity for insured losses and/or the impact credit-based insurance scores have on low-income or minority populations. It is certainly the most studied rating and underwriting variable currently used by insurers.

These studies all share some common findings, primarily that credit-based insurance scores are predictive of loss, that the majority of consumers benefit from the practice and that credit-based insurance scores are not a proxy for race or income.

The focus of our testimony today is on the two most comprehensive studies conducted to date, the Texas Department of Insurance study of 2005 and the study conducted by the Federal Trade Commission released in 2007. I will also review the survey conducted by the Arkansas Department of Insurance.

## **Texas**

The Texas Department of Insurance (TDI) released the main body of the report in December 2004, and issued a supplemental report in January 2005. The TDI study was based on data obtained from six leading insurers for approximately 2 million policies. Of these, approximately 1.2 million were for personal auto insurance and 800,000 were for homeowners insurance. The personal auto policies covered roughly 2.5 million vehicles.

The TDI study was unusual both because of the size of its database, and because it included individual information on race and ethnicity. That information was missing from other studies because insurers do not collect information concerning the race or ethnicity of their policyholders. The TDI, however, was able to draw on the resources of the Texas Department of Public Safety and the Texas Office of the Secretary of State. Based on data supplied by those agencies, the TDI was able to classify individual policyholders as white, black, Asian, and Hispanic.

The December report concluded that “there appears to be a strong relationship between credit scores and claims experience on an aggregate basis,” but cautioned that “credit scores, to some extent, may be reflective of other risk characteristics associated with claims.” The report explained that the department would need to perform a multivariate analysis to determine whether credit scoring enables an insurer to predict losses more accurately than it could by relying solely on more traditional underwriting variables. The report also found that some minority populations were over-represented in the lower score categories but that no unfair discrimination was detected.

A month later, the department released its supplemental report containing the multivariate analysis. It found that “for both personal auto liability and homeowners, credit score was related to claim experience even after considering other commonly used rating variables. This means that credit score provides insurers with additional predictive information

distinct from other rating variables. By using credit score, insurers can better classify and rate risks based on differences in claim experience.”

This finding so surprised then Texas Insurance Commissioner Jose Montemayor that he felt obliged to acknowledge, in a letter to Governor Rick Perry, that his “initial suspicions were that while there may be a correlation to risk, credit scoring’s value in pricing and underwriting risk was superficial, supported by the strength of other risk variables.” The study, however, “did not support those initial suspicions.” Moreover, credit scoring “is not unfairly discriminatory as defined in current law because credit scoring is not based on race, nor is it a precise indicator of one’s race.” A copy of the letter from Commissioner Montemayor is included in this testimony.

### **Federal Trade Commission**

When the federal Fair Credit Reporting Act with reauthorized in 2003 there was language inserted directing the Federal Trade Commission (FTC) to study the impact insurance scores had on the availability and affordability of insurance. The authorizing statute also directed the FTC to examine whether insurance scores had a disparate impact on protected classes. The study was made public in early 2007.

The FTC found that 59 percent of consumers benefitted from the use of credit-based insurance scores and that scores were correlated to and predictive of loss.

The FTC stated that credit-based insurance scoring provides benefits to consumers, including rates that are more accurate, effectively reducing subsidies which also allow insurers to offer insurance to higher risk drivers who otherwise may not be able to obtain coverage. The FTC also said that credit-based insurance scoring may reduce the cost of granting and pricing insurance with the cost savings passed along to consumers in the form of lower premiums.

The FTC found that “credit-based insurance scores appear to have little effect as a ‘proxy’ for membership in racial and ethnic groups in decisions related to insurance.” The study noted that there was a range of credit-based insurance scores and losses within every group studied and that insurance scores are predictive *within* racial groups. In other words, every racial group has individuals with low scores and high scores and within those groups insurance scores are predictive of loss.

### **Arkansas**

In 2005, the Arkansas Department of Insurance began an annual survey of the effect of the state’s insurance scoring law, which is based on the NCOIL model, on insurance consumers. The 2007 survey concluded that of 3,026,092 personal lines policies written or renewed in that year, 32 percent of customers received a discount, 9 percent received an increase, and the remaining 59 percent of consumers saw a neutral impact due to insurer use of insurance scores. In other words, 91 percent of personal lines customers either received a discount for credit or it had no impact on premium. For policies where credit played some role in determining the final premium, those receiving a decrease outnumbered those receiving an increase by a ratio of 3.44 to 1. These results were

virtually identical to findings of the 2005 and 2006 survey. All the surveys are available on the Arkansas Department of Insurance website.

### **Conclusion**

Several other studies have been conducted by different state insurance departments over the last 10 years (Virginia, Washington and Alaska, for example), all these studies have two clear findings – that credit-based insurance scores are predictive of loss and that the vast majority of consumers benefit from the tool. There have been no academic studies that include insurance loss or rate information that have found that credit-based insurance scores are either predictive of, or a proxy for, race or income.

We also believe a common sense examination of insurance markets is revealing. It would stand to reason that if credit-based insurance scores have a negative effect on availability or affordability that residual market mechanisms and consumer complaints would be skyrocketing. Neither phenomenon is occurring. In nearly every state in the country the personal lines markets are competitive, vibrant and healthy. Consumers have choices and all the serious research indicates that a vast majority benefit from the use of this valuable tool.

National Association of Insurance Commissioners  
Property and Casualty Insurance (C) Committee &  
Market Regulation and Consumer Affairs (D) Committee

Public hearing on Credit-Based Insurance Scores

Testimony of Charles Neeson, MAAA, ACAS  
Senior Executive  
Westfield Insurance

April 30, 2009

Thank you for the opportunity to speak today on Credit Based Insurance Scores (insurance scores). My name is Charles Neeson and I am a Senior Executive with Westfield Insurance. I am also a member of the American Academy of Actuaries and an Associate in the Casualty Actuarial Society. Westfield Insurance is a multi line regional insurance company, writing both personal lines and commercial lines insurance. We have been in business since 1848 and are proud to offer our products exclusively through professional local independent agents. Partly because of our tag line, "Sharing Knowledge, Building Trust" I am here today.

My prepared testimony will focus on three areas; the history and use of insurance scores at Westfield Insurance, how insurance scores benefit the majority of Westfield customers, and the stability of insurance scores for Westfield Insurance customers.

Insurance is an incredibly competitive business. One way an insurance company, such as Westfield, can distinguish itself from its competitors is to find better ways to price its business. That means improving the accuracy of premium as an estimate of expected future loss. When insurers are able to properly underwrite risks, consumers benefit with lower rates and more choices.

Prior to our use of insurance scoring, Westfield utilized traditional classification variables like vehicle use and vehicle performance to help estimate future risk of loss. In 1999, we conducted research on insurance scoring, to determine whether it would benefit the company and our customers. In analyzing the relationship between credit information and our loss data, we found a strong correlation. We also found it did not replace traditional classification variables, but worked well with them.

(Appendix 1 shows the relationship of several classification variables, both traditional and credit, to loss.)

Based upon that research, Westfield Insurance began using insurance scores in 2000 as part of its pricing of automobile and homeowners' insurance. Used in conjunction with more traditional



rating factors such as vehicle performance, age, territory and prior claims, credit-based insurance scoring allowed Westfield to more accurately price its products, improve its competitive position and write more business.

(Appendix 2 shows how insurance scoring and prior claims can work together.)

Today, about 90% of Westfield auto-home customers either benefit or have no impact from insurance scoring, indeed, approximately 75% pay less.

Westfield's introduced insurance scoring in 2000. As part of the roll out, we provided training to help our agents effectively communicate with customers. The training included information about credit reports and insurance scoring. We followed up at several later dates in group meetings and seminars, plus we developed literature and job aids.

We also tracked how our customers accepted our new pricing that included credit based insurance scoring. We were pleased to find that not only did new business increase, but we also saw an improvement in retention on policies renewed with insurance scoring.

(Appendix 3 shows how Westfield Insurance customers benefited and how their retention improved with insurance scoring.)

I cannot say insurance scoring has been without its unique challenges. For example, during the early days of its use, some agents spoke up about the additional effort needed to quote multiple companies. Each year though, I have heard fewer and fewer issues raised.

More recently, some parties worry poor current economic conditions may cause a steep decline in credit based insurance scores. Data shows these worries to be unfounded.

All of the recent score stability studies done by credit bureaus show no decline in FICO credit based insurance scores. In fact, they show

the trend to be flat or slightly improving. Westfield Insurance data supports this conclusion as well.

(See Appendix 4 showing the stability of insurance score pricing tier.)

Considering the troubling economic times we are in, it is good to know insurance scoring continues to benefit so many people through lower insurance premiums.

Thank you for allowing me to testify before you today. I would be happy to address any questions you may have on this subject.



*Independent Insurance Agents  
& Brokers of America, Inc.*

**WRITTEN STATEMENT OF WESLEY BISSETT  
SENIOR COUNSEL, GOVERNMENT AFFAIRS  
INDEPENDENT INSURANCE AGENTS & BROKERS OF AMERICA**

**BEFORE THE**

**NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS  
PUBLIC HEARING ON CREDIT-BASED INSURANCE SCORES**

**APRIL 30, 2009**

---

On behalf of the Independent Insurance Agents and Brokers of America (IIABA), the nation's oldest and largest association of insurance producers, I am privileged to offer the association's outlook on the manner in which the insurance industry uses credit information. IIABA represents a network of more than 300,000 agents, brokers, and employees nationwide, and our members provide insurance products to and serve the insurance needs of millions of American consumers. The independent agent community brings a unique perspective to this issue, largely because we work with our insurance company partners while remaining sensitive to and focused on the needs and concerns of consumers.

**Background and Historical Context**

This is not a new issue for the association, and we appreciate having the opportunity to briefly discuss the issue today. For more than 12 years, the Big "I" has worked with insurers on business issues and concerns related to the use of credit information, and, throughout that time, we have also been incredibly active in the public policy arena.

In preparing for Thursday's hearing, I was reminded that the NAIC's Market Conduct and Consumer Affairs Committee held a similar public hearing examining the industry's use of credit histories and credit scoring back in December 2001. Much has changed since that time. While financial services providers had long used credit data and credit history to evaluate loan applications, determine creditworthiness, and predict the likelihood of default and delinquency, the insurance industry was only beginning to widely utilize similar data to predict future losses and claim costs and to determine prices in a more accurate manner. One study at the time

found that approximately one-half of the 100 largest personal automobile insurers in the country had only begun utilizing credit histories and scores since 1998, so the use of such information was relatively new and novel.

The somewhat sudden increase in the use of credit information produced what might generously be described as “growing pains,” and many of these were self-inflicted by the insurer community at the time. Some carriers did a poor job of educating agents and the public about the use of credit data, and there were documented abuses and poor business practices that generated concern among those in the agent community. The exclusive reliance on and inflexible use credit information by some carriers, the lack of transparency and meaningful disclosure to consumers, the negative effects on those with no credit history, and similar questions and problems created skepticism and doubts among many.

During this time, the use of credit information was a regular topic of discussion among IIABA’s leadership structure and public policy-related committees, and agents were voicing many of the same concerns that they were hearing from their clients. The often contentious debate and controversy that existed, however, was largely alleviated by three important developments:

- First, personal lines insurers began to do a much better job educating consumers, agents, and other stakeholders about the use of credit information, and this had the effect of increasing awareness and understanding.
- Second, many carriers reevaluated the manner in which credit data was being utilized and ultimately implemented more reasonable business practices that considered the interests of consumers and addressed many of the legitimate criticisms that were being made.
- Third, due in large part to the efforts of the NAIC and state officials (and with the strong support of IIABA), comprehensive and effective regulation and meaningful restrictions and limitations on the use of credit information were implemented in nearly every state.

The statutory enactments and business practice reforms put in place since the early part of this decade have dramatically improved the manner in which credit information is utilized in the underwriting and rating process and have dramatically reduced the level of consternation that previously existed. While limited problems and unfortunate anomalies may still arise on a periodic basis, IIABA rarely receives complaints today from its members about the use of credit information. This is a dramatic change from the state of affairs eight years ago and reflects the positive changes and reforms outlined above.

### **Additional Observations**

IIABA supports the use of underwriting and rating tools that foster enhanced competition and the fair and accurate pricing of risk and recognizes that consumer credit information is a powerfully predictive tool when used appropriately. The effectiveness of utilizing credit information has become increasingly apparent and widely accepted, even to those who were previously critical of its use, and agents can attest to the fact that it enables insurers to more accurately predict losses and the severity of future claims. The increased use of credit-based insurance scores has enhanced competition as companies have become more confident with the accuracy of their underwriting and rating tools, and, as a result, many agents are now able to find coverage (and prices) for clients in instances where such options were unavailable in the past.

At the same time, however, independent agents and brokers believe credit-based insurance scores must be used in sensible, responsible, and consumer-friendly ways – and IIABA has supported and helped implement a meaningful series of consumer protections at the state level. Most states have now enacted restrictions that limit when and how credit information and scores may be used in the insurance arena. These safeguards, for example, require additional underwriting factors to be taken into consideration when evaluating whether to underwrite, deny, cancel, or non-renew a policy; protect those with little or no credit history; impose helpful disclosure requirements; and restrict the use of certain types of factors or credit information. These and other critical measures have proven to be highly successful.

IIABA believes that effective regulation of the use of credit information and credit-based insurance scores by the insurance industry helps ensure that this powerful tool is used in a reasonable and proper manner. State policymakers have enacted comprehensive legislation that strikes the appropriate balance between the concerns of consumers and the needs of the industry and are considering additional steps. Insurance agents and brokers believe credit-based insurance scores are an effective, objectively verified, and fair risk measurement tool, and IIABA strongly opposes any efforts to ban the use of this information or unnecessarily restrict its use.

## **Conclusion**

While it is unclear what, if any, future discussion and deliberation concerning these issues may occur at the NAIC level, IIABA looks forward to assisting you in any manner that we can. We have a strong interest in this subject matter, considerable experience with legislative action in this area, and insight as to what is happening on the ground floor of the marketplace. Thank you again for the opportunity to appear before your committees.





**Consumer Federation of America**

**TESTIMONY OF**

**J. ROBERT HUNTER,  
DIRECTOR OF INSURANCE,  
CONSUMER FEDERATION OF AMERICA**

**BEFORE**

**SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS  
OF THE  
COMMITTEE ON FINANCIAL SERVICES  
OF THE  
UNITED STATES HOUSE OF REPRESENTATIVES**

**REGARDING**

**THE IMPACT OF CREDIT-BASED INSURANCE SCORING ON  
THE AVAILABILITY AND AFFORDABILITY OF INSURANCE**

**MAY 21, 2008**

Good morning Mr. Chairman and members of the Subcommittee. Thank you for inviting me here today to discuss the impact of credit-based scoring on the availability and affordability of insurance. And thank you for all you are doing for the many consumers of insurance who are being harmed by the use of credit scoring today. My name is Bob Hunter and I am the Director of Insurance for the Consumer Federation of America (CFA). CFA is a non-profit association of 300 organizations that, since 1968, has sought to advance the consumer interest through research, advocacy and education. I am a former Federal Insurance Administrator under Presidents Ford and Carter and have also served as Texas Insurance Commissioner. I am also an actuary, a Fellow of the Casualty Actuarial Society and a member of the American Academy of Actuaries. I am testifying on behalf of CFA and the Center for Economic Justice.<sup>1</sup>

At your last hearing on this subject, testimony was delivered by Birny Birnbaum, the Executive Director of the Center for Economic Justice. A statement on insurance credit scoring was also submitted by CFA, Consumers Union, National Council of LaRaza, National Consumer Law Center, and National Fair Housing Alliance. Today, I will touch on a number of the concerns raised in the testimony and statement, which are attached.

## **KEY FINDINGS**

Insurance scoring occurs when insurers use consumer credit information to determine whether a person is eligible for coverage, which company affiliate will offer the coverage, the “rate tier” at that company in which the person will be placed and, finally, the premium the consumer will pay. Insurance scoring is used by nearly all insurers and has grown to become one of the most important factors in determining a consumer’s automobile and homeowners insurance premium. Insurance scoring is typically done through the use of a computer model that converts information in a consumer’s credit report into a score, or numerical value.

Many organizations have called for a prohibition on insurers’ use of consumer credit information for underwriting and ratings. These groups include not only consumer organizations, but civil rights groups, several associations representing insurance agents and some insurers. The case for such a prohibition is strong. There is more than enough information currently available to justify such a prohibition. A closer look at insurance scoring reveals that the practice has the following serious flaws:

- Undermines core functions of the insurance system by decreasing insurance availability and affordability, and undermining the critical role of insurance in encouraging loss prevention;
- Has an adverse, disparate impact on low income and minority consumers and is discriminatory;
- Is based on credit reports that often have erroneous or incomplete information;

---

<sup>1</sup> Center for Economic Justice is a Texas-based non-profit organization that advocates on behalf of low income and minority consumers on insurance, credit and utility issues.



- Is inherently unfair and penalizes consumers who are the victims of economic, medical or natural catastrophes;
- Penalizes consumers because of the business decisions of lenders.

The insurance industry maintains that there are a variety of benefits from their use of credit scoring. Upon examination, these assertions are illusory and contradicted by the available evidence. Ultimately, however, all of the insurer arguments for insurance scoring come down to a single point: insurance scoring is predictive of the likelihood that a consumer will have a claim and consumers will benefit if insurers are able to price more accurately.

The problem with this contention is that insurers cannot tell us what it is about a credit score that is linked with risk. If you ask proponents of the use of credit scoring to explain to a person who suffered a decline in credit as a result of being in Hurricane Katrina, or lost her job because of outsourcing, or lost his job in the current economic downturn, why these events that they had no control over made them a worse auto or home insurance risk, they have no response..

Unlike insurance classifications that were in use before credit scoring was adopted, credit scoring is not based on an appropriate thesis, confirmed by a statistical analysis. In fact, there is no legitimate thesis for the use of credit scoring. There is only an alleged correlation based on proprietary information not open to public scrutiny.<sup>2</sup> However, a correlation in search of an appropriate thesis raises serious questions about the classification that is being used.

The lack of a thesis means that credit scoring violates actuarial principles. Some actuaries say that a thesis is not required because actuarial principles state that a cause and effect relationship is not required. Although this is true, the principles, which were developed by a group of mostly industry-employed actuaries with an overwhelming industry bias, also say that a thesis -- a logical underpinning for the use of the information -- is required. Here is what the principles say, in relevant part, on this subject:

Classification characteristics may be more acceptable to the public if there is a demonstrable cause and effect relationship between the risk characteristic and expected costs. However, in insurance it is often impossible to prove statistically any postulated cause and effect relationship. Causality cannot, therefore, be made a requirement for risk classification systems.

Often causality is not used in its rigorous sense of cause and effect but in a general sense, implying the existence of a plausible relationship between the characteristics of a class and the hazard insured against. Living in a river valley would not seem to cause a flood claim, but it does bear a reasonable relationship

---

<sup>2</sup> This is another difference from all previous classes where the data is public and part of rate filings made with insurance departments. Previously, an insurer would propound a thesis and test it with the data. If a thesis was confirmed, the insurer would file for a new class with the commissioner showing the thesis and the data in the rate filing. An example was the use of accidents and tickets. The thesis was that people with more accidents and tickets would be worse drivers in the future because their historic driving record indicated less care in driving. The thesis was confirmed by data that can be viewed in its' entirety in rate filings.

to the hazard insured against and thus would be a reasonable basis for classification.

Risk classification characteristics should be neither obscure nor irrelevant to the insurance provided; but they need not always exhibit a cause and effect relationship.<sup>3</sup>

Credit scoring is at best obscure relative to auto and home insurance, if not downright irrelevant. Since there is no clear relationship, no thesis, underlying credit scoring, the classification violates actuarial principles.<sup>4</sup>

Some in the industry appear to believe that a correlation between the classification and the risk of loss is all you need to create a class, despite the principles. Taken to its logical extreme, this point-of-view would indicate that race should be used if a correlation existed. Obviously, this is wrong from a public policy perspective. The fact that credit scoring triggers the indirect use of race for insurance underwriting and rating purposes makes it no more socially acceptable. Policymakers need to control the use of such illegitimate classes. Congress should do so since the insurance industry lobby is too strong to overcome in many states.

In fact, there is strong evidence that insurance scoring itself is not a predictor of risk or insurance claims, but, rather, that insurance scoring is a proxy for other factors that are related to claims experience, such as the income, miles driven, or geographic location of the consumer. In particular, insurance scoring is a proxy for race and income. Two independent studies by the Texas and Missouri Departments of Insurance found a strong relationship between insurance scores and race and income.<sup>5</sup> The Missouri study found the single most predictive factor of an insurance score was race.

Even the recent substandard report of the Federal Trade Commission (FTC) on the use of automobile insurance scores, despite relying upon data hand-picked by the insurance industry, found insurance scores were worse on average for African-Americans and Hispanics and that insurance scoring was a proxy for race. Had the FTC actually used an independent and comprehensive set of insurance data, the measured negative racial impact would likely have been much greater.<sup>6</sup> Although the FTC report discounts its own findings and plays down the possibility of racial discrimination, the strong evidence of an adverse, disparate racial impact from insurance scoring justifies a prohibition on its use. Insurers should not be permitted to use a proxy for race when the direct use of race itself for underwriting or rating is prohibited.

---

<sup>3</sup> Risk Classification Statement of Principles, American Academy of Actuaries Committee on Risk Classification, at <http://actuarialstandardsboard.org/pdf/appendices/risk.pdf>.

<sup>4</sup> There are other actuarial principles that credit scoring violates as well, including the fact that it is not socially acceptable, is subject to manipulation (there are firms that offer, for a fee, to sharply improve your score), and is ambiguous.

<sup>5</sup> Texas Department of Insurance, "Report to the 79<sup>th</sup> Legislature: Use of Credit Information in Texas," December 30, 2004, page 3. "Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri," State of Missouri Department of Insurance, January 2004.

<sup>6</sup> Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance," Federal Trade Commission, July 2007, at [http://www.ftc.gov/os/2007/07/P044804FACTA\\_Report\\_Credit-Based\\_Insurance\\_Scores.pdf](http://www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf).

In fact, I would strongly encourage the Subcommittee to continue to critically evaluate the FTC credit scoring analysis of automobile insurance scoring, which is deeply flawed and unresponsive to its Congressional mandate. The problems with the report include the failure of the FTC to obtain a comprehensive and independent data set for analysis and the agency's reliance upon a data set hand-picked by the insurance industry. The report also lacks any substantive analysis of the impact of insurance scoring on the availability and affordability of insurance products as requested by Congress, ignores evidence indicating that the correlation between insurance scores and claims is spurious, and fails to analyze the false claim that the use of insurance scoring is legitimate because people who manage their finances well are likely to manage other risks well.<sup>7</sup>

The FTC passed a resolution on May 16 that could lead to a better data collection process for the home insurance scoring study that is now underway. However, given the serious flaws detailed above with the automobile insurance report, we continue to have significant concerns about the FTC's ability and willingness to conduct a thorough, unbiased review of the impact credit scoring on those who purchase home insurance.

Insurers also claim that competition would be harmed and that the availability of insurance would be curtailed if credit scoring was banned. This is a false claim. I need only to point to California, where credit scoring is banned from use in auto insurance. In CFA's recent in-depth study of auto insurance regulation,<sup>8</sup> we found that the state had the best system of regulation in the nation. In particular, California is a leader in protecting consumers from abusive class systems. Rate increases in California were the lowest in the nation over the period we studied. More importantly, despite claims by insurers that a credit scoring ban would harm competition, California had the fourth most competitive automobile insurance market. Further, the number of Californians who were required to receive insurance for the state's high-cost assigned risk plan was very low; only 0.1 percent of the state's automobiles were insured in the plan. The California system proves that robust competition and insurance availability can occur without the use of credit scoring.

## **LEGISLATION BEFORE THE COMMITTEE**

### **H.R. 5633 -- Gutierrez**

CFA very much appreciates the efforts of the sponsors of this bill to curb the inappropriate use of insurance scoring. We support the legislation's goal to ban insurance credit scoring if the use of consumer credit information for insurance underwriting or rating discriminates on the

---

<sup>7</sup> The fact is that, by the credit modelers own admission, fully 20 percent of the population is unscorable with traditional credit reports because of little or no information in the files. These individuals are disproportionately low income and minority consumers who get charged higher rates through no fault of their own. Even a cursory examination of actual scoring models reveals that many of the factors determining an insurance score have nothing to do with whether a consumer pays his or her bill on time, but with factors related to socio-economic status. Yet, the FTC report dutifully repeats this rationalization for insurance scoring with no critical analysis.

<sup>8</sup> State Automobile Insurance Regulation: A National Quality Assessment and In-depth Review of California's Uniquely Effective Regulatory System, April 24, 2008 at <http://www.consumerfed.org/topics.cfm?section=Finance&Topic=Insurance&SubTopic=Insurance%20Regulation>.

basis of race or ethnicity. However, as written, we fear that the legislation will not achieve the desired goal:

- The bill could serve to legitimize insurers' use of credit-based insurance scoring so long as the use of the scoring methodology was not found to be discriminatory.
- The bill establishes the FTC as the arbiter of determining racial discrimination, although the agency has virtually no track record or enforcement experience in this area. In fact, the FTC study demonstrated a severe bias against consumers in favor of insurers regarding insurance scoring. We do not trust the FTC to fairly make impartial findings relative to credit scoring. To give just one example of the agency's bias, Congress asked the FTC to study the impact of insurance scoring on the availability and affordability of automobile insurance. Instead of getting data on applications for coverage that resulted in policies being issued or rejected from a large number of insurers serving all parts of the market, the FTC relied upon data handpicked by the industry from a few companies for only the policies they issued. Thus, the FTC had no ability to determine whether insurance scoring resulted in large numbers of consumers being denied coverage, priced out of the market, or charged higher premiums. Yet, despite this obvious limitation, the FTC concluded that credit scoring was a benefit to the majority of consumers. The data problem was brought to the FTC's attention early on, yet despite offers of assistance from state insurance regulators and a period of three years to do the study, the FTC was apparently satisfied to let insurers exercise undue influence over the study through their control of the data.
- The bill lacks an objective standard for identifying racial discrimination, again giving broad discretion to the FTC. As written, the proxy effect language does not clearly and adequately incorporate the legal concept of disparate impact. Under the bill, the FTC could find some statistical correlation to race and income and some proxy effect, but determine that this effect is not substantive and conclude that no discrimination or proxy effect exists. The bill should prohibit BOTH systems that incorporate racial proxies and those that have unlawful disparate impacts.
- To make determinations of discrimination and proxy effect, Congress should vest authority with agencies that have the experience and jurisdiction to regulate insurance and enforce anti-discrimination laws. State insurance departments and the National Association of Insurance Commissioners, who are already authorized to collect the necessary data and take corrective regulatory action, should be allowed to make these determinations. If any federal agency is given authority to make these determinations, the U.S. Department of Justice, not just the FTC, should also be provided with jurisdiction.
- The bill makes no provisions for a private right of action. If the FTC has the final say, there is no recourse for anyone who wants to challenge the racially discriminatory use of credit in insurance. This would be a significant problem for civil rights groups and individual consumers who wish to challenge this practice in the future.

- The bill is unclear about what types of state insurance regulation are or are not pre-empted. Although the bill strives to not pre-empt stricter state laws on insurance scoring, the legislation vests authority with federal agency -- the task of identifying and stopping unfair discrimination – that has traditionally been the role of states.
- The bill does not provide timely assistance for the millions of consumers who are facing higher auto and homeowners insurance rates now because their credit scores have been negatively affected by abusive and reckless lending practices.

We believe it would be simpler to ban the use of consumer credit information for insurance. In the near term, we would encourage you to consider legislation to at least impose a temporary "freeze" on the use of this information by insurers during the current mortgage crisis.

#### HR 6062 – Waters

CFA supports the bill but we seek clarification on one aspect of the bill.

Since the bill declares that some type of reports, such as motor vehicle records, Comprehensive Loss Underwriting Exchange (CLUE), and medical history records are not consumer reports for purposes of the section, is there any chance that, the way bill is written, it could be interpreted as eliminating adverse action notification for insurers' use of non-credit consumer reports? It should be clarified if there is any chance of such an interpretation.

#### **CONCLUSION**

Credit scoring is harmful to consumers, particularly low income and minority consumers. Millions of consumers are threatened with foreclosures and a variety of financial stresses resulting from the sub prime lending crisis, the resulting credit crunch, and the loss of jobs in the current weak economy. It is clearly unfair for millions of consumers to experience higher auto and homeowners' insurance rates because of reckless and abusive practices by lenders or because of conflicts between lenders and bondholders, which are preventing foreclosure assistance. As part of the package of assistance to consumers in financial distress, a ban, or, in the short term, a moratorium on insurance scoring should be enacted.

Credit scoring also undermines the very foundation of a sound insurance system, which involves the use of broad, risk-spreading classes tied to risk factors understandable by consumers that promote loss prevention.

It is time to ban the use of these unfair classes. It is time to pass H.R. 6062.

## ATTACHMENT 1



Consumer Federation of America



Written Testimony Before the

Subcommittee on Oversight and Investigations  
Financial Services Committee  
U.S. House of Representatives

October 2, 2007

The undersigned civil rights and consumer organizations applaud Chairman Watt and members of the Subcommittee on Oversight and Investigations for holding this hearing on Credit-Based Insurance Scores: Are They Fair? This statement is intended to supplement the written testimony submitted by the Center for Economic Justice and the National Council of La Raza.

Unknown to most consumers, insurers' use of consumer credit information has spread to almost all insurers and is one of the most important factors in determining how much a consumer pays

for auto or homeowners insurance. Insurance companies use credit scores – three digit numbers generated using a consumer’s credit report – in insurance underwriting and rate setting. This practice creates wide racial disparities as previous studies have found. Nevertheless, much of the insurance industry relies on credit scoring because it is allegedly predictive in forecasting which consumers will have higher loss ratios. Yet the industry has not been able to provide credible explanation as to why there is a correlation between credit scores and loss ratios.

For these reasons, we echo the call of many organizations and public officials for a prohibition on insurance scoring and insurers’ use of consumer credit information for underwriting and ratings purposes.

Before the introduction of the credit scoring systems, the insurance industry had used other unsupported standards and stereotypes with a racial proxy effect. After the major companies were sued for fair housing violations and were forced to eliminate these practices, the industry introduced a new practice – credit-based insurance scoring – that consumer and civil rights groups see as re-introducing unfair racial and ethnic impacts into the pricing of insurance.

Previous studies by the Missouri and Texas Departments of Insurance have found that insurance scoring discriminates against low income and minority consumers because of the racial and economic disparities inherent in scoring. The Missouri study concluded that a consumer’s race was the single most predictive factor determining a consumer’s insurance score and, consequently, the consumer’s insurance premium.

We were pleased that Congress, through the inclusion of Section 215 of the Fair and Accurate Credit Transactions Act of 2003, directed the Federal Trade Commission in conjunction with the Federal Reserve Board to study the impact of credit scoring on the availability and affordability of credit and insurance and to determine whether credit scoring was truly related to insurance losses or simply a proxy for race, income or other factors. The FTC conducted the insurance scoring component of this research.

Unfortunately, we find that the FTC study is fatally flawed in key areas and is not responsive to the Congressional mandate contained in the FACT Act. Most critically, instead of requiring the submission of comprehensive policy data by a large number of insurers, the FTC allowed the insurance industry to self-select the data for analysis. Thus the industry was unnecessarily afforded an opportunity to control the outcome of the study.

Even so, the FTC study found that insurance scores were worse on average for African Americans and Latino consumers, although this finding is downplayed in the report. The study also confirms that despite the growing reliance on credit-based insurance scores, there was no evidence to prove a causal connection between a consumer’s score and auto insurance losses. Without the need to demonstrate such a connection, insurers could use any consumer characteristic, such as hair color, to price insurance products.

The FTC report acknowledges that the alleged correlation between risk and credit-based insurance scores might be explained by other factors. Instead of pursuing these other factors, the FTC employed subjective and pejorative racial stereotypes to try to support the alleged link

between credit-based insurance scores and legitimate risk. Thus the FTC report mimics the insurance industry blaming-the-victim rationalization of claiming credit history is related to responsibility and risk management. A look at the actual scoring models shows that socio-economic factors have more impact on the score than loan payment history and that an insurance credit score has little to do with personal responsibility and everything to do with economic and racial status.

In short, there is ample evidence to justify banning credit-based insurance scores. Moreover, given the biased and flawed nature of the FTC study on scoring for auto insurance, the undersigned organization encourages Congress to consider assigning responsibility to conduct the homeowners scoring study to another agency, such as the U.S. General Accountability Office, which could then work in conjunction with state insurance regulators who have the necessary authority to obtain the desired data set from the insurance industry.

###

**Center for Economic Justice** is a Texas-based non-profit organization that advocates on behalf of low income and minority consumers on insurance, credit and utility issues

**Consumer Federation of America** is a nonprofit association of some 300 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education. [www.consumerfed.org](http://www.consumerfed.org)

**National Consumer Law Center** is a non-profit organization specializing in consumer issues on behalf of low-income people. NCLC recently released *Credit Scoring and Insurance: Costing Consumers Billions and Perpetuating the Economic Racial Divide*, available at [www.consumerlaw.org](http://www.consumerlaw.org).

**National Council of La Raza** is a private, nonprofit, nonpartisan organization established in 1968 to reduce poverty and discrimination and improve opportunities for the nation's Hispanics. As the largest national Latino civil rights and advocacy organization, NCLR serves all Hispanic nationality-groups in all regions of the country through a network of more than 300 affiliate community-based organizations.

**National Fair Housing Alliance** is a consortium of more than 220 private, non-profit fair housing organizations, state and local civil rights groups, and individuals from 37 states and the District of Columbia. Headquartered in Washington, DC and founded in 1988, NFHA, through comprehensive education, advocacy and enforcement programs, provides equal access to housing for millions of people.

**Consumers Union of U.S., Inc.** Consumers Union (CU) is an expert, independent, nonprofit organization, whose mission is to work for a fair, just, and safe marketplace for all consumers. CU publishes *Consumer Reports* and [ConsumerReports.org](http://ConsumerReports.org) in addition to two newsletters, *Consumer Reports on Health* and *Consumer Reports Money Adviser* with combined subscriptions of more than 7 million. Consumers Union also has more than 500,000 online activists who help work to change legislation and the marketplace in favor of the consumer



interest and several public education Web sites. Since its founding in 1936, Consumers Union has never taken any advertising or freebies of any kind. The organization generates more than \$160 million in revenue and a staff of more than 500 work at either CU's 50 state-of-the-art labs in Yonkers, NY; its 327-acre auto test facility in East Haddam, CT.; or the three advocacy offices in Washington DC, Austin, TX, and San Francisco, CA.

## **ATTACHMENT 2**

Testimony Before The  
House Financial Service Committee  
Subcommittee on Oversight and Investigations  
Credit-Based Insurance Scores: Are They Fair?

October 2, 2007

Birny Birnbaum  
Executive Director  
Center for Economic Justice  
1701 A South Second Street  
Austin, TX 78704  
(512) 912-1327  
[birny@flash.net](mailto:birny@flash.net)

### **1. Introduction**

Chairman Watt, Ranking Member Miller and Members of the Committee:

Thank you for the opportunity to discuss insurers' use of consumer credit information for auto and homeowners insurance. My name is Birny Birnbaum and I am the Executive Director of the Center for Economic Justice, an Austin, Texas-based non-profit that advocates on behalf of consumers on insurance, credit and utility matters.

I have been working on insurance credit scoring issues since 1991 as both an insurance regulator – Chief Economist and Associate Commissioner for Policy and Research at the Texas Department of Insurance – and as a consumer advocate. I have testified about insurance credit scoring before legislatures and administrative agencies, including insurance departments and public utility commissions, and provided expert testimony in litigation related to insurance credit scoring. I received my formal training in economics from the Massachusetts Institute of Technology and have been accepted as an expert on both economic and actuarial matters related to auto and homeowners insurance rates and risk classification.

## 2. Summary of Testimony

Insurance scoring is the use by insurance companies of consumer credit information to determine whether a consumer is eligible for coverage, the types and amount of coverage offered to a consumer and the premium charged to the consumer. The use of insurance scoring has grown to become one of the most important factors in determining a consumer's auto and homeowner's insurance premium and is used by almost all insurers. Insurance scoring is typically done through the use of computer model that converts information in a consumer's credit report into a score, or numerical value, which is then used as an underwriting or rating factor.

Many organizations have called for a prohibition on insurance scoring and insurers' use of consumer credit information for underwriting and rating. These groups include not only consumer organizations, but civil rights groups, insurance agents' groups and some insurers. The case for such a prohibition is strong – there is more than enough information currently available to justify such a prohibition. A closer look at insurance scoring reveals that the practice

- Undermines core functions of insurance system by worsening insurance availability and affordability and undermining the critical role of insurance in encouraging loss prevention;
- Discriminates against low income and minority consumers;
- Is arbitrary and unrelated to how well a consumer "manages" her finances;
- Is inherently unfair and penalizes consumers who are the victims of economic or medical or natural catastrophes;
- Penalizes consumers because of the business decisions of lenders.

The insurance industry claims a variety of benefits from their use of credit scoring. Upon examination, these claims are illusory and contradicted by the available evidence. Ultimately, however, all of the insurer arguments for insurance scoring come down to a single claim: insurance scoring is predictive of the likelihood of a consumer having a claim and consumes benefit if insurers are able to price more accurately.

There is, however, strong evidence that insurance scoring itself is not a predictor of risk or insurance claims, but, rather, that insurance scoring is a proxy for some other factor or factors that are truly related to claim experience. In particular, insurance scoring is a proxy for race and income. Two independent studies by the Texas and Missouri Departments of Insurance found a strong relationship between insurance scores and race and income. The Missouri study found the single most predictive factor of an insurance score was race. Even the recent flawed and biased FTC report on insurance scoring – despite relying upon data hand-picked by the insurance industry – found insurance scores were worse on average for African-Americans and Hispanics and that insurance scoring was a proxy for race. And had the FTC actually used an independent

and comprehensive set of insurance data, the measured racial discrimination would have been much greater. Although the FTC report discounts its own findings and plays down the importance of racial discrimination, the finding of racial discrimination from insurance scoring justifies a prohibition. Insurers should not be permitted to use a proxy for race when the direct use of race itself for underwriting or rating is prohibited.

The FTC analysis of insurance scoring is deeply flawed and the report is unresponsive to its Congressional mandate. The problems include:

1. The failure to obtain a comprehensive and independent data set for analysis and the reliance upon a data set hand-picked by the insurance industry. The insurance industry effectively controlled the study by dictating the data that would be used in the study.
2. No substantive analysis of the impact of insurance scoring on the availability and affordability of insurance products as requested by Congress. Because of its reliance on industry-selected data, the FTC performed no analysis of how consumers actually fared from insurers' use of credit scoring.
3. Regurgitating insurer claims about credit scoring despite evidence that contradicts these claims. The FTC ignored evidence indicating that the correlation between insurance scores and claims was a spurious correlation – that insurance scoring was a proxy for some other factor actually related to claims.
4. The failure to analyze the "blaming-the-victim" strategy used by insurers to justify insurance scoring -- the bogus claim that people who manage their finances well are likely to manage their risks well and that's why credit scoring works. The fact is that, by the credit modelers own admission, fully 20% of the population is unscorable with tradition credit reports because of little or no information in the files. These folks are disproportionately low income and minority consumers who get charged higher rates through no fault of their own. And even a cursory examination of actual scoring models reveals that most of the factors determining an insurance score have nothing to do with whether a consumer pays her bill on time, but with factors related to socio-economic status. Yet, the FTC report dutifully repeats this desperate rationalization for insurance scoring with no critical analysis.

5. The failure to examine any alternatives to insurance scoring that are predictive of claims but are not based on any consumer credit information. The FTC ignored research indicating that insurers could eliminate the use of credit information but obtain the same ability to predict claims with advanced modeling and data mining of traditional rating factors. Consequently, the FTC ignored an obvious alternative to insurance scoring that could reduce the impact on low income and minority consumers.

There is no need for further study of insurance scoring to justify its prohibition. The problems with insurance scoring are well documented and the alleged benefits claimed by insurers are illusory. However, if Congress does want additional study, it has become clear that the FTC should not be doing that analysis. The FTC has not only revealed a strong bias toward the insurance industry in the July report on auto insurance, but has indicated it remains willing to allow the insurance industry to control the data for an analysis of insurance scoring for homeowners insurance. Congress should turn to the Government Accountability Office and state insurance regulators for any additional research on insurance scoring. The active involvement of state insurance regulators is particularly important for two reasons. First, state insurance regulators have authority to obtain data from insurance companies and the use of a comprehensive and independent data set is crucial to an unbiased analysis. Second, insurance scoring is primarily regulated by the states. State insurance regulators should be the most knowledgeable about how insurance scoring is used and how it impacts the availability and affordability of insurance.

The remainder of my testimony expands upon these points.

### **3. Insurance Credit Scoring is an Unfair Practice**

Insurance credit scoring is the practice by insurers of using consumers' credit information for underwriting, tier placement, rating and/or payment plan eligibility. The problems with insurance scoring are so great that the practice should be prohibited. Insurance scoring should be prohibited because it:

- is inherently unfair;
- has a disproportionate impact on consumers in poor and minority communities;
- penalizes consumers for rational behavior and sound financial management practices;
- penalizes consumers for lenders' business decisions unrelated to payment history;
- is an arbitrary practice; and
- undermines the basic insurance mechanism and public policy goals for insurance.

There is widespread opposition to insurance credit scoring among consumers and insurance agents. There are hundreds of agents who want to come forward and tell why they are opposed to insurance credit scoring, why insurance credit scoring has worsened insurance availability and how insurance credit scoring has a disproportionate impact on poor and minority consumers. But they can't tell their stories because of their fear of reprisal by the insurance companies they represent. To hear from these agents, the agents must be given protection against these reprisals. To give you a sense of who these agents are, the following agent organizations have come out

against insurance credit scoring – National Association of State Farm Agents, National Association of Professional Allstate Agents and the United Farmers Agents Association.

### Insurance Scoring is Inherently Unfair

You've just been laid off from your job. Or your daughter has a major medical problem that your health insurance (if you have any) doesn't fully cover. Or you've just gotten a divorce. These three life events account for 87% of family bankruptcies.<sup>9</sup> To "help" you out in this stressful time, your insurance company will raise your homeowners and auto insurance rates because of insurance credit scoring.

The disagreements about insurance credit scoring really boil down to what "fair" means. For insurers, "fair" means that an insurer can produce some kind of data showing a statistical relationship between credit scores and insurance losses. For consumer groups, such a statistical relationship is a necessary, but not sufficient, definition of fair insurance practices. Fair rating factors must also not penalize consumers for rational behavior, for factors outside of their control and for arbitrary practices of insurers and lenders. Fair means that consumers who are the victims of some economic or medical catastrophe are not penalized because they were unlucky enough to lose their jobs, have a family member get sick or get divorced.

When it comes to the real world understanding of fair, insurance credit scoring is terribly unfair.

- Because your credit score depends on having the "right" kind of information in your credit report, you can have a perfect credit history and still get a bad credit score. Contrary to insurer credit scoring myths, your credit score has nothing to do with your "financial responsibility."
- Because your credit report can vary dramatically among the three major credit bureaus, your credit score can vary from good to bad depending upon which bureau provided your insurer with information.
- Because your credit score is based on many things other than how timely you pay your loans, your score can vary dramatically depending on what time in the month your credit report was ordered.
- Because your credit score depends on what type of credit you have, you can get a low score even if you have a perfect payment record. If you have a credit card with a tire company, a loan from a consumer finance company like Household or Beneficial, or have an installment sales contract from a used car dealer, you get a lower score regardless of whether you pay on time. But if you have a gas station credit card, your score is higher!
- Because your credit score depends on the presence of loan information, you get a lower score if you pay in cash or don't borrow much or if you use lenders that don't

---

<sup>9</sup> 2001 Consumer Bankruptcy Project, cited on page 81 of *The Two Income Trap*, Elizabeth Warren and Amelia Tyagi.

report to credit bureaus. Many younger consumers were penalized with higher rates due to so-called “thin” credit files because the Sallie Mae – the student loan lender to millions – decided it would only report payment history to one of the three major credit bureaus.

- Because your credit score depends on the ratio of your debt to your credit card limit, a consumer who uses one credit card to maximize frequent flier miles gets a lower score than another consumer who charges the same amount but does it on three or four cards.

### Insurance Scoring Penalizes Victims of Economic or Medical Catastrophes

Insurance credit scoring is inherently unfair because it penalizes consumers who are the victims of economic or medical catastrophes, such as job loss, divorce, dread disease or terrorist attack. For example, in the aftermath of the September 11 attack, hundreds of thousands of people working in the travel-related industry lost their jobs. Out of this group, thousands had to increase borrowing to offset loss of income or loss of health insurance. Many filed for bankruptcy. In the aftermath of Hurricane Katrina, hundreds of thousands of consumers were displaced and placed in financial stress. It is unfair for insurance companies to further penalize these victims by raising their homeowners and auto insurance rates.

One of the myths perpetrated by insurers to rationalize the use of insurance credit scoring to legislators is the myth of the immoral debtor. Insurers argue that good credit scores reflect the financial responsibility of consumers. And they ask why should financially responsible consumers subsidize the rates of consumers who are not financially responsible? As explained further below, this argument fails because a good credit history does not equate to a good credit score. Stated differently, an insurance score is simply not a measure of financial responsibility.

Regarding the “immoral debtor,” data on the causes of bankruptcies reveal that the overwhelming majority of bankruptcies result from job loss, medical problems and divorce. Fully 87% of bankruptcies for families with children arise from these three reasons. And the remaining 13% includes reasons such as natural disaster or crime victim.<sup>10</sup>

In their recent book, *The Two Income Trap*, Elizabeth Warren and Amelia Tyagi study the growth, composition and causes of bankruptcy. They were astonished to find that the number of women filing for bankruptcy grew from 69,000 in 1981 to nearly 500,000 by 1999. As they researched the causes of this phenomenon, they documented the fact that financial strain on families – particularly families with children – resulted from dramatic increases in the cost of housing, health care and schooling combined with deregulation of interest rates for loans and business decisions made by lenders for easy credit. They found that married couples with children are more than twice as likely to file for divorce than couples without children and that a divorced woman raising a child is nearly three times more likely to file for divorce than a single woman without a child. They concluded that “having a child is the single best predictor that a

---

<sup>10</sup> 2001 Consumer Bankruptcy Project, cited on page 81 of *The Two Income Trap*, Elizabeth Warren and Amelia Tyagi.

woman will end up in financial collapse.” Their research shows that the insurer rationalization for insurance credit scoring – “financial responsibility” – is indeed a myth refuted by the facts.

### A Good Credit History Does NOT Equal a Good Credit Score

Insurance credit scoring is inherently unfair because a good credit history does not equal a good credit score or favorable insurance treatment. This occurs because insurance credit scores are based not just on bankruptcies and delinquencies, but also on other factors unrelated to credit management. For example, credit scores are often based on the type of credit (consumer finance loans are less favorable than bank loans), the number of credit cards (there is a magic number that is optimal, even if the consumer only uses the retail store cards once to get the first time 10% purchase discount), length of time credit has been established (which is another way of charging younger people more), length of time since last account opened (which penalizes families that have just moved or refinanced their mortgage) and the number of inquiries (which penalizes consumers who shop around for the best rate – behavior that should be rewarded and not punished with higher insurance rates.) While the insurance industry offers a rationale for each of these factors, the fact is that insurance credit scoring casts too wide a net and penalizes people engaged in behavior we would all consider good financial management.



## Insurance Credit Scoring Produces Arbitrary Results

Insurance credit scoring is unfairly discriminatory and violates actuarial standards for risk classification because it is an arbitrary process. For example, your score can vary from very bad (“high risk”) to very good (“low risk”) depending on which credit reporting agency provides the credit information to the insurer because a consumer’s information varies among the big three bureaus. A representative from ChoicePoint admitted this in a hearing before the Georgia Insurance Commissioner in 2001. The author recently ordered my three-bureau credit report and found different inquiries in each of the three bureaus – not one single inquiry was reported by more than one bureau.

Insurance credit scoring is arbitrary because a score can change dramatically over a short time frame for no apparent reason. The author’s auto credit score in November 2002 (obtained from [www.choicetrust.com](http://www.choicetrust.com)) was very low – around the 17<sup>th</sup> percentile. In May 2003, the author’s score was in the 82<sup>nd</sup> percentile. In six months (or perhaps a shorter period), the author’s score went from very high risk to very low risk. No other insurance risk factor is so arbitrary.

## Consumers Penalized for Lenders’ Business Decisions

Over the course of the 1990’s consumer debt grew dramatically as lenders made credit more easily available to many consumers. The number of credit card solicitations grew from 1 billion to 5 billion annually. Lenders moved to low- or no-down payment mortgages. Although lenders are certainly free to make business decisions about loaning money, consumers should not be penalized with higher homeowners or auto insurance premiums because of those decisions.

To illustrate the problem, Fannie Mae recently began requiring a 10% down payment for 30 year mortgages on manufactured homes. Previously, consumers could get a loan with no money down. In defending the proposal, Deborah Tretler, vice president of single family homes for Fannie Mae, stated, "We don't serve borrowers well when it is easy for a borrower to get into a home under very flexible terms, only to have them lose their home, their credit ruined and their homeownership dreams turned into a nightmare."<sup>11</sup>

Warren and Tyagi, in *The Two-Income Trap*, explain how lenders make lots of money off of problem borrowers through higher interest rates and substantial penalty fees.

It is not only lenders’ lending decisions that make insurance scoring unfair, it is also lenders’ reporting decisions to credit bureaus. In some cases, lenders report only partial information about loans to credit bureaus. For example, some major credit card vendors do not report card limits, to prevent competitors from learning about their customers. But by failing to report credit limits, the insurance credit scoring models often use the current balance as the limit – with the result that the consumer appears to be maxing out his or her credit line. Which, in turn, lowers the insurance score.

---

<sup>11</sup> “Mortgage regulations could stop some would-be homeowners,” by Genaro C. Armas of the Associated Press in the September 12, 2003 issue of the *Austin American-Statesman*.

In another example, Sallie Mae, the nation's largest lender for student loans with millions and millions of borrowers, has decided to report loan information to only one of the three major credit bureaus – again, to protect its customer list. If a consumer who has a good student loan payment history seeks auto insurance and the insurer happens to use a credit bureau that Sallie Mae has not reported to, the consumer gets a lower score than he or she should because a lack of information penalizes a consumer in an insurance score.

In yet another example, journalist Ken Harney explains how some lenders refuse to report the credit limits on credit cards and other loans to credit bureaus. Absent this information, the credit bureaus report the current debt balance as the credit limit. This harms consumers because a factor in credit scores is the ratio of current debt to credit limits. Harney cites a consumer who was charged a much higher rate than she would have been had the lenders reported her credit limits:

*That extra expense would not have been caused by anything she did wrong, but rather by what the card company did without her knowledge: keep her good credit behavior a secret from potential competitors by withholding her credit limit and highest balance, thereby decreasing her credit score. Credit card companies sometimes try to hide their best customers' identities from other lenders trolling the credit bureaus' vast databases to prescreen targets for card offers. Typically the trollers ask the bureaus for lists of cardholders with higher scores, and avoid those with marginal or lower scores.<sup>12</sup>*

These examples of how lenders' business decisions can dramatically affect an insurance consumer's insurance score further illustrate the arbitrary and unfair nature of insurance credit scoring.

Most recently, the explosion in subprime lending included thousands of instances of inappropriate loans to consumers – loans the consumer would clearly be unable to afford even if housing prices continued to grow and interest rates remained low. There were instances of abusive sales practices. Again, the question arises, why should these consumers suffer higher auto and homeowners insurance rates because of the business decisions and practices of lenders?

---

<sup>12</sup> Ken Harney, "2 Missing Numbers Can Doom a Loan," *Washington Post*, 1/1/05, page F1. See also Kenneth Harney, "Credit Card Limits Often Unreported," *Washington Post*, 12/25/05, page F1.

## Insurance Credit Scoring Penalizes Consumers in Poor and Minority Communities

In addition to being arbitrary, insurance credit scoring also has a systematic bias against consumers in poor and minority communities, described further below. ***It is important to state clearly that the claim that insurance credit scoring has a disproportionate impact on consumers in poor and minority communities is NOT an argument that poor people are poor financial managers. The two arguments are unrelated because good financial management / good credit history does NOT equate to a good insurance credit score. It is the structure of insurance credit scoring models – and not the financial management habits of low-income consumers – that creates the bias against consumers in poor and minority communities.*** Further, it is unclear how anyone who has actually examined the factors and structure of insurance credit scoring models could legitimately assert that the claim of systematic bias against consumers in poor and minority communities is a critique of the financial management habits of low-income consumers.

## Insurance Credit Scoring: 21<sup>st</sup> Century Redlining and the End of Insurance

There are two main reasons CEJ works on insurance issues, particularly as they impact low income and minority consumers. First, insurance is the mechanism that consumers and businesses use to protect their assets in the aftermath of a catastrophic event – whether that’s a fire, an auto accident, a natural disaster, theft. Insurance enables consumers and businesses to preserve and to build assets, wealth and financial security. Insurance is essential for individual and community economic development. And low income consumers should have the same access to these essential financial tools as more affluent consumers. The history of insurance redlining, however, is a story of less access, inferior products and higher prices for low income and minority consumers.

Second, insurance is the primary mechanism for loss prevention – insurance provides economic incentives for less risky behavior and economic disincentives for more risky behavior. Or at least, that is what insurance pricing should do. Insurance pricing should be based on factors that are under the control of the consumer and which make a difference in the likelihood of an auto accident or homeowners’ claim. Insurance is the primary tool to encourage behavioral changes that actually reduce accidents, human suffering and property damage.

Insurance credit scoring undermines these public policy goals in at least two ways. First, even if insurance credit scoring did what it’s purported to do – charge higher rates for consumers with a poor credit history – it is inherently unfair and undermines the basic purpose of insurance which is to protect consumers’ assets in catastrophic times. Consider that 87% of families who file for bankruptcy do so because of one of three reasons – job loss, divorce, catastrophic illness. So even if insurance credit scoring is working as its proponents claim, the practice penalizes those consumers who are victims of an economic catastrophe with, at best, higher rates, and at worst, the elimination of coverage in the time of greatest need.

Second, the use of insurance credit scoring undermines the other core purpose of insurance by giving more and more weight in the rating process to factors outside of the consumer’s control and which provide no economic incentive for loss prevention. Insurance credit scoring undermines the loss prevention capacity of insurance because it is unrelated to behavioral

changes that reduce the likelihood of an accident or damage from an event. When you know that insurance rates will go up by 25% if you get a speeding ticket or an at-fault accident, that knowledge affects your behavior. When you get a discount for putting on hail-resistant shingles on your home or installing an anti-theft device in your vehicle, the consumer is in a position to take positive action to not only affect the likelihood of an accident or claim, but also in a position to lower his or her premium. And these types of discounts provide a benefit to some consumers without raising the rates for other consumers – you can give someone a 40% discount for a hail resistant roof and pay for that discount with lower expected losses – so a discount for one does not mean a rate increase for another. With insurance credit scoring, it's less than a zero sum game – since there is no reduction in losses, any discounts for some consumers must be paid for by rate increases for other consumers and insurance credit scoring adds costs to the system.

#### **4. The Impact of Insurance Credit Scoring on Poor and Minority Consumers**

Despite insurers' claims to the contrary, it is clear that insurer underwriting and rating practices now emphasize a consumer's economic status rather than their driving record.

##### **4.1 Prior Bodily Injury Limits**

For example, several insurers now charge higher rates to consumers because of their prior liability limits. If your previous policy was a basic limits policy, you will be charged more than if your previous policy was, say, 50,000/100,000 limits. The use of prior liability limits by insurers to determine assignment to a rating tier clearly penalizes low income consumers because of their income. Given that insurers are completely willing to use underwriting and rating factors that penalize consumers because of economic status, it should be no surprise that insurance credit scoring has a disproportionate impact on consumers in low-income and minority communities.

##### **4.2 Insurance Credit Scoring Penalizes Consumers in Low-Income and Minority Communities**

Despite insurer protests, there is no ample evidence that insurance credit scoring penalizes consumers in low-income and minority communities.

#### 4.2.1 Fair Isaac Admission

On the issue of insurance credit scoring versus income and race, the Executive Vice President of Fair, Isaac and Company, Peter McCorkell, admitted that insurance credit scoring has a disparate impact based upon race and income:

***Doesn't scoring result in higher reject rates for certain minorities than for whites?***

Again, the short answer is, "Yes," but it is the wrong question. The question ought to be: "Does credit scoring produce an accurate assessment of credit risk regardless of race, national origin, etc.?" Studies conducted by Fair, Isaac, and Company, Inc. (discussed in more detail below) strongly suggest that scoring is both fair and effective in assessing the credit risk of lower-income and/or minority applicants. Unfortunately, income, property, education, and employment are not equally distributed by race/national origin in the United States. Since all of these factors influence a borrower's ability to meet financial obligations, it is unreasonable to expect an objective assessment of credit risk to result in equal acceptance and rejection rates across socioeconomic or race/national origin lines. By definition, low-income borrowers are economically disadvantaged, so one would not expect their score distributions to mirror those of higher-income borrowers.<sup>13</sup>

#### 4.2.2 Freddie Mac Study

In its 1999 National Consumer Credit Survey, Freddie Mac found:

Having a poor credit record is a relatively common problem in today's society. Using the combined results from the CCS (i.e., African-Americans, Hispanics and Whites) we estimate that:

30% of these groups have "bad" credit records  
13% of these groups have "indeterminate" credit records  
57% of these groups have "good" credit records

Credit problems persist across income groups. We estimate that:

36 % of consumers with incomes under \$25,000 had "bad" credit records  
33 % of consumers with incomes of \$25,000 to \$44,999 had "bad" credit records  
25 % of consumers with incomes of \$45,000 to \$64,999 had "bad" credit records  
22 % of consumers with incomes of \$65,000 and \$75,000 had "bad" credit records

Minority borrowers are more likely than white borrowers to experience credit problems. For African-Americans we estimate that:

48% of African Americans have "bad" credit records

---

<sup>13</sup> Page 15, Fall 2000 Issue of *Profitwise*, a publication of the Federal Reserve Bank of Chicago.

16% of African Americans have "indeterminate" credit records  
36% of African Americans have "good" credit records

For Hispanics we estimate that:

34% of Hispanics have "bad" credit records  
15% of Hispanics have "indeterminate" credit records  
51% of Hispanics have "good" credit records

For Whites, in contrast, we estimate that:

27% of Whites have "bad" credit records  
12% of Whites have "indeterminate" credit records  
61% of Whites have "good" credit records

It is unclear how the quality of credit histories can vary by income and race, but the insurance industry still maintains insurance credit scoring has no disparate impact based upon income and race.

#### *4.2.3 Data from the Survey of Consumer Finances*

Statistics the Survey of Consumer Finances, reported in the 2000 Statistical Abstract of the United States reveal that credit characteristics vary not only by age and income, but also over time within age and income segments. Table 792 – *Financial Assets Held by Families by Type of Asset: 1992 to 1998* shows the ownership of any financial assets varies dramatically by age and income. The ownership of financial assets is related to the ability of a family to withstand an economic or medical catastrophe.

Table 796 – *Ratios of Debt Payments to Family Incomes: 1992 to 1998* shows higher ratios of debt payments to family income and much higher ratios of families with payments 60 or more days due for younger and lower income families. The table also shows how these ratios – both of which figure prominently in insurance credit scores – vary over time.

Table 817 – *Usage of General Purpose Credit Cards by Families: 1992 to 1998* shows that younger and poorer families are much less likely to pay off credit card balances each month and far more likely to hardly ever pay off the balance than older or more affluent families. Again, these characteristics – which vary by age and income – figure prominently in insurance credit scores.

#### *4.2.4 The University of Texas Study*

Further evidence of the disproportionate impact of insurance credit scoring on poor and minority consumers comes from the report prepared by the University of Texas Bureau of Business Research on the relationship between insurance credit scoring and insurance losses. The authors' analysis of the correlation between insurance credit scoring and insurance losses is unreliable – it relies upon a simple loss ratio methodology that the NAIC insurance credit scoring working

group rejected in 1996 as “misleading and counterproductive.” However, the report does reveal other important findings.

The authors found that average and median credit scores were much higher in the standard market than in the nonstandard (so-called “high risk”) market. But the scores were taken from policies issued in 1998 – before the insurers were using credit history to underwrite consumers in the standard and nonstandard markets. Consequently, if credit history was unrelated to underwriting risk factors used by insurers, we would expect average scores to be similar in the standard and nonstandard markets. The fact that the scores were so different between the two markets means that insurers were already using some underwriting factor or factors to distinguish risk of consumers that is correlated to credit.

In addition to showing that credit scores are a proxy for other risk factors used by insurers, the difference in credit scores between the standard and nonstandard markets also indicates that credit scores are correlated to race and income of consumers. Just as low credit scores are more prevalent in the nonstandard market, the likelihood of being denied coverage in the standard market and ending up in a high-cost county mutual grows dramatically as the neighborhood becomes less affluent and less white.

## Standard Auto Insurance Market Rejection Rates in Texas versus Race and Income

Automobile Rejection Rate	1996 Average of Non-Anglo Population Percentage	1996 Average of Median Household Income	1996 Number of ZIP Codes
0.0% to 5.2%	4.7%	\$22,414	1
5.3% to 10.4%	12.1%	\$44,042	74
10.5% to 15.6%	13.6%	\$30,565	317
15.7% to 20.8%	20.7%	\$24,871	413
20.9% to 26.0%	29.4%	\$24,523	280
26.1% to 31.1%	43.0%	\$23,456	142
31.2% to 36.3%	54.6%	\$21,549	79
36.4% to 41.5%	68.5%	\$19,954	65
41.6% to 46.7%	82.7%	\$17,682	45
46.8% to 51.9%	83.7%	\$16,441	38
Over 51.9%	92.3%	\$14,015	26

### 4.2.5 *Factors Used in Insurance Credit Scoring Models are Biased Against Consumers in Low-Income and Minority Communities*

A review of the factors contained in insurance scoring models – and the information missing from consumer credit reports and scoring models – further documents the disproportionate impact of insurance credit scoring against poor and minority consumers.

Reason codes for insurance models from ChoicePoint include factors that systematically discriminate against consumers in poor and minority communities. In the ChoicePoint models, a consumer's score is affected by the type of credit and/or the type of lender -- regardless of whether the consumer is current on the payments. A consumer who gets a loan from a consumer finance company gets a lower score than a consumer who gets a loan from a bank – even if the consumer has a perfect payment record. A consumer who has a credit card from a tire store -- such as Goodyear -- gets a lower score just for having that account. A consumer who buys a car through an installment sales contract gets a lower score -- even if the payment record is perfect. Clearly, consumers in less affluent neighborhoods are far more likely to use these types of credit mechanisms than consumers in more affluent communities.

The fact is that the financial institutions in poor and minority communities are different from those in more affluent white communities. And this difference results in a systematic bias in insurance credit scoring models. As a further example, consider payday lenders, check cashing lenders and rent-to-own businesses – which target poor consumers. Even if a consumer was able to pay the extraordinarily high interest rates from these businesses, it would not help the consumer's insurance score – because these institutions do not report to credit bureaus. And the



absence of information in a credit report is a credit score negative. Consequently, consumers who pay in cash or who use financial institutions that do not report to a credit reporting agency are penalized with lower scores. Finally, consider a consumer who demonstrates financial responsibility by paying all her utility bills on time for decades. This actual financial responsibility is not rewarded in insurance credit scoring models because these payments do not appear in credit reports.

#### 4.2.6 *The Missouri Department of Insurance Study*

A few weeks ago, the Missouri Department of Insurance released a study that specifically examined the impact of insurance credit scoring on the availability of insurance coverage in poor and minority communities. This is the first independent study based on detailed insurance credit scoring data using rigorous statistical analysis. The Department collected credit score data aggregated at the ZIP Code level from 12 insurers for the study period of 1999 to 2001. For each Missouri ZIP Code, the Department obtained:

- Mean credit score
- The number of exposures for each of five equal credit score intervals

The Department then utilized a variety of multi-variate statistical techniques to isolate the relationship of income and race to insurance credit scoring, independent of other factors. The study found:

- ***The insurance credit-scoring system produces significantly worse scores for residents of high-minority ZIP Codes.*** The average credit score rank in “all minority” areas stood at 18.4 (of a possible 100) compared to 57.3 in “no minority” neighborhoods – a gap of 38.9 points. This study also examined the percentage of minority and white policyholders in the lower three quintiles of credit score ranges; minorities were overrepresented in this worst credit score group by 26.2 percentage points.
- ***The insurance credit-scoring systems produces [sic] significantly worse scores for residents of low-income ZIP Code.*** The gap in average credit scores between communities with \$10,953 and \$25,924 in *per capita* income (representing the poorest and wealthiest 5 percent of communities) was 12.8 percentiles. Policyholders in low-income communities were overrepresented in the worst credit score group by 7.4 percentage points compared to higher income neighborhoods.
- ***The relationship between minority concentration in a ZIP Code and credit scores remained after eliminating a broad array of socioeconomic variables, such as income, educational attainment, marital status and unemployment rates, as possible causes.*** Indeed, minority concentration proved to be the single most reliable predictor of credit scores.
- ***Minority and low-income individuals were significantly more likely to have worse credit scores than wealthier individuals and non-minorities.*** The average gap between minorities and non-minorities with poor scores was 28.9 percentage points. The gap between

individuals whose family income was below the statewide median versus those with family incomes above the median was 29.2 percentage points.

Based upon the results of this study, the former Governor of Missouri has called for a ban on insurance credit scoring.

#### *4.2.7 The Texas Department of Insurance Preliminary Report*

The Texas Department of Insurance (TDI) reviewed over 2 million policyholder records and obtained policyholder-specific information on race. The TDI report, issued in the beginning of January 2005, states unequivocally that insurance credit scoring discriminates against minority consumers:

The individual policyholder data shows a consistent pattern of differences in credit scores among the different racial/ethnic groups. The average credit scores for Whites and Asians are better than those for Blacks and Hispanics. In addition, Blacks and Hispanics tend to be over-represented in the worse credit score categories and under-represented in the better credit score categories.<sup>14</sup>

The TDI study confirms and validates the Missouri Department of Insurance (MDI) study. Insurers complained about the Missouri study because it inferred socio-economic characteristics from ZIP Codes to average credit scores. But the MDI methodology is well accepted in the field of fair lending analysis. The TDI study not only confirms the MDI study results – it validates the MDI methodology.

#### *4.2.8 Traditional Credit Reports Penalize Low Income and Minority Consumers*

CEJ and other consumer groups have long argued that traditional credit reports penalize low income and minority consumers because the absence of credit information – so-called “thin files” – results in higher premiums. In the past year, the credit report and credit scoring industry has admitted this bias against consumers. Several vendors are now developing “non-traditional” credit reports, which include information not contained in traditional credit reports, such as rent and utility payments and activity related to non-traditional loans. Fair, Isaac, the original developer of lending and insurance credit scoring models claims that 50 million Americans are unscorable using traditional credit information because of thin files.<sup>15</sup> First American, a provider of credit information, claims its non-traditional credit reports will benefit minority and low-income families<sup>16</sup>, indicating that traditional credit reports harm these consumers. Insurers have always used traditional credit reports and penalized consumers with thin files and such practices have resulted in disproportionately higher premiums for low-income and minority consumers as well as some seniors.

---

<sup>14</sup> Texas Department of Insurance, “Report to the 79<sup>th</sup> Legislature: Use of Credit Information in Texas,” December 30, 2004, page 3.

<sup>15</sup> “Giving Credit Where Credit’s Due,” Kenneth Harney, *Washington Post*, November 11, 2006, Page F1

<sup>16</sup> <http://www.credco.com/Anthem/default.htm>

### 4.3 Conclusion

In conclusion, the problems with insurance credit scoring are apparent and even acknowledged by the industry, as evidenced by their “compromise” proposal (the NCOIL model) with a variety of purported restrictions and regulatory oversight. But what are the great benefits to consumers that warrant the use of this problematic factor and intense regulatory resources? Ultimately, there are none. Moreover, all the benefits alleged by the insurance industry come down to one claim – the purported statistical relationship between credit scores and loss ratios. And while a definitive statistical relationship is a necessary justification for the use of certain information as an underwriting or rating factor, such a statistical relationship can not be sufficient justification. If it were, then race would be a legitimate rating factor. But lawmakers across the country have decided that race is not a legitimate basis for underwriting for rating insurance. If race can not be used directly by insurers, then insurers should not be permitted to use race indirectly through insurance credit scoring.

## 5. **False Industry Claims About Insurance Scoring**

The insurance industry, at one time or another, has claimed insurance scoring is the cause of untold benefits for consumers and has denied any problems or consumer harm resulting from insurance credit scoring. Simply stated, the insurance industry has no credibility when it comes to insurance credit scoring. For example, in 1999, at the same time the industry was denying state insurance regulators the data necessary to evaluate the impact of insurance scoring on low income and minority consumers, the American Insurance Association issued a report claiming a study by one of its member companies (Hartford) had shown “that credit score is not significantly related with income. . .”<sup>17</sup> The insurance industry also claimed no relationship between insurance score and race.<sup>18</sup> Once insurance regulators obtained the data necessary to perform an independent study, the industry claims were proven false. The Texas and Missouri Departments of Insurance both found that insurance scoring has a disproportionately negative impact on low income and minority consumers, as discussed above.

The insurance industry continues to make false claims about the benefits of insurance scoring. Just this week, the industry media organization, the Insurance Information Institute, claimed insurance scoring was responsible for auto insurance rate reductions. As shown below, this claim is incorrect. In fact, insurance scoring has been responsible for excessive auto insurance rates.

### ***Industry Claim 1: Insurance Scoring Is an Accurate Predictor of Claims, Promotes Competition and the Availability of Affordability of Insurance***

---

<sup>17</sup> Statement of the American Insurance Association on the Lack of Correlation Between Income and Credit Score, March 1999, page 1

<sup>18</sup> See testimony of Progressive Insurance before the Florida Task Force on the Use of Credit Reports in Underwriting Automobile and Homeowners Insurance, 2001-02.

Insurance scores can help make insurance more affordable.

Insurers have found that using insurance scores as a factor in the underwriting process helps them to more accurately price policies and actually write more policies. In some cases, consumers pay less for insurance. This information helps insurance companies determine a fair premium for each consumer that is related to their potential for filing a claim.

Insurance scoring can help increase the availability of insurance.

Many consumers, who might otherwise have less access to or have been denied coverage for a variety of reasons, are able to find coverage because insurance companies use credit history to underwrite policies.

Insurance scoring promotes competition.

**Facts:**

Insurance scoring decreases insurance availability by raising rates for those consumers for whom price increases make a difference in the ability to purchase insurance – low income consumers. Objective measures indicate that insurance scoring has decreased competition and worsened insurance availability and affordability.

Insurers claim that insurance credit scoring allows more accurate pricing. If this were the case, we would expect some consumers to pay more and some to pay less while the ratio of claims paid to premiums collected to remain constant. In fact, insurance scoring has led to lower loss ratios and higher profits for insurers. In addition, measures of uninsured motorists by the industry's own research organization indicate more uninsured motorists – direct refutation of the claim that insurance credit scoring promotes greater insurance availability and affordability

**Excessive Rates and Profitability:**

Private Passenger Automobile Loss Ratios, Countrywide

2000	71.2%
2001	72.7%
2002	67.5%
2003	62.8%
2004	58.6%
2005	60.1%
2006	57.9%

The report *Credit Scoring And Insurance: Costing Consumers Billions And Perpetuating The Economic Racial Divide* analyzes auto insurer profitability over the period in which insurers started using insurance scoring more intensively. The report found over \$55 billion in excessive auto insurance premiums for the three years 2004 through 2006.

As the profitability data show, any recent reduction in auto insurance rates has not been caused by insurance scoring. In fact, auto insurance rates are too high and the absence of competition to drive rates to reasonable levels is attributable to insurance scoring. Consider the comments of Ed Liddy, then-CEO of Allstate to investment analysts in 2005:

Tiered pricing helps us attract higher lifetime value customers who buy more products and stay with us for a longer period of time. That's Nirvana for an insurance company. That drives growth on both the top and bottom line.

This year, we've expanded from 7 basic price levels to 384 potential price levels in our auto business.

Tiered pricing has several very good, very positive effects on our business. It enables us to attract really high quality customers to our book of business.

Make no mistake about it, the economics of insurance are driven largely by retention levels. It is a huge advantage. And our retentions are as high as they have ever been.

The key, of course, is if 23% or 20% of the American public shops, some will shop every six months in order to save a buck on a six-month auto policy. That's not exactly the kind of customer that we want. So, the key is to use our drawing mechanisms and our tiered pricing to find out of that 20% or 23%, to find those that are unhappy with their current carrier, are likely to stay with us longer, likely to buy multiple products and that's where tiered pricing and a good advertising campaign comes in.

It (tiered pricing) has raised the profitability of the industry.<sup>19</sup>

As made clear by Ed Liddy's comments, insurance scoring is used to predict consumer profitability, which is not the same as predicting risk of loss.

### **Uninsured Motorists**

According to a recent Insurance Research Council (IRC) study, the estimated percentage of uninsured motorists increased nationally from 12.7 percent in 1999 to 14.6 percent in 2004. (*Uninsured Motorists, 2006 Edition*) These data directly refute industry claims that insurance scoring promotes insurance availability and affordability.

### **Residual Market**

According to data from the Auto Insurance Plan Service Office, an organization that operates or assists in the operation of assigned risk plans across the country, the number of vehicles insured through assigned risk plans grew by about 70% from 217,200 in 2000 to 368,831 in 2003 not including the New York assigned risk plan and 100% from 433,242 to 864,074 including New

---

<sup>19</sup> Partial Transcript of Presentation to Edward M. Liddy, Chairman and CEO, The Allstate Corporation Twenty-First Annual Strategic Decisions Conference, Sanford C. Bernstein & Co., June 2, 2005.

York.<sup>20</sup> These data directly refute industry claims that insurance scoring promotes insurance availability and affordability.

### **No Evidence of Consumer Harm in States Where Insurance Scoring is Banned**

In addition, there is no evidence that insurers have restricted their writings in states that ban insurance credit scoring. In California, insurance credit scoring is not permitted for private passenger automobile insurance, yet there are many insurers offering insurance and, in 2003, the percentage of vehicles insured through the involuntary market (assigned risk plan) was 0.3% or 3 out of every 1,000 vehicles insured. In contrast, in 2003 in New York, where insurers use insurance credit scoring, the assigned risk share of the market is 5.5% or 18 times higher than in California

### **Insurance Credit Scoring is Part of a Trend to Rating Based on Economic Status**

The insurance industry has long targeted low income and minority communities with high-cost auto and home insurance products, in the same manner that predatory lenders targeted low-income and minority communities with subprime and predatory loans. A recent risk classification filing in Texas provides a tier matrix based on the following factors, showing that economic status has greater weight in determining a consumer's premium than driving record or miles driven.:

- Prior insurer
- Prior liability limits
- Previous non-standard insurance
- Lapse status
- College education
- Occupation
- Age of vehicle
- Multi-car policy
- Years with current employer
- Home ownership
- Not-at-fault accidents
- Credit score

### **Some Evidence Refutes the Alleged Relationship Between Credit and Claims**

Insurers argue that there is a powerful correlation between insurance scores and expected claims. If such a relationship actually existed, then we would expect that an increase in delinquencies and bankruptcies would be matched by an increase in insurance claims. In fact, the opposite has occurred. Despite rapid increases in bankruptcies and delinquencies since 2000, auto claims have remained stable or declined. This suggests that the correlation between insurance credit scores and claims is not real and that insurance scores are a proxy for some other factor that is truly related to claims.

---

<sup>20</sup> *Auto Insurance Report*, "Residual Market Growth Continues Despite Strong Voluntary Profit," August 29, 2005. Note, the cited AIPSO data covers 46 states.

## ***Industry Claim 2: Most Consumers Benefit***

### Most people benefit from insurance scoring.

Most people have good credit and can benefit from insurance scoring. It can help consumers qualify for lower insurance rates and in some cases, even offset a less than perfect driving record.

### Most consumers pay less because of insurance scoring.

An NAII member company found that insurance scoring helps it offer lower premiums to nearly 70 percent of its policyholders. Insurance scores enable insurers to price products with greater accuracy, and with every customer paying according to his or her potential for loss.

## **Facts:**

### **Insurance Credit Scoring Hurts All Consumers**

There are two basic public policy purposes of insurance. The first is to provide individuals, businesses and communities with a financial security tool to avoid financial ruin in the event of a catastrophic event, whether that event is a traffic accident, a fire or a hurricane. The essential financial security tool is accomplished by the spreading of risk over a large number of consumers and business and is typically performed by insurers accepting the transfer of risk from individuals and by spreading the individual risks through the pooling of very large numbers of individual risks. The pool of risks is diversified over many types of perils and many geographic locations.

The second essential purpose of insurance is to promote loss prevention. Insurance is the fundamental tool for providing economic incentives for less risky behavior and economic disincentives for more risky behavior. The insurance system is not just about paying claims; it is about reducing the loss of life and property from preventable events. Historically, insurers were at the forefront of loss prevention and loss mitigation. At one point, fire was a major cause of loss – no more, in large part due to the actions of insurers in the 20<sup>th</sup> century.

Insurance credit scoring hurts all consumers by undermining the both goals of insurance. It hurts the goal of providing an essential financial security tool by making insurance less affordable and available to the consumers most in need of the tool. It undermines the loss prevention role of insurance by removing the ability of insurance rating to provide economic incentives for less risky behavior and economic disincentives for more risky behavior.

### **Good Credit Histories Don't Equate to Good Credit Scores**

Insurance credit scoring is inherently unfair because a good credit history does not equal a good credit score or favorable insurance treatment. This occurs because insurance credit scores are based not just on bankruptcies and delinquencies, but also on other factors unrelated to credit management. For example, credit scores are often based on the type of credit (consumer finance loans are less favorable than bank loans), the number of credit cards (there is a magic number that is optimal, even if the consumer only uses the retail store cards once to get the first time 10% purchase discount), length of time credit has been established (which is another way of charging

younger people more), length of time since last account opened (which penalizes families that have just moved or refinanced their mortgage) and the number of inquiries (which penalizes consumers who shop around for the best rate – behavior that should be rewarded and not punished with higher insurance rates.) While the insurance industry offers a rationale for each of these factors, the fact is that insurance credit scoring casts too wide a net and penalizes people engaged in behavior we would all consider good financial management.

Over the course of the 1990's consumer debt grew dramatically as lenders made credit more easily available to many consumers. The number of credit card solicitations grew from 1 billion to 5 billion annually. Lenders moved to low- or no-down payment mortgages. Although lenders are certainly free to make business decisions about loaning money, consumers should not be penalized with higher homeowners or auto insurance premiums because of those decisions.

To illustrate the problem, Fannie Mae recently began requiring a 10% down payment for 30 year mortgages on manufactured homes. Previously, consumers could get a loan with no money down. In defending the proposal, Deborah Tretler, vice president of single family homes for Fannie Mae, stated, "We don't serve borrowers well when it is easy for a borrower to get into a home under very flexible terms, only to have them lose their home, their credit ruined and their homeownership dreams turned into a nightmare."<sup>21</sup>

It is not only lenders' lending decisions that make insurance scoring unfair, it is also lenders' reporting decisions to credit bureaus. In some cases, lenders report only partial information about loans to credit bureaus. For example, some major credit card vendors do not report card limits, to prevent competitors from learning about their customers. But by failing to report credit limits, the insurance credit scoring models often use the current balance as the limit – with the result that the consumer appears to be maxing out his or her credit line. Which, in turn, lowers the insurance score.

In another example, Sallie Mae, the nation's largest lender for student loans with millions and millions of borrowers, has decided to report loan information to only one of the three major credit bureaus – again, to protect its customer list. If a consumer who has a good student loan payment history seeks auto insurance and the insurer happens to use a credit bureau that Sallie Mae has not reported to, the consumer gets a lower score than he or she should because a lack of information penalizes a consumer in an insurance score.

### **Every Consumer Organization and Most Agent Groups Want Insurance Credit Scoring Banned**

The National Association of State Farm Agents, Inc. (NASFA) hereby resolves that we are opposed to any insurance company using credit scoring for the purpose of property and casualty underwriting and rating. We believe credit scoring is part of a marketing scheme designed to curtail market share, avoid rate regulation and it improperly emphasizes credit as an underwriting characteristic without sufficient demonstration of its

---

<sup>21</sup> "Mortgage regulations could stop some would-be homeowners," by Genaro C. Armas of the Associated Press in the September 12, 2003 issue of the *Austin American-Statesman*.



reliability for underwriting purposes. There is tremendous opportunity to mischaracterize potential insurers and inadvertently or intentionally illegally discriminate. We further support legislation to prohibit credit scoring for the purpose of property and casualty underwriting and rating.

The National Association of Professional State Farm Agents and The United Farmers Agents Association and other agents' groups oppose insurers' use of insurance credit scoring. Every consumer organization opposes insurance credit scoring – Consumer Federation of American, U.S. Public Interest Research Group, state PIRGs, Consumers Union, AARP and many more. Consumers Union recently wrote:<sup>22</sup>

Even though insurance companies cannot use race or ethnicity to decide who gets insurance and how much it will cost, evidence shows that insurance scores disproportionately affect certain minority groups and low-income consumers, which raises concern that scores can serve as a proxy for race or ethnicity. Research shows that people in areas with a high concentration of minorities are more likely to have lower credit scores.

The consequences are far-reaching. The economic stability of our cities and our nation depends in part on access to fairly priced coverage. Insurance is based on the concept that spreading the risk helps society protect itself from economic devastation and more quickly recover from catastrophes. When insurance costs are inflated for the wrong reasons, people are unfairly cut off from access to its protection. The whole community suffers, and those who cannot afford insurance struggle to recover if disaster hits.

Another hurricane season is already upon us. Based on past years with similar conditions, the National Oceanic & Atmospheric Administration estimates that two to four hurricanes could affect the U.S. in 2006. But there's more trouble on the horizon than just bad weather. In any state that allows insurers to use credit information to rate and underwrite homeowners- and auto-insurance policies, consumers are already in the middle of a storm, and most of them don't know it.

The devastation caused by Hurricanes Katrina, Rita, and Wilma shows us that people without adequate insurance may face compounded tragedy. Since economic losses caused by catastrophe can send a credit score plummeting, even consumers who can afford insurance today may feel the repercussions of credit scoring in their premiums tomorrow.

Consumers Union advocates have been urging legislators and regulators in several states to ban the practice, and we'll continue those efforts.

### **Polls Show the Public is Opposed to Insurance Credit Scoring**

In a poll of Texas consumers conducted from April 28, 2003 through May 10, 2003, 68% voiced the opinion that the Texas Legislature should “ban insurance companies from using a homeowner’s credit history to decide whether it will insure a person or to adjust a premium,” compared to 23% who voiced support.

---

<sup>22</sup> *Consumer Reports*, August 2006, Page 61

### **Insurers Hide their Use of Insurance Credit Scoring**

If insurers really believed that the public supports the use of insurance credit scoring, why don't we see any insurers' ads or marketing efforts that promote their use of insurance credit scoring? Why don't we see any ads that even mention insurance credit scoring?

### **Most Consumers Don't Get Lower Rates**

Data from actual filings refute the industry claim. My analysis of actual rate filings shows that in many cases, the so-called "discounts" consumers receive from insurance scoring are more than offset by increases in the base rate. The fact is that, because insurance scoring does nothing to reduce insurance claims, insurance scoring simply redistributes premiums among different consumers. And in most cases, the number of consumers who see a premium reduction is the same or less than the number who see a premium increase.

### ***Industry Claim 3: Insurance Scoring is An Objective Tool***

#### Insurance scoring provides an objective tool for decision-making.

This tool does not discriminate against any specific group of customers. It avoids subjective value judgments because the information is based solely on credit-related material.

#### It provides an objective tool for decision-making that does not discriminate against specific groups or individuals.

Insurers are interested in having available as many tools as possible to assist them in making a fair and objective decision about whom to insure and at what rate. The development of an insurance score only takes into account credit-related information and does not consider race, gender, religion, marital status and birthplace.

#### Insurance Scores are reliable.

The Consumer Data Industry Association, formerly Association of Credit Bureaus, reports that less than 1 percent of all credit report challenges result in a change once the inquiry has been fully investigated. Studies have found that credit reports are more reliable than motor vehicle records. The use of credit reports is routine throughout the financial services industry and is widely accepted by consumers.

#### Insurance Scores are Not Correlated to Income

March 1999, Statement of the American Insurance Association, "On the Lack of Correlation Between Income and Credit Score When Tested Against the Average or Median Score"

The precise objective of the company analysis was to determine the extent to which the credit score is correlated to income. AIA presented important, new evidence that credit scores do unfairly discriminate against or even negatively impact lower income groups. Indeed, research revealed that the lowest income groups have the highest average credit score.

The analysis concluded that credit score is not significantly correlated with the income for the AIA company's policyholders.

## **Facts:**

### **Selection of Factors in Insurance Scoring Models Involves Judgment and Bias**

The mere fact that insurance scores are produced by a computer model does not mean insurance scores are objective. If the factors that go into the scoring model discriminate against low income and minority consumers, then the model itself will be biased against such consumers. As discussed above, two independent studies confirm that insurance credit scoring is highly correlated to income and race.

### **Insurance Scoring is Arbitrary**

There are many examples of illogical and arbitrary results from insurance scoring:

- Because your credit score depends on having the “right” kind of information in your credit report, you can have a perfect credit history and still get a bad credit score. Contrary to insurer credit scoring myths, your credit score has nothing to do with your “financial responsibility.”
- Because your credit report can vary dramatically among the three major credit bureaus, your credit score can vary from good to bad depending upon which bureau provided your insurer with information.
- Because your credit score is based on many things other than how timely you pay your loans, your score can vary dramatically depending on what time in the month your credit report was ordered.
- Because your credit score depends on what type of credit you have, you can get a low score even if you have a perfect payment record. If you have a credit card with a tire company, a loan from a consumer finance company like Household or Beneficial, or have an installment sales contract from a used car dealer, you get a lower score regardless of whether you pay on time. But if you have a gas station credit card, your score is higher!

- Because your credit score depends on the presence of loan information, you get a lower score if you pay in cash or don't borrow much or if you use lenders that don't report to credit bureaus. Many younger consumers were penalized with higher rates due to so-called "thin" credit files because the Sallie Mae – the student loan lender to millions – decided it would only report payment history to one of the three major credit bureaus.
- Because your credit score depends on the ratio of your debt to your credit card limit, a consumer who uses one credit card to maximize frequent flier miles gets a lower score than another consumer who charges the same amount but does it on three or four cards.

***Industry Claim 5: One of Many Factors***

It's just one of many factors.

Most companies that use insurance scoring treat it as just one of several factors in the underwriting decision. Generally your insurance score alone is not likely to keep you from getting insurance or cause you to pay more for it, although it can help you get insurance.

**Facts:**

**Insurance Credit Scoring Affects Your Rates – Why Else Would Insurers Use It?**

This industry argument is truly a red herring. The fact that insurance scores are one of many factors does not change the fact that a consumer's insurance score affects his or her premium and, typically, is the most important factor in determining that premium. If insurance credit scoring were simply a minor factor and not likely to affect the insurer decision to offer insurance or affect the insurer decision about the price of insurance, why would insurers fight so hard to use it and put up with all the requirements of federal and state law regarding the use of consumer credit reports and insurance scoring?

***Industry Claim 6: Rewards Responsible Financial Behavior***

Insurance scores reward responsible financial behavior, not just the length of credit experience.

Insurance scoring is designed to examine credit management patterns and the process used provides an objective evaluation of a consumer's credit history whether it is long or short. When a consumer does not have enough history to generate a score, this information often will not be considered as a positive or negative characteristic.

**Fact:**

This argument represents a reprehensible blaming-the-victim strategy by insurers. In fact, a credit history is not a measure of financial responsibility and a good credit history does not equate to a good credit score.

### **A Credit Score is Not a Measure of Financial Responsibility**

- Limited Info in Credit Report
  - No Utility Payment History
  - No Rental Payment History
  - No Savings Information
  - No Insurance Purchase Information
- Credit Score Factors Unrelated to Payment History
  - Type of Credit
  - Length of Credit
  - Inquiries
  - Balance to Limits
  - Thin Files
- After the Fact Rationale

### **Insurance Credit Scoring Penalizes Victims of Economic and Medical Catastrophes**

Insurance credit scoring is inherently unfair because it penalizes consumers who are the victims of economic or medical catastrophes, such as job loss, divorce, dread disease or terrorist attack. For example, in the aftermath of the September 11 attack, hundreds of thousands of people working in the travel-related industry lost their jobs. Out of this group, thousands had to increase borrowing to offset loss of income or loss of health insurance. Many filed for bankruptcy. It is unfair for insurance companies to further penalize these victims by raising their homeowners and auto insurance rates.

One of the myths perpetrated by insurers to legitimize the use of insurance credit scoring to legislators is the myth of the immoral debtor. Insurers argue that good credit scores reflect the financial responsibility of consumers. And they ask why should financially responsible consumers subsidize the rates of consumers who are not financially responsible? As explained further below, this argument fails because a good credit history does not equate to a good credit score. Stated differently, an insurance score is simply not a measure of financial responsibility.

Regarding the “immoral debtor,” data on the causes of bankruptcies reveal that the overwhelming majority of bankruptcies result from job loss, medical problems and divorce. Fully 87% of bankruptcies for families with children arise from these three reasons. And the remaining 13% includes reasons such as natural disaster or crime victim.<sup>23</sup>

In their recent book, *The Two Income Trap*, Elizabeth Warren and Amelia Tyagi study the growth, composition and causes of bankruptcy. They were astonished to find that the number of women filing for bankruptcy grew from 69,000 in 1981 to nearly 500,000 by 1999. As they

---

<sup>23</sup> 2001 Consumer Bankruptcy Project, cited on page 81 of *The Two Income Trap*, Elizabeth Warren and Amelia Tyagi.

researched the causes of this phenomenon, they documented the fact that financial strain on families – particularly families with children – resulted from dramatic increases in the cost of housing, health care and schooling combined with deregulation of interest rates for loans and business decisions made by lenders for easy credit. They found that married couples with children are more than twice as likely to file for divorce than couples without children and that a divorced woman raising a child is nearly three times more likely to file for divorce than a single woman without a child. They concluded that “having a child is the single best predictor that a woman will end up in financial collapse.” Their research shows that the insurer rationalization for insurance credit scoring – “financial responsibility” – is indeed a myth refuted by the facts.

***Industry Claim 7: Consumer Protections Exist***

The NCOIL Law, as adopted in many states, provides necessary consumer protections.

The Fair Credit Reporting Act provides consumer protections.

**Facts:**

**The NCOIL Model Provides Little or No Consumer Protections.**

The NCOIL model law, adopted in many states, allows insurers to continue their insurance scoring practices with few or no substantial consumer protections. I discuss this issue at length in my testimony before the Colorado Legislature in 2004, available on the CEJ web site: [www.cej-online.org](http://www.cej-online.org).

**Insurers Seek to Avoid Telling Consumers About Insurers’ Use of Credit Scoring**

Adverse Action Notices: Insurers have resisted providing adverse action notices to consumers who suffered higher rates because of insurance credit scoring. Insurers claimed that a new business customer – even a customer charged the highest rate because of her credit score – was not entitled to an adverse action notice.

## **Insurers Oppose Laws That Allow Consumers to Freeze Their Credit Information Because of Identity Theft**

New York recently adopted a credit information security freeze law, described by its sponsor as follows:

"This security freeze acts as a barricade against those who would commit fraud," Senator Steve Saland (R-C, Poughkeepsie), co-sponsor of the legislation, said. "Identity thieves have already preyed on thousands of New York consumers, stealing personal information that leaves consumers severely at risk. This law enables consumers to avoid victimization by empowering them to place security freezes on their consumer reports."

But the New York measure is the only credit freeze legislation passed in the nation this year that does not exempt insurers. Nine other states have passed credit freeze legislation in 2006, (Colorado, Florida, Illinois, Kentucky, Wisconsin, South Dakota, Utah, Kansas, and Vermont), and all of them allow insurers to continue to access credit information for underwriting and other legitimate business purposes, according to the Property Casualty Insurers Association of America (PCI), which has asked Gov. Pataki to veto credit freeze legislation.

PCI says including insurers in the freeze provides no benefit to consumers while increasing costs for the industry.

"While PCI supports the effort to prevent identity theft, the application of credit freeze legislation should be tailored to address areas in which there is a prevalence of identity theft," said Kristina Baldwin, regional manager and counsel for PCI. "The security provisions in this legislation have no practical application or consumer benefit in the context of insurance."

According to Baldwin, it is "highly unlikely" that illegally procured credit information would be used to purchase insurance. She cites a Federal Trade Commission study in January that found that 99.6 percent of identity theft complaints were related to areas other than insurance.

"Consumers obtain little or no benefit from having a security freeze which applies to insurers. The insurer and the consumer would experience increased burdens, costs and inconveniences associated with this credit freeze legislation. It is important to bear in mind that additional insurance company burdens and costs are ultimately borne by all policyholders through higher premiums. In short, the burdens associated with applying credit freeze provisions to insurers are not outweighed by the very limited consumer benefits which would be achieved through applying credit freeze provisions to insurers," Baldwin added.

The arguments are, of course, a non-sequitor. If a consumer has been a victim of identify theft, then an insurers' use of that that consumer's credit information can hard the consumer because the credit report has been damaged. Why would a consumer want an insurer to use her credit report when it has been damaged by identify theft? Why would an insurer want to use such a

report? And why would insurers oppose giving consumers a tool to protect themselves from use of their credit information when they suspect they have been the victim of identify theft?

Insurers' actual insurance credit scoring practices and policies are profoundly anti-consumer. The security freeze position is the latest example of insurers placing their interests above those of consumers.

**The recent Supreme Court Decision about Adverse Actions Contradicts Congressional Intent and Denies Consumers Essential Consumer Protections.**

As with the security freeze issue, insurers have tried to keep consumers in the dark about insurance scoring practices by denying consumers adverse action notices required under the Fair Credit Reporting Act. Some insurers refused to provide any new business applicant with an adverse action notice – even if the consumer suffered a high premium because of insurance credit scoring. The recent Supreme Court decision in *Safeco v Burr* and *GEICO v Edo* did determine that insurers did need to provide adverse action notice to new business consumers who suffered an adverse action, but defied congressional intent and incorrectly defined what constitutes an adverse action. Despite a clear and simple definition of insurance adverse action endorsed by state insurance regulators and the Federal Trade Commission – a consumer suffers an adverse action if she suffers less favorable treatment that she would have received if she had a more favorable credit report – the Court argued that too many consumers would get adverse action notices and endorse a standard based on a so-called “neutral” credit score. Since there is no standard for “neutral” credit score, the Supreme Court decision allows insurers to effectively define which consumers get adverse action notices.



# Why Low Credit Scores Predict More Auto Liability (& UM) Claims: Two Theories<sup>1</sup>

Patrick Butler, Ph.D.<sup>†</sup>

April 30, 2009

Submitted as testimony to the hearing on credit score rating by the  
National Association of Insurance Commissioners (NAIC)

*Summary.* To help inform NAIC deliberations in regard to the hearing's third issue—"how current economic conditions have affected policyholder premiums related to credit-based insurance scores"—this testimony considers two explanations for the fact that auto liability claims vary inversely with driver credit scores. Theory 1 attributes the correlation to a direct connection between financial negligence and driving negligence, but this testimony identifies difficulties for Theory 1 and offers an alternative explanation. Theory 2 proposes that since people (at all income levels) with low credit scores must economize, many do this by a reduction in car owning without a proportional reduction in driving. Such economizing raises the average miles per car and consequently the number of liability claims per 100 car-years. Both theories are also critiqued with respect to explaining other predictors such as driver sex and accident record. At stake is NAIC backing for an effective response to the conflict between mandatory insurance and ability-to-pay. Theory 1 suggests a need for strong price regulation to cross-subsidize low credit-score, presumably more negligent drivers while Theory 2 explains why effective regulation of credit score rating—and of other measures of financial status such as education and occupation levels—might be difficult and ineffective. Theory 2 instead suggests encouragement by regulators of an informed, free market demand by consumers—and an entrepreneurial response by insurers—for an odometer mile exposure unit as an optional alternative to the car year exposure unit for private passenger cars.

\* \* \* \*

Mandatory liability insurance has long been demanded by the public and, despite steadfast opposition by major insurers, has been increasingly adopted over time by state legislatures. But concern that insurance also be affordable leads to attempts to control some pricing variables. A recent example is legislative efforts to prohibit the use of credit

---

<sup>1</sup> The analysis of this testimony was cited by the July 2007 Federal Trade Commission (FTC) "Report to Congress on Credit-Based Automobile Insurance Scores." Although the report presents a truncated version of the economic logic (page 32, citing a 2006 academic paper of mine), it does not consider the *inevitability* of the correlation of more claims with lower credit scores caused by the need to economize on car insurance.

<sup>†</sup> Insurance Project Director, National Organization for Women, 1100 H Street, NW 3<sup>rd</sup> Floor, Washington, DC 20005, tel. 202.628.8669 x148, email [pbutler@centspermilenow.org](mailto:pbutler@centspermilenow.org), cell 512.695.5136.

scores in pricing. In response, insurers commissioned a study by Miller and Smith (2003) of a random sample comprising nearly 2.7 million car-year records from the files of national insurers. The sample shows that the cars owned by drivers with the lowest credit scores produced 2.5 times as many liability claims per 100 car-year exposure units as the cars owned by the highest score drivers. But this also means that credit score pricing charges more to those generally on tighter budgets, which contributes to pressure for regulating prices.

To help resolve the conflict between affordability and free-market pricing, this essay further examines *why* lower credit scores predict more liability claims. Two theories are brought to bear on this question. The prevailing explanation, Theory 1, is that a lower credit score predicts more driver negligence. The basis is that each liability claim requires a negligent act by the insured car's driver to cause the accident. Since the cars of low credit score drivers produce more liability claims than other cars in their insurance class, it is assumed that these drivers perform more negligent acts and therefore on average are more negligent drivers. In a 2002 report on credit-score pricing to the NAIC, the American Academy of Actuaries (AAA) likens the way credit scores work to the way driver records work in identifying subgroups within insurance classes:

[H]istories of past accidents and violations do not *cause* drivers to have more accidents. The rating practice that does exist is based on the fact that, as a group, drivers who have been accident-prone in the past are likely to be accident-prone in the future. [Emphasis original.]

But the AAA report is also arguing here that the cause of a correlation need not be identified in order to gain approval for its use in pricing. Nevertheless, legislators, insurance commissioners, and consumer advocates continue to call for an explanation for the credit score correlation with claims.

As the first academic response to these calls, Brockett et al. (2005, 2007) provide backing for Theory 1's driver negligence explanation. They review studies about how the "characteristics of individual risk taking . . . affect both financial decision making and risky driving habits." Brockett and Golden (2007) conclude that the research examined by their article

suggests that the discussed individualized biological and psychobehavioral correlates provide a connection between credit scores and automobile insurance losses. Credit scores, like good student discounts and marital status, tap a dimension of responsibility and stability for the individual that can permeate multiple areas of behavior.

But this suggested connection entails unaddressed issues. One is that the studies reviewed by Brockett and Golden rely on accident data based on the *driver year*, whereas insurance claim data are based on the *car-year* exposure (statistical) unit and tied to the driver-type classification of the car rather than to the driver driving at the time the car

was involved in an accident. Moreover the review takes no notice that according to periodic federal travel surveys (Hu and Reuscher, 2004) different categories of drivers and cars represent a wide range in average annual miles and, furthermore, that within the categories themselves drivers and household cars individually traveled from zero to 50,000 miles and more in the years surveyed. Differences in annual mile averages can readily match reported ranges in liability claims per 100 car years from the lowest to highest credit score categories. For instance, the 2.5 times difference in annual liability claims reported by Miller and Smith can be matched by the 2.5 times difference in annual miles from 6,000 miles to 15,000 miles. According to the 1995 travel survey, 30% of cars were driven less than 6,000 miles and 25% of cars were driven more than 15,000 miles.<sup>2</sup> Characterizing those with low credit-scores as “high risk drivers” on the basis of insurance records misleadingly implies that the high risk must be on the same statistical per-mile basis used in engineering studies<sup>3</sup> rather than as possible consequences of large annual-miles-per-car differences among categories of insured cars defined by classification and underwriting rules.

Theory 1 also entails generally unaddressed problems. One is that drivers subject to tighter budgets as indicated by lower credit scores should be more risk averse and should be, therefore, if anything, less negligent. Moreover, insurers report that lower credit scores also predict more uninsured motorist claims per 100 car years. These claims require as a condition of payment the non-negligence of the insured car’s driver. The cars belonging to lower credit score drivers must therefore be both more negligently and more non-negligently involved in accidents.

As an alternative to the driver negligence explanation, Theory 2 proposes that low credit scores predict more miles per insured car. Significantly, the uninsured motorist claims problem for Theory 1 is actually a requirement for Theory 2: liability and uninsured motorist claims must correlate positively. The more miles an insurance category of cars averages, the more accident involvements and claims per 100 car years the category must produce, which will include both more negligent (liability) claims and also more non-negligent (uninsured motorist) claims. This means that compared to an overall class average miles per car the sub-class of cars belonging to financially-constrained drivers must be averaging more miles per car.

---

<sup>2</sup> Because the distinction between *insured* and *uninsured* cars is not included in the federal travel surveys, the average mileages for categories of household cars reported by the surveys do not necessarily represent the averages for matching insurance categories, especially in places where the proportion of uninsured cars is large.

<sup>3</sup> For example, Williams (1999) shows how per-mile risk rates vary strongly with driver age. Age 17 drivers average about 30 state-reported accident involvements per million miles compared with adult driver involvements of 4-5 per million miles. Drivers over age 79 average about 18 involvements per million miles.

The logical basis of Theory 2 is supported by several easily verified givens. First, accidents are a cost of operating cars. Parked cars rarely cause accidents, but each odometer mile driven entails a risk of accident and therefore must transfer a statistical but real cost to the car's insurer.<sup>4</sup> Statewide, liability claims historically vary directly with the amount of driving as negatively affected by sharp increases in gasoline prices and unemployment. Second, as demonstrated by consulting an agent's manual of rates and rules, premiums are charged not as a cost of operating cars but of owning them. As long as classification and coverage are unaffected, adding or subtracting cars from a policy results in a proportional change in premiums. Finally, premiums are paid in advance of coverage and are never readjusted at the end of the policy period regardless of how many, few, or no miles the car was actually driven.

According to Theory 2, traditional pay-per-car premiums must *cause* adverse selection under certain circumstances. Per-car prices allow only one certain way to economize on mandatory insurance: drive fewer cars more miles each. Inconvenience keeps most drivers from doing this—until the pressure to economize is great. When drivers remove marginal cars from insurance pools and start to share cars kept insured, average miles-per-car rises. The result is that insurers correlate more liability claims per 100 car years with lower credit scores and raise prices accordingly (if for no other reason than fear of being adversely selected against by a competitor that is pricing according to the credit score indications).

Theory 2 also explains other predictors of liability claims insurers use. Just as more liability claims correlate with lower credit scores, more claims are predicted for the cars of residents of lower-income zip codes, more claims for the cars of drivers with lower educational and occupational levels, more for installment plan premium payers, and more for cars newly insured after having been uninsured for a period—the so-called no-prior-insurance variable. Generalizing from these predictors, any marker of a need to economize predicts more liability claims per 100 car years. (See the top set of predictors in Table 1.)

In accord with the Theory 1 explanation that low credit scores identify negligent drivers, Brockett and Golden (2007) cite the use of driver sex and the AAA report (2002) cites the use of driver records for the same purpose. However, the logic of Theory 2 provides an alternative explanation for both of these traditional predictors, as shown in Table 1. For example, men average more driving than women the same age and therefore

---

<sup>4</sup> Measurement of the cents-per-mile class rates at which risk is transferred to insurers would require large numbers of cars in each class (for future statistical stability of the class per-mile rate determined) by risk-related categories such as car use, residence territory, and driver age. Under today's car-year exposure unit, the total cost of past claims for each class is divided by the insured car-years of exposure that produced the claims to obtain the dollars-per-car-year basis of the future price. Under the odometer-mile exposure unit the cents-per-mile cost basis of a class price would simply be the total cost of claims divided by the total insured odometer miles of exposure that produced the class's claims.

are involved in more state-reported accidents annually on a per-100-licensed-drivers basis.

**Table 1**  
**Two explanations for why credit scores and other predictors work**

Predictor variable (of liability claims per 100 car years)	Correl- ation	Theory 1 (Variable proxies for driver negligence)	Theory 2 (Variable proxies for avg. miles per car year)
Credit score	negative	“Lack of stability and impulsive behavior affect both driving and credit history.”*	Variables are measures of need to economize on liability insurance, which can be done directly by giving up some cars and driving the insured cars remaining more miles each.
Zip code income	negative		
Education and occupation levels	negative		
Installment plan	positive		
No prior insurance	positive		
Driver sex – man (Controversial for adults. Used where allowed, mainly for cars accessible to young drivers)	positive	“[T]he psychobehavioral characteristics of risk-taking are related to impulsivity, sensation seeking, aggression, and sociability with men engaging in more overall risky behavior than women.”**	At every age men average more miles than women, and presumably so do the cars they drive relative to the cars women drive.
At-fault accident (Use is often disallowed for small claims)	positive	“[D]rivers [who were] accident prone in past are likely to be accident prone in the future”***	As sub-classes, “accident-sampled” cars continue to average more miles per car than the main classes from which they are separated.
Not-at-fault accident (Controversial, but may or may not be used where allowed)	positive		
Car age (not disallowed but not used for liability prices)	negative		Annual mile averages decrease with car age
* Brockett and Golden, 2007 ** Brockett et al., 2005 *** American Academy of Actuaries, 2002.			

When it comes to Theory 2 explaining why past accidents are predictors of more claims per 100 car years, accidents may be realistically modeled as random sampling—not of car year records from company files as employed in the Miller and Smith (2003) study—but perforce of cars that are on the road. Although the low- and average-miles cars in an insurance class are sampled by accident involvement, this sampling obviously will be biased to those cars in the class that spend the most time on the road. This

sampling process raises the average annual odometer miles of the sub-classes defined by accident involvement, as modeled by Butler and Butler (1989). Rather than identifying accident prone drivers in the future, accident records actually define sub-classes that average more miles per car year in the future than the cars will average in the large matching accident-free sub-classes.

In addition to the traditional predictors cited by AAA (2002) and by Brockett and Golden (2007) as validating Theory 1 explanations, however, are equally reliable predictors that if used would raise difficult questions for auto insurers. A noteworthy example is that car age is not used for liability pricing even though liability claims per 100 insured car years decrease with car age (McNamara, 1987). If this correlation were used in pricing, liability premiums would increase for a driver who trades an older for a newer car. But it would be difficult for Theory 1 to explain how buying a newer car causes a driver to become more negligent. However, Theory 2 explains that since annual mile averages decrease with car age, so must claims per 100 car years also decrease with car age. Trading an older for a newer car does not necessarily change the number of miles a driver drives whether many or few, but the car they drive definitely changes to a younger car age group that averages more miles per car.

In 1994 Harrington examined the case that mandatory auto insurance is “taxing low income households in pursuit of the public interest.” But the case presented against such taxing is weakened by the implication that low income drivers pay the same insurance prices as higher income drivers. More recent work by Harrington and Niehaus (1998) confirms that the cars of lower income drivers produce more liability claims<sup>5</sup> and consequently are charged higher “taxes” per car year for mandatory liability insurance. Moreover, according to the present study’s Theory 2, Harrington’s case (1994) misidentifies the law-abiding choice as “pay or take the bus,” i.e., pay the price of mandatory insurance or give up driving. Instead, the law-abiding choice that pay-per-car pricing actually offers is not giving up *driving* and taking the bus, but giving up *cars* and driving the remaining ones more. Hence more miles per car, more claims, and higher prices must follow in what insurers term “hard to serve markets.” Theory 1 suggests that more driver negligence in these markets causes the higher prices. But this suggestion means that—other than to repeal mandatory insurance as auto insurers would have it—there is no alternative to regulating prices to maintain affordability for the presumed negligent driver groups insurers identify.

Instead of these undesirable alternatives, however, the strong demand by the public for enforcing mandatory auto insurance could be accompanied by a strong demand informed by Theory 2 that automobile insurers provide the audited odometer mile

---

<sup>5</sup> In the Missouri zip codes studied, liability claims per 100 car years exposure averaged 8.25 in the lower income zip codes which is 36% more than the 6.06 claims the other zip codes averaged.

exposure unit (Butler, 1993)—an option insurers offer to some fleet owners—as an option for private passenger car owners. At competitive cents-per-odometer-mile class prices this option would constitute a free-market remedy for the upward cost-price cycle that the traditional car-year exposure unit sets off for groups of economizing drivers. With this option drivers could car pool or take the bus to save on insurance while still keeping their own cars legally insured and available for use.

Critical to informing a public demand for a remedy to mandated car insurance which many cannot now afford is engagement by insurance commissioners and consumer advocates, as well as scholars, with the explanation offered by Brockett and Golden (2007) and the alternative explanation provided by this essay for why low credit scores and like correlations work to predict more liability claims per 100 insured car years.

### REFERENCES

- American Academy of Actuaries, 2002. *The Use of Credit History for Personal Lines of Insurance: Report to the National Association of Insurance Commissioners*, Nov. 15, Washington, DC: AAA.
- Brockett, Patrick L., Linda L. Golden, and Sandra H. Dunn, 2005. “Biological and Psycho-behavioral Correlates of Risk Taking, Credit Scores, and Automobile Insurance Losses: Toward an Explication of Why Credit Scoring Works,” *World Risk & Insurance Economics Conference*, August 9, 2005, Salt Lake City, Utah.
- Brockett, Patrick L., and Linda L. Golden, 2007. “Biological and Psychobehavioral Correlates of Credit Scores and Automobile Insurance Losses: Toward an Explication of Why Credit Scoring Works.” *Journal of Risk and Insurance*, 74: 23-63
- Butler, Patrick, 1993. “Operation of an Audited-Mile/Year Automobile Insurance System Under Pennsylvania Law,” *Casualty Actuarial Society Forum*, Summer 1993: 307-338, available at <http://www.casact.org/pubs/forum/93sforum/93sf307.pdf>
- Butler, Patrick, and Twiss Butler, 1989. “Driver Record: a Political Red Herring That Reveals the Basic Flaw in Automobile Insurance Pricing,” *Journal of Insurance Regulation*, 8: 200-234.
- Federal Trade Commission, 2007. “Credit-Based Insurance Scores: Impacts On Consumers Of Automobile Insurance.” *A Report To Congress by the Federal Trade Commission, July 2007*.  
[http://www.ftc.gov/os/2007/07/P044804FACTA\\_Report\\_Credit-Based\\_Insurance\\_Scores.pdf](http://www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf)
- Harrington, Scott E., 1994. “Taxing Low Income Households in Pursuit of the Public Interest: The Case of Compulsory Automobile Insurance.” In Sandra Gustavson and Scott Harrington, eds. *Insurance, Risk Management, and Public Policy*. Boston, Kluwer Academic Publishers.
- Harrington, Scott, and Greg Niehaus, 1998. “Race, Redlining, and Automobile Insurance Prices,” *Journal of Business*, 71: 439-69

- Hu, Pat S. And Timothy R. Reuscher, 2004. "Summary of Travel Trends, 2001 National Household Travel Survey," *Federal Highway Administration*, available at <http://nhts.ornl.gov/2001/pub/STT.pdf>
- McNamara, Daniel J., 1987. "Discrimination in Property-Liability Insurance Pricing," in *Issues in Insurance*, 1-67, Everett D. Randall ed., 4th Ed.
- Miller, Michael J., and Richard Smith, 2003, "The Relationship Between Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity." Bloomington, IL: Epic Actuaries, LLC, available at [http://www.ask-epic.com/Publications/Relationship%20of%20Credit%20Scores\\_062003.pdf](http://www.ask-epic.com/Publications/Relationship%20of%20Credit%20Scores_062003.pdf)
- Williams, Allan, 1999. "Licensing Policies for Young Drivers in the United States," in *Automobile Insurance: Road Safety, New Drivers, Risks, Insurance Fraud and Regulation*, edited by Georges Dionne and Claire Laberge-Nadeau, Kluwer Academic Publishers, Boston: 215-220.



■ VARIABLES QUESTIONED

## Insurers Pile On To Consumer Hardship

BY GREGORY D. SQUIRES

**A**T A TIME WHEN greater transparency in financial services is called for and many are suffering from the collapse of financial institutions and other key sectors through no fault of their own, the insurance industry seems committed to greater opacity, and indeed, compounding the hardship of working families.

The advent of education and employment status as underwriting criteria for property insurance, particularly automobile, is just the latest manifestation. This "innovation" by the industry also undercuts a core underwriting objective.

Use of education and employment in the underwriting of property-casualty insurance undermines a key function of insurance—discouraging irresponsible behavior and incentivizing responsible loss prevention. It also exercises an adverse disparate impact on racial minorities, despite protestations to the contrary by some within the industry. Consequently, some of the most vulnerable segments of the population are hurt.

The issue is NOT whether risk or cost-based pricing and underwriting tools should be utilized.

Robert Hartwig of the Insurance Information Institute appropriately asserted in testimony before the Florida Office of Insurance Regulation in February 2007: "Society also benefits from risk or cost-based pricing. High auto insurance premiums offer poor drivers a significant financial incentive to improve their driving behavior, thereby reducing accidents, injuries and fatalities. These are socially desirable outcomes whose benefits are diminished when restrictions on actuarially valid underwriting criteria result in premiums that are less than accurate messengers of risk."



► Gregory D. Squires is a professor of sociology and public policy and public administration at George Washington University.

In other words, he said, "when the message itself is statutorily redacted—in some way blurred, garbled or lost—the consequences for society are unambiguously negative because the incentive to improve driving behavior is diminished."



► UNDERWRITING VARIABLES like education and employment status provide no incentive for responsible behavior.

But statistical correlation is only one part of sound underwriting. If the variable associated with loss has no intuitive relationship to the actual cause of loss, particularly if that variable is something over which the insured has no control, then there is no incentive for responsible behavior.

In fact, just the opposite might be the case. If a driver believes his or her rates will be determined, even just in part, by education, occupation, credit score, or some other factor that has no common sense relationship to the cause of loss—and is something they cannot readily control anyway—no additional positive incentive is provided.

It is precisely the use of such factors that sends a blurred, garbled and perhaps lost message to most policyholders.

Use of such criteria is particularly problematic in the current economy, with many people losing their jobs. Now in addition to losing their income, health insurance and often their very sense of identity, they will also suffer the indignity

of higher insurance premiums.

Does the industry really want to be viewed as piling onto vulnerable populations, particularly at a time when they are most vulnerable?

There are racial implications as well. Even assuming education and occupation predict loss, there cannot help but be an adverse disparate impact. In 2007 among people 25 or older, 28 percent of whites were college graduates compared to 17 percent of blacks and 12 percent of Hispanics. And any other education level or occupational index will yield a similar pattern.

This current debate reflects longstanding controversy over the question of race, ethnicity and socio-economic status in the pricing, underwriting and marketing of property insurance. It is long past time for the industry to provide a level of transparency that the mortgage lending industry has provided for more than 30 years.

Insurers should be required to publicly disclose the race, gender and income of applicants and the disposition (such as approved or denied) of those applications. Given the importance of location in most underwriting schemes—and the close association between race and place as well as poverty and place—the geographic location of where insurers are writing, renewing, nonrenewing and cancelling policies should also be disclosed.

Through the Home Mortgage Disclosure Act mortgage lenders have been doing this for decades without revealing the identity of any individuals or families or any trade secrets of any lender. Confidentiality has been maintained. And it has worked.

Douglas Duncan, senior vice president for research and business development and chief economist with the Mortgage Bankers Association, recently told the House Subcommittee on Financial Institutions and Consumer Credit: "MBA uses HMDA data to assist its members in analyzing the industry's performance in serving the nation and identifying new markets and investment opportunities...The data fairly

► continued on page 25

## P-C SURPLUS DROPS

*continued from page 23*

cutting measures, such as higher retentions and lower limits, the report said.

As the falloff in demand produces a top-line premium drop across the industry, the economic crisis will also directly impact the incurred losses due to fraud, increased professional liability lawsuits and higher workers' compensation payouts.

But in the current depressed economic environment, increased losses will not drive premiums up until policyholders' surplus "becomes more drastically reduced," Advisen predicted. "Such loss increases will merely serve to strain insurance companies' balance sheets through at least mid-2009."

## NOT THE GREAT DEPRESSION

Mr. Hartwig drew his own analogies to the Great Depression but easily pushed aside direct comparisons by presenting some historical numbers.

Although 2007 and 2008 did indeed mark the first consecutive years of negative premium growth since 1930-1933, he said estimates from I.I.I. indicate that premiums written fell by a staggering 35 percent over a four-year span from their 1929 peak through their 1933 trough.

In addition, during the Great Depression policyholders' surplus fell by an estimated 37 percent, contrasting the 12 percent dip of 2008.

"The bottom line is that the impact of the current financial crisis on p-c insurance, as bad as it is, is not even remotely close to the impacts experienced during the Great Depression," he said. "Indeed, premiums, surplus and assets will likely return to their pre-crisis levels within a few years, [while] it took 10-to-12 years (i.e., until 1939, 1940 or 1941) for these same financials to recover in the wake of the Depression."

Likewise, Advisen expects a quicker recovery. When policyholders' surplus as a percentage of GDP is declining, "supply is shrinking relative to demand and a hard premium market usually follows," the Advisen report said.

While both policyholders' surplus and GDP have been dropping, the level of decline in the GDP is becoming "less dramatic" than policyholders' surplus, "and continual large declines in GDP are unlikely to persist beyond midyear," the report said. ■

## FORMER CEO BANNED

*continued from page 8*

Mr. Vukelic was CEO from August 1997 until October 2002. During that time Mr. Vukelic was responsible for overseeing and structuring three different transactions that were designed to allow the client insurance companies to hide very significant losses in their accounts, the FSA said.

Mr. Vukelic, according to FSA, knew that the deals were not genuine reinsurance transactions and that they could be used to mislead the clients' auditors.

It noted that two of the three client insurance companies subsequently collapsed with wide-ranging consequences.

The Tribunal found that Mr. Vukelic had "turned a blind eye" to the true nature of the contracts and was "reckless as to whether they were intended to mislead auditors and others."

Margaret Cole, FSA director of enforcement, said in a statement: "This case has been fought every inch of the way by Mr. Vukelic. We are determined to take whatever action is necessary to ensure that individuals should not avoid the consequence of their actions. The Tribunal rightly criticized his persistent failure to recognize his shortcomings.

"Those carrying out senior functions in regulated firms need to be clear that the FSA will hold them to the highest standards of behavior and will take action against those who fall short. There is no place in financial services for the sort of behavior demonstrated by Mr. Vukelic."

FSA said Mr. Vukelic ceased to be an approved person for the industry in July 2005.

He is the second executive connected to a Gen Re subsidiary against whom the FSA has taken action in the past two years.

## INSURERS ADD TO HARDSHIP

*continued from page 26*

present a picture of the industry's work, offering information to further effective investment and, where appropriate, provide flags for further regulatory review."

Federal Reserve Board Governor Mark Olson told that same subcommittee: "The data prompt discussion, investigation, analysis and research that may deepen our understanding of why these patterns occur and allow us to increase fairness and effi-

In 2006 John Byrne, a reinsurance specialist with Cologne Re, was prohibited from working in the industry for five years.

Separately, in the U.S. District Court in Hartford, Conn., on April 2, Judge Christopher E. Droney's sentence for Ms. Monrad was the fourth sentence he has handed down to executives for the roles they played in a sham insurance scheme involving American International Group.

In addition to the prison term, Judge Droney sentenced Ms. Monrad to three years probation and fined her \$250,000.

Ms. Monrad was found guilty in February of last year of conspiracy, securities fraud, making false statements to the U.S. Securities and Exchange Commission, and mail fraud.

Ms. Monrad and four others were convicted of creating two sham insurance deals. The deals increased AIG's loss reserves by \$250 million in the fourth quarter of 2000 and \$250 million in the first quarter of 2001. An investigation forced AIG to restate its earnings in 2005, costing shareholders more than \$500 million.

Others sentenced in the case were Ronald E. Ferguson, Gen Re's former chief executive officer; Christopher P. Garand, former senior vice president and chief underwriter of the company's finite reinsurance operations in the United States; and Christian M. Milton, a vice president of reinsurance at AIG.

Mr. Ferguson was sentenced to two years in prison and fined \$200,000. Mr. Milton was sentenced to four years in prison and fined \$200,000. Mr. Garand received a year and a day in prison and was fined \$150,000.

The fifth defendant, Robert D. Graham, formerly Gen Re senior vice president and assistant general counsel, is still awaiting sentencing. ■

ciency in the home loan market."

Loss costs, of course, are central determinants of the pricing and underwriting of insurance. Loss information should also be publicly disclosed so it is clear for all to see why insurance availability and pricing take the patterns that they do.

Simply asserting that risk, and risk alone, accounts for the pricing and underwriting of insurance is not sufficient.

It is time for the property insurance industry to finally step out of the shadow and let the sun shine in. ■



April 27, 2009

Property and Casualty (C) Committee  
Market Regulation and Consumer Affairs (D) Committee  
Public Hearing on Credit-Based Insurance Scores  
Arlington, Virginia

Director Michael McRaith (IL)  
Commissioner Kim Holland (OK).

Dear Director McRaith and Commissioner Holland:

The Delaware Insurance Commissioner's Office worked with the Delaware General Assembly to pass a new law in 2007 that makes Delaware one of the five strictest states in the country with regards to how credit information can be used in setting insurance rates. The new law took effect on January 1, 2008.

Many Delawareans believe credit scoring would increase the cost of insurance for those who are already least able to afford insurance and who are already having the most difficulty paying their bills. Further, it has a disproportionate impact on poor and minority policyholders.

As of January 1, 2008, auto and homeowners insurance companies in Delaware have been prohibited from adjusting their current policyholders' rates based on changes in the policyholders' credit ratings. This ban is the result of legislation passed in June 2007 by the General Assembly and signed into law by the Governor.

Policyholders can also take advantage of one provision of the new law. After January 1, 2008 policyholders can ask their insurance companies to recalculate their credit ratings once a year when their policies come up for renewal and if their credit has improved they may see a benefit in their insurance rates. If their credit has worsened, their insurance rates will not be affected.

Commissioner Stewart said: "The law, consistent with my long held position, is that a change in a policyholder's credit score must only help and not harm a current policyholder." The Commissioner further stated: "Thanks to our new law, policyholders have a right to ask for this possible discount without the need to read or understand any deceiving or contradictory fine print. Why? Because there isn't any."



Page 2  
April 27, 2009

A regulation requiring insurance companies to notify their policyholders of this new right to have their credit recalculated at renewal took effect on April 1, 2008.

The Delaware Insurance Department provides consumers with a guide to Delaware's new law regarding insurance and credit. The guide is available online at <http://delawareinsurance.gov/credit>.

As respects to our concerns we would like the following issues addressed during the hearing:

How do insurers handle improvement (or deterioration) in scores from year-to-year?

How do insurers handle those who wish not to have their scores checked, thin-files, or no-hits?

What variety is out there for what insurers do with the scores?

Least use: not use credit at all. Next: yes/no for eligibility for insurance. Next: use for tiering (underwriting only, not rating). Next: Use as rating factor. Most use: integrated into the rating through a multi-point model.

How do insurers avoid double-counting so-called negative characteristics, like urban dwellers with poor credit, or youthful drivers with poor credit, or low-valued homes whose owners have poor credit?

We appreciate the opportunity to submit our comments and concerns and look forward to the results of the hearing.

Sincerely,

Karen Weldin Stewart, CIR-ML  
Delaware Insurance Commissioner

April 28, 2009

Commissioner Kim Holland  
Oklahoma Insurance Department  
P.O. Box 53408  
Oklahoma City, OK 73152-3408

Director Michael McRaith  
Illinois Division of Insurance  
320 W. Washington Street  
Springfield, IL 62767-0001

Dear Regulators:

As leaders of the National Conference of Insurance Legislators (NCOIL), we write in advance of your April 30 hearing on insurance credit scoring because we also have recognized the importance of this issue. We wish to offer insight into the 2002 model law that we developed in response—specifically, into the model's long-standing and well-accepted consumer protections. We also note that NCOIL will soon revise its model to more directly assist victims of today's economic climate.

The NCOIL *Model Act Regarding Use of Credit Information in Personal Insurance* was and remains a timely and effective response to consumers who feel blindsided by insurer use of their credit information. NCOIL believes strongly that insurers should not have free reign and that we as legislators have a duty to promote balanced public policy that safeguards our constituents from possible abuse. The NCOIL model act—which evolved through two years of special sessions, model drafts, and many hours of debate with all key players—does just that. It has become the standard for state insurance scoring policy and would, among other things:

- promote so-called credit “passes” for persons impacted by **extraordinary life events**—such as divorce, illness, job loss, or death of a spouse—which could encompass fallout from the financial crisis.
- prohibit an insurer from **calculating an insurance score** based on income, gender, address, zip code, ethnic group, religion, marital status, or nationality.
- discourage insurers from taking an adverse action based on “**thin**” or **non-existent credit**—a circumstance common among seniors, young people, and low-income consumers.
- prohibit insurers from treating negatively **credit inquiries** that a consumer did not initiate—as when banks mine credit reports prior to sending credit card offers.
- prohibit insurers from looking negatively upon **collection accounts** related to a sickness or other medical event for which a consumer could not pay.
- provide that insurers can only consider **multiple inquiries** from the mortgage or auto lending industries in any 30-day period as one credit “hit”—as these multiple inquiries indicate that a consumer has wisely shopped around for the best deal.
- require insurers, before taking an adverse action, to use credit reports issued or insurance scores calculated **within 90 days** from the time a policy was initiated or renewed.

- direct insurers to **re-underwrite or re-rate** if a consumer or his/her agent requests it at annual renewal.
- require an insurer, if a consumer **challenges his/her credit report** and has it corrected, to re-underwrite or re-rate based on the new information—and return any amount of **overpayment**.
- mandate that insurers provide key **consumer notifications**—including up to four credit-related reasons for an adverse action if credit was a factor and up-front notice that credit will be considered in underwriting and/or rating.
- direct insurers to **file their insurance scoring models** with state insurance departments.
- prohibit credit reporting agencies from **selling insurance-related data** to third-parties that do not deserve it.

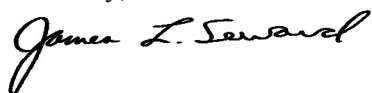
NCOIL will consider an amendment at the July 9 through 12 NCOIL Philadelphia Summer Meeting to target consumers whose fallen credit is traceable to the financial crisis not of their making—even though the model’s extraordinary life events language already applies.

The amendment would correlate the time a person’s credit began suffering with decline of the U.S. economy. It would specifically acknowledge certain major credit events, such as foreclosures, that run counter to a person’s otherwise solid credit history. The amendment will be drafted to capture only people who are true crisis victims, rather than people who are victims of their own poor decisions. NCOIL will have further details as the Summer Meeting approaches.

We look forward to dialoging with you regarding suitable insurance-scoring public policy, and we appreciate your efforts during this difficult time. As legislators and regulators—and first and foremost consumers—we agree that too many in this country are struggling to pay bills and stay in homes. We must stand together to protect consumers from credit misuse and encourage strong insurance markets that benefit us all. The NCOIL model law—which has been adopted in your states of Illinois and Oklahoma, as well as in 24 others—strikes the critical balance.

Please feel free to contact the NCOIL National Office at 518-687-0178 should you have any questions.

Sincerely,



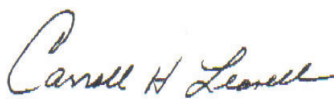
Sen. James Seward (NY)  
NCOIL President



Rep. Robert Damron (KY)  
NCOIL President-Elect



Rep. George Keiser (ND)  
NCOIL Vice President



Sen. Carroll Leavell (NM)  
NCOIL Secretary



Sen. Vi Simpson (IN)  
NCOIL Treasurer

cc: NCOIL Legislators  
NAIC Market Regulation & Consumer Affairs (D) Committee  
NAIC Property-Casualty Insurance (C) Committee  
Therese Vaughan  
Tim Mullen/Eric Nordman