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CREDIT-BASED INSURANCE SCORES: ARE THEY FAIR?

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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CREDIT-BASED INSURANCE SCORES: ARE THEY FAIR?

Tuesday, October 2, 2007

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:02 p.m., in room 2128, Rayburn House Office Building, Hon. Melvin L. Watt [chairman of the subcommittee] presiding.

Members present: Representatives Watt, Waters, Klein; Miller, Price, and Roskam.

Chairman WATT. This hearing of the Subcommittee on Oversight and Investigations will come to order. Without objection, all members' opening statements will be made a part of the record, and I will now recognize myself for an opening statement.

Credit-based insurance scores are numerical summaries of the credit histories of consumers. The scores are calculated using information contained in a consumer report, information such as past delinquencies, consumer debt ratios, and the length of credit. The use of credit-based insurance scores has increased rapidly during the 1990's and today credit-based insurance scores are widely used.

While common sense tells you that speeding tickets, driving under the influence of drugs and alcohol, or automobile accidents should increase automobile insurance premiums, most Americans would probably be surprised to learn that late payments on credit cards can dramatically increase the premiums they pay for automobile insurance. In other words, one's credit history, not one's driving history, is likely to be determinative of the cost of one's automobile insurance. That might be the equivalent to having your driving history determine whether you get a bank loan or determine the interest rate you will pay on your bank loan.

The question we need to address is whether this is fair. Today's hearing is entitled, "Credit-based Insurance Scores: Are They Fair?" Our objective is to shed light on the growing but often hidden use of credit information in the pricing and underwriting of insurance and to start analyzing, discussing, and determining whether that is fair or whether it even makes sense.

A number of consumer and civil rights groups and some States say that it's not fair. They argue that these scores are used to raise premiums, deny coverage for new customers, and deny renewals of existing insurance policies, even in the absence of common-sense risk factors, such as moving violations or accidents. They say that

the use of credit-based insurance scores disproportionately hurts young people and minorities. Some States have already enacted laws or adopted regulations that either ban or restrict the use of credit-based insurance scores. For example two of our witnesses today represent States, Hawaii and Washington, that limit or ban the consideration of credit-based insurance scores in underwriting automobile insurance.

We look forward to their testimony, and I think you will find it interesting. I've reviewed, for example, the legislative history for the Washington State law and find this interesting quote in their legislative history:

"There have been hundreds of complaints filed in the OIC regarding insurance companies' use of credit scoring for use of underwriting and rate-setting purposes. For example, one woman who paid her premiums and never had an accident was told that her premiums went up because her credit rating was bad due to a period of unemployment. A woman who had her insurance premium rates increase by 46 percent, even though she paid all her premiums on time, discovered that her credit score was low due to a bankruptcy filed by her ex-husband. A couple was denied access to reasonable rates because they paid all their bills in cash, and therefore had no credit history. There are many reasons for a low credit score that do not take into account individual circumstances or creditworthiness."

That is from the legislative history of the Washington statute.

The first Federal study on credit-based insurance scores was recently released by the Federal Trade Commission. The FTC was directed under Section 215 of the Fact Act to study whether the use of credit-based insurance scores "could result in negative or differential treatment of protected classes under the Equal Credit Opportunity Act and whether such underwriting systems could achieve comparable results through the use of factors with less negative impact."

The FTC study grew out of a compromise between the prospect of an outright Federal ban on the use of credit-based insurance scoring, on the one hand, and doing nothing, on the other hand, and I would note that neither one of the two—both of the members who were responsible for the study are on this committee: the chairman, who orchestrated the study, and is opposed an outright ban; and Representative Gutierrez, whom I hope will show up here at some point during the course of this hearing because he is on the subcommittee.

The first FTC report focused exclusively on automobile insurance, and while it concluded that credit-based insurance scores are "effective predictors of risks," it also found that in three out of four lines of automobile insurance there is "some" proxy effect based upon race. While the FTC didn't get to this latter finding until page 69 of the report, I believe that any finding of a proxy effect, however small, should be cause for concern in this day and age.

Several concerns have been raised about the reliability and validity of the FTC's report. One FTC Commissioner dissented from the report, noting disagreement with the methodology used to generate the underlying data used in the report because it relied solely on data the insurance industry voluntarily submitted and on publicly

available data. The dissent suggested that the FTC could have served insurance companies with Section 6(b) orders to obtain a "more accurate and complete dataset, which would have provided a strong foundation for staff's complex economic analysis."

Even with perceived shortcomings of the data, the FTC report still concluded that there was some proxy effect from the use of credit-based insurance scores in three out of four lines of automobile insurance. As the dissenting Commissioner noted, the study "still found that credit-based insurance scores have a small effect as a proxy for membership in racial and ethnic groups. Given the incompleteness of the data, it is unclear whether the actual proxy effect might be greater." Another Commissioner's concurring statement to the report conceived that "the results in today's report are no cause for celebration," referring to the difference in credit-based insurance scores across racial and ethnic groups. In short the FTC's report, the one on automobile insurance that we are considering today, may raise more questions than it answers, especially about whether the use of credit-based insurance scoring disproportionately impacts minorities.

The FTC is preparing a second report on the impact on using credit-based insurance scoring on homeowner's insurance. Given the serious concerns raised about the validity of the data for the automobile insurance report and the critical importance of the second report on homeowner's insurance, Chairman Frank, Representative Gutierrez, and I have requested the FTC to consider using its more extensive authority for the homeowner's study to obtain a large and statistically valid dataset from insurers.

The FTC has advised us that this could take 2 to 3 years longer, and one of the things I'll be asking about today is whether this is likely to get a more reliable conclusion or whether it would just take 2 to 3 years more to get another study that probably would be perceived as just as unreliable.

Due to the uncertain reliability of using credit-based insurance scores in setting insurance rates, we certainly must proceed with care. This hearing is the first step, certainly not the last, in the process of raising the important questions that need to be asked, and in educating ourselves, other Members of Congress, and the public about the critical importance of this issues.

In the final analysis, I think it should be clear that neither the FTC report nor today's hearing should deter the States from their traditional role in regulating insurance. The fact that Hawaii and Illinois or Hawaii and Washington or Hawaii and North Carolina differ in their legislation and in their regulation of credit-based insurance scores is not necessarily a bad thing. States have historically regulated and controlled insurance, and have historically been the so-called "legislative and regulatory laboratories for innovation." State insurance regulators are the best-equipped to regulate insurance credit scoring and should continue to do so, certainly until we have a better understanding of the facts and the arguments for and against whether credit-based insurance scoring is fair.

I will now recognize Ranking Member Miller for an opening statement.

Mr. MILLER OF CALIFORNIA. Thank you very much.

I think it's important to recognize right off the bat that credit-based insurance scores are just one of the tools that insurance companies use to determine rates for the people they are insuring. It is not the only tool, and we need to highlight the fact that the States make the determination whether or not they are used and applied at the State level. The Federal Government does not do that.

But over the years insurers have been using credit scores as an objective underwriting factor to evaluate insurance applications, especially for automobile and homeowner insurance, as a predictor of possible future insurance claims their customers might incur. After some questioned the legitimacy of this practice and expressed concerns that the screening method was discriminating against minorities, Congress directed the Federal Reserve Board and the Federal Trade Commission, the FTC, to study the effects of credit scoring on credit and insurance markets and report their findings back to Congress. The Fed's report evaluated credit markets and the FTC examined the use of credit scoring in establishing insurance prices.

The FTC has recently published a portion of their study which closely examined the effects of credit-based insurance scores on the availability and affordability of automobile insurance. Expert economists at the FTC concluded that these scores are effective predictors of claims that consumers file, and that there is no evidence of credit score discrimination against any minority group. This conclusion was reached after the Commission reviewed almost 200 public comments, researched and evaluated data collected from a wide variety of sources, consulted with community, civil rights, consumers', and housing groups, government agencies, and private companies. In fact, their conclusion was similar to results formed after the Texas Department of Insurance studied the use of credit scores to assess automobile risks.

Further the FTC concluded that credit scoring is not only valid, it is actually good for consumers. This study along with many other studies indicates that credit scoring is beneficial to consumers because it is one of the most accurate ways to gauge risk and price fairly. Consumers have power over their credit scores, and credit scores are one tool insurers have to better match an individual's risk with a suitable premium, which for consumers with good credit means lower premiums. Actually the FTC concluded that scores give insurers the opportunity to offer insurance to higher-risk consumers for whom they otherwise would not be able to determine an appropriate premium.

The Feds also issued a report this summer on credit, which described credit scoring as likely increasing 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 and ethnicity.

The link between credit history and loss potential has also been frequently examined by academia. These studies show that consumers under stress are more likely to have auto accidents and financial problems. Studies have found that people with poor insurance scores are more likely to engage in risky behavior, and there-

fore are more likely to incur financial losses. Insurance appraisers evaluate their customers and price policies to ensure that consumers less likely to incur losses are not subsidizing those who are riskier and tend to have more auto accidents.

Researchers indicated that if people take care of their finances, they are likely to exercise the same amount of responsibility in other aspects of their life. While it is unclear exactly why there is a correlation between credit scores and insurance losses, the relationship is proven to exist. It has been determined that drivers with bad credit histories are more likely to have repeated accidents than those with good credit history. With years of studies and research showing that there is a clear and consistent relationship, it seems it would be irresponsible for the insurance industry to ignore the predictive power of insurance credit scoring, and consumers less likely to incur losses would ultimately pay the price.

It seems to me that instead the Financial Services Committee should instead be examining ways to improve consumer credit reports through consumer finance education and the use of non-traditional credit providers, like utilities and phone companies, to report information to their customers.

Once again, I think this is an appropriate hearing we're having today. We requested that these studies be prepared, and the studies were prepared. I know not everybody is going to like the results of the study, but the studies were very conclusive that using credit-based insurance scores were not discriminatory and that they were beneficial to individuals. And it was a predictor of basically the loss an insurance company might suffer, and therefore they could apply it in appropriate ways.

I thank you and I yield back.

Chairman WATT. I thank the gentleman. As I had previously indicated, opening statements of all members will be made a part of the record. Unless somebody's crying out to be heard, we will proceed.

We have received a number of requests for submissions to the record, so let me get that dispensed with. I ask unanimous consent to submit the following written documents for the record: a copy of the House Bill Report on ESHB2544, that's Washington State's bill; the report to the legislature called "Insurance Credit Scoring" from the State of Washington Office of the Insurance Commissioner; a letter from Chairman Barney Frank, Representative Gutierrez, and myself to the FTC about the process that was used and the process that will be used or may be used in their follow-up study—that letter is dated August 28, 2007; a response from the Federal Trade Commission dated September 17, 2007, giving us their response to our letter; a submission from a number of consumer groups, Consumer Federation of America, Fair Housing Alliance, Consumer Union, and others, dated October 2, 2007; a submission dated October 2, 2007, from the National Conference of Insurance Legislators; a submission dated October 1, 2007, from the Hispanic Alliance for Progress Institute; and a submission dated October 2, 2007, from the American Insurance Association, the National Association of Mutual Insurance Companies, and the Property Casualty Insurance Association of America. Without objection, those documents will be submitted for the record.

We will now introduce this outstanding, distinguished panel of witnesses and try to get to them to do their testimony.

The first witness we will hear from is Commissioner J. Thomas Rosch, who was sworn in as a Commissioner of the FTC on January 5, 2006, to a term that expires in September of 2012. He joined the FTC from the San Francisco law firm of Latham and Watkins, where he was formerly the managing partner. Mr. Rosch has served as chair of the ABA's Antitrust Section in 1990 and chair of the California Bar Association's antitrust section, and also served as the FTC's Director of the Bureau of Consumer Protection from 1973 to 1975. And he is nationally regarded for his antitrust and trade regulation law experience, has been lead counsel in over 100 Federal and State court antitrust cases, and in 2003, was honored as antitrust lawyer of the year by the California State Bar antitrust section. He obtained his law degree from Harvard in 1965.

Our second witness will be Hawaii Insurance Commissioner J. P. Schmidt. Mr. Schmidt was appointed insurance commissioner of Hawaii in 2003. Previously, he was a partner in the law firm of Crockett, Nakamura, and Schmidt in Maui. In the 1990's, he was corporation counsel for the County of Maui. Before moving to Maui in 1989, he was an officer with a Los Angeles bank in commercial lending, and he received his J.D. degree from the University of California, Davis, and a B.A. degree in philosophy from U.C.L.A.

The third witness is, I realized earlier today when I was reading the bios, my classmate and former colleague in Congress. We were both elected to Congress in 1992, and he is a living example that there is life after Congress. I keep trying to figure out whether that's true or not, but I think I'm convinced of that. He is Washington Insurance Commissioner Mike Kreidler.

Mike was elected insurance commissioner of Washington in 2000. He is also a former Member of Congress where he served on the House Energy and Commerce Committee. He served in the Washington Legislature for 16 years, focusing on issues related to healthcare and the environment. As insurance commissioner, he was instrumental in studying the effect of credit-based insurance scores on consumers, and helped win passage in 2003 of Washington's law limiting the use of credit-based insurance scores in personal lines of insurance. He earned a master's degree in public health from U.C.L.A. and a doctor of optometry from Pacific University in Oregon. He is a retired lieutenant colonel with 25 years of active and reserve service in the Army.

Our fourth witness—I just want to give a special welcome to my former classmate here in Congress. Our fourth witness is Birny Birnbaum from the Center for Economic Justice. Mr. Birnbaum is a consulting economist and 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. He has been working on insurance credit scoring 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. He has testified about insurance credit scoring many times before legislatures and administrative agencies including insurance departments and public utility commissions.

He has provided expert testimony in litigation related to insurance credit scoring, and he has worked extensively in auto and homeowner's insurance availability in red-lining issues and is recognized as an expert in both economic and actuarial matters related to rates and risk classification. He received his training in economics from M.I.T., where he earned a master's degree in management and urban planning.

Our fifth witness is Mr. Eric Rodriguez of the National Council of La Raza. Mr. Rodriguez is deputy vice president at the National Council of La Raza, the largest national Latino civil rights organization in the United States. He helps in that capacity to supervise and coordinate core operations of the Office of Research Advocacy and Legislation, and he's responsible for providing strategic guidance for public policy, legislative, and advocacy activities related to economic mobility and economic security policy issues. This work involves coverage of a wide range of issues including Federal budget tax, banking, homeownership, and social security. He holds a B.A. degree from Sienna College in New York and a master's degree in public administration from American University in Washington, D.C.

And our final witness will be Mr. Nathaniel Shapo, who is a partner in the law firm of Katten, Muchin and Rosenman's litigation and dispute practice in Chicago, Illinois. He served for 4 years as director of the Illinois Department of Insurance where he consulted with Congress and Federal bank regulators on the Gramm-Leach-Bliley Financial Services Modernization Act, and helped draft the National Association of Insurance Commissioners' statement of intent for the future of insurance regulation. He has been named as a "renaissance regulator" by Best Review, was chosen for Crain's Chicago Business 40 Under 40 list of newsmakers and groundbreakers, and he has been a lecturer in law and has served as a member of the visiting committee of the University of Chicago Law School. He earned his B.A. and J.D. degree with honors from the University of Chicago.

We welcome each one of our witnesses. Without objection, each witness' written statement will, in its entirety, be made part of the record, and each witness will be recognized for a 5-minute summary of their testimony.

Let's start, if we may, with Commissioner J. Thomas Rosch. You are recognized for 5 minutes or thereabouts.

STATEMENT OF THE HONORABLE J. THOMAS ROSCH, COMMISSIONER, FEDERAL TRADE COMMISSION

Mr. ROSCH. Thank you very much, Chairman Watt, Ranking Member Miller, and distinguished members of the subcommittee.

I very much appreciate this chance to speak about the Commission's report on the impact of credit-based insurance scores on consumers of car insurance. I'm afraid there's a danger here that the forest will get lost in the trees, the trees in this case being criticisms about the methodology used in compiling the Commission's report. Please don't misunderstand me. I have the greatest respect for those voicing the criticisms including those at the table, especially, however, for Commissioner Harbour, who's not only a col-

league but a very close friend of mine. But I'm concerned lest the critiques obscure the report's two critical conclusions.

The first conclusion is that credit-based scores do effectively predict risk under car insurance policies. That conclusion isn't affected by debates over whether the Commission should have gotten additional data bearing on that issue, whether it should have gotten that data from more insurance companies, or whether it should have used compulsory process to get the data that it got.

There are two fundamental reasons why those debates don't impact that conclusion. First, the data that came from insurance companies came from companies representing more than 25 percent of the market, and those companies submitted written assurances of the information's reliability, assurances which if false would support criminal prosecution.

Second, the report's conclusion in this respect wasn't just based on data that came either directly or indirectly from those insurance companies. The reliability of the data from those sources was cross-checked by performing the same analyses based on claims data obtained from ChoicePoint's CLUE database, and I'm referring now to its comprehensive loss underwriting exchange database. And beyond that, the conclusion was supported by the Texas study, whose methodology critics say should have been used by the Commission.

The second critical conclusion of the report is that credit-based scores are distributed differently among racial and ethnic groups, with African-Americans and Hispanics, on average, being more likely than others to have lower scores. Accordingly, insofar as credit-based scores are used, they're likely to result in higher car insurance premiums being charged to African Americans and to Hispanics than to others.

Again, that conclusion isn't affected by the current debates over methodology. The data supporting that conclusion didn't come from the insurance policies at all because they don't track the race or ethnicity of their policyholders. It was instead based on inferences about the race and ethnicity of car owners drawn from data whose sources were the Social Security Administration, the Bureau of the Census, and information from an Hispanic surname matching firm. Again, the report's conclusion was consistent with the Texas study.

Nothing in the report tries to blur that second conclusion. As my colleague Commissioner Leibowitz pointed out in his concurring decision when the report was issued, this conclusion serves as a reminder of the fact that some things, even today in our society, may adversely affect racial and ethnic minorities. And as Commissioner Harbour pointed out, it underscores the importance of educating minorities about the use of credit scores in pricing insurance and the importance of avoiding borrowing practices that can adversely affect their credit scores. We at the Commission have devoted substantial resources and will continue to do so.

All that said, Mr. Chairman, the Commission has carefully considered the concerns about methodology that have been raised about our automobile insurance study. A majority of the Commission, four of us, continue to believe that the methods used were sound and that the findings made and conclusions reached were supported. But I speak for all five of us in emphasizing that we believe it's important for the public to have confidence in Commission

reports. To that end, in our study of the impact of credit-based scores on consumers of homeowner's insurance, the Commission intends to use our authority under Section 6(b) of the FTC act to get policy information from insurance companies. A description of our plan for the homeowner's insurance study, including the use of 6(b) orders, is set forth in our recent letter from Chairman Majoras to Chairman Frank, to you, Chairman Watt, and to Chairman Gutierrez.

Thank you for your time and interest today, and I look forward to answering any questions you might have.

[The prepared statement of Commissioner Rosch can be found on page 109 of the appendix.]

Chairman WATT. Thank you for your testimony.

Commissioner Schmidt, you are recognized for 5 minutes or thereabouts.

STATEMENT OF THE HONORABLE J.P. SCHMIDT, COMMISSIONER OF INSURANCE, STATE OF HAWAII

Mr. SCHMIDT. Thank you, Chairman Watt, Ranking Member Miller, and committee members. Thank you for this opportunity to testify on credit-based insurance scoring, and to provide some background on why policymakers ban this practice in the 50th State. In 1987, the Hawaii Legislature amended the Hawaii Revised Statues to prohibit discriminatory practices in the pricing of automobile insurance premiums. The law applies to rating plans, ratemaking standards and underwriting standards, and bars use of race, creed, ethnic extraction, age, sex, length of driving experience, credit bureau rating, marital status, or physical handicap in the direct or indirect pricing of Hawaii's automobile insurance premiums.

Then as now arguments were made that credit scoring is an accurate predictor of the number of and total cost of claims. Arguments were also proffered both for and against the promise that credit scoring results in unfair and discriminatory pricing for low-income and minority groups.

In its deliberations on this issue 20 years ago, the Hawaii Legislature determined that the use of credit bureau rating reports could result in discriminatory rating practices and acted to specifically include credit bureau rating in the list of prohibited criteria. Two decades later a report to Congress by the Federal Trade Commission reports that credit-based insurance scores are distributed differently among racial and ethnic groups, and that this difference may result in higher insurance premiums, on average, that these groups pay. While it's been actuarially demonstrated that there is a correlation between an individual's credit score and the propensity for that individual to be involved in future claim activity, that relationship only provides a portion of the information needed to develop and to regulate an insurance rate regulatory system.

It's essential that policymakers have the flexibility to consider any corollary effects that may result from the criteria used in the insurance classification system. A good legal regulatory system balances the various and varied factors providing appropriate consumer protection with as little government intrusion as possible. The result should be a healthy, competitive market providing fair treatment and rates to consumers.

It was determined by the Hawaii Legislature that any benefits accruable to some consumers by allowing credit bureau scoring as a rating factor in automobile insurance pricing were outweighed by the potential for harm to a greater number of the State's citizens and to its economic wellbeing. In this regard the legislature's policy decision accomplished a major goal of a risk classification system to produce rates that are not unfairly discriminatory. It is essential to recognize and acknowledge that credit scoring, if allowed and given jurisdiction, will per force result in all insurers giving consideration to use of credit-based insurance scores, regardless of whether they would have opted to use the criteria on their own in order to avoid adverse selection.

Another important factor to consider is that credit scoring likely may present obstacles to employers, particularly small businesses, during less than favorable economic times, which would be counter to the economic goals of the State and Nation. Small business owners may have to borrow funds during economic downturns in order to keep the business going and to keep employees on the payroll. A rating system based upon credit scores may add additional surcharges and burdens when those burdens are most potentially harmful, adding to the economic problem due to intolerable marginal cost increases associated with the purchase of insurance.

Why is this State like any other? The one thing we do hold in common with our 49 sister States is our firm belief in home rule. Legislative and regulatory processes must be tailored to best fulfill the needs of a particular region, taking into consideration its demographics, business climate, and social structure. As in other areas of law, one size does not fit all in establishing a legal structure for auto insurance. This concept is embodied in the guidelines of the Actuarial Standards Board of the American Academy of Actuaries, which avoid placing undue restraints on actuarial lawmakers by not requiring a specific system of specific rating criteria while allowing the balance of numerous pertinent factors under tested actuarial guidelines.

In summary, 20 years of experience has provided no evidence that Hawaii statutory exclusion related to the use of credit bureau ratings in the pricing or underwriting of insurance has diminished the efficacy of the Hawaii insurance market. The current automobile insurance environment in Hawaii is competitive and healthy. And while the argument continues over whether credit scoring discriminates unfairly against low-income and minority groups, I can assure you with 100 percent confidence that such discrimination does not exist today in the Aloha State.

Thank you again for the opportunity to address this honorable body and to share with you Hawaii's approach and experience with this important insurance law policy.

[The prepared statement of Mr. Schmidt can be found on page 152 of the appendix.]

Chairman WATT. Thank you, Commissioner, for your testimony. Commissioner Kreidler, you are recognized for approximately 5 minutes.

STATEMENT OF THE HONORABLE MIKE KREIDLER, COMMISSIONER OF INSURANCE, STATE OF WASHINGTON

Mr. KREIDLER. Thank you, Chairman Watt, Ranking Member Miller, and distinguished members of the committee.

I'm here to testify on "Credit-based Insurance Scores: Are They Fair?" My name is Mike Kreidler. I'm the elected insurance commissioner of the State of Washington, and I serve on a number of committees nationally with my fellow regulators that deal with this particular issue.

When I was first elected as insurance commissioner in the year 2001, the issue was really starting to hit full steam from the standpoint of consumers. I literally received thousands of complaints from consumers. They didn't understand what their credit history had to do with how much they paid for personal lines of insurance, like automobile insurance and homeowner's insurance. The insurance companies were using credit information very differently from one company to another, and consumers quite frankly were disgusted that they were seeing rate increases based on factors that they didn't understand or could not be explained to them.

In 2002, I proposed legislation to our State legislature. I would have proposed an outright ban, but I couldn't go that far successfully so I went as far as I could to put the strongest laws into effect. And when it passed it was the strongest law that had passed up to that point as a direct result of credit scoring. Today, something like 48 States have stepped in to vary degrees of trying to put limits into effect.

What we wound up doing is that we wound up saying that you couldn't cancel or non-renew a policy based on credit information. We also said that you couldn't because of the absence of credit history, the number of credit inquiries, because of medical bills, because of the impact of the initial purchase of a vehicle or a house, or the type of card—credit, debit, or charge—that you might have, or the available line—that couldn't be used to either deny you or to be used as part of the rating for your insurance.

In addition to that, we wound up saying that if the insurer wound up using bad information, they retroactively had to adjust the premiums that you had been paying under the bad information. In addition to that, we required enhanced adverse action statements, in effect saying that consumers deserved the right to know why they didn't get the best rate.

All of that helped, but in my mind it still doesn't go far enough and I'm still deeply concerned about the—that it thoroughly discriminates against protected classes and the economically disadvantaged.

Insurance by its very nature discriminates. If you have a teenager on your policy, you quickly realize that this discrimination takes place. Our job is to make sure that credit scoring does not unfairly discriminate and harm protected classes of people.

Unfortunately—in our State we attempted to do a study, but because of the demographics and small ethnic minority populations in our State, it was inconclusive. We relied on the FTC; we hoped that the FTC would provide answers to the questions about unfair discrimination. After 3 years, we got the report that confirmed my

suspicion that, in fact, there is a disparate impact on protected classes.

The study indicated that African Americans and Hispanics are strongly overrepresented in the lower step, lower scores, and underrepresented in the higher scores. To me that looks like it's a pretty straightforward case, yet the FTC report reached the conclusion that credit scoring is not a proxy for race. That seems somewhat counterintuitive to me.

Now, what I saw—was most disappointed in, was that there appeared to be a real disconnect in being able to explain why there was this disproportionate representation in lower credit scores and yet it was not a proxy for race. I also saw that there was incomplete data for the purposes of the study, and only a few insurers did participate and did not identify the data so that it could be appropriately verified.

Should we allow credit scoring even if it may have—be a valid indicator of risk, or does it have a disparate impact on protected classes and should be banned?

Insurance commissioners dealt with this issue on race-based premiums in life insurance. When it was obvious that life insurance companies used different actuarial tables for African Americans, we went in, did a multi-state examination, reached settlements with life insurance companies, and they wound up paying back the premiums that they had been charging people over the years. It was recognized as public policy and equal protection as something that we needed to do.

What we're looking at right now is that if we were to ban credit scoring, what would be the net effect? Well, it just simply will wind up redistributing how much we pay. It's certainly not going to have an overall positive effect for everybody or a negative impact. It just redistributes how much you pay.

We heard that in the description from what the experience has been in Hawaii, but don't be confused here. We're also starting to see multiple other factors that are starting to creep in like education and occupation along with credit scoring. It makes me, quite frankly, very nervous.

In closing, let me just say I realize that probably banning credit scoring is going to be a tough proposition but there are some things you can do. Let me recommend three of them:

One of them would be to restore the adverse action notices to be consistent with legislative intent in the face of the recent U.S. Supreme Court case, *Safeco* v. *Burr*. The second is to use adverse action and statements to consumers that are meaningful, much like what Washington has done in explaining why they're not getting the best rates. And third, if insurers want to use these multiple factors, insurers should have to prove that their models are not unfairly discriminatory; make them prove it if they want to use it.

Thank you, Mr. Chairman. It is my pleasure to be here today.

[The prepared statement of Mr. Kreidler can be found on page 79 of the appendix.]

Chairman WATT. Thank you so much. Maybe I'll find a life after Congress one of these days, following in your footsteps.

Mr. Birnbaum, you are recognized.

STATEMENT OF BIRNY BIRNBAUM, EXECUTIVE DIRECTOR, CENTER FOR ECONOMIC JUSTICE

Mr. BIRNBAUM. Thank you very much, Chairman Watt, Ranking Member Miller, and members of the committee. I really appreciate the opportunity to visit with you today.

As you know, insurance scoring is basically the practice of insurance companies using consumers' credit histories to determine whether they're eligible for insurance, what types of coverage they're going to be offered, and what premiums they're going to pay. And basically the credit information has become one of the most important if not the most important factor that companies consider in determining what to charge you.

For auto insurance, it has become more important than your driving record, in many cases. And the fact that the companies use more than one factor or they use factors in addition to credit doesn't diminish the importance of credit. Credit alone can make the difference of 100, 200, 300, or even 400 percent in a consumer's rate, so the fact that companies use multiple factors is really irrelevant. It's the impact of credit.

Many organizations have called for a ban on credit scoring. They include the consumer and civil rights organizations that you mentioned earlier, but there are also agent organizations. The Allstate agents organization, State Farm agents, Farmers agents, they've all come out for a ban. The folks who would benefit from any tool that allows them to write more business are the ones who are coming out saying we want this practice banned because it's unfair.

There are insurance companies who oppose it. In Massachusetts where they're talking about allowing credit scoring, there are insurance companies that want to prohibit it, including Arbella Insurance.

The case for such a prohibition is actually quite strong. First of all, credit scoring undermines the core functions of insurance. It really provides disincentives for loss prevention. Instead of providing consumers with incentives to drive safely, spend $200 on a driver's safety course, it encourages people to spend $200 for a credit repair or credit checkup, things that have absolutely nothing to do with actual losses.

It discriminates against low-income and minority consumers. This is pretty clear. This leads to higher rates for those consumers who are least able to afford the insurance in the first place, so it increases uninsured motorist rates, which is what the FTC study found, and of course it makes poor people into criminals because they can't comply with financial responsibility laws.

It's arbitrary and unrelated to how well a consumer manages her finances. Your score can vary from good to bad depending on which bureau, which of the three credit bureaus provides the information, because the information is different.

Your score can also vary from good to bad, depending on what time of the month it's taken. If it is at the end of the month, right before you pay your bill, you will have a high balance-to-limit. If it is taken a week later, you get a better score because your limits are now—your balance-to-limits is now lower.

It is arbitrary because of the financial institutions that you use. If you live in a neighborhood where the financial institutions are

payday loans, check-cashing operations, and rent-to-own, they don't report to credit bureaus, so you don't have information and you get charged higher rates even if you pay your utility bills and all your other bills on time.

You can manipulate a credit score. There has been ample information about how you can go in and change a few things, and quickly manipulate your score. How can that be an objective measure when you can manipulate the score? It's not like your driving record; you can't manipulate whether or not you have had an accident.

It's inherently unfair because it victimizes people who have experienced economic or medical catastrophes. Look at the people who were the victims of Hurricane Katrina—who but an insurance company actuary would say that it's fair to charge people who have been displaced from their homes higher auto and homeowner insurance rates because they're under financial stress? I don't know of anyone.

Think about how this practice penalizes people for the business decisions of lenders. Let's put aside the fact that companies issue 6 billion credit card solicitations a year, throwing credit at people. Look at the abuses in the student credit card market, look at the abuses in the subprime market. Why should those consumers be penalized with higher auto and homeowner's insurance rates because of the faulty business decisions of lenders?

The insurance industry offers a variety of claims about how credit scoring benefits consumers. These are all illusory. There is no substance to any of these claims. It all comes down to if we can predict risks better then we can do a better job.

There is however strong evidence that credit scoring is in fact not correlated to risk, that it's a proxy for some other factor that's really at play. For example, over the last 10 years we have seen an explosion in the number of bankruptcies, delinquencies and debt load. These are all things that are supposed to have great weight in a credit score and yet, while these things are going up, auto claim frequency is going down. So how can that be?

If all of a sudden the number of young people in the population doubled, youthful drivers doubled, you can be sure there'd be an increase in claims. How is it that this increase in the number of bad credit risks doesn't yield an increase in claims?

The FTC didn't even address stuff like that. So there's plenty of other evidence, but I'm going to just finish up quickly by saying the FTC study is really flawed. And not only that, it's unresponsive to what you asked for.

The failure to obtain a comprehensive data set rendered the study really meaningless. There's no application data in it. It's only data on policies that were issued, which means that all of the people who were denied coverage because of credit, all the people who were priced out of the market because of credit dropped out. And we know that portion of the population is disproportionately poor and minority.

So the impact that they did find, the impact on poor minority consumers, was dramatically understated from the reality of the marketplace. The study was flawed because it turned on a theory

that more accurate pricing would result in more availability into a conclusion, despite the fact that their own findings disputed that.

They found that the number of uninsured motorists increased. They found that the number of people denied coverage and ending up in the assigned risk market increased. How do you basically say that supports the conclusion that credit scoring promotes availability?

The most disturbing part of it was the failure to address this "blaming the victim" mentality, that somehow people who have bad credit scores are really just—they just don't manage their credit well, and if they don't manage their credit, they can't manage their auto risk.

The fact of the matter is, and Fair Isaac, the credit modeler has stated that 20 percent of the population is unscorable using traditional credit information. There's not enough information in the credit report.

That 20 percent is disproportionately poor and minority. How can you say that those people whose information is insufficient in the files, how can you say that those people are at fault?

Let me finish up by saying that there is really no need to further study this issue. There is ample information to justify a prohibition, but if you do want to study this, our view is that the FTC has really demonstrated that it is incapable of doing this without bias and if you want a study you should ask the GAO to do it and get the active participation of State insurance regulators who have the clear authority to demand and collect the information from insurance companies.

We think that these are the folks who really are in the business of regulating credit scoring and they should be the ones who have a much more active role than they do.

I'm happy to answer questions and thank you again for the opportunity to visit on this issue.

[The prepared statement of Mr. Birnbaum can be found on page 47 of the appendix.]

Chairman WATT. Thank you for your testimony.

Mr. Rodriguez, you are recognized for your statement.

STATEMENT OF ERIC RODRIGUEZ, DEPUTY VICE PRESIDENT, NATIONAL COUNCIL OF LaRAZA

Mr. RODRIGUEZ. Thank you, Chairman Watt, Ranking Member Miller, and distinguished members of the committee.

For over a decade I have supported, led, and directed the National Council of LaRaza's legislative and advocacy activities on economic and financial security issues.

In that time we have studied closely the staggering rates and ethnic wealth gap among American households and we have come to understand how policies and practices within financial markets perpetuate exploitation and unfairly distribute wealth opportunity among families. Disparity in overall wealth between Hispanic and non-Hispanic white households is greater than ten to one.

More Latinos today own cars than own homes; about 80 percent of Latino households report owning at least one car, but only half of Latino households own their own homes. Unfair practices in the

auto industry stand to have a widespread impact on the Latino community.

Research also shows that Latinos tend to pay more than necessary to finance their car. One study found that regardless of creditworthiness, Latino borrowers paid on average $266 more in finance costs per loan than non-Hispanic borrowers.

In addition, there is a well-documented history of redlining and race-ethnic discrimination in the insurance industry. Altogether, whether negotiating the price of a car or arranging financing or securing insurance, Latinos are paying more than their white peers, and the experience of Latinos in the car market mirrors their experience in U.S. credit markets more broadly.

In some cases uneven and unfair treatment is a reflection of outright discrimination, but in many cases it is the application of policies and practices in financial markets that produce unfair results.

Approximately 35 million to 54 million Americans remain outside the credit system. In other research, about 18 million credit eligible Americans had credit files too thin to score and another 17 million had no files.

The problem of thin and no-credit files is particularly acute among immigrants and youth. As a result, one study found that 22 percent of Hispanic borrowers had no credit score, compared to 4 percent of whites and 3 percent of African Americans.

Latinos have thin credit files for a number of important reasons. A substantial share are unbanked. More than a third of Hispanics lack a basic checking and savings account. Credit scoring models weigh heavily length of credit history. Meanwhile about 45 percent of Latino adults in the U.S. are foreign born. Also more than half of Hispanics, either native or foreign born, are under the age of 27.

Latinos are also less likely than their peers to use credit cards. Only 56 percent of Latino households report having a credit card, compared to 80 percent of all households. Despite this, the FTC report on credit-based insurance scores reported a small share of the overall population with no credit scores.

More incredibly, the FTC study found that it was more difficult to find credit reports for African Americans than Latinos. According to the study, credit reports could not be located for 9.2 percent of the Hispanic population compared to 9.7 percent of African Americans and 7.8 percent of non-Hispanic whites.

These data are counterintuitive and should have given the FTC some pause. Instead, the report concluded that not having a credit score was unlikely to be an important source of difference in auto insurance premiums among race and ethnic groups. That said, the study did find that consumers for whom scores were not available appeared riskier when scores were used than when scores were not.

In this case, no credit report automatically resulted in a high-risk designation within insurance scoring models. This finding, coupled with the results of the Federal Reserve study on credit scoring, documents the problem for Latinos.

The Federal Reserve confirmed that foreign-born consumers consistently performed better than predicted by their credit scores. As the studies revealed, credit scoring adversely, unfairly, and dis-

proportionately impacts those who are young and foreign born, a substantial share of the overall Latino population.

So what can we do about this? Hispanics have experienced a long history of exploitation and discrimination at the hands of insurance agents and companies. This is how insurance redlining emerged as the major civil rights issue.

Insurance scoring does have the benefit of removing a measure of discretion that in the past resulted in outright discrimination against Latinos, however credit-based insurance scoring models undeniably result in Latinos and African Americans paying more for insurance than their white peers. That alone ought to raise caution flags for industry, regulators, and policymakers.

The use of credit information in insurance scoring models is now ubiquitous. Many States have taken steps to address public concerns about this development, but State policy is inconsistent. Unquestionably there should be a prohibition against using credit information for those consumers who have no credit score or thin credit files.

Other recommendations worth considering include the following: improve consumer information; improve transparency; improve oversight; and encourage voluntary improvements in credit scoring models. Of course, we have lots of ideas on how to do that well and we hope to share those with others moving forward.

We thank you again and look forward to your questions.

[The prepared statement of Mr. Rodriguez can be found on page 101 of the appendix.]

Chairman WATT. Thank you so much for your testimony.

Mr. Shapo, our final witness, is recognized for his statement.

STATEMENT OF NATHANIEL SHAPO, PARTNER, KATTEN MUCHIN ROSENMAN, LLP

Mr. SHAPO. Chairman Watt, Ranking Member Miller, and members of the subcommittee, it is good to see you again. Thank you for the opportunity to appear before you regarding the use of credit-based insurance scoring.

The FTC study verifies that by using credit-based insurance scoring automobile insurers are more precisely evaluating and classifying risks. As a result, consumers are grouped and paying premiums according to their likelihood of incurring a claim against the common fund.

The study also quells fears that credit-based insurance scoring is a proxy for racial or ethnic discrimination. The results of the FTC study thus demonstrate that credit-based insurance scoring achieves a basic norm of fairness found in the state of unfair discrimination laws. It is a wholly legal and appropriate method of risk classification.

Before further discussing the study, it is worth discussing the prevailing legal and policy framework in the States pertaining to risk classification, in order to apply the standards and mandates under which automobile insurers have been instructed to go about their business by the insurance codes.

As explained by Maryland's highest court, "unfair discrimination, as the term is employed by the insurance code, means discrimination among insurers of the same class based upon something other

than actuarial risk." Unfair discrimination as explained by a New York court recently "is a word of art," used in the field of insurance, which in a broad sense means the offering for sale to customers in a given market segment identical or similar products that differ in probable cost.

Insurance risk classification schemes by necessity group people by their shared characteristics, be it age, gender, driving record, scholastic achievement, or credit-based insurance scores. Some grouping methods have been found by insurers and regulators to serve as actuarially significant factors in predicting a person's risk of future loss.

Thus, the unfair discrimination laws focus on whether a risk classification standard factor is actuarially sound. In addition to the basic unfair discrimination standard, the State insurance codes prohibit using a protected class such as race, national origin, or religion as a classification factor regardless of its actuarial use.

The courts have explained very plainly that the law's focus on grouping consumers by actuarial risk establishes a basic norm of fairness. The Massachusetts Supreme Court crisply explained the consumer benefits, "the intended result of the process is that persons of substantially the same risk will be grouped together, paying the same premium, and will not be subsidizing insurers who present a significantly greater actuarial hazard."

The Florida Appellate Court put it another way, approvingly citing an administrative law judge's holding that "the most equitable classification factors are those that are the most actuarially sound." They did settle on a case supporting the use of the classification factors of gender, marital status, and scholastic achievement.

In Louisiana Appellate Court, a decision supporting the use of age and gender boiled down the legal issues in a very practical way that is worth quoting at length: "The evidence taken by the commissioner indicates that there exists a sound statistical basis for using classifications based on age and sex in fixing insurance rates. It further appears that any classification system which results in different classes paying different rates for the same protection is, to some extent, discriminatory.

"If, for instance, age and sex are not used as factors in establishing classifications in automobile insurance rates, women and all those over 24 years of age, or about 70 percent of drivers, would pay a higher premium, all those under 25 years of age, about one-forth of drivers, would pay substantially less than what they are now paying. The older and more experienced drivers would therefore be discriminated against by having to subsidize the higher risk class of younger drivers."

The court continued explaining that the unfair discrimination statute requires that the classifications used in establishing rates be reasonable and not unfairly discriminatory. We agree with the trial judge that classifications based on age and sex are not unreasonable. In other words, although there is discrimination against the good young driver it is not unfair or unreasonable.

This well-reasoned opinion puts in very practical terms the reason that the law requires insurers to group consumers based on actuarial risk and why the law encourages insurers to seek out better

predictors of risk of future loss. That's because it leads to a fair result.

Consumers put into the common fund in the form of premiums, in an amount proportional to what they are expected to take out in the form of claims. As explained by the courts, any and all risk classification methods result in some members of an actuarially riskier class paying more than they really will be responsible.

For instance, there are many teenage drivers who are, in fact, very safe, but they and/or their parents must pay more than older drivers and more than would be called for if we could chiefly evaluate every person's individual driving skills.

But insurers cannot perform a comprehensive and accurate individualized test of each driver without incurring prohibitive costs, so they classify risks according to groups so long as they are not protected classes such as race, national origin or religion.

The social benefits of actuarially sound risk classification, as explained by the courts are, according to the FTC study, furthered by the use of credit-based insurance scoring. In fact, the conclusions of the study precisely tracked the explanations at the Louisiana court and others regarding the basic fairness of actuarially sound risk classification.

The study states that credit-based insurance scores are effective predictors of risk under automobile policy, predictive of the number of claims consumers file and the total cost of those claims. The use of scores is therefore likely to make the price of insurance better match the risk of loss posed by the consumer.

Applying the well-established law and prevailing public policy discussed above, the findings of the FTC study precisely established that the use of credit-based insurance scoring is a legal, appropriate, and fundamentally fair risk-classification method by automobile insurers.

The study further found that credit-based insurance scoring has a benign affect on minorities when compared with other established risk-classification methods: "Several other variables in the FTC database have a proportional proxy effect that is similar in magnitude to the small proxy effect associated with credit-based insurance scores."

This mirrors the result of the legislatively mandated study performed in Texas by former commissioner Jose Montemayor. Commissioner Montemayor told the commissioner and the legislature, "Prior to the study, my 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; credit scoring, if continued, is not unfairly discriminatory as defined in current law because credit scoring is not based on race, nor is it a precise indicator of one's race."

And the recent Federal Reserve study in a non-insurance context gives further comfort regarding concerns about credit scores and demographic effects.

In summary, credit-based insurance scores are an excellent predictor of future risk, consistent with and indeed a manifestation of the legal and policy framework under which insurers function as

a regulated entity, a fair, legal, and appropriate method risk classification and as a result beneficial to consumers.

Mr. Chairman, I see that my time is up, and I would again like to extend my sincere thanks for the opportunity and privilege to appear before you.

[The prepared statement of Mr. Shapo can be found on page 155 of the appendix.]

Chairman WATT. Thank you so much. Let me just thank all of the witnesses for laying out this issue and kind of setting the framework.

Regardless of how you approach it, we need to have this discussion, and it is an extremely important discussion, and I don't think we could have had a better panel of witnesses to kind of put out the issues and start our evaluation and discussion.

I'm going to recognize each of the members of the subcommittee for questions in 5-minute blocks, and I will recognize myself for 5 minutes initially.

And I want to get right to the bottom of this. I was struck by Commissioner Rosch's testimony that we need to educate minorities more about how to have better credit or how to get their credit scores up. And I guess my question is, if I got my credit score up, would that make me a better driver?

Mr. ROSCH. I think the answer to that is that the Commission's report takes absolutely no position whatever with respect to that, Mr. Chairman.

Mr. WATT. So if there's not a correlation between my driving, which is what automobile insurance is about, I guess, isn't it? Is that what automobile insurance is about?

Mr. ROSCH. Well, it's about that, but it's also about things such as the frequency of claims. I mean I guess it can be said that there's certainly a logic—

Mr. WATT. But is the frequency of claims related to driving history?

Mr. ROSCH. Very definitely it's related to it, but there's not, as we would put it, a proxy effect involved there.

Let me make it clear that what we're talking about here in our report are averages. We're not talking about your particular rates. We're not talking about mine.

Mr. WATT. I understand that, but it strikes me as being—I mean I don't think you'll find a stronger supporter of the need for credit education and improving credit histories and credit scores. I think the problem I'm having is what in the world does that have to do with the insurance rates that I pay?

And maybe I ought to ask the question this way. Is there some statistical—has there been a determination that African American drivers are worse drivers than white drivers?

Mr. ROSCH. No, there has not. There has not, Mr. Chairman.

Mr. WATT. All right. I'm just trying to get this on the record so that we make sure that is the base that I'm operating from. And if that is not the case, I don't know how—what the justification is for basing—if you know that disproportionately African-Americans and Hispanics have lower credit scores, and you know that there's no correlation between race and safe driving, is there something else I need to know?

Mr. ROSCH. Well, let me make it clear what the Commission's report said and what it did not say, if I may, Mr. Chairman, because this really cuts right to the heart of your question.

Chairman WATT. I'm trying to get to the heart of it.

Mr. ROSCH. The Commission's report took definitive positions only with respect to those matters which we felt were completely established beyond peradventure by the statistical analyses that were done. We interpreted your mandate that way, and those statistical analyses show that there was unquestionably a relationship, a correlation between credit scores on the one hand and the frequency of claims on the other hand.

Chairman WATT. Okay.

Mr. ROSCH. No, just to finish up on this if I may, Mr. Chairman, we took no position on why that existed because we did not have a statistical basis for taking a position.

Chairman WATT. Okay. That's fair. Let me ask two other questions quickly because my red light is going to come on, and I try to apply the same rules to myself even more vigorously than I apply them to the other members.

I take it, Commissioner, that what you are saying is even if you take 2 more years or 3 more years to study this issue, the public may deem what you say as more—as having gone through a more methodical process. I guess the question I'm asking is would the end justify the means? Would we have anything better at the end of that 2 or 3 years than we have now based on the way you did this study?

Mr. ROSCH. The answer, I think, in all fairness, Mr. Chairman, is I don't know. We set forth in our letter to you and to Chairman Gutierrez and to Chairman Frank what we intended to do in terms of compulsory process the next time around. We also intend to get from consumer groups like that represented by Mr. Birnbaum, from LaRaza, from the insurance commissioners, their input—

Chairman WATT. I understand all that, but I guess one of the concerns I have is that we may be pressing you into a process that you don't think is going to yield a better result, and it might look better to the public that you went through that process, but if the result is no better and no more reliable in your estimation, I guess I'm beginning to have second thoughts about whether we ought to be pushing you to do a study using a process that you can't verify to me is going to have a better—more reliable, not better, because we're just trying to get to the bottom of this; a more reliable conclusion to it.

Mr. ROSCH. Well, I think that's a perfectly legitimate question, Mr. Chairman. That is a decision for this committee and this Congress to make. I cannot sit here and tell you right now that the conclusions, the basic conclusion particularly that I described in my opening statement, with respect to homeowner's insurance, is going to be one bit different as a result of the use of compulsory process or the input that we receive in the future from these groups.

Chairman WATT. I'm not worried about whether it's different or not. I'm worried about whether it would be more reliable. We're not looking to program the result, but we ought to be able to say at the end of the day that the study is reliable. And the question I asked you didn't have to do with whether you were going to change

the result or not. The result might be exactly the same, but I don't want to do 2 or 3 years waiting for a study that's not going to be perceived as being any more reliable than the study you've already done in a much, much, much shorter and less extensive period of time.

Mr. ROSCH. I think that's a perfectly legitimate issue. All I'm trying to say, Mr. Chairman, is that as matters now stand a majority of our Commission feels that the data that we got, the data that we used for the current study was reliable. However, we are going to use compulsory process this next time to get the same kinds of data. The problem is that I can't sit here and tell you right now that the quality of that data is going to be any more reliable than that which we got the last time.

I'm sorry. I misunderstood your prior question.

Chairman WATT. All right. Let me ask, just because we are in this line of questioning and I want to be clear, would you, in the absence of the letter that Chairman Frank, Representative Gutierrez and I wrote to you, would you have used 6(b) process or would you have used the same process?

Mr. ROSCH. Frankly, I think that I would have voted to use 6(b) process, and I can tell you why I would have voted to use 6(b) process is that even apart from this committee's letter to the chairman questions have been raised about our lack of compulsory process this time around.

As I said in my opening statement, we at the Commission feel that having the public have confidence in the way that we prepare our report is exceedingly important to us. Whether or not that's worth the time, the extra time it will take, is a matter for your—

Chairman WATT. My time has expired. I'll come back to this on the second round. The ranking member is recognized, and I'll be as generous with his time as I was—

Mr. MILLER OF CALIFORNIA. Thank you. Years ago my attorney advised me not to ask a question that I wasn't sure I was going to get the right answer for because you might not hear what you expected to hear, and I think that kind of happened here with the FTC study. I mean when I read in the study, the data shows that drivers—I wasn't referring to you, I was referring to years ago.

Chairman WATT. I did want to clarify that the two people who orchestrated this aren't even here today. You and I are just kind of innocent bystanders.

Mr. MILLER OF CALIFORNIA. But a question was asked and you based your answer on all of the available data that existed. Instead of what you believed, or what you heard, or what you suspected, you went to the insurance industry and then you verified that the information you got was genuine and real.

And when the data comes back and says drivers with bad credit histories are more likely to have repeated accidents than those with good credit history, I don't know why gravity is there either, but it is. And the data that's in the marketplace today shows this to be accurate. I don't know why it's accurate, but it's accurate.

And they went on to say that credit scores are the most objective method of determining insurance premiums and may help diminish the possibility that credit decisions will be influenced by personal characteristics or other factors prohibited by law such as race and

ethnicity, which—I agree, you should not look at the individual, how they appear to you, and charge the rates based on that, nor the color of their skin or because I'm from Arkansas. I mean I shouldn't be discriminated against because I'm from Arkansas.

So those are given. But the conclusion came back very consistent in all the reports, Texas, the Fed, and the FTC. And Mr. Shapo, I guess I'd like to ask you this question because you didn't prepare the reports, but when you look at the FTC release on their position that came forward in July and you look at what the Fed's recent studies said and you combine that with one that wasn't taken into consideration in the Texas study, what does the fact that these entirely different studies reached very similar conclusions tell you about the criticism level against the studies?

Mr. SHAPO. I think the studies are consistent, two of them specific to insurance and one of them, the Fed study, with respect to credit and its potential proxy effects. I think they clearly demonstrate that the use of credit-based insurance scoring correlates precisely with prevailing notions under both the law and public policy of what insurers are supposed to be doing.

They're supposed to be using risk classification methods and they're mandated to use risk classification methods that correlate the amount of money, that correlate premiums, the amount of money put into the common fund, with claims, the amount of money taken out of the common fund. And this is a manifestation of the instructions insurers have been given under the insurance code for years.

Mr. MILLER OF CALIFORNIA. Mr. Rosch, you—preparing your conclusion in the study, you took this data and you verified that it was correct as you objectively could, is that not correct?

Mr. ROSCH. Well, what we did do is that we tried to determine, first of all, whether there was a correlation between credit scoring on the one hand and the frequency of claims on the other hand. And we did find that relationship. There was no question about that.

However, the whys of that—

Mr. MILLER OF CALIFORNIA. That's my problem because I don't know why either.

Mr. ROSCH. I don't know why, and we took no position on that, Congressman, because we couldn't. We gave you the explanations that have been proffered by various people.

Mr. MILLER OF CALIFORNIA. And I appreciate that. I understand the difficulty you have. When—I've read your information in the reports. I don't know why either. But if something does what it does, it does it. And they're using a method to determine that would be most fair.

I guess the problem that I had on Mr. Kreidler—not the problem but the one point that I picked up on that I thought was important, you said that banning the use of this would redistribute how we pay insurance premiums, and that's scary to me, because if credit scores have proven to be accurate—we don't know why; if you have bad credit or good credit, your driving record is based on that, accordingly if you have bad, you have a bad record, if you have a good score you tend to have a good record, I would hate to have

that banned and everybody to start subsidizing people who have bad driving records because we don't want to accept it.

But I guess the one question I had for Mr. Kreidler, and this is probably a stupid question, but do you think credit scores discriminate?

Mr. KREIDLER. I think insurance credit scores—

Mr. MILLER OF CALIFORNIA. No, I'm saying credit scores because all the insurance companies are doing is using a credit score. You either pay your bills or you don't pay your bills. If there is some flaw in the credit score, you can have that corrected.

I mean if somebody—I had a situation where somebody with my name in a different city didn't pay his bills. He happened to be a contractor 2 years ago, and I got my credit score back and I had this off rating, and I started looking at all the payments that were not made were not paid by this other jerk named Gary Miller.

Mr. KREIDLER. I think it's an underwriting tool. I think that credit scoring, credit scores are obviously going to discriminate. I think the real question, though, is does it do it fairly.

Mr. MILLER OF CALIFORNIA. But the question is do credit scores discriminate in and of themselves.

Mr. KREIDLER. In and of themselves? No, I think they're—

Mr. MILLER OF CALIFORNIA. Okay. Now back to Mr. Shapo.

Could you explain how the insurance industry cooperated with the FTC in order to ensure that the data submitted for the study was accurate and reliable?

Mr. SHAPO. As Commissioner Rosch said, several carriers representing at least a quarter of the market provided data and submitted it with affirmations that would have subjected them to criminal penalties if the data was false or misleading.

Mr. MILLER OF CALIFORNIA. Mr. Rosch, you also said in your comments that the credit-based insurance scores are useful for predicting which individuals are more likely to file an automotive insurance claim versus those who don't. But does the inconclusive result indicate that the study is flawed in any way?

Mr. ROSCH. I don't believe that's the case.

Mr. MILLER OF CALIFORNIA. So you think even though you don't know why it occurs, it occurs?

Mr. ROSCH. Correct.

Mr. MILLER OF CALIFORNIA. And, former Congressman, I can tell why you decided to go to work in Washington State. I was in the San Juans Islands about a month ago; I'd go there too. So you made a good choice.

Mr. Schmidt, from the State of Hawaii, I don't understand why you're here at all. I'd rather hang in Hawaii any day than here.

But you note that a one-size-fits-all structure for setting automobile premiums likely wouldn't work, and that Hawaii is an especially unique State. Wouldn't the Federal banning be highly restrictive on credit scores and wouldn't that override the home rule concept you believe in?

Mr. SCHMIDT. Yes, and I think it should be left up to the individual States to deal with that particular issue.

Mr. MILLER OF CALIFORNIA. Well, I'm going to yield back. I know you'd be kind, but I have two more gentlemen to ask questions, so I want to yield back.

Chairman WATT. I appreciate it. We'll do a second round, but it is fair to them, to the other members, to allow them to go ahead in case they have other commitments.

Mr. Roskam is now recognized for his questioning.

Mr. ROSKAM. Thank you, Mr. Chairman. First of all, to all six of you witnesses, I appreciate your taking the time to give us the benefit of your wisdom today, and I found it to be helpful and instructive.

I guess, Commissioner, you're here in a sense because I think you're experiencing the same experience I had as a schoolboy, not to compare your work with my essays as a kid, but what I would do occasionally, and I would sense that others in this room have done the same thing, is you write an essay, and it's before that it's actually time to submit the essay and you go to the teacher and you say, hey, could you look at this? And the teacher will come back and say, hmm. Well, I think you need another paragraph here, and your conclusion isn't very good, and, you know, your margins aren't very well, and then you go back to your desk and you rewrite the essay and you submit it again and you get an A, lo and behold, because you're giving the right answers.

And my sense is that there's a little bit of a subtext of the answers that you came up with on the first draft aren't necessarily the answers that everybody was looking for. So, hang in there with whatever version or incarnation of a study you come up with in the future. But I appreciate your evaluating the data, you know, under the mandate that you had, and you're calling balls and strikes the way you see them, and I know it tends to be sort of charged up area. But I appreciate your integrity in looking at those things.

Commissioner Schmidt, when I was listening to your testimony it seems like your experience is actually very limited in that Hawaii—unless you have other professional experience that I'm not aware of—but since Hawaii banned credit scoring in the late 1980's, you don't have the same level of experience as a regulator that other States do that have dealt with it. So your testimony was conclusionary, but it was anecdotal based on your observations and not on your actual experience.

Former Member Kreidler, my pen came out at the same moment that Mr. Miller's pen came out with your observation that to ban credit scoring will redistribute what you pay. And that is—that's part of really what's driving this coverage, isn't it? It is who pays what and how do we move forward? You know, you shared with us your experience in Washington, and your particular vantage point as an elected commissioner, which has different types of pressures than Mr. Shapo experienced in Illinois as an appointed commissioner. But I think that there's going to be sort of more said, and you'll find yourself quoted in absentia from time to time based on that observation. And I appreciate that, because it was—I think it was a forthright thing to say that once you change these models, once you take tools away and put different things in, people are going to pay differently, and I think that is something that this committee needs to be aware of.

Mr. Birnbaum, when you said that credit scoring is a proxy, it sounded a little conspiratorial for me, and I'd love to have a conversation with you, maybe offline, to learn more about where you

think the helicopters are coming over the hilltop. But I do seriously want to learn what you think the proxy battle is actually all about.

But what I heard you and Mr. Rodriguez saying, and I think that this is maybe an area to work on, is this notion of people having thin files—I think that was the term of art that you used—but not enough information from a credit point of view, and those people would be left behind. And that's an area, I think a common ground, that if there is going to be credit scoring, there has to be an ability to, you know, include those things that some groups are using, phone bills, utility bills, and those types of things. And I think that's an area that we may all be able to come together in and focus in on.

Mr. Shapo is the former director, clear thinking, good clear thinking from the land of Lincoln, and it was good to see you. Thank you.

And with that, I yield back the balance of my time.

Chairman WATT. I thank the gentleman. Mr. Price.

Mr. PRICE. Thank you, Mr. Chairman. And I want to thank you and the ranking member for holding this hearing and I thank all the witnesses for their testimony. I am curious about the comments being made that we find a report, but we want a better result.

My statistics professor in college would chuckle at the thought that you could look at numbers and statistics and come up with a conclusion that was based upon those numbers and those statistics and then want a better result. It's a little perplexing to me. I think one can indeed ask for a more reliable result. But what I heard, Commissioner, you say, is that you felt that given the parameters of the charge put to you, that you feel that the conclusions that the Commission drew are in fact reliable and that there was a majority of the Commissioners who felt that. Isn't that correct?

Mr. ROSCH. That's correct.

Mr. PRICE. And I think it's also important for us to appreciate that there may be no correlation whatsoever between credit scores and driving acumen, but I understand you to say and I understand your conclusion to be that there is a correlation between credit score and making a claim. That's a distinction that you draw. Is that accurate?

Mr. ROSCH. That's correct. Actually, the frequency of claims, Congressman.

Mr. PRICE. So—I'm reminded of my father, who loathes insurance, but when he took it out, vowed never to file a claim because he didn't want his insurance to go up. So his insurance never went up and he probably paid more out of pocket than he would have otherwise, but be that as it may.

Commissioner, I also was interested in your comment that you, at that point when you recognized or when you'd reached the conclusion, given the charge that was given to you, that you said, "We didn't go any further because we didn't have a statistical basis to do so." Would you elaborate on that and why some may be troubled that the answer to their desired question wasn't given?

Mr. ROSCH. Yes. What we tried to do, and this is based on our understanding of our mandate, was that we gave you firm conclusions where we thought we could do so based upon the data that we had and the statistical analyses that we had. Otherwise, all we

did was to report to you what others had said about the various matters that are covered in the report.

For example, whether or not there are benefits to society as a whole in having this relationship between credit scoring, on the one hand, and claims frequency on the other. We took no position on that because we had no hard data to support any position on that.

Secondly, we took no position on whether or not there was a relationship between credit scores on the one hand and whether or not African Americans or Hispanics were poor drivers on the other hand. We reported to you the various speculations with respect to why this correlation existed so that you could make up your own minds based upon that data. But we had no—and the report is quite specific about this—we had no hard data to support a conclusion on that. And consequently, we did not take a position with respect to it.

So there are very definite limitations on our report to you, but that's as a result of how we understood our mandate.

Mr. PRICE. I appreciate that, and I found the report to be factual and objective in the findings. And so I appreciate that. I want to, in the brief time I have left, address the issue of the dissent in the Commission's report. The dissenting opinion was that there was never provided in the Commission with written verification of the accuracy, authenticity, or representativeness of the data that was furnished. You alluded to this in that you said you would—you I think preferred to use 6(b) data if you were given the opportunity, or if you had that to do over again. Do you believe this comment, though, in the dissenting opinion to be a valid criticism?

Mr. ROSCH. I would always prefer—I will tell you as a Commissioner, I always prefer—maybe this is my training as a lawyer, but I would always prefer compulsory process to any kind of voluntary production. In this particular case, however, we, number one, we did receive written assurances from the insurance companies from whom the data came that the—as to how the data was gathered, and that it was accurate. And that is subject to criminal penalties.

Number two, the data that we received was actual policy data. It would be hard to fiddle with that data if one were an insurance company or one were trying to interpret it.

Number three, the most critical elements of this study were not based exclusively on the data that we got from the insurance companies. The data that we got with respect to the frequency of claims came instead mainly from Choicepoint's comprehensive loss underwriting database, which is an independent credit-scoring agency. It is not an insurance company. And number two, the data that we got with respect to ethnicity and race came not from the insurance companies, because they don't have that data, but rather from the Social Security Administration and the Census Bureau, as well as from the Hispanic surname matching service that I alluded to. So there were cross-checks.

Mr. PRICE. Thank you. I appreciate it. I think that demonstrates the authenticity and the accuracy of the information. I want to thank the chairman again. I'm going to have to run, but I appreciate that. I am heartened by your comments that you continue to believe that insurance regulation ought to be left at the State level, and I'm pleased to hear that.

Chairman WATT. I don't think you've ever heard me express a different opinion, Mr. Price. Much to the dismay of all of the folks who are looking for an optional Federal charter.

Mr. MILLER OF CALIFORNIA. Except me. I think the optional Federal charter is a good option.

[Laughter]

Chairman WATT. See. This is not States' rights. This is a States' rights Democrat versus a raving liberal over here who wants to federalize everything.

[Laughter]

Chairman WATT. Let me—I appreciate you coming, and you're welcome to stay. We're going to go another round, just because I have some more questions. And probably even at the end of that round, I won't have exhausted all my questions.

One of the great things I've found about being a Member of Congress that I didn't find about the practice of law was that when I was practicing law, I'd never ask a question I didn't know the answer to already, because you had to live with the consequences. I'm not interested in programming the outcome of the responses that I get, so this is just about making public policy now and getting honest assessments.

I noticed, Mr. Rosch, that you've been very careful to talk about the frequency of claims. And maybe that's a term of art that translates into some other things. I'm interested in knowing whether the frequency of claims has a correlation between dollar amounts, payment of claims, the amounts paid. Is that all included in frequency of claims, or is it just the—what is included in frequency of claims?

Mr. ROSCH. Frequency of claims does translate into higher premium—I'm sorry—total claims paid out.

Chairman WATT. Okay. So it is inclusive of more than just the rate at which claims are filed?

Mr. ROSCH. That's correct. But I wanted—

Chairman WATT. That's fine. That's not a trick question.

Mr. ROSCH. No, no. I understand.

Chairman WATT. I am just trying to understand. You said that your analysis was limited to policy data. What do you say in response to Mr. Birnbaum's concern that one of the shortcomings of the analysis was that it didn't deal with denials, which probably, possibly would be disproportionately even greater racially disparate?

Mr. ROSCH. That I think is speculation at this point, Mr. Chairman. Let me make—

Chairman WATT. But does—maybe I asked the question the wrong way. Does the data you used have the denials in it?

Mr. ROSCH. It does not have application data. And let me tell you why, if I may.

Chairman WATT. Well, I—

Mr. ROSCH. Let me tell you why.

Chairman WATT. Okay.

Mr. ROSCH. Because it really bears directly on whether or not the whole study was reliable. The first reason why is because insurance companies by and large do not keep application data. And what that meant back in 2001—

Chairman WATT. I actually would be more interested in finding out whether you think that would be a relevant—I'm satisfied that your information doesn't include denials. And I'm satisfied that there are probably reasons why that is the case, very good reasons. Would denial information be an important factor to take into account?

Mr. ROSCH. If we could get it, Mr. Chairman.

Chairman WATT. Yes. Okay. That's—

Mr. ROSCH. But the McCarran-Ferguson Act is—currently is as much a constraint on the Commission as it is on the Congress.

Chairman WATT. Okay. I understand, Mr. Rosch. I'm not being hard on the FTC.

Mr. ROSCH. No, I understand.

Chairman WATT. These questions are not aimed at discrediting what the FTC has done. I'm just trying to get the bottom of this really. I don't understand how you can take something that appears to me to be unrelated. It's just common sense to me.

And even if there were a correlation, I'm not sure I would be convinced that it would be appropriate to use something that correlated with race that had a disproportionate racial content. We outlawed it in the life insurance context. There's certainly a whole wealth of information, body of information that black people live shorter lives than white people, and we said, you just can't—I mean, you can't do that in setting insurance rates, because you have to do it on a gross basis. So, even if there is a correlation, I'm not sure I'd buy the notion that we ought be doing this.

Mr. ROSCH. Please, please don't take this report as suggesting—

Chairman WATT. Okay.

Mr. ROSCH. —that we disagree with that one iota.

Chairman WATT. All right. And I've heard you say that over and over again. I guess I have that bias coming in whether your study is reliable or not, and at some level I guess that's why I'm questioning whether we even need another study because it seems to me that if there is a proxy effect, even though statistically what you say is there's a reliable predictor of risk, I'm not sure if it's a fair predictor of how insurance rates ought to be set, I guess is the concern I have.

What do you have to say about that, Mr. Kreidler? You all obviously decided regardless of what the circumstances were, that this didn't—well, let me ask a different question. What are the insurance companies in Hawaii and Washington State using if they are not using credit-based scoring?

Mr. KREIDLER. Mr. Chairman—

Chairman WATT. And what impact does that have on your rate setting, which might be a better way to get to the bottom of this?

Mr. KREIDLER. Well, as you pointed out, you know, Hawaii wound up with effectively banning it for auto whereas we're in a position that we've limited what you can use. The net effect is, is that I think we've done a better job of limiting the adverse impacts of credit scoring. Nobody has said it's not a predictor. What we're saying is, is it fair?

I mean, I think your example of life insurance, we dealt with it, but there's also the issue related to lenders and redlining. Nobody said that if you redlined out the inner city that somehow that you

weren't making loans probably more prudently. The question was, was it a surrogate for race? And I think that's the question right here. Is the use of credit scoring a surrogate for race? And if it is, then it should be banned. And we've answered it for life insurance. We've answered it for redlining on lending.

I think the FTC came back and showed that, yes, there is a disparate impact, and you know, there's some real limitations on the study that they did. Not their fault, but because of the data. And I look at it and I say, you know, if this question is as clear as it appears right now, you should take the same approach relative to what you did for life insurance and what you did for redlining on lending.

Chairman WATT. Commissioner Schmidt, what are you all using other than credit-based scoring in Hawaii?

Mr. SCHMIDT. Yes. We're using driving history and the accident experience that individuals have. As I noted in my testimony, we not only ban credit bureau rating, but a variety of other factors which have an actuarial basis that show that there are difference in premiums that could be had based on gender, based on length of driving experience, age and other factors.

But we do focus on what the actual driving experience and claims history was. During the course of this ban, Representative Roskam was right that we don't have necessarily the experience of having no credit reports being used and then having credit reports being used to compare it.

But in my testimony, we have banned it for a number of years, and during that course of those years, we have had a bad and difficult auto insurance market based on some of the other laws that we had enacted where we had few companies writing, where we had high premiums. And then we made some reforms that enabled us to drop the premiums from third-highest in the Nation to 21st, one of the biggest drops of any State. And we have a very healthy auto insurance market now with lower premiums. And through both, we had the ban on credit scoring.

So there still are valid criteria for evaluating the insurance rates that companies can use.

Chairman WATT. My time has long since expired, and I recognize Mr. Miller.

Mr. MILLER OF CALIFORNIA. I was enjoying the red light. That's okay. To my knowledge, I don't think there's a State or an insurance company that doesn't use driving history. I mean, if—I don't want anybody to listen to this hearing today and assume that some insurance companies or some States are just using credit-based insurance scores. And I don't think anything in Mr. Rosch's report states that. I mean, they use multiple—it could be 20 or 30 different things they take into—as a factor when they're determining somebody's fee they're going to charge.

But it seems like all the reliable sources that have done the data research have come up with the conclusion for some reason, credit-based insurance scores are very predictable as it applies to loss. And I think that's all Mr. Rosch's report says, is that based on the information, if you have a bad credit score, you have a tendency to have many more claims than somebody who has a high credit score, has fewer claims or a better record.

But, Mr. Shapo, can you describe how residual market rates have declined since credit-based insurance scores started to be used as an underwriting tool? And can you explain why this is the case?

Mr. SHAPO. The residual markets serve people who cannot obtain insurance through primary carriers, and they have been healthy and have gotten healthier since—in recent years. It seems to be a reasonable inference that, you know, that the use of credit scoring has not harmed people in that market sector.

Mr. MILLER OF CALIFORNIA. So rates have dropped by using them?

Mr. SHAPO. It seems to be a reasonable inference.

Mr. MILLER OF CALIFORNIA. And the FTC said that credit-based insurance scoring may reduce costs of granting and pricing insurance, and those costs generally are passed on through a competitive market to the person you're insuring. Is that a reasonable statement?

Mr. SHAPO. Yes. I think that was a clear—the way I read this study, that was a clear conclusion of the study, that it correlates risk to premium rates. It makes the amount people pay a more accurate representation of what they're expected to take out from the insurance company through the submission of claims. And on the whole, this—the report concluded that that will lead to both more accurate and better rates for a majority of drivers.

Mr. MILLER OF CALIFORNIA. Some States have taken the extreme and severely restricted the use of credit scores in the processing of insurance claims, writing insurance policies. So what effect does this regulation have on the availability and the affordability of insurance, in your opinion?

Mr. SHAPO. It's my general presumption that any restrictions that prevent a more precise allocation of premiums with respect to—in their correlation with risk, will ultimately not help and likely harm the availability and affordability of insurance in a State, because that, under, you know, fairly basic economic theory, will, you know, will impinge the working of a free market and harm the pairing of supply and demand.

Mr. MILLER OF CALIFORNIA. Back to you, Mr. Rosch. I'm not going to get to you, Mr. Schmidt, because you are crazy to be here. You should be in Hawaii. I'm telling you, anybody who would come to Washington rather than Hawaii—I mean that in a good way, my friend. I'd rather be right now on vacation.

Mr. Rosch—

Mr. ROSCH. I'm from California.

Mr. MILLER OF CALIFORNIA. Yes. I move we adjourn and reconvene this in Honolulu or something. Is that feasible? Mr. Rosch—

Mr. SCHMIDT. That's a good idea.

Mr. MILLER OF CALIFORNIA. I knew you'd like that. The report states that the theory that credit scores are solely a proxy for race or ethnicity cannot be upheld because credit scores are predictive within racial and ethnic groups as well as within general population. Can you elaborate on that?

Mr. ROSCH. Actually, Congressman, the report says that it is not solely a proxy. It does not rule out a proxy effect by any matter of means. It says that because it is predictive within each of those ra-

cial groups, it cannot be considered solely a proxy, and I think that is simply a matter of logic.

However, we didn't stop there. There was a second test that was done, first of all to determine the extent to which there were increases in the risk for each of these groups, and it turned out that for African Americans, the average predicted risk went up by 10 percent, and for Hispanics by 4.2 percent. And then we tried to figure out how much of that 10 percent and how much of that 4.2 percent was attributable to—could be said to be attributable to race and thus be said to be a proxy effect. And we found that in the case of African Americans, it was about 1 percent of that 10 percent. And in the case of Hispanics, it was about .7 of that 4.2 percent.

So I think—I would like the record to be clear that we did not rule out a proxy effect.

Mr. MILLER OF CALIFORNIA. Okay. Mr. Kreidler. You're grinning. You never thought I'd get to you, did you? This is my last question. In your written testimony, you stated that the use of credit scores, if it's banned, some people's—and we talked about this—rates would go up, and other people's would go down. But the FTC report's estimate that if credit-based insurance scores are used, more consumers would be predicted to have a decrease in their premiums than an increase. Would you like to address that?

Mr. KREIDLER. In no small part, the insurance industry has certainly strongly implied that credit scores are good for everybody. They are not. Some people go up. Some people go down. There is a distribution. What the proportion is of who benefits and who doesn't is not really the issue from my standpoint. It is the one that not everybody is going to be a beneficiary. Only so much is made from selling insurance, and that net profit or the premiums that are charged in order to remain solvent are going to be ones that will be distributed over the entire load.

Mr. MILLER OF CALIFORNIA. Well, thank you. I yield back. And now Ms. Waters has showed up.

Chairman WATT. The gentlelady from California is recognized.

Ms. WATERS. Thank you very much, Mr. Chairman. I'm sorry I could not be here earlier. This has been a very busy day with so many overlapping hearings going on. But this is a most important hearing, and I thank you for holding this hearing and for all of the witnesses who are here today. I thank you for being here.

I am from California, and I was in the California State assembly for 14 years before coming to Washington, D.C., and for that entire period of time, I worked on redlining in automobile insurance. And it has been a tough and long battle in the State of California to get rid of redlining in automobile insurance.

And it seems to me as we have begun to win this battle against redlining in automobile insurance, it's simply being charged more money based on where you live, somebody just has come up with another way by which to exclude and/or charge more money. And I don't care what is said, the information that I have here just basically shows that African Americans and Latinos, a large percentage of them—it's here someplace—are likely to be impacted by this policy of using FACTA scores or credit history as a way of determining the cost of your insurance.

Someone probably asked this. You probably discussed it already. Will someone tell me what the documented relationship is between your credit history and how you drive? Where is the empirical data that connects the two?

Mr. BIRNBAUM. Well, I'll jump in and say that there is no data that connects the two. What the insurance industry does is they go into your credit history and they do a data mining exercise. It's a huge database, and they data mine it to see which characteristics are associated with claims, with people who are likely to renew their policy, with people who are likely to buy additional policies, people who are likely to be more profitable. Then they build a model that puts a numerical value on that.

There's no theory there. There's no theory about how credit history relates to driving. It's a data mining exercise. And what you get now is a bunch of after-the-fact rationalizations that blame the victim. You basically say that, oh, people, you know, it's related to claims because people don't manage their finances well and they don't manage their risks well.

Well, that's just simply not true. We know that poor people have to manage their finances better, because they don't have as much to work with. We know that the people who are penalized from credit scoring are the victims of economic and medical catastrophes. We know that the victims of credit scoring are people who don't have information in their files because they deal with payday lenders, check-cashing operations, and they can't get mainstream credit.

The fact is, that there is information out there that calls into question the so-called correlation. And this is something I definitely wanted to address. When I was a regulator in Texas, one of the companies came in and said we want to give a discount to people who have been with us longer, because our loss ratios decline with homeowners as people who have been with us longer. And we said, why is that? Why do you think that is? Oh, we don't know, but there's a correlation.

Well, if we had just said, okay, fine, there's a correlation, then we would have basically been going along with unfair treatment. Because when we dug a little deeper, we found that what they had given us was a combination of homeowners and renters. The renters' loss ratio was higher than the homeowners' loss ratio. And the percentage of the people who had renters insurance in the early years was greater, so the loss ratio was greater. So it appeared as if the longer you'd been with the company, the less likely you would be to have an accident, when in fact it was simply a function of what data you were looking at.

I think that's the same thing that's happening here, is that there's not really any relationship between your credit history and the likelihood of claim. There's something being hidden in the data, because there are things that happen that are inconsistent with the theory. I mentioned that earlier about how delinquencies and foreclosures and debt load has increased over a period of time when auto claims have decreased. How do you jibe that with the claim that credit history is related to claims? No.

Ms. WATERS. Well, I think I would certainly agree with the analysis that you just gave. But I'd like to ask the Commissioner, is it Rush or Rosch?

Mr. ROSCH. It is Rosch, and I'm from California, too, Congresswoman.

Ms. WATERS. Good. Thank you. I asked the question about the correlation, and I just received an answer that makes a lot of sense to me. But what I want to do is I want to ask you about the conclusion of the Commission and what you decided to do about this. It says, "The FTC therefore recently revised and reissued its consumer education materials, including its Spanish language materials, to give greater emphasis to the link between credit history and insurance premiums."

I guess that means you're counseling people that if you don't want to have increased premiums, you better have a better credit history. I mean, that's what it sounds like. "We hope that these materials, this hearing, and other efforts will alert consumers that having the best possible credit history is critical not only in decisions creditors will make about them, but in the decisions insurance companies will make about them too."

Is that all you intend to do? I mean, do you really think that's credible?

Mr. ROSCH. Congresswoman, please understand that there are limitations on our jurisdiction that have been placed on us by Congress.

Ms. WATERS. Well, tell us how we can undo that.

Mr. ROSCH. The McCarron-Ferguson Act delegates the power to regulate insurance to the States, not to the Federal Trade Commission. So we are embarking on—we are doing as much as we can do. We're not the only ones who are doing this, by the way. The States are also requiring the same kinds of disclosures. So they're reinforcing what we're doing. But we are doing as much as we can do within the jurisdiction that you've given us.

Ms. WATERS. But what you basically say is you believe that there is a correlation and that it's all right for the credit histories to be used to determine the premiums and how much money people are paying.

Mr. ROSCH. Please—

Ms. WATERS. You're agreeing with that.

Mr. ROSCH. No. No, please, Congresswoman, please—that is not what our report says. We take no position on whether or not that—

Ms. WATERS. But you do take a position in the way that you have decided to handle your so-called consumer education. You're saying you agree. Well, this is what the insurance companies are doing. This is how they determine your premiums. Now you just make your credit histories better so that you won't have to be charged more money. I mean, that's the conclusion there.

Mr. ROSCH. We are doing as much as we can do in the real world today.

Ms. WATERS. Well, can you say I don't think that there's a correlation? I don't think that there should be a relationship to your credit history and the amount of money that you pay? That's what they're doing, but we disagree with that. Can you say that?

Mr. ROSCH. I can say that we do think there is a correlation, because that's exactly what our report to you shows, that there is a correlation. We are not in a position to say whether using that correlation to price insurance is right or wrong because that is a policy decision to be made currently by the States. But if this body decides that it should be taken over by the Federal Government, it is a policy decision that we're trying to inform you as much as we can about so that you can make it on a reasonable basis.

Ms. WATERS. Well, thank you very much. Mr. Chairman, I really do thank you. You know, I almost feel like minorities are under siege in so many ways. I just left a hearing about some bills that are being produced about gang warfare and how they want to create databases and identify whole communities as, you know, gang communities. I just got back from Jena, Louisiana, last week where we have a prosecuting attorney or a DA who has abused his power in, you know, charging young people who happen to be African American with criminal charges. Everywhere I look, it appears that there's another instance of really; what amounts to discrimination and abuses of power and that people of color are under siege in this country. And I don't care—I'm sure you're doing the best job you can do, Mr. Rosch, but whatever data that you have or whatever your information is that would lead you to believe that there is a correlation between your credit history and the way that you drive, it's just not believable to me. And once more, I'm going to end this day feeling rather offended by more information that causes—or undermines the quality of life for, you know, African Americans and people of color, whether we're talking about the home foreclosures or now this new way of redlining.

So I thank you for bringing it to my attention. I just have to go home tonight and rededicate myself to the proposition that I have to do a lot of fighting. We have to confront a lot of issues and a lot more people. But thank you for the information. This hearing is extremely important.

I yield back the balance of my time.

Chairman WATT. The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

I want to again applaud this panel. It has been an absolutely eye-opening exercise. All of you have contributed in very, very important ways to this very, very important discussion.

Mr. MILLER OF CALIFORNIA. Might I say that I'd like to thank Mr. Schmidt and Mr. Kreidler for the sacrifice they made of being here today.

Mr. SCHMIDT. Thank you very much, Representative.

Chairman WATT. Especially Commissioner Schmidt.

Mr. SCHMIDT. And I will be happy return to my home in Hawaii.

Chairman WATT. Thank you again for testifying, and the hearing is adjourned.

[Whereupon, at 4:12 p.m., the hearing was adjourned.]

A P P E N D I X

October 2, 2007

OPENING STATEMENT OF CHAIRMAN MELVIN L. WATT

"CREDIT-BASED INSURANCE SCORES: ARE THEY FAIR?"

October 2, 2007

Credit-based insurance scores are numerical summaries of the credit histories of consumers. The scores are calculated using information contained in a consumer report, information such as past delinquencies, consumer debt ratios and the length of credit. The use of credit-based insurance scores has increased rapidly since the 1990's and, today, credit-based insurance scores are widely utilized.

While common sense tells you that speeding tickets, driving under the influence of drugs and alcohol or automobile accidents should increase automobile insurance premiums, most Americans would probably be surprised to learn that late payments on credit-cards can dramatically increase the premiums they pay for automobile insurance. In other words, one's credit history, not one's driving history, is likely to be determinative of the cost of one's automobile insurance. That would be equivalent to having your driving history determine whether you get a bank loan or the interest

rate you will pay on the loan. The question we need to address is whether this is fair?

Today's hearing is entitled, "Credit-Based Insurance Scores: Are They Fair? Our objective is to shed light on the growing, but often hidden, use of credit information in the pricing and underwriting of insurance and to start analyzing, discussing and determining whether that is fair or whether it even makes sense.

A number of consumer and civil rights groups and some states say that it's not fair. They argue that these scores are used to raise premiums, deny coverage for new customers and deny renewals of existing insurance policies, even in the absence of common sense risk factors such as moving violations or accidents. They say that the use of credit-based insurance scores disproportionately hurts young people and minorities.

Some states have already enacted laws or adopted regulations that either ban or restrict the use of credit-based insurance scores. For example, two of our witnesses today represent states, Hawaii and Washington, that

limit or ban the consideration of credit-based insurance scores in writing automobile insurance. We look forward to their testimony.

The first federal study on credit-based insurance scores was recently released by the Federal Trade Commission. The FTC was directed under Section 215 of the FACT Act to study whether the use of credit-based insurance scores "could result in negative or differential treatment of protected classes under the Equal Credit Opportunity Act, and [whether such] underwriting systems . . . could achieve comparable results through the use of factors with less negative impact." The FTC study grew out of a compromise between an outright federal ban on the use of credit-based insurance scoring, on the one hand, and doing nothing on the other hand.

The first FTC report focused exclusively on automobile insurance and, while it concluded that credit based insurance scores are "effective predictors of risk," it also found that in three out of four lines of automobile insurance there is "some" proxy effect based upon race. While the FTC didn't get to this latter finding until page 69 of the report, I believe that *any* finding of a proxy effect, however small, should be cause for concern in this day and time.

Several concerns have been raised about the reliability and validity of the FTC's report. One FTC Commissioner dissented from the report, noting disagreement with the methodology used to generate the underlying data used in the report because it relied solely on data the insurance industry voluntarily submitted and on publicly available data. The dissent suggested that the FTC could have served insurance companies with Section 6(b) orders to obtain a "more accurate and complete data set, which would have provided a strong foundation for staff's complex economic analyses."

Even with perceived shortcomings of the data, the FTC report still concluded that there was some "proxy" effect from the use of credit-based insurance scores in three out of four lines of automobile insurance. As the dissenting Commissioner noted, the study "still found that credit-based insurance scores have a small effect as a 'proxy' for membership in racial and ethnic groups. Given the incompleteness of the data, it is unclear whether the actual proxy effect might be greater." Another Commissioner's concurring statement to the report concedes that the "results in today's Report are . . . no cause for celebration" referring to the differences in credit-based insurance scores across racial and ethnic groups.

In short, the FTC's report; the one on automobile insurance that we're considering today, may raise more questions than it answers, especially about whether the use of credit-based insurance scoring disproportionately impacts minorities.

The FTC is preparing a second report on the impact of using credit-based insurance scoring on homeowners insurance. Given the serious concerns raised about the validity of the data for the automobile insurance report and the critical importance of the second report on homeowners insurance, Chairman Frank, Rep. Gutierrez and I have requested the FTC to consider using its more extensive authority for the homeowners portion of the study to obtain a large and statistically valid data set from insurers. The FTC has advised us that this could take 2-3 years longer and one of the things I'll be asking about today is whether this is likely to get a more reliable conclusion or whether it would just take 2-3 more years to get another study that many would perceive as just as unreliable.

Due to the uncertain reliability of using credit-based insurance scores in setting insurance rates, we certainly must proceed with care. This hearing is the first step, certainly not the last, in the process of raising the important

questions that need to be asked and in educating ourselves, other Members of Congress and the public about the critical importance of this issue.

In the final analysis, I think it should be clear that neither the FTC report nor today's hearing should deter the States' from their traditional role in regulating insurance. The fact that Hawaii and Illinois differ in their regulation of credit-based insurance scores is not necessarily a bad thing. States have historically regulated and controlled insurance and have historically been the, so called "legislative and regulatory laboratories for innovation." State insurance regulators are the best equipped to regulate insurance credit scoring and should continue to do so.

Opening Statement of the Honorable Maxine Waters (D-35th-CA)

Hearing of the Oversight and Investigations Subcommittee

Financial Services Committee

"Credit-Based Insurance Scores: Are They Fair?"

Tuesday, October 2, 2007

2:00 p.m

Room 2128 Rayburn House Office Building.

I would like to start by thanking Chairman Watt for holding this hearing. The increasingly widespread use of credit-based insurance scores by insurance companies for underwriting and rating purposes would, alone, justify this session.

But much more is going on here, clearly. The recent FTC report on the use of credit-based insurance scores in the automobile insurance industry concluded that:

- There is a strong correlation between credit-based insurance scores and race and ethnicity. More precisely, Blacks and Hispanics are

over-represented in the low score percentiles and underrepresented in the higher credit percentiles—for example, 26 percent of blacks had scores in the lowest 10 percent, and 50 percent of blacks had scores in the bottom 23 percent.

- Credit-based insurance scores are proxies for race in three out of four lines of auto insurance. Only in the area of property liability coverage did the FTC observe no racial proxy effect.

While nobody disputes the right of insurance companies to make prudent business decisions, the history of racism in this country – and its persistent impact on the access of minorities to affordable home, business, and personal loans, insurance and other financial products – compels us to look closely whenever a racial proxy effect of this magnitude emerges.

Furthermore, an additional reason has emerged to push beyond the conclusion of the report that the insurance industry, I suspect, wishes to focus on—namely, that credit-based insurance scores are an effective predictor of risk, insofar as they are predictive of the number

of claims consumers will file and the total cost of those claims. I am speaking of course, of the decision of FTC Commissioner Pamela Jones Harbour to file a dissenting statement against the report, arguing that the underlying data was incomplete and possibly flawed because FTC staff relied solely on data that the insurance companies were willing to disclose or was otherwise publicly available. In other words, when it comes to data-driven reports, "garbage in, garbage out," and Commissioner Jones Harbour is leveling a serious charge regarding the credibility of the data on which this report was founded.

Given the sensitive racial implications of the FTC report, I concur in Chairman Watt's view that we need to hear from the witnesses today to learn more about these issues. I am, moreover, interested to observe that several states—which are the linchpin of our nation's insurance regulatory system—have chosen to ban or otherwise regulate the use of credit-based insurance scores. Therefore, I look forward to today's testimony and subsequent question period.

Testimony Before The

House Financial Service Committee
Subcommittee on Oversight and Investigations

Credit-Based Insurance Scores: Are They Fair?

October 2, 2007

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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.[1] 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.

[1] 2001 Consumer Bankruptcy Project, cited on page 81 of *The Two Income Trap*, Elizabeth Warren and Amelia Tyagi.

- Because your credit score is based on many things other than how timely you pay your loans, you 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, you 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.

Insurance Scoring Penalizes Victims or 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.[2]

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 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.

[2] 2001 Consumer Bankruptcy Project, cited on page 81 of *The Two Income Trap*, Elizabeth Warren and Amelia Tyagi.

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' auto credit score in November 2002 (obtained from www.choicetrust.com) was very low – around the 17th percentile. In May 2003, the author's score was in the 82nd 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."[3]

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

[3] "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.*

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.

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.*[4]

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?

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[4] 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: 21st 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 is there 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.[5]

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

[5] Page 15, Fall 2000 Issue of *Profitwise*, a publication of the Federal Reserve Bank of Chicago.

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
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.[6]

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

[6] Texas Department of Insurance, "Report to the 79th Legislature: Use of Credit Information in Texas," December 30, 2004, page 3.

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.[7] First American, a provider of credit information, claims its non-traditional credit reports will benefit minority and low-income families[8], 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.

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. . ."[9] The

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[7] "Giving Credit Where Credit's Due," Kenneth Harney, *Washington Post*, November 11, 2006, Page F1

[8] http://www.credco.com/Anthem/default.htm

[9] Statement of the American Insurance Association on the Lack of Correlation Between Income and Credit Score, March 1999, page 1

insurance industry also claimed no relationship between insurance score and race.[10] 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

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

[10] See testimony of Progressive Insurance before the Florida Task Force on the Use of Credit Reports in Underwriting Automobile and Homeowners Insurance, 2001-02.

– 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.[11]

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 York.[12] 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 that driving record or miles driven.:

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[11] 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.

[12] *Auto Insurance Report*, "Residual Market Growth Continues Despite Strong Voluntary Profit," August 29, 2005. Note, the cited AIPSO data covers 46 states.

- 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.

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 is 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 or 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 20th 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."[13]

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 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:[14]

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[13] "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.*

[14] *Consumer Reports*, August 2006, Page 61

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.

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. Ad discussed above, two independent studies confirm that insurance credit scoring is highly correlated to income and race.

Insurance Scoring is Arbitrary
There are many example 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, you 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, you 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.[15]

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 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.

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.

[15] 2001 Consumer Bankruptcy Project, cited on page 81 of *The Two Income Trap*, Elizabeth Warren and Amelia Tyagi.

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.

Testimony of Mike Kreidler
Washington State Insurance Commissioner

Before the
United States House of Representatives
Oversight & Investigations Subcommittee of the Financial Services Committee

Regarding:
"Credit-based Insurance Scores: Are They Fair?"

October 2, 2007
2128 Rayburn House Office Building
Washington, DC

Testimony of Mike Kreidler
Washington State Insurance Commissioner

Chairman Watt, Ranking Member Miller, and members of the Committee, I thank you for the opportunity to testify here today on, "Credit-based Insurance Scores: Are They Fair?"

My name is Mike Kreidler, and I am the elected Insurance Commissioner for the State of Washington. I am also active in many of the committees of the National Association of Insurance Commissioners (the "NAIC") related to the topic of today's hearing.

Since my election as insurance commissioner, I have had concerns about credit scoring and the impact it has on consumers and the potential disparate impact on protected classes of people. I am not alone in my concerns. Credit scoring invokes more confusion and even outright anger from consumers than any other issue I've faced since taking office. Since it surfaced in the year 2000, my office has received nearly 5,000 calls from consumers about credit scoring. While there are a variety of issues that concern consumers, some of the more prevalent problems are:

- Consumers do not understand why their credit history should impact how much they pay for insurance rates;
- Each insurance company uses credit information differently; and
- Consumers' insurance rates increased because of the use of credit scoring or a credit factor.

To address some of our concerns with credit scoring and how companies were using it, I proposed legislation back in 2002 that our state legislature enacted into law. At the time, it was one of the strongest laws regulating how credit scoring could be used and it set a national precedent. As of today, 48 states have joined Washington State and have enacted some level of regulation over this practice. While I favored an outright ban of credit scoring, I knew we wouldn't succeed in that endeavor. With this in mind, we targeted the most unfair aspects of credit scoring in our legislation.

Under our state's law, as of January 1, 2003, insurance companies cannot use credit history to cancel or non-renew a personal insurance policy (primarily auto and homeowners insurance). In addition, insurance companies cannot use the following six attributes of credit history to deny insurance coverage:

- The absence of credit history;
- The number of credit inquiries;
- Collection accounts identified as medical bills;
- The initial purchase or finance of a vehicle or house that adds a new loan to a person's existing credit history;
- The use of a particular type of credit card, debit card, or charge card; and
- The total available line of credit a person holds.

Additionally, after June 30, 2003, insurers cannot use the above attributes to set premiums with one exception. Insurers may use the absence of credit history to set premiums, if they provide statistical data that proves consumers without credit histories are more likely to file claims. Two other important consumer protections in the law are:

- Insurers must retroactively correct a premium if the company uses incorrect credit history for rating or underwriting; and

- Insurers must send enhanced "adverse action" notices to consumers so they know what items in their credit history are affecting insurance premiums and what they could do to improve their score.

While these consumer protections helped address some of the general problems with credit scoring, I'm still not satisfied we are doing enough. I believe that credit scoring unfairly discriminates against protected classes and the economically disadvantaged. Granted, insurance does discriminate when statistics can support charging different rates to people based on certain risk attributes. Anyone with a teenage driver in their household understands that. But it is our responsibility as regulators to ensure that credit scoring does not unfairly discriminate and harm protected classes of people.

Our 2002 law attempted to look at the unfair discrimination issue, and required a report back to the legislature. In 2003, we issued a report that looked at the effect of credit scoring on auto insurance and pricing. One of the key questions in our study was, "Does credit scoring discriminate against the poor and people of color?" Our report clearly suggested there was a potential negative impact as it found:

- Age was the most significant factor; and
- Income was the second most significant factor.

Unfortunately, due to our small sample size and small ethnic minority population, our results were inconclusive. We attempted to organize a comprehensive multi-state study to gather enough data to draw some valid conclusions, but when the Federal Trade Commission (FTC) was tasked with undertaking a similar study, the states decided to hold off and let the FTC conduct its study. We hoped it would result in a well-reasoned comprehensive study that would help answer the questions about unfair discrimination.

After three years of waiting, we finally have the FTC report. I believe the report confirms my suspicion that credit scoring has a disparate impact on protected classes. With regard to credit scores, the study indicated that "African-Americans and Hispanics are strongly over-represented in the lowest deciles and under-represented in the highest deciles." It seems to clear to me that credit scoring models will harm these classes of people. Yet, the FTC's report reached a conclusion that credit scoring is not a proxy for race. That seems counterintuitive to me.

Frankly, I'm disappointed with the FTC's report. As I stated earlier, we expected a comprehensive study with well-reasoned conclusions. I don't think the report lived up to those expectations. In particular, I'm disappointed because:

- The report failed to explain the disconnect between how a greater number of minority populations had lower credit scores, yet credit scoring was not a proxy for race;

- The report did not use complete data from more insurance companies; and

- The few insurers who did participate would not identify their data so it could be verified.

As we look at the future of credit scoring, it is worth noting again that 48 states have enacted some type of regulation of credit scoring. Some states have effectively banned

credit scoring. Some states have adopted the National Conference of Insurance Legislators (NCOIL) model that says credit cannot be the "sole basis" for increasing insurance rates or taking underwriting action. Some states have landed somewhere in between. The reason for this regulation is that credit scoring is problematic. Consumers don't understand it, companies can't explain it well, and it appears it creates a disparate impact on protected classes of people.

I think it's time to ask the question, "Should we allow credit scoring, even if it may be a valid indicator of risk, if it also has a disparate impact on protected classes?"

We answered this question correctly not that long ago. In 2002, the NAIC completed several multi-state examinations of companies that rated life insurance differently based on the race of the applicant. African-Americans were being charged higher rates because they had lower life expectancies. Actuarially, it was a "sound practice." But the practice was appropriately stopped because of public policy and equal protection concerns.

If we banned credit scoring, similar to the life insurance example above, there would be an effect on rates. Some people's rates would go up, and some would go down. Credit scoring doesn't make insurance more affordable for everyone, it simply redistributes how much each of us pay for it.

The controversy doesn't stop with credit scoring. Insurance companies found credit scores to be a useful risk assessment tool, and now they are looking for other factors in order to gain an advantage over their competitors. Now we are seeing models proposing to use education and occupation as factors in determining insurance rates. It seems to me that if credit scoring has a disparate impact on protected classes, allowing companies to consider other factors such as education and occupation may bring the same results.

Whether it is credit scoring, occupation, education, or any other new factor that insurance companies are developing or using, as regulators, we must be vigilant. Our country has a long history of civil justice and protecting the most vulnerable in our society. I'm afraid that these new tools- regardless of their intent or reliability- are moving

us away from this history. Quite simply, business arguments are not a good enough reason to allow some factors to be considered, and we should hold companies to this higher standard.

In closing, I realize that effectively banning credit scoring would be difficult and perhaps not even practical, considering how far down the road we have gone in using this practice. But I do think we can do some things to protect consumers and protected classes from being harmed by credit scoring.

Here is what I suggest:

1) Restore "adverse action" notices. When a consumer's insurance rate is impacted by credit factors, the FACTA Act and many state laws require an "adverse action" notice to be sent to the consumer. Recently, the U.S. Supreme Court in *Safeco v. Burr* significantly altered the circumstances as to when consumers should receive an "adverse action notice." You should consider clarifying FACTA and restoring it to its original legislative intent.

2) Make "adverse action" notices more meaningful. Consider using language in FACTA similar to Washington State law that requires companies to disclose to consumers the top factors that impacted their credit score.

3) Require insurers to prove their models do not unfairly discriminate. If companies want to use credit or insurance scores, make the company prove that the models do not unfairly discriminate against protected classes.

Thank you for the opportunity to testify about this important issue, and I would be happy to answer any questions.

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The date following each state indicates the last time information for the state was reviewed/changed.

STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
AL (8/07)	Reg. 482-1-127-.01 to 482-1-127-.11	Personal lines	Make procedures used to obtain credit reports and insurance scores available to commissioner. If use credit scoring, file the scoring model with the commissioner. May not calculate score based on lack of credit history. May not use credit score as sole reason to deny coverage or refuse to renew.
AK (8/07)	§§ 21.36.460; 21.39.035	Personal lines	If use credit information in underwriting or rating, disclose that fact at the time the application is taken. Must consider in combination with other factors. May not consider absence of credit history or medical accounts. File credit scoring model with commissioner.
	Bulletin B04-11		Use departments' consumer brochures to inform the public about credit scoring.
AZ (8/07)	§ 44-1692	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting.
	§§ 20-2102; 20-2109 to 20-2110	Property and casualty	Must provide specific reasons for adverse decision based on credit history or credit score.
	§ 20-1652	Property and casualty	Must get credit information promptly; cannot cancel or decline coverage more than 30 days after date of application based on credit report.
	§ 20-2113.01	All lines	A consumer reporting agency shall not sell data that includes information about an insurance score.
	§ 20-2110		In the event of an adverse underwriting decision, provide the specific reasons. If based on credit-related information, must decide factors that were primary cause. May not use the following credit-related factors for property or casualty premiums: absence of credit history, credit history based on collection of medical bills, total available credit, etc.
AR (8/07)	§§ 23-67-401 to 23-67-415	Personal lines property and casualty	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)
	Bulletin No. 14-2004	Personal lines property and casualty	Form for report on number of policies with increase/decrease in premium due to credit scoring.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
CA (8/07)	Civ. §§ 1785.10 to 1785.11	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting. Agency must notify consumer of rights and provide copy of file, including any credit score used.
	Civ. § 1786.18	All lines	May not include specified information in an investigative report except when used in underwriting life insurance expected to amount to $250,000 or more.
	Bulletin 76-3, Civ. §§ 1785.20, 1786.40	All lines	Users of credit reports who deny insurance or increase the prices charged on the basis of information contained in the reports must disclose the information that was the basis for the adverse decision.
CO (8/07)	§ 12-14.3-103	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting. Must notify consumers that will be using credit report for determination of eligibility for coverage or to determine premiums.
	§ 12-14.3-105.3	Life	May use credit report in underwriting life insurance expected to amount to $150,000 or more.
	§ 10-4-116	Personal lines property and casualty insurance	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)
	§ 10-4-616	Personal lines property and casualty insurance	Must notify consumers that new or updated credit information will be used in insurance underwriting or rating.
	§ 10-4-110.7	Homeowners	An insurer is required to provide notice to an applicant if the insurer uses credit scoring, claims history of the property, or clams history of the applicant in determining whether to insure the applicant's property.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
CT (8/07)	Guidelines for the Examination of Financial History Measurement Programs for Personal Risk Insurance Underwriting and Rating Plans	All lines	File measurement tools with the department. May only be used for new business. May not consider lack of credit history. Demonstrate coordination with expected risk of loss. Disclosure to customer.
DE (8/07)	18-900-906 Del. Code Reg §§ 1.0 to 12.0	Personal lines	May not use credit report or score unless the company has obtained authority to do so in its rate filing. File supporting information showing it is actuarially supported and is not the sole basis for denying coverage or assigning the consumer to a premium class. May not assign a higher rate because the consumer has no credit history. May consider insufficient credit history or no available credit history in setting a premium or rate, or underwriting an insurance policy, to the extent such us is actuarially justified and consistent with the rate filing. Models filed with the commissioner shall be considered as confidential proprietary information.
DC (8/07)	No provision		
FL (8/07)	Rule 69O-125.004	All lines	An insurer shall notify an insurance applicant in writing, or in the same medium as the application, that a credit report will or may be requested as part of the application process. If the application is denied, the insurer must tell the applicant in the notice of the denial how a copy of the credit report can be obtained so the applicant can identify the items that resulted in the denial.
	§ 626.9741	Personal lines Auto and homeowners	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
GA (8/07)	§§ 33-24-90 to 33-24-98	Personal lines property and casualty	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)
	Reg. 120-2-15-.01 to 120-2-15-.06	Private passenger auto, residential property	Insurer may cancel, nonrenew or decline a policy based on an individual's credit report. Insurer shall file this information quarterly with the commissioner. Insurer shall provide notice and the specific reason for the decision to the insured.
	Reg. 120-2-65-.01 to 120-2-65-.07	Private passenger auto	An insurer shall not use underwriting criteria or guidelines that result in the fictitious grouping of risks and results in unfair discrimination. The use of credit reports in determining an applicant's or insured's acceptability for coverage may create fictitious grouping and unfair discrimination.
HI (8/07)	§ 431:10C-207	Auto	Insurer shall not base standard or rating plan upon a person's credit bureau rating.
ID (8/07)	Bulletin 91-9	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting.
	§ 41-1843	Property or casualty	May not charge a higher rate or cancel coverage based primarily on a credit rating or credit history.
	Ins. Reg. 18.01.19	Personal lines property and casualty	Aggregate weight given to noncredit factors must be at least as great as the aggregate weight given to credit factors. Items identified as trade secrets are not subject to public disclosure. Insurers must retain documentation for 5 years.
IL (8/07)	215 ILCS 157/1 to 157/55	Personal lines property and casualty	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model) A certification that the treatment is actuarially justified is required.
	215 ILCS 157/22	All lines	Shall review and consider an exception to the risk score based on extraordinary life events, such as a catastrophic illness, divorce, death of a spouse, child or parent, involuntary loss of employment for three months or more, or identity theft.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
IN (8/07)	Bulletin 111 (July 1, 2002); Bulletin 130 (May 26, 2005)	Personal lines property and casualty	Submit to insurance department information on how credit information is utilized in underwriting, including the factors from a credit report that are included in a credit score, the computer model used to determine a credit score, any underwriting guidelines related to the use of credit scores and documentation to demonstrate the correlation between credit information and expected risk of loss. May not use credit scores after 10/1/02 unless the information is filed with the department.
	§§ 27-2-21-1 to 27-2-21-23	Personal lines property and casualty	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model).
IA (8/07)	§ 515.103	Personal lines Property and casualty	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model).
KS (8/07)	§§ 40-5101 to 40-5114	Personal lines property and casualty	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model).
	Bulletin 2004-10 and 2005-1		Answer questions about above legislation.
	Reg. 40-1-50	Personal lines, property and casualty	Document factors considered in addition to credit score. Maintain evidence to support adverse action. Provide an explanation to an insured adversely affected.
KY (8/07)	§ 304.20-040	Auto	May not refuse to issue or renew a policy solely because of credit history, or lack of credit history of the applicant.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
LA (8/07)	§ 22:1214	Auto liability	Prohibits an insurer from terminating, refusing to renew or refusing to issue insurance because the insured has declared bankruptcy.
	§§ 22:1481 to 22:1494	Personal lines property and casualty	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)
	Directive No. 181 (2004)	Personal lines property and casualty	Directive addresses issues that have arisen in above statute.
	Directive No. 196 (2006)	Personal lines	Right of an insured to be exempt from the use of adverse credit information directly or indirectly caused by Hurricane Katrina and/or Hurricane Rita. All insurers writing personal lines are advised and directed to ignore all unfavorable entries entered into an individual's credit record beginning with entries posted on August 26, 2005, and all entries posted thereafter related to Hurricane Katrina and/or Hurricane Rita.
ME (8/07)	tit. 10 § 1313-A	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting.
	tit. 24-A § 2917	All lines	Insurer must notify policyholder of reason intend to nonrenew, such as "credit report."
	tit. 24-A § 2169-B	Personal lines auto, property and casualty	May not use an insurance score calculated using income, gender, ZIP code, religion, etc. or raise rates based solely on credit score. Provide notice to consumer.
	tit. 10 § 1315	Credit reporting agencies	Disclose procedures to consumers to correct inaccurate credit reports.
	Bulletin 329 (2004)	Personal lines	Guidance on issues that have arisen.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
MD (8/07)	Ins. § 27-501	Private auto and Homeowners	May not refuse to underwrite based solely on credit history.
	Commercial § 14-1202	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting.
	COMAR 31.15.11.01 to 31.15.11.11	Personal lines property and casualty and private auto	Insurers that use credit reports or credit scores must provide the commissioner with underlying information so the commissioner can ensure that reports are used in accordance with the law. Must notify consumers of actual reason for an adverse action.
	Ins. § 27-501	Personal lines property and casualty	May not use credit history to rate or refuse to underwrite homeowners coverage. May not use credit history to refuse to renew an auto policy or increase its premium. May use credit history to rate a new auto policy. Advise applicant that credit history is being used. May not consider the absence of a credit history as a factor.
	Ins. § 11-317	Private auto	Must provide a policyholder statement on rating factors. If use credit scoring, explain how it may cause an increase in premiums.
	Bulletin 02-14; 02-16	Personal lines property and casualty	Address questions in implementation.
MA (8/07)	93 § 51	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting.
	93 § 62	Personal lines	If coverage is denied or price increased because of credit report, must notify consumer of right to receive a credit report.
MI (8/07)	Bulletin 2003-01-INS	Personal lines	File formula used to compute credit score with the department. Must recalculate credit score at least yearly.
	Bulletin 2003-02-INS	Personal lines	Revises 2003-01-INS to require rescoring only at the request of the policyholder. Notify consumers of their score and the discount tier they are in.
	Reg. 500.2151 to 500.2155	Personal lines	Beginning 7/1/05, insurers may not use credit scores as a rating factor.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
MN (8/07)	§ 72A.20 subd. 36	Private passenger auto and homeowners	May not reject, cancel or nonrenew a policy solely on the basis of credit information. If will use credit information, must notify consumer. If use a credit scoring system, must have methodology on file with the commissioner.
	§ 72A.501 subd. 2	Property and casualty	Code sections limiting collection of information do not apply to credit scoring, as long as the agent informs the policyholder.
MS (8/07)	Reg. 2003-1.1 to 2003-1.13	Personal lines	Disclose to consumer that insurer may gather and consider credit information. File scoring models with department. Must inform applicant if credit score or report adversely affected him.
MO (8/07)	Reg. tit. 20 § 500-9.100	Homeowner	Insurer must inform the Dept. of Insurance that it is using credit history as an underwriting guideline.
	§ 375.918	Personal lines property and casualty	May not use credit report or credit score as the sole rating factor. Must disclose the fact that will gather credit information. Must inform applicant if credit score or report adversely affected him.
MT (8/07)	§ 31-3-111	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting.
	§§ 33-18-601 TO 33-18-611	Personal lines	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Most recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)
	Advisory Memorandum Dated 9/7/01	Property and casualty	Montana law requires notification to consumers when their credit history adversely affects their ability to obtain or renew insurance.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
NE (8/07)	§ 44-7516.01	Private passenger auto	Policy must be accompanied by disclosure stating if any credit-based rating was used to determine rate charged for coverage.
	§§ 44-7701 to 44-7712	Personal lines	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider solely the absence of a credit history. Most recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)
NV (8/07)	§§ 686A.600 to 686A.730	Personal lines	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. (NCOIL model)
	NAC 686A § 3		At renewal of a policy, the consumer credit report or insurance score used on the policy with the earliest effective date may be used, provided that the credit information is not more than 36 months old.
NH (8/07)	§ 359-B:4	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting.
	§ 359-B:5	Life	May use credit report in underwriting life insurance expected to amount to $50,000 or more.
	Reg. Ins. 3301.01 to 3310.02	Auto and homeowners	If use credit scoring, must establish written standards to prevent discrimination and submit scoring model to the insurance department for review. Update credit score at least every 3 years. Submit to commissioner information on the factors considered and the statistical validation.
NJ (8/07)	§ 56:11-31	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting.
	Bulletin No. 04-05	Property and casualty	Insurance scoring is permitted, provided that consumer protections are maintained. Submit model to department for review; credit score may be considered as only one of factors in determining rates; provide specific information if the insurer takes an adverse action.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
NM (8/07)	Bulletin 2002-001	All lines	All insurers that use credit scoring in underwriting or rate making must submit all portions of the programs that include the use of credit scoring to the Insurance Division.
	§ 59A-17A-1 to 59A-17A-9	Personal lines	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)
	Reg. 13.8.6.1 to 13.8.6.9	Personal lines	Standards for the notification required in statute.
NY (8/07)	General Business § 380-i	All lines	Requires users of consumer reports to advise the consumer of adverse action taken in reliance on the report.
	OGC Opinion No. 96-1	Homeowners	Must give specific reasons for cancellation.
	Ins. Law §§ 2801 to 2809	Personal lines Property and casualty	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)
	Reg. tit. 11 §§ 221.0 to 221.10 (Reg. 182)	Personal lines	May not take an adverse action based on a list of situations and events. Filings of scoring models must include listed information.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
NC (8/07)	§ 58-36-90	Private passenger auto	May not use credit reports as sole rating factor. Must notify consumer if will be used. File scoring models with insurance department.
	Bulletin 03-B-3		Requirements for insurers who have trade secret pages in their credit scoring models
ND (8/07)	§§ 26.1-25.1-01 to 26.1-25.1-11	Personal lines	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score. May not consider absence of a credit history unless insurer treats the consumer as otherwise approved by the Insurance Commissioner if insurer presents information that such absence relates to the risk for insurer, if consumer is treated as through the credit information is neutral, or if credit information is excluded as a factor. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)
OH (8/07)	Bulletin 2002-2	Property and casualty	Insurers must establish that credit history and credit scores are valid risk characteristics. May not use for discriminatory purposes.
OK (8/07)	Guidelines adopted by Oklahoma State Board for Property and casualty Rates 6/15/2000	Property and casualty	Insurers that use credit history or credit scores must provide the board with underlying information to show they are using the information in accordance with OK law. Notify the insured of any adverse action taken as a result of the credit history or credit score.
	Bulletin No. PC 2001-07		Revised credit scoring guidelines.
	tit. 36 §§ 950 to 959	Personal lines	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
OR (8/07)	§ 746.635	All lines	Insurer, agent or insurance support organization may not prepare or request an investigative consumer report about a person involving an insurance transaction unless the insurer or agent informs the person that he may request to be interviewed in connection with the preparation of the report and that the person may request a copy of the report.
	Reg. §§ 836-080-0425 to 836-080-0440	Personal lines property and casualty	Prior to use, must notify consumer that credit history will be used. Must notify consumers during the application process that consumer may request information about the use of credit histories or insurance scores. Notice may be either in writing or in the same medium as the medium in which the application is made. The statement must address the following items: (a) Why the insurer uses credit history or insurance scores, (b) How the insurer uses credit histories or insurance scores, (c) What kinds of credit information are used by the insurer, (d) Whether a consumer's lack of credit history will affect the insurer's consideration of an application, (e) Where the consumer may go with questions. An insurer that uses credit history or insurance score in connection with a renewal shall notify consumer of that use when renewal offer is made. Notice shall address the items above. In addition, insurer shall inform consumer that consumer has a right annually to request the insurer use current credit information in the renewal process and that insurer will update the credit information used upon receiving such a request.
	§§ 746.600 to 746.686	Personal lines	If adverse underwriting decision, provide consumer with specific reasons. If based on credit score, include specifics of no more than 4 reasons for score. Provide information on how to dispute. May use credit history only in combination with other factors to decline coverage. May not consider absence of history, number of inquiries, total available credit, etc. Consumer may request yearly re-rating. File scoring models with dept. Prohibits an insurer from rerating the policy or consumer when the consumer's marital status changes because of death or divorce. Allows an insurer to consider the last five years of claim history when rating a policy, however a insurer can use a longer claim history for the purpose of providing a discount. Allows insurer to consider the second or any subsequent claims in the last 5 years to determine whether to issue or renew a policy.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
PA (8/07)	No provision		
RI (8/07)	§ 6-13.1-21	All lines	May not request a credit report without first notifying the insurance applicant. If deny coverage or charge more, must notify consumers that is due to credit report.
	§§ 27-6-53; 27-9-56; R27-25-011; R26-16-007	Homeowners and personal auto	May use credit scoring for rating and underwriting only if the insurer demonstrates the predictive nature of the score to the insurance department. If requested by customer, must do new credit score every 2 years and lower rates if score is better. May not use revised score to raise rates except as noted. Rates may only be changed at time of renewal. List of factors that may not be considered. Reporting agency may not sell data or lists that include information about credit report.
	Bulletin 2002-16	Homeowners and personal auto	May not decline insurance for a new consumer based solely on the credit score. If use in rating, must demonstrate the statistically predictive nature of the score in the rate filing.
SC (8/07)	§ 38-73-740	Auto	Credit report used as basis for rate classification must be kept on file by the insurer for 3 years, and be available to the applicant.
	§ 38-73-425	Property and casualty	An insurer may use absence of credit as a criterion for underwriting if the insurer presents information satisfactory to the director.
	Bulletin 2002-04	Private passenger auto	May not refuse to insure, cancel or non-renew based solely on credit history or credit score. A filing including credit scoring must include justification. Disclose to consumer that insurer may gather and consider credit information.
	Bulletin 2004-09	Property and casualty	If insurers use lack of a credit score as an underwriting criteria, must provide the department with support.
	Bulletin 2004-12	Property and casualty	Must get approval from department before using lack of a credit score as a criterion for underwriting.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
SD (8/07)	Bulletin 2002-3	Personal lines property and casualty	May not use credit information as the sole rating factor.
TN (8/07)	Department Policy	All lines	Justification for use of credit scoring must be provided in the filing. Credit scoring cannot be the sole basis for determining rates.
	§§ 56-5-401 to 56-5-407	Personal lines property and casualty	May not include ZIP code as a factor. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. File scoring models with department. (NCOIL model)
	Bulletin Dated 12/13/04	Personal lines	Sets procedures for filing of credit scoring models.
TX (8/07)	Business and Commerce § 20.02	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting.
	Business and Commerce § 20.05	Life	May use credit report in underwriting life insurance expected to have a value of $150,000 or more.
	Reg. 28 TAC §§ 5.9340 to 5.9342	Personal lines	Filing requirements for credit scoring models.
	Reg. 28 TAC §§ 5.9940 to 5.9941	Personal lines	Disclosure statement for consumers on how score is calculated, right to appeal, requirement for actuarial justification. Rate differences due solely to use of credit scoring must be supported by actuarial analysis
	Ins. §§ 559.002 to 559.151	Personal lines	Insurer may not use credit scoring that is computed using factors that constitute unfair discrimination. Shall not refuse to renew an insurance policy solely based on credit information. If credit information is used in underwriting or rating, disclose that fact at the time the application is taken. May not consider medical history codes. File scoring models with department.

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
UT (8/07)	§ 31A-22-1307	Homeowners liability	Insurer that uses credit reports in underwriting must comply with federal Consumer Credit Reporting Act.
	§ 31A-22-320	Auto	May only use credit information to reduce rates or in conjunction with other factors.
	Reg. R590-219-1 to R590-219-8	Private passenger auto	Inform consumer of factors used in adverse underwriting decision. May not use credit information to cancel or nonrenew coverage that has been in place 60 days or more or as the primary reason to refuse to issue a new policy.
VT (8/07)	No provision		
VI (8/07)	No provision.		
VA (88/07)	§§ 38.2-2114; 38.2-2212	Auto, fire	Insurers shall not refuse to renew an insurance policy solely based on credit information contained in a consumer report, bearing on an individual's creditworthiness, credit standing or credit capacity. If credit information is used in part, it shall be based on a consumer report procured within 120 days from effective date of nonrenewal.
	Administrative Letter 2002-6	All lines	Any insurer intending to use credit score must file the model prior to their use.
	§§ 38.2-2126; 38.2-2234	Homeowners, renters, auto	May not include income, gender, race, religion, marital status, ZIP code, nationality, etc. as factors. May not base rates solely on credit score or consider absence of a credit history. Must recalculate credit score after 3 years. May not consider medical history codes. (NCOIL model)

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STATE	REFERENCE	LINE OF BUSINESS	SUMMARY OF PROVISIONS
WA (8/07)	§ 19.182.020	All lines	Consumer reporting agency may furnish credit report where the insurer intends to use it for underwriting.
	§ 19.182.040	Life	May use credit report in underwriting life insurance expected to amount to $50,000 or more.
	§ 48.18.545	Personal lines	Credit history may not be used to cancel or non-renew insurance. May only be used to deny coverage if combined with other substantive underwriting factors.
	§ 48.19.035	Personal lines	Credit history shall not be used to determine insurance rates unless the credit scoring models are filed with the commissioner. May not use certain attributes of credit history in credit scoring model.
	Reg. 284-24A-001 to 284-24A-065	Personal lines	Regulation describes standards that apply to insurers that use credit history.
WV (8/07)	§ 91-8-3	Auto	Dept. of Motor Vehicles may furnish credit information from its files where an insurer intends to use it for underwriting.
	Informational Letter No. 142A (August 2003)	Personal lines	Guidelines for filings containing credit scoring. Data may not be used in unfairly discriminatory manner. May not be sole basis for deciding whether to write coverage. If used for rating, must recheck scores of policyholders after 3 years.
	§ 33-6B-3	Auto	May not decline a policy based solely on adverse credit report.
	§ 33-17A-6	Property	May not decline a policy based solely on adverse credit report.
WI (8/07)	Bulletin dated 6/16/97	Personal auto and homeowners	Can use credit reports but not as the sole reason to refuse, cancel or nonrenew a policy.
WY (8/07)	§ 26-2-134	Personal lines, auto, homeowners	Authority to adopt regulation to provide that credit history may not be sole factor and to require disclosures. Protect consumers against unfair discrimination.

This chart does not constitute a formal legal opinion by the NAIC staff on the provisions of state law and should not be relied upon as such. Every effort has been made to provide correct and accurate summaries to assist the reader in targeting useful information. For further details, the statutes and regulations cited should be consulted. The NAIC attempts to provide current information; however, readers should consult state law for additional adoptions.

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NCLR
NATIONAL COUNCIL OF LA RAZA

Credit-based Insurance Scoring: Why Latinos Pay More for Auto Insurance Than They Should

Submitted to:

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

Submitted by:

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INTRODUCTION

My name is Eric Rodriguez, Deputy Vice President at the National Council of La Raza (NCLR), the largest national Latino civil rights and advocacy organization in the United States. For more than 12 years, I have prepared policy analyses and conducted direct legislative and advocacy activities on economic and financial security public policy issues. One important part of NCLR's mission is to carry out public policy and programmatic initiatives that improve the opportunity for and the ability of Hispanic* families to build wealth and move permanently into the ranks of the American middle class. There are now more than 44.3 million Latinos residing in the U.S., and their purchasing power was estimated at nearly $800 billion in 2006. However, the most recent household wealth survey shows that the median net worth of Hispanic households is $7,932, compared to $88,651 for White non-Hispanic households.[1] Given the importance of addressing the nation's racial and ethnic wealth gap, we thank Chairman Watt (D-NC) and Ranking Member Gary Miller (R-CA) for inviting us to provide expert testimony for the hearing entitled, "Credit-Based Insurance Scores: Are they Fair?"

CREDIT SCORING: A STRUCTURAL BARRIER TO WEALTH FOR LATINOS

NCLR has closely examined financial markets as a means of better understanding wealth disparities. This body of work includes the preparation and release of articles, papers, reports, and other written analyses about how Latinos participate in the mainstream financial services industry. For example, NCLR prepared *Jeopardizing Hispanic Homeownership: Predatory Practices in the Homebuying Market* (2005) and *Latino Credit Card Use: Debt Trap or Ticket to Prosperity?* (2007), two issue briefs that identified how policy and practice within the mortgage lending and credit card industries adversely impact Latino consumers. NCLR also released two other notable papers, *Reforming the Remittance Transfer Market* (2005), and *Financial Counseling: A Meaningful Strategy for Building Wealth in the Latino Community* (2005).

NCLR's assessment is that disparities in wealth between Hispanic and White households have more to do with economic and structural barriers within U.S. financial markets than cultural or language barriers. This perspective is discussed in more detail in the article, "Closing the Wealth Gap: Eliminating Structural Barriers to Building Assets Within the Latino Community," published in the current edition of the *Harvard Journal of Hispanic Policy*.

In the U.S. financial market, credit scores are the key to unlocking the door of economic opportunity for American workers and families. A person's credit score can influence a broad range of job and financial opportunities. Given the uneven distribution of wealth opportunity among American workers, more attention has been paid in recent years to the way in which the market determines the creditworthiness of consumers. A number of studies have found that minorities are overrepresented among those with poor credit scores and that credit scoring disproportionately impacts minorities.[2]

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* The terms "Hispanic" and "Latino" are used interchangeably by the U.S. Census Bureau and throughout this document to identify persons of Mexican, Puerto Rican, Cuban, Central and South American, Dominican, and Spanish descent; they may be of any race.

For lenders, credit scoring systems have helped to decrease costs and the time it takes to evaluate a potential customer's creditworthiness. However, because mainstream financial institutions overly rely on credit scoring to determine creditworthiness, Hispanics, who tend to be nontraditional borrowers, are disproportionately and adversely impacted. Individual credit records that have limited information (so-called "thin" files), or no information (so-called "no hits" because they generate no credit score), are often designated as high risk by financial institutions or would-be creditors.

The result is that far too many Latinos, those who pose a low credit risk and should be eligible for the most affordable products and services in the market, are pushed unnecessarily into high-cost and fringe financial markets where predatory lenders await. For example, research by the Center for Responsible Lending shows that Latinos are 30% more likely than Whites to receive a high-cost loan when purchasing a home. Moreover, about two in five mortgage loans made to Latinos are subprime.[3]

The experience of Latinos and other minorities, and the research to date, cast serious doubt on the fairness of credit scoring models. For this reason, in 2003 Congress mandated an examination of credit scoring and its impact on consumers. The Federal Trade Commission (FTC) was required to study credit-based insurance scores and the impact on the availability and affordability of financial products. In July 2007, the FTC released the report, "Credit-based Insurance Scores: Impact on Consumers of Automobile Insurance." The report deserves great scrutiny and has added to the debate over credit scoring's role as a barrier to wealth for minorities.

AUTOMOBILES, INSURANCE, AND LATINO WEALTH

More Latinos today own cars than they do homes. Industry policy and practice in the car-buying, auto finance, and auto insurance fields have a widespread impact on the Hispanic community. According to a 2002 study by the Pew Hispanic Center, almost 80% of Latino households reported owning at least one car, compared to 67.8% of non-Hispanic Black households and 88.3% of non-Hispanic White households.[4] In contrast, in 2007 only half of Latino households own their own homes compared to more than three-quarters of non-Hispanic Whites.[5] Moreover, for many Latinos a car is their only asset. The Pew study found that 25% of Latinos owned no assets other than a vehicle or unsecured liabilities, compared to 6% of Whites.

In addition, Latinos tend to pay more than necessary to finance their car. Data from one major vehicle financing company show that, regardless of creditworthiness, Latino borrowers paid, on average, $266 more in finance costs per loan than non-Hispanic borrowers.[6] Collectively, these Latino borrowers paid $36 million in additional charges.[7]

With respect to both homeowners and auto insurance, there is a long and sordid history of redlining and racial/ethnic discrimination. Policy and practice in the industry have evolved over the decades, but research still finds that minorities pay more than their White peers for insurance. For instance, regarding car insurance, Consumers Union recently released a study which examined data from a number of insurance companies and found that good drivers in the predominantly African American and Latino communities of Baldwin Hills and Inglewood

(California) pay $951 and $899, respectively, more for insurance than the same good driver pays in Westchester, which is predominantly non-Hispanic White. Similarly, in the majority Latino 95205 ZIP Code in Stockton (California), good drivers pay $252 more per year than drivers in the adjacent and largely non-Hispanic White 95204 ZIP Code in Stockton.

Across the board, Latinos are paying more than their White peers to own a car, and the resulting cumulative loss of income and assets from Hispanic households undermines their ability to advance economically into the ranks of the American middle class.

THE PROBLEM WITH CREDIT-BASED INSURANCE SCORING

Credit-based insurance scoring is unfair to Latinos. The principal problem lies in the inaccurate assumptions built into traditional scoring models. The value of scoring is in the ability of a number to reflect a person's actual credit risk, as demonstrated by an individual's behavior or "performance." With respect to Latinos, for a number of reasons credit information is limited; as a result credit scores are a poor predictor of actual creditworthiness.

Gap Between Credit Scores and Creditworthiness

The assumption in traditional credit scoring models is that creditworthiness can be assessed by examining a person's record of making timely payments to many different creditors, and to a lesser extent, the amount of assets held in financial institutions. Insurance scoring models can use any number of credit-related factors to determine a score. Credit factors that could be used include the number of accounts opened, age of oldest accounts, number of credit card accounts opened, or number of department store accounts. Many creditworthy Hispanic families, especially those that include immigrants, are inaccurately and unfairly deemed "high risk" because of this operating assumption. For example, families may be financially conservative and risk averse and avoid opening up credit card accounts. But the very fact that they decline to assume personal or household debt should make them less, not more, of a credit risk than comparable non-Latino families.

Many such households live in extended families where incomes are pooled from multiple wage earners. In such cases, the absence of or having only a "thin" credit file is compounded by the failure of traditional models to attribute all the available income to the household. Similarly, many of these families remit funds to family members abroad, not just for subsistence but also for investment purposes. These families are doubly penalized in that conventional models do not reward their deferred consumption and do not take into account the value of assets held abroad. In sum, by living modestly, declining to accept debt, pooling resources, deferring consumption in favor of savings, and investing abroad, perhaps half of Latino households are penalized instead of rewarded by traditional credit scoring systems.

Moreover, the inaccuracy of credit information in credit reports further penalizes these families with disproportionate adverse effects. Studies show that 29% of consumer credit scores differ by 50 points between credit bureaus.[8] This may not matter for a high-scoring consumer, but could inaccurately place millions of other consumers unfairly into subprime ratings. Furthermore, studies show that 50% to 70% of credit reports contain inaccurate information regarding a

consumer's general credit history.[9] There is also no requirement for lenders to weigh all three credit scores to determine the creditworthiness of potential customers. Also, most credit scoring models collect only limited information on other data that could demonstrate creditworthiness, such as utility bills. A study by The Brookings Institution found that Hispanics experienced a 21% increase in acceptance rates (a meaningful improvement in their creditworthiness and risk assessment) when nontraditional payment data were factored in.[10]

Impact of No Credit Score and "Thin" Credit Files

A study by The Brookings Institution found that approximately 35 million to 54 million Americans remain outside of the credit system.[11] The Information Policy Institute reported data from the credit bureau Experian showing that 18 million credit-eligible Americans had credit files too "thin" to score and another 17 million had no files.[12]

The problem of "thin" and no credit files is particularly acute among immigrants and many Hispanic households that include both native and foreign-born individuals. According to a study by the Center for Community Capitalism, 22% of Hispanic borrowers had no credit score compared to 4% of Whites and 3% of African Americans.[13]

Moreover, Latinos are more likely than their peers to have no credit score or a "thin" credit file for a number of important reasons, including the following:

- **A substantial share of Latinos are unbanked.** The principal data furnishers to credit bureaus are mainstream creditors. Research and data reveal that more than one-third of Hispanics lack a basic checking or savings account.

- **Latinos tend to be young and many are foreign-born and new to U.S. financial markets.** Credit scoring models heavily weigh variables such as the average number of months that accounts have been on file and the age of the oldest accounts (i.e., length of credit history). These factors favor older consumers and those with a long-standing presence in the market. About 45% of Latino adults in the U.S. are foreign-born and more than half of Hispanics, whether native or foreign-born, are under the age of 27.

- **Latinos are less likely than their peers to use credit cards.** Credit card issuers are important sources of credit information to credit bureaus. Only 56% of Latino households report having a credit card, compared to 80% of all households.

- **The use of Social Security numbers as an identifier by credit bureaus limits the ability of some foreign-born residents to accumulate a payment history.** Nearly half of Latino adults in the U.S. are foreign-born and several million do not have Social Security numbers, a principal means of recording and reporting consumer payment data with credit bureaus.

Finally, because Latinos have lower homeownerships rates, only roughly one-third are making steady mortgage payments, and surveys confirm that, on the whole, Hispanics tend to be risk averse and proportionately less likely to carry debt.

Notwithstanding these factors, the report on credit-based insurance scores released in July 2007 by the FTC reported a small share of the overall population with no credit scores. More incredibly, the FTC study found that it was more difficult to find credit reports for African Americans than for Latinos. According to the study, credit reports could not be located for 9.2% of the Hispanic population compared to 9.7% of African Americans and 7.8% of non-Hispanic Whites.[14] These obviously flawed data led the FTC to conclude that not having a credit score was unlikely to be an important source of difference in auto insurance premiums among racial and ethnic groups.

Despite that anomaly, the study did find that consumers for whom scores were not available appeared riskier when scores were used than when scores were not. In this case no credit record, rather than a record of relatively poor repayment of debt, automatically resulted in a "high risk" designation within insurance scoring models. This finding, coupled with the results of the Federal Reserve study on credit-scoring, documents the problem for Latinos. The Federal Reserve confirmed that foreign-born consumers consistently performed better than predicted by their credit scores. As the studies reveal, credit scoring adversely, unfairly, and disproportionately impacts those who are young and foreign-born, a substantial share of the overall Latino population.

Role of Limited Information

Information about how credit-based insurance scoring models work and how they impact different segments of consumers is limited. The FTC study is a reflection of how closely guarded insurance companies keep this information and how little we know. In particular, it is extremely difficult for regulators to effectively conduct oversight without some further measure of transparency from those using credit-based insurance scoring models.

Moreover, it is virtually impossible to effectively "shop" for the best insurance policy when basic pricing information is unclear or not communicated by companies. In the case of credit cards, the data strongly suggest that Latinos are much less likely than their peers to shop for the best terms. Undoubtedly, many Hispanics are unaware that they are paying much more than their peers – and much more than they should – for car insurance.

CONCLUSION AND POLICY RECOMMENDATIONS

Hispanics have experienced a long history of exploitation and discrimination at the hands of insurance agents and companies, which is how insurance redlining emerged as a major civil rights issue. Insurance scoring does have the benefit of removing a measure of discretion that in the past resulted in outright discrimination against Latinos. However, persistent imperfections within insurance scoring models undeniably results in Latinos and African Americans paying more for insurance than their White peers. That alone ought to raise caution flags for industry, regulators, and policy-makers. The FTC study reveals that the use of credit information in insurance scoring models is now ubiquitous and that while many states have taken steps to address public concerns about this development, state policy is inconsistent. Until the credit recording and reporting system materially improves the quality of information for nontraditional

borrowers, the insurance industry should be barred from using it within insurance scoring models. Unquestionably, there should be a prohibition against using credit information for those consumers who have no credit score or "thin" credit files. Other recommendations worth considering include the following:

- **Improve consumer information.** For insurance companies that use credit information, require that the exact credit-related reason for rate changes or denial be included in consumer notices, along with steps consumers can take to remedy errors.
- **Improve transparency.** For companies that use credit-based insurance scoring models, require data reporting to regulators on rates and claims disaggregated by race and ethnicity, similar to that employed in the Home Mortgage Disclosure Act.
- **Improve oversight.** Require all companies to register their insurance scoring models with federal and state regulators.
- **Develop a more rigorous regulatory enforcement regime.** To ensure an insurance market free of discrimination or policies that have clear disparate impact on minority consumers, a new regulatory framework is needed to monitor and provide redress against such policies.
- **Encourage voluntary improvements in credit-scoring models.** Partnerships and pilot projects should be encouraged between industry and nonprofit organizations which test models that more accurately take into account the actual behavior of nontraditional borrowers.

Finally, NCLR strongly supports the creation of a network of community-based financial counselors to provide basic financial advice for low-income families. In the absence of effective policy and regulatory oversight, more needs to be done to empower low-income Latino consumers. Research demonstrates that one-on-one counseling is an effective, and perhaps the *only* effective, approach for doing this.

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[1] Kochhar, Rakesh, *The Wealth of Hispanic Households: 1996 to 2002.* Washington, DC: Pew Hispanic Center, 2004.
[2] Wu, Chi Chi with Birny Birnbaum, *Credit Scoring and Insurance: Costing Consumers Billions and Perpetuating the Economic Racial Divide.* Center for Economic Justice, National Consumer Law Center, June 2007.
[3] Bocian, Debbie Gruenstein, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on Price of Subprime Mortgages.* Center for Responsible Lending, May 2006.
[4] *The Wealth of Hispanic Households, op.cit.*
[5] U.S. Department of Housing and Urban Development, *U.S. Housing Market Conditions*, 2nd Quarter 2007.
[6] *The Hidden Markup of Auto Loans: Consumer Costs of Dealer Kickbacks and Inflated Finance Charges*, Consumer Federation of America, January 26, 2004.
[7] *Ibid.*
[8] Carter, Carolyn, Elizabeth Renauart, Margot Saunders, and Chi Chi Wu, "The Credit Card Market and Regulation: In Need of Repair," North Carolina Banking Institute, Vol. 10, March 2006. Citing Consumer Federation of America study.
[9] *Ibid.*
[10] *Give Credit Where Credit Is Due: Increasing Access to Affordable Mainstream Credit Using Alternative Data.* Political and Economic Research Council and The Brookings Institution Urban Markets Initiative, 2006.
[11] *Ibid.*
[12] *Giving Underserved Consumers Better Access to the Credit System: The Promise of Non-Traditional Data.* Information Policy Institute, July 2005.

[13] Stegman, Michael, et al., "Automated Underwriting: Getting to 'Yes' for More Low-Income Applicants," Presented before the 2001 Conference on Housing Opportunity, Research Institute for Housing America Center for Community Capitalism, University of North Carolina-Chapel Hill, April 2001.
[14] *Credit-Based Insurance Scores: Impact on Consumers of Automobile Insurance*, A Report to Congress by the Federal Trade Commission, July 2007.

PREPARED STATEMENT OF

THE FEDERAL TRADE COMMISSION

on

"Credit-based Insurance Scores: Are They Fair?"

Before the

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
HOUSE COMMITTEE ON FINANCIAL SERVICES

Washington, D.C.
October 2, 2007

I. Introduction

Chairman Watt, Ranking Member Miller, and members of the Subcommittee, I am Commissioner J. Thomas Rosch of the Federal Trade Commission ("Commission" or "FTC ").[1] I appreciate the opportunity to appear before you today to discuss the Commission's recent study of the impact of credit-based insurance scores on consumers of automobile insurance, and the effect of scores on members of racial and ethnic minority groups. I also am grateful for this chance to describe how the Commission intends to conduct a similar study of the impact of credit-based insurance scores on consumers of homeowners insurance.

II. Background of Credit-Based Insurance Scores and Studies

Over the past decade, insurance companies have increasingly used information about credit history in the form of credit-based insurance scores to decide whether to offer insurance, and, if so, at what price. Credit-based insurance scores are numerical summaries of a consumer's credit history. These scores typically are calculated using information about past delinquencies and information on the public record (*e.g.*, bankruptcy); debt ratios (*i.e.*, how close a consumer is to his or her credit limits); evidence of seeking new credit (*e.g.*, inquiries and new accounts); the length and age of the credit history; and the use of certain types of credit (*e.g.*. automobile loans). Insurance companies use scores as a factor when estimating the number or total cost of insurance claims that prospective customers (or customers renewing their policies) are likely to file. Insurance companies then use this information to assign consumers to risk pools and to determine the premiums that consumers pay.

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[1] While the views expressed in this statement represent the views of the Commission, my oral presentation and responses to questions are my own and do not necessarily reflect the views of the Commission or any individual Commissioner.

Insurance companies and other proponents of credit-based insurance scores contend that they assist in predicting risk of loss more accurately, thereby allowing insurance companies to charge consumers premiums that conform more closely to their individual risk of loss. However, consumer advocates, civil rights groups, and other opponents of credit-based insurance scores raise the concern that their use results in members of racial and ethnic minority groups and members of other protected classes paying higher insurance premiums than other consumers.

To assist policymakers in evaluating these arguments, Congress directed federal agencies to conduct empirical studies of the impact of credit-based insurance scores on the availability and affordability of insurance. Pursuant to Section 215 of the Fair and Accurate Credit Transactions Act ("FACTA"),[2] the FTC, in consultation with the Office of Fair Housing and Equal Opportunity at the Department of Housing and Urban Development ("HUD"), is required to study whether credit-based insurance scores affect the availability and affordability of insurance. Among other things, Congress specifically directed the Commission to focus its empirical analysis on the effects of scores on members of racial and ethnic minority groups.

III. FTC Automobile Insurance Study

The FTC recently submitted to Congress a report with its assessment of the effects of credit-based insurance scores on consumers of automobile insurance.[3] The FTC is submitting a complete copy of its automobile insurance report, as well as statements of Commissioner views regarding the report, for the record of this hearing. I will describe briefly the methodology the FTC staff used to conduct the automobile insurance study, and present an overview of the

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[2] 15 U.S.C. § 1681 note.

[3] *See* Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* (July 2007) ("FTC Automobile Insurance Report"), available at http://www.ftc.gov/opa/2007/07/facta.shtm.

report's findings and conclusions.

A. FTC Automobile Insurance Study Methodology

Section 215 of the FACTA specified some of the process used in the FTC automobile insurance study. As directed by law, the Commission sought input from federal and state officials, industry members, consumer, civil rights, and housing organizations, as well as members of the public concerning methodology and research design. The FTC received nearly 200 public comments in response to requests for views on these issues, and learned more about these issues from numerous discussions with government officials, industry groups and private companies, as well as with community, civil rights, consumer, and housing groups. Following this process, the FTC's expert economic researchers determined the data that needed to be obtained and the methodology to be employed in analyzing the data.

At the heart of the methodology was the Commission staff's creation of its own extensive database with information from automobile insurance policies and other sources. Through a third party, the FTC staff obtained insurance policy information regarding the customers of five large automobile insurance companies, who represented 27% of the United States automobile insurance market. FTC staff supplemented this data with additional insurance claims information from an independent source. Because neither the automobile insurance companies nor the independent source have data concerning the race and ethnicity of their customers, race and ethnicity information from the Social Security Administration, the United States Bureau of the Census, and a Hispanic surname match was added to the insurance policy information. In addition, credit-based insurance score information was obtained from ChoicePoint and Fair Isaac Corporation and added to the insurance policy information.

The FTC staff used econometric and statistical techniques to analyze the information in its

database. As a threshold matter, it determined to what extent credit-based insurance scores are predictive of claims on automobile policies. The results of that analysis were then used to calculate the effects of scores on predicted claims for all automobile insurance consumers, with these predicted claims serving as a measure of the likely effects of scores on the premiums all consumers pay. The Commission staff then compared the average scores of different racial and ethnic groups, and the likely impact of differences in average scores on the premiums different groups would pay. The FTC staff also determined whether, and to what extent, scores remained predictive of claims when controls were included for race, ethnicity, and income.

The FTC staff also attempted to construct an alternative scoring model that would predict risk accurately while decreasing the differences in scores, on average, among racial and ethnic groups. The agency staff created a baseline credit-based insurance scoring model that was as predictive as possible of automobile insurance claims. Several scoring models were then built that were intended to be predictive of claims, yet have smaller differences across racial and ethnic groups than the baseline scoring model.

As in many research studies, the Commission had to make a significant number of judgment calls requiring the application of significant technical expertise and experience in econometrics and statistics. Reasonable minds may differ on these judgment calls. There was robust debate about these issues among the Commissioners at the time that the report was submitted to the Congress. Commissioner Leibowitz supported the decision to issue the report, but wrote separately to emphasize that "while the analysis demonstrates that credit-based insurance scores are correlated with risk . . . differences in credit-based insurance scores across racial and ethnic groups are a disturbing reminder that our society is - still - not race blind, and that the vestiges of our history of discrimination remain ever-present." Commissioner Harbour

dissented from the decision to issue the report because she "distrust[ed] the integrity of the underlying data," "disagree[d] with the methodology used," and "doubt[ed] the reliability of any conclusions the report might draw."

In addition, some consumer groups have raised concerns about the methodology used. FTC Chairman Majoras recently responded to these concerns in detail in letters she sent to Chairmen Frank, Watt, and Gutierrez. We would like to submit these letters for the record of this hearing.

The FTC has given careful and thorough consideration to the methodological concerns that have been raised about our automobile insurance study. Following this consideration, a majority of the Commission continues to believe that the methods used were sound and that the findings made and conclusions reached were well-supported.

B. FTC Automobile Insurance Study Results

The FTC's automobile insurance study compared risk predictions for the consumers in the FTC database with and without the use of credit-based insurance scores. Consistent with prior research,[4] the Commission found that using credit-based insurance scores led to more effective prediction of risk under automobile insurance policies. Scores predict both the number of claims that consumers are likely to file and the total cost of those claims to the insurance company.

The use of effective risk prediction techniques, including credit-based insurance scores, decreases premiums for less risky consumers and increases premiums for more risky consumers.

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[4] *See* Texas Department of Insurance, "Use of Credit Information by Insurers in Texas: The Multivariate Analysis" (Jan. 31, 2005) (supplemental report) ("2005 Texas Report"); Texas Department of Insurance, "Use of Credit Information by Insurers in Texas" (Dec. 30, 2004) ("2004 Texas Report"); Michael J. Miller and Richard A. Smith, *The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity: An Actuarial Study by EPIC Actuaries, LLC* (June 2003).

Specifically, the FTC study found that if credit-based insurance scores are used, 59% of consumers in the FTC's database would be predicted to have their premiums decrease and 41% of them would be predicted to have their premiums increase. The average amount of these premium decreases was smaller than the average amount of these premium increases.

Although the Commission study found that credit-based insurance scores are effective predictors of automobile insurance risk, it is not clear why. A variety of alternative explanations for the link between scores and risk have been suggested in the economics literature and elsewhere. But the FTC was not able to determine which of these possible explanations, if any, is correct.

The FTC study also revealed that credit-based insurance scores are distributed differently among racial and ethnic groups of consumers. African Americans and Hispanics tend to be over-represented among consumers with the lowest credit-based insurance scores and under-represented among consumers with the highest scores. This result is consistent with prior research.[5] With the use of scores, the average predicted risk for African Americans and Hispanics therefore increased by 10% and 4.2%, respectively, while the average predicted risk for non-Hispanic whites and Asians decreased by 1.6% and 4.9%, respectively. These changes in predicted risk would be expected to increase the insurance premiums that African Americans and Hispanics pay on average, while decreasing the premiums that non-Hispanic whites and Asians pay on average.

Averages, however, do not tell the complete story. The use of credit-based insurance scores increases and decreases the premiums of some consumers in each racial and ethnic group. The impact of the use of scores differs on average across racial and ethnic groups, because some

[5] *See* 2005 Texas Report and 2004 Texas Report.

groups have a lower proportion of consumers with higher scores than other groups. For this reason, the use of credit-based insurance scores is likely to result in reductions in premiums for 62% of non-Hispanic whites and 66% of Asians, but only 47% of Hispanics and 36% of African Americans. Or, to put this another way, the use of scores is likely to lead to increased premiums for 64% of African Americans and 53% of Hispanics, but only 38% of non-Hispanic whites and 34% of Asians.

The FTC also evaluated whether credit-based insurance scores act as a "proxy" for membership in racial and ethnic groups in insurance decisions. Membership in racial and ethnic groups cannot be used directly to determine what premiums to charge. Some have suggested that, because race and ethnicity cannot be used directly to assess premiums, other factors might be used as a "proxy" for membership in racial and ethnic groups in determining what premiums to charge. The FTC conducted statistical tests to determine whether credit-based insurance scores act as such a proxy.

To test this hypothesis, the FTC added to its model controls for race and ethnicity. As discussed above, adding credit-based insurance scores to the model resulted in the average predicted risk of African-American and Hispanic consumers increasing by 10% and 4.2%, respectively. When the model included controls for race and ethnicity, adding the scores resulted in the average predicted risk of African-American and Hispanic consumers increasing by only 8.9% and 3.5%, respectively. Of the predicted increase in average risk of 10% and 4.2% for African Americans and Hispanics, 8.9% and 3.5%, respectively, of the increase therefore cannot be attributed to race or ethnicity because it appeared in a model that controlled for race. The difference between these two sets of predictions (1.1% for African Americans and 0.7% for Hispanics) shows the effect of scores as a statistical proxy for race and ethnicity. This proxy

effect was proportional to the proxy effect that the FTC found for other tested factors, such as geographic risk, tenure of customer, and prior claims. In short, this FTC study did find that the credit-based insurance scores have a proxy effect, but it appears to be relatively small.

As part of its proxy analysis, the FTC also tested to determine whether credit-based insurance scores predict risk for a sample composed of members of only one racial or ethnic group. The FTC tests showed that scores predict risk for samples which include only members of a particular racial or ethnic group. For example, African Americans with higher credit-based insurance scores were found to have a lower risk of loss, while African Americans with lower scores were found to have a higher risk of loss. These findings suggest that credit-based insurance scores predict risk of loss apart from the role they play as a proxy for race or ethnicity.

Finally, the FTC automobile insurance study assessed whether the agency could develop a credit-based insurance score model that both predicted risk effectively and decreased the differences in scores among racial and ethnic groups. Despite substantial efforts, the FTC staff was not able to develop a model that effectively predicted risk and narrowed the differences in scores among racial and ethnic minority groups. This does not necessarily mean that such a model could not be constructed, but it does suggest that there is no readily available scoring model that would satisfy these criteria.

IV. FTC Homeowners Insurance Study

In addition to the completed FTC automobile insurance study, Section 215 of FACTA mandates that federal agencies, in consultation with HUD, conduct a study of the impact of credit-based insurance scores on the availability and affordability of homeowners insurance. The Commission therefore has commenced this study and has begun the process of obtaining the data necessary to do the requisite econometric and statistical analysis.

The methodology that the Commission staff will use in the FTC homeowners insurance study to obtain and analyze data generally will be the same as or similar to the methodology used in the FTC automobile insurance study. There is one important exception, however.

Some consumer, civil rights, and housing groups raised a number of methodological concerns related to the FTC automobile insurance study, primarily objecting to the fact that the information in the FTC database had its genesis in information that insurance companies voluntarily provided through a third party. To increase the level of public confidence in its homeowners insurance study, the FTC intends to use its authority under Section 6(b) of the FTC Act to obtain homeowners policy information from insurance companies. A description of the FTC's plan for the homeowners insurance study, including the use of Section 6(b) orders, is set forth in the recent letter from Chairman Majoras to Chairmen Frank, Watt, and Gutierrez.

The Commission notes that using Section 6(b) orders to increase the level of public confidence in its homeowners insurance study means that the study will take longer to complete. Although the time required to complete the homeowners insurance study will depend on a number of contingencies, the Commission estimates that the use of Section 6(b) orders will delay its completion from late spring of 2008 until sometime between the summer of 2009 and the winter of 2010.

V. Conclusion

The Commission's core mission is protecting consumers. In the context of credit-based insurance scores, the FTC plays two important roles in fulfilling that mission. One role is to conduct research and policy activities to inform the debate about scores and help policymakers make critical decisions related to the use of scores. The FTC's automobile insurance and homeowners insurance studies are intended to perform this function.

The Commission's other role regarding scores is just as important. To protect consumers, we provide them with critical information so that they can make decisions that are in their best interest. The use of credit-based insurance scores has an effect on the insurance premiums consumers are likely to pay. Some consumers, however, may not realize that their credit history may affect their premiums. The FTC therefore recently revised and reissued its consumer education materials, including its Spanish language materials, to give even greater emphasis to the link between credit history and insurance premiums. We hope that these materials, this hearing, and other efforts will alert consumers that having the best possible credit history is critical not only in decisions creditors will make about them, but in the decisions insurance companies will make about them too.

Thank you.

Statement of Chairman Deborah Platt Majoras, Commissioner William E. Kovacic, and Commissioner J. Thomas Rosch

Study of Insurance Scores Pursuant to Section 215 of the Fair and Accurate Transactions Act of 2003 ("FACTA")

FTC Project No. P044804

In response to a Congressional directive in Section 215 of the Fair and Accurate Transactions Act of 2003 ("FACTA"),[1] the Commission today issued a comprehensive report[2] describing its study of the effects of credit-based insurance scores on the availability and affordability of automobile insurance. As directed by Congress, the report also contains an extended discussion of the FTC's empirical analysis of the impact of these scores on racial and ethnic minority groups.

Section 215 of FACTA sets forth a series of specific requirements for studying the effects of credit-based insurance scores in the context of automobile insurance. It directs the FTC to: describe how credit-based insurance scores are created and used; assess the impact of scores on the availability and affordability of automobile insurance products; undertake a statistical analysis of the relationship between credit-based insurance scores and membership in racial, ethnic, and other protected classes; evaluate whether these scores act as a proxy for membership in racial, ethnic, and other protected classes; and analyze whether it is possible to construct alternative scoring models that predict risk effectively and result in narrower differences in scores among racial, ethnic, and other protected classes. In conducting the study, Section 215 directs

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[1] 15 U.S.C. § 1681 note.

[2] Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* (July 2007) ("the Report"), available at http://www.ftc.gov/os/2007/07/P044804FACTA_Repor_Credit-Based_Insurance_Scores.pdf

the Commission to seek input from federal and state officials, consumer, civil rights, and housing organizations, and the public concerning methodology and research design.

In directing the Commission to perform this study, Congress entrusted the FTC with a difficult task that raises important and sensitive policy issues. As explained in more detail below, a talented and dedicated team of career Ph.D. economists produced a study in the manner that Congress instructed. The research team consulted with numerous stakeholders, examined voluminous public comments concerning methodology and survey design, developed a database, painstakingly evaluated the underlying data, and conducted multiple, rigorous evaluations of the data, including an analysis of data obtained from an independent source. We stand by the conclusions reached through this process.

Pursuant to the directive of Congress, the FTC published two Federal Register Notices[3] soliciting comments from the public concerning methodology and research design. The agency received nearly 200 public comments in response to these notices. Commission staff also met with community, civil rights, consumer, and housing groups, as well as with government agencies and private companies. Based on extensive contributions from all of these stakeholders, the FTC's expert economic researchers made well-informed decisions regarding the data to be collected and the methodology to be used in analyzing that data.

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[3] Public Comment on Data, Studies, or Other Evidence Related to the Effects of Credit Scores and Credit-Based Insurance Scores on the Availability and Affordability of Financial Products, 70 Fed. Reg. 9652 (Feb. 28, 2005); Public Comment on Methodology and Research Design for Conducting a Study of the Effects of Credit Scores and Credit-Based Insurance Scores on Availability and Affordability of Financial Products, 69 Fed. Reg. 34167 (June 18, 2004).

FTC staff economists developed a database to analyze the specific issues set forth in Section 215 of FACTA. As an initial matter, the agency obtained, through a third party,[4] automobile insurance policy data for five firms representing 27% of the United States automobile insurance market in 2000. The data, which included ChoicePoint credit-based insurance scores, covered a two-year period (2000-01). Because the automobile insurance companies do not have any data concerning the race and ethnicity of their customers, the FTC staff had to obtain this information from other sources. Commission staff obtained non-public race and ethnicity information about the insurance company's customers from the Social Security Administration and a non-public Hispanic surname match, and obtained similar public information from the Bureau of the Census. The agency staff also obtained and added to its database non-public credit history information from ChoicePoint and credit-based insurance score information from Fair Isaac Corporation. All of this information was combined to create the FTC database, which the agency's economists then used to evaluate the relationship between credit-based insurance scores and risk, as well as the effects of these scores on racial, ethnic, or other protected classes.

Commission staff also obtained data that ChoicePoint had collected from most major insurance companies in the ordinary course of its business concerning past claims that customers had filed.[5] The staff used this data to conduct tests of the relationship between credit-based insurance scores and risk. The tests using this data from Choicepoint independently assessed the

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[4] The third party that provided the data was EPIC Actuaries, LLC, an actuarial and financial risk management and consulting firm which specializes in property and casualty insurance.

[5] This ChoicePoint data and its use are discussed more fully in the Report at 28-29.

results of tests using the FTC database, and both sets of tests showed the same relationship between scores and risk.

Our colleague dissents from the issuance of the report. Commissioner Harbour criticizes the data used, disagrees with the methodology employed, and "doubt[s] the reliability of any conclusions the report might draw." Nearly all studies involving the collection and statistical analysis of large amounts of empirical data require the exercise of judgment in making many decisions about which reasonable minds might differ. While we respect the dissent's views as to the data and methodology used here, we have confidence in the quality of the process that the Commission staff used and soundness of the results obtained.

In her dissenting statement, Commissioner Harbour raises a number of concerns about the data the agency used. She emphasizes that the Commission did not issue Section 6(b) orders[6] to compel insurance companies to provide relevant data about their customers. In our view, the critical question is not the particular method the Commission selected to obtain relevant information; instead, it is whether the data obtained is reliable, regardless of the specific method used.

The FTC uses many techniques for gathering the information it uses in its research and policy development projects. Section 6(b) orders constitute one important technique, but there are other useful methods as well. The Commission has issued a number of significant reports

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[6] Section 6(b) empowers the Commission to require the filing of "annual or special * * * reports or answers in writing to specific questions for the purpose of obtaining information about "the organization, business, conduct, practices, management, and relation to other corporations, partnerships, and individuals" of the entities to whom the inquiry is addressed. 15 U.S.C. § 46(b). As with FTC civil investigative demands, the recipient of a 6(b) order may file a petition to quash, and the Commission may seek a court order requiring compliance.

where we obtained industry-specific data without using the 6(b) process.[7] In addition, as noted above, insurance companies do not acquire or maintain race and ethnicity data about their customers. Obtaining information from insurance companies alone through any method, including 6(b) orders, therefore would not have allowed the FTC to conduct the analysis Congress requested. Moreover, because the information collection, retention, and storage practices and procedures of insurance companies vary, even if the Commission staff had obtained information directly from insurance companies through 6(b) orders, we would have had to reconcile the data so that necessary tests could be conducted.

Commissioner Harbour states that the underlying data used in the study is not reliable because it comes from only "two sources of information: data the insurance industry was willing to turn over voluntarily, and data that were publicly available." We respectfully disagree for three reasons. First, we do not assume that data is unreliable simply because it can be obtained

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[7] *See, e.g.*, Federal Trade Commission Report, Marketing Violent Entertainment to Children (April 2007), available at http://www.ftc.gov/opa/2007/04/marketingviolence.shtm (industry voluntarily provided internal marketing documents to FTC staff as part of study of marketing of violent entertainment to children); Federal Trade Commission Report, Marketing Violent Entertainment to Children (April 2004), available at http://www.ftc.gov/os/2004/07/040708kidsviolencerpt.pdf (same); Federal Trade Commission Staff Report, The use of Slotting Allowances in the Retail Grocery Industry (Nov. 2003) (data for study of slotting allowance in grocery stores obtained through voluntary access letters to industry); Federal Trade Commission Report, Marketing Violent Entertainment to Children (Dec. 2001), available at http://www.ftc.gov/os/2001.12/violencereport1.pdf (Industry voluntarily provided internal marketing documents to FTC staff as part of study of marketing of violent entertainment to children); Federal Trade Commission Report, Marketing Violent Entertainment to Children (Sept. 2000), available at http://www.ftc.gov/reports/violence/vioreport.pdf (same); Robert P. Rogers, The Effect of State Entry on Retail Automobile Markets, Bureau of Economics Staff Report to the Federal Trade Commission 11 (Jan. 1986) (industry voluntarily provided pricing data to FTC staff as part of a study on state laws restricting the establishment of new automobile dealerships in the vicinity of present dealers selling cars of the same make).

from publicly available sources such as the Bureau of the Census.[8] Second, as described above and in more detail in Appendix C of the report, the Commission used proprietary data from insurance companies and credit score developers (ChoicePoint and Fair Isaac Corporation), non-public data from the Social Security Administration, and publicly available data from Bureau of the Census and a Hispanic surname match. Third, and most significantly, the FTC has a sound basis for believing that the information it received voluntarily from the insurance companies was reliable. The dissent states that the insurance participants "never provided the Commission with written verification of the accuracy, authenticity, or representativeness of the data." Yet the companies did provide written assurances of the data's reliability on March 30, 2007.[9] These assurances could be used to help establish criminal liability under 18 U.S.C. § 1001 if a company submitted false data. We believe that the potential of criminal liability has a deterrent effect.

In addition, nothing suggests that the data submitted were false. Because insurance companies do not acquire or maintain information about the race and ethnicity of their customers, they could not have manipulated the data with regard to race and ethnicity. The FTC staff later matched customer information it received from insurance companies with race and ethnicity data the agency obtained from the Social Security Administration, a Hispanic surname match, and the

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[8] Researchers often use Census Bureau data, presumably because they believe it is reliable.

[9] Although the Commission staff had not obtained such assurances at the time that the Commission discussed this issue in a letter to now-House Financial Services Committee Chairman Barney Frank on December 8, 2005, these assurances were provided subsequently to Commission staff. *See* Letter from Richard A. Smith, Towers Perrin Tillinghast, to Jesse Leary, Ph.D, Assistant Director, Division of Consumer Protection, Bureau of Economics, Federal Trade Commission (Mar. 30, 2007) (on file with the FTC). Consequently, although there was a time at which these assurances had not been provided to Commission staff, staff ultimately did obtain them.

Bureau of the Census. At the time of submission, insurance companies could not have known what data to manipulate to try to obtain a particular result.

Commissioner Harbour also writes that the FTC's data was inadequate because "it did not accurately reflect the racial and economic demographics of the country,"[10] and, therefore, the Commission staff had to "use statistical weighting to make the pool more racially and economically diverse." As we understand the sector, no insurance company is likely to have a base of customers who fully reflect the racial and economic demographics of the entire United States. Like other businesses, automobile insurance companies compete with one another based on price, location, coverage, service, and other factors. These variations make it unlikely that the customers of a single insurance company, or even a group of companies, will have the same racial or economics demographics of the entire country. Consequently, the use of a statistical technique to weight the sample would have been necessary to produce a representative sample of all customers for any subset of automobile insurance customers. In other words, the need for weighting the sample was not the product of the particular data that the Commission staff obtained and used.[11]

The dissent further observes that the FTC's data on race was problematic because it was

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[10] The Texas studies that our colleague suggests as a template, *see infra* n. 8, also did not assess whether the data it obtained from six insurance companies was representative of the racial and economics demographics of the United States or Texas.

[11] The dissent also notes that the FTC's data did not contain "critical elements" on individual consumers, such as street addresses and actual premiums. The Commission staff had access to street address information, which was used to separate out consumers based on a wide variety of geographic information. The FTC staff also received information on the actual premiums consumers paid, but, as described in the text of the report, *see* Report at 36-37, actual premium information was used only on a very limited basis, *see* Report at 66 n.199, because credit-based insurance scores often had not been used to calculate these premiums.

based on: (a) Social Security Administration data that did not include Hispanic and Asians categories before 1981, and (b) Census Bureau information concerning the block on which consumers live. She also notes that ethnicity was based on a Hispanic surname match.[12] We acknowledge that these methods are imprecise. But we are not aware of any available measures that are more precise.[13]

With regard to the reliability of the FTC's data, the dissent suggests that the agency could have used as a "template" the type of data that the Texas Department of Insurance ("TDI") used in its studies evaluating credit-based insurance scores and automobile insurance risk. Although the TDI used its regulatory authority to obtain data directly from individual companies, both the Texas and FTC studies reached similar conclusions. Both studies found that scores were negatively correlated with total dollars of claims; as the scores of customers increased, the total amount that insurance companies paid out in claims decreased.[14] Both the Texas and FTC studies also found that African Americans and Hispanics have lower credit-based insurance scores on average than non-Hispanic whites and Asians.[15] The results of these two studies

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[12] A Hispanic surname match also was used in the Texas Department of Insurance studies that Commissioner Harbour suggests as a template for the FTC study. Texas Department of Insurance, "Use of Credit Information by Insurers in Texas: The Multivariate Analysis"(Jan. 31, 2005) (supplemental report); Texas Department of Insurance, "Use of Credit Information by Insurers in Texas" (Dec. 30, 2004) (collectively "the Texas studies").

[13] The Texas studies that the dissent suggests as a template for the FTC study matched information from insurance companies with race and ethnicity information from the Texas Department of Public Safety. We are not aware of any reason to believe that the race and ethnicity data that the Commission staff obtained from the Social Security Administration and Bureau of Census is less reliable than the data TDI acquired from the Texas Department of Public Safety.

[14] *See* Report at 22-23.

[15] *See* Report at 52.

therefore are consistent on the key issues studied, regardless of whether the TDI data or the FTC data are used.

Commissioner Harbour also faults the study for concluding that "we don't really know" whether a credit-based risk-scoring model could be created that would predict risk effectively while narrowing the differences between members of racial and ethnic minority groups. Our colleague "suspect[s] that, given a more robust data set, [the Commission] might have been able to answer this question more definitively."

We do not know whether her suspicion is correct. What we do know is that the FTC undertook a comprehensive empirical analysis of a reliable data set. We were not able to reach a conclusion about whether a model could be constructed with the desired effects. It is very difficult to prove that something could not exist, and so the conclusion that we do not really know whether such a model could be constructed is not particularly surprising. Indeed, inherent in an objective application of the scientific method to the available facts, especially when researchers are asked to prove a negative, is that sometimes the correct answer will be that "we really don't know."

In short, we have confidence in the quality of the process used and the results obtained in the study, and we anticipate that the information in the report will prove useful to policymakers in the on-going debate concerning the use of credit-based insurance scores.

Finally, we agree with Commissioner Harbour that it is important for the Commission to promote financial literacy in all communities, including, particularly, poor and racial and ethnic minority communities. This is part of the Commission's core mission as evidenced by our

extensive and continuing educational activities.[16]

[16] The Commission engages in extensive consumer education and policy research activities to enhance financial literacy. For a more complete description of these activities, please see Prepared Statement of the Federal Trade Commission, "Consumer Protection in Financial Services," before the House Committee on Financial Services 15-20 (June 13, 2007), available at www.ftc.gov/os/2007/06/070613.pdf.

DISSENTING STATEMENT OF COMMISSIONER PAMELA JONES HARBOUR

Study of Insurance Scores Pursuant to Section 215 of the Fair and Accurate Credit Transactions Act of 2003 ("FACTA") Commission File No. P044804

Today's Commission report explores the impact that credit-based insurance scores may have on the availability and affordability of automobile insurance. This report responds to a Congressional directive. Section 215 of the Fair and Accurate Credit Transactions Act of 2003 ("FACTA") requires the Commission to conduct a study and issue a report to inform Congress on whether the use of credit-based insurance scores "could result in negative or differential treatment of protected classes under the Equal Credit Opportunity Act, and [whether such] underwriting systems . . . could achieve comparable results through the use of factors with less negative impact."[1]

I respectfully dissent from this report for several reasons:

- I disagree with the methodology used to generate the report. The data collection and analysis fell short of the Commission's gold standard for rigor and completeness, and did not reflect the agency's best practices. Better alternatives were available and should have been utilized.
- Because I distrust the integrity of the underlying data set upon which the study was based, I also doubt the reliability of any conclusions the report might draw.
- For these and other reasons, the report, with improved methodology, could have more aptly addressed Congress's questions.

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[1] Pub. Law 108-159 § 215(a)(3), 111 Stat. 1952, 1985 (Dec. 4, 2003).

In no way do I question the good faith of Commission staff, or of my fellow Commissioners who have approved the submission of today's report. Since 2003, skilled professionals in the Commission's Bureau of Economics have done their best possible work, using the limited data made available to them. Unfortunately, however, I do not believe the efforts of staff were sufficient to overcome incomplete and unreliable data.

Methodological Problems

When Congress created the Federal Trade Commission in 1914, the Commission was equipped with a wide range of research and investigatory tools. In particular, Section 6(b) of the Federal Trade Commission Act broadly empowers the Commission to issue orders to compel, under oath, "reports or answers in writing to specific questions, furnishing to the Commission such information as it may require . . . ."[2]

A statistical study is only as sound as the underlying data. In recent years, the Commission repeatedly has relied on its Section 6(b) powers to acquire comprehensive and credible industry information. The Commission's May 2006 report on gasoline pricing in the aftermath of Hurricanes Katrina and Rita is one noteworthy example.[3] Section 6(b) orders were served on 99 companies in the oil industry, along with an additional 139 Civil Investigative Demands; sworn testimony also was received.[4] In September 2005, the Commission issued a report on pharmacy

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[2] 15 U.S.C. § 46(b).

[3] INVESTIGATION OF GASOLINE PRICE MANIPULATION AND POST-KATRINA GASOLINE PRICE INCREASES (May 22, 2006), *available at* http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf.

[4] *Id.* at iv-v.

benefit managers' ownership of mail-order pharmacies;[5] to conduct the underlying study, the Commission had subpoenaed documents and information from nearly 20 industry participants.[6] The Commission's July 2002 study of generic drug entry prior to patent expiration is another example;[7] the Commission subpoenaed documents and information from 78 brand-name and generic drug manufacturers.[8]

In stark contrast, this report relies solely on two sources of information: data the insurance industry was willing to turn over voluntarily, and data that were publicly available. The data from the insurance industry came from a study of credit-based insurance scores that the industry sponsored. Not all of the firms that contributed to the study agreed to have their data forwarded to the Commission. Staff ultimately used a subset of the industry's data that came from five insurance

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[5] PHARMACY BENEFIT MANAGERS: OWNERSHIP OF MAIL-ORDER PHARMACIES (Aug. 2005), *available at* http://www.ftc.gov/reports/pharmbenefit05/050906pharmbenefitrpt.pdf.

[6] *See id.* at iii-iv.

[7] GENERIC DRUG ENTRY PRIOR TO PATENT EXPIRATION: AN FTC STUDY (July 2002), *available at* http://www.ftc.gov/opa/2002/07/genericdrugstudy.shtm (includes link to full report).

[8] *Id.* at 3. In addition, the Commission currently is in the early stages of a study on "authorized generic" drugs. The study will rely on data collected pursuant to Section 6(b). Two Federal Register notices have been published, and the study is pending approval by the Office of Management and Budget. *See* FTC News Release, FTC Proposes Study of Competitive Impacts of Authorized Generic Drugs (Mar. 29, 2006), *available at* http://www.ftc.gov/opa/2006/03/authgenerics.shtm; FTC For Your Information: Federal Register Notice Issued on Authorized Generic Drug Study (April 30, 2007), *available at* http://www.ftc.gov/opa/2007/04/fyi07238.shtm (both include links to Federal Register notices). "Based on a preliminary analysis, approximately 80 brand-name drug manufacturers, several authorized generic drug companies, and 100 generic companies will receive Special Orders." 72 Fed. Reg. 25306 (May 4, 2007).

companies.[9] As the Smith letter cited in footnote 9 of the majority's statement confirms, these industry participants never provided the Commission with written verification of the accuracy, authenticity, or representativeness of the data.[10] Moreover, records were stripped of identifying data, such that individual records could not be linked to specific companies. The data cannot be independently verified to determine whether any bias was introduced during the selection process.

The data did not contain critical elements on individual policyholders. For example, staff did not have access to all of the characteristics upon which the insurers based their underwriting tier placements. Nor did staff use street addresses, which would have enabled staff to make better assessments based on geography. Staff's analysis did not incorporate data on actual premiums charged to individual policyholders.

Commission staff then adjusted the insurance industry data, based on multiple layers of assumptions and publicly-available data sources, to create an "FTC database" that was not reflective of any actual insurance company's practices. Staff immediately recognized that the original data set did not accurately reflect the racial and economic demographics of this country. Minorities and poor people were under-represented in the sample provided by the insurance industry. Staff recognized

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[9] Appendix C § C.2.

[10] *Compare* Majority Statement at 5-6 ("Yet the companies did provide written assurances of the data's reliability.") *with* Commission letter to Congressman Barney Frank (Dec. 8, 2005) at 4 ("The agency will not be able to independently verify the accuracy of the data received on automobile policies (the "EPIC") data [sic], nor the data expected on homeowners policies. Staff had expected to receive and rely upon written representations from the firms that contributed the data, stating that the data had been selected randomly following a methodology that staff agreed was appropriate. However, because of the reluctance of the firms to identify themselves to the agency and risk being identified publicly, the agency has not been able to receive such written assurances.").

this shortcoming and used "statistical weighting" to make the pool more racially and economically diverse. It would have been vastly preferable to use data reflecting actual insurance policies purchased by a representative sample of U.S. residents.

Appendix C to the report describes how the FTC database was created. Staff needed to make many assumptions to address deficiencies in the original, incomplete data set. Just the first few pages of Appendix C provide the following examples:

- larger firms were under-represented relative to their market share;
- drivers in small states were over-represented;
- important risk variables were missing from the data, including prior claims and territory;
- credit-based insurance scores had never been calculated for many of the policies in the database;
- among policies that had been scored, different companies used different models, which may have varied by state;
- a score was calculated only for the first-named insured on each policy, which may have skewed the results for multi-driver and multi-car households; and
- high-risk drivers likely were under-represented.[11]

Appendix D to the report explains that the data on race were compiled using imperfect data from the Social Security Administration. Race was sometimes recorded using a predicted probability based on the race of persons on a Census block. The Hispanic surname match is also imprecise;

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[11] Appendix C, § C.1.

many people who have an Hispanic surname do not report themselves as Hispanic, and vice-versa. There were so few Native Americans in the sample that they were not included in the analysis.[12]

By serving insurance companies with 6(b) orders, Commission staff could have obtained a more accurate and complete data set, which would have provided a strong foundation for staff's complex econometric analyses.

Notably, the University of Texas conducted a study in 2003, which triggered follow-up studies in 2004-05 by the Texas Department of Insurance, addressing the exact issue of using credit-based insurance scores for automobile insurance purposes. The Texas studies were based on a far more detailed data set, including hundreds of characteristics of individual policyholders, as well as actual underwriting decisions by insurance companies. The scope of the Texas data collection – especially its heavy reliance on raw, unbiased data – might have provided a template for the Commission's own data collection efforts.

Substantive Conclusions Drawn By The Study

In light of these significant methodological problems, I cannot endorse the report's favorable view of using credit-based insurance scores to inform decisions related to automobile insurance. I recognize that credit-based insurance scores may be effective predictors of risk under automobile policies. But as the report acknowledges, it is impossible to know *why* this correlation exists, based on the Commission's study alone.

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[12] Appendix D, § D.1.1.

Even using the "best" data the industry had to offer, the study still found that credit-based insurance scores have a small effect as a "proxy" for membership in racial and ethnic groups. Given the incompleteness of the data, it is unclear whether the actual proxy effect might be greater.[13]

Responsiveness of Study to Congressional Inquiry

Congress asked the Commission to conduct a study based on real-world facts. Congress specifically called upon the Commission to study "the extent to which, if any, the use of underwriting systems relying on [credit-based] models could achieve comparable results through the use of factors with less negative impact." Reading between the lines of the report, the answer I take away is, "we don't really know." Rather than answering the question of what insurers actually are doing, today's report discusses at great length whether a theoretical insurer with a nationally-representative, hypothetical book of automobile insurance business might have been able to engage in some form of credit-based insurance scoring in a manner that was not unduly "negative or differential" in its treatment of protected classes.

The report devotes only a few pages to a discussion of alternative scoring models. Commission staff endeavored to create a model that did not "derive predictive power from a relationship with race, ethnicity, and income."[14] Staff tried several different approaches and was

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[13] The report notes that several states (California, Massachusetts, Georgia, Hawaii, Illinois, Maryland, Oregon, and Utah) restrict the use of consumer credit history or credit-based insurance scores in insurance. Report at 19.

[14] Report at 76.

unable, using the available data, to build a model that predicted risk but narrowed the differences in scores among racial and ethnic minority groups.[15]

The report concedes, however, that the FTC's "inability" to build such a model is "by no means definitive. Perhaps someone could develop a model that meets both of these objectives."[16] I suspect that, given a more robust data set, staff might have been able to answer this question more definitively. I also would have preferred to see a more balanced discussion of the benefits and detriments of using credit scores and credit-based insurance scores.

* * * * *

Congress is faced with difficult policy questions regarding possible racial bias in the insurance industry. Congress asked the Commission to apply its substantial expertise to study one potential problem – the possible use of credit-based insurance scores to disadvantage protected classes – and to report on how consumers actually are being treated in the insurance marketplace.

Had this report been based on the real insurance marketplace – using actual, verifiable data on individual policyholders, from a broad cross-section of insurance companies – reliable answers might have emerged. Staff made their best, good-faith efforts to work with the data they were given. But in the end, I cannot endorse this report due to my grave methodological concerns. This study fell short of the rigorous research and data-collection standards to which the Commission usually adheres.

Section 215 of FACTA requires the Commission to conduct a similar analysis with respect to homeowners' insurance. The Commission should use all available investigative powers, including

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[15] Report at 72.

[16] Report at 80.

6(b) orders, to assemble a more reliable data set – just as it has done in other superbly executed studies involving other critical industries. The study should include a more thorough and balanced discussion of alternative predictors of risk, and their relative costs and benefits.

Finally, this report reminds me how important it is for the Commission to promote financial literacy in poor and ethnic minority communities. Credit scores clearly are affecting decisions outside of the credit context. The Commission should help all consumers to understand the extremely negative impact of paying bills late, making inquiries about credit, using payday lenders, and taking other actions that may reduce their credit scores. More than ever, protecting one's credit score is a critical step toward achieving financial stability and owning a piece of the American dream.

Concurring Statement of
Commissioner Jon Leibowitz

Study of Insurance Scores Pursuant to Section 215 of the
Fair and Accurate Transactions Act of 2003 ("FACTA")

FTC Project No. P044804

I voted to release this Report because staff's analysis of the data – albeit data primarily provided by a subset of insurers that elected to submit their data for the study – makes a substantial contribution to public discussion in this area. While the analysis demonstrates that credit-based insurance scores are correlated with risk, countering the hypothesis that scores are used principally as a proxy for race or ethnicity, the results in today's Report are of course no cause for celebration. The differences in credit-based insurance scores across racial and ethnic groups are a disturbing reminder that our society is – still – not race blind, and that vestiges of our history of discrimination remain ever-present.

We can, and must, do more.

BARNEY FRANK, MA, CHAIRMAN

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August 28, 2007

The Honorable Deborah Platt Majoras
Chairman
Federal Trade Commission
600 Pennsylvania Avenue, NW
Washington, DC 20580

Dear Chairman Majoras:

We are writing to express concerns about the process the Federal Trade Commission (FTC) will use as it reviews the use of credit-based insurance scores to fulfill the congressional mandate under Section 215 of the Fair and Accurate Credit Transactions Act (FACTA). As the study progresses, we urge the FTC to use all available authority to require insurers to provide relevant data.

Section 215 of FACTA requires the FTC to review the impact of the use of credit-based insurance scores on the availability and affordability of automobile and homeowners insurance. The FTC has already publicly released a report detailing the results of the first phase of the Section 215 study, relating to automobile insurance. The FTC must still review the impact the use of these scores is having on homeowners insurance. We understand that the FTC is likely to release this second report in the Spring of 2008.

A number of consumer, community and civil rights groups have expressed concerns about the quality of the policy data collected and about the research methodology used to generate the first phase of the Section 215 report on automobile insurance. Among the concerns expressed have been: (1) the fact that the FTC relied exclusively upon voluntary insurance data from self-selected companies that are not representative of the full spectrum of insurance markets and consumers; (2) the fact that the FTC did not seek "application data" on consumers whose applications were denied (the absence of such data prevented the FTC from analyzing the impact of insurance scoring on the availability and affordability of automobile insurance and could understate the impact of insurance scoring on low-income and minority consumers); (3) the fact that the FTC did not review whether the data reflected policyholders who had been underwritten based on credit history (as a result, some consumers who would be adversely affected by the use of credit-based insurance scores may have already been eliminated from the data); and (4) the fact that the FTC did not consider alternative models that exclude the use of insurance scores completely yet still effectively predict risk.

Some of these concerns were also echoed in the Dissenting Statement filed by FTC Commissioner Pamela Jones Harbour. Commissioner Harbour's dissent raised concerns that the methodology used to generate the report adversely impacted the reliability of any findings outlined in the report, noting that the FTC could have served insurance companies with 6(b)[1] orders to obtain "a more accurate and complete data set, which would have provided a strong foundation for staff's complex economic analyses." Commissioner Jon Leibowitz, who voted with the majority to release the report, also pointed out that the data used was primarily provided by a subset of insurers that elected to submit their data for the study voluntarily.

We urge the FTC to address the criticisms that have been raised regarding the data quality and research methodology for the automobile insurance study. The FTC has used its 6(b) authority in the past when producing comprehensive reports on particular industry sectors, including the gasoline industry[2] and pharmaceutical industry[3]. The Commission also has the authority to issue Civil Investigative Demands and receive sworn testimony in pursuit of its investigations.[4] We ask the FTC to explain why, in striving to fulfill its statutory mandate under Section 215 of FACTA, the FTC chose not to employ these types of investigatory tools to study the use of credit-based insurance scores for automobile insurance. We also urge the FTC to utilize its full authority under 6(b), as well as any other appropriate authority available to the FTC, to obtain comprehensive policy data by a large number of insurers to complete the second phase of the Section 215 report on homeowners insurance.

We request that the FTC provide a written response in which the FTC: (1) explains its methodological approach to the automobile insurance study; (2) addresses the criticisms raised against this study; (3) indicates whether the FTC intends to issue 6(b) orders or use other compulsory process to obtain data for the homeowners insurance study; and (4) explains the methodology the FTC intends to utilize for data collection and analysis in the homeowners insurance study.

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[1] Section 6(b) empowers the Commission to require the filing of "annual or special . . . reports or answers in writing to specific questions for the purpose of obtaining information about 'the organization, business, conduct, practices, management, and relation to other corporations, partnerships and individuals' of the entities to whom the inquiry is addressed. 15 U.S.C. §46(b).

[2] *See* INVESTIGATION OF GASOLINE PRICE MANIPULATION AND POST-KATRINA GASOLINE PRICE INCREASES (May 22, 2006) available at: http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf. In this case, §6(b) orders were served on 99 companies in the oil industry.

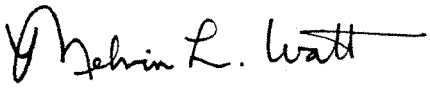
[3] *See* PHARMACY BENEFIT MANAGERS: OWNERSHIP OF MAIL-ORDER PHARMACIES (August 2005), available at: http://www.ftc.gov/reports/pharmbenefit05/050906pharmbenefitrpt.pdf. The Commission issued a report on pharmacy benefit managers' ownership of mail-order pharmacies. To conduct the underlying study, the Commission subpoenaed documents and information from nearly 20 industry participants.

[4] In the gasoline price manipulation study, the Commission issued 139 Civil Investigative Demands, as well as received sworn testimony from oil companies.

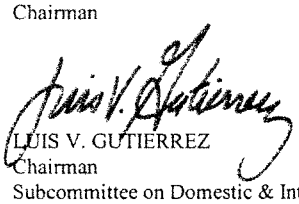
We appreciate the work that the FTC has done to date. We must, however, ensure that the FTC's study of the use of credit-based insurance scores is sufficiently rigorous and accurate to achieve the goals of Section 215 of FACTA. We urge the FTC to use all available investigatory measures to fulfill its statutory mandate under Section 215.

Thank you for your attention to this matter. We look forward to your response by September 17, 2007.

BARNEY FRANK
Chairman



MELVIN L. WATT
Chairman
Subcommittee on Oversight & Investigations



LUIS V. GUTIERREZ
Chairman
Subcommittee on Domestic & International Monetary Policy

cc: The Honorable Pamela Jones Harbour
The Honorable Jon Leibowitz
The Honorable William E. Kovacic
The Honorable J. Thomas Rosch

FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

THE CHAIRMAN

September 17, 2007

The Honorable Barney Frank
Chairman
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Frank:

I am writing in response to your letter of August 28, 2007 expressing concern about the methods the Federal Trade Commission (Commission or FTC) used in conducting, pursuant to the Fair and Accurate Credit Transactions Act (FACTA), its recent study of credit-based insurance scores and automobile insurance. Your letter also encourages the Commission to use all available authority to obtain relevant data from insurance companies in the agency's ongoing study of credit-based insurance scores and homeowners insurance. I am grateful for this opportunity to explain the methodology we used in our automobile insurance study and the methodology we will use to acquire and analyze data in our homeowners insurance study. As to the latter, I will ask my colleagues on the Commission to approve a resolution authorizing the use of Section 6(b) orders to obtain information from insurance companies for use in the study.

Under Section 215 of FACTA,[1] Congress entrusted federal agencies with the difficult task of examining the impact of credit scores and credit-based insurance scores on consumers. The statute requires the Commission and the Federal Reserve Board, in consultation with the Office of Fair Housing and Equal Opportunity at the Department of Housing and Urban Development, to study the impact of credit scores and credit-based insurance scores on consumers of credit and insurance, respectively. To comply with these requirements, the Federal Reserve Board has evaluated and reported to Congress on the impact of credit scores on consumers of credit.[2] The FTC has studied and reported to Congress about the effect of credit-

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[1] Section 215(a) of FACTA, 15 U.S.C. § 1681 note.

[2] *See* Board of Governors of the Federal Reserve System, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit* (August 2007), available at http://www.federalreserve.gov/boarddocs/RptCongress/creditscore/creditscore.pdf.

based insurance scores on consumers of automobile insurance.[3] The FTC continues to study the impact of credit-based insurance scores on consumers of homeowners insurance.

The FTC Automobile Insurance Study

The FTC's automobile insurance study required that the agency obtain and analyze a substantial amount of information related to automobile insurance policies, credit-based insurance scores, and demographic information related to consumers who purchased such policies. As in many studies, the Commission had to make a significant number of judgment calls requiring the application of significant technical expertise and experience in econometrics and statistics. In making these decisions, the FTC relied on the advice of a talented and dedicated team of career Ph.D. economists who consulted with numerous stakeholders, examined nearly 200 public comments concerning methodology and survey design, developed a database, painstakingly evaluated the underlying data, and conducted multiple, rigorous evaluations of the data. Although reasonable minds may differ on some of these judgment calls, I think that the methods used were sound and the conclusions reached were well-supported.

The Commission's automobile insurance study involved three main data and analysis steps: creating an FTC database of relevant information about consumers of automobile insurance; analyzing the information in that database; and assessing the viability of alternative credit-scoring models. In creating its database,[4] the FTC staff started with some of the information from a pre-existing database that EPIC, an actuarial consulting group, had created for purposes of an earlier study. In 2003, EPIC conducted a study of credit-based insurance scores and automobile insurance. A number of insurance companies submitted to EPIC a random sample of their automobile policy data, including claims data from 2001 and 2002. EPIC used this information to conduct an empirical analysis of the relationship between credit-based insurance scores and claims on automobile insurance policies. EPIC later published the results of its empirical research.[5]

The database the FTC staff created for use in its study began with a subset of the information in the EPIC database. Five insurance companies (representing about 27% of the

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[3] *See* Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* (July 2007) ("FTC Automobile Insurance Report"), available at http://www.ftc.gov/opa/2007/07/facta.shtm.

[4] The process the Commission staff used to create the database in its automobile insurance study is described in detail in Appendix C of the FTC Automobile Insurance Report.

[5] Michael J. Miller and Richard A. Smith, *The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity: An Actuarial Study by EPIC Actuaries, LLC* (June 2003).

automobile insurance market) that had submitted insurance policy information for the EPIC study agreed to provide voluntarily the same information for the FTC automobile insurance study. The five insurance companies submitted 2.5 million records concerning 1.4 million automobile insurance policies.

The FTC database was not limited to the information of these five insurance companies. The Commission staff also added credit-based insurance score and other credit history information about each of the customers to expand the database. To obtain this type of information, EPIC forwarded the database with insurance policy information to ChoicePoint, a firm with access to credit report information of consumers.[6] ChoicePoint appended credit-based insurance scores and other credit history information to the insurance policy information, replaced customer names and addresses with a new anonymous unique identifier, and returned the database to EPIC. EPIC standardized the coding of the data from the five insurance companies and combined all of this information to create a single database. EPIC forwarded this combined database to the Commission staff.

The FTC staff also added information to the database concerning race, ethnicity, national origin, and gender. The Social Security Administration (SSA) obtains and records racial, ethnic, national origin, and gender information of people who apply for a Social Security number (SSN). To match the insurance policy information in the FTC database with demographic information in databases at the SSA, the Commission retained Experian. From a random sample of 400,000 consumers in the FTC database,[7] Experian located the SSN or date of birth for about 325,000 consumers, and then forwarded that information and a unique anonymous identifier to the SSA. The SSA added information about race, ethnicity, national origin, and gender to the information it received from Experian; deleted the names, SSNs, and dates of birth; and sent the transformed database to the Commission staff.[8]

The FTC staff then used econometric and statistical techniques to analyze the information

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[6] ChoicePoint maintained this information separate from other information in its databases, including information it sells to the public.

[7] For budgetary reasons, the FTC purchased demographic information for a random sample of 400,000 consumers rather than for all consumers in its database.

[8] The FTC also hired ChoicePoint to match the addresses of the consumers in the database to United States Census geographic identifiers, which were used to bring in Census data on race, ethnicity, and income. Experian also matched the last names of consumers in the database with the list of Hispanic surnames that the United States Bureau of the Census maintains. Following this matching, Experian reported to the FTC which of these consumers had Hispanic surnames. Additional data were appended from several other sources.

in its database.[9] As a threshold matter, we first determined to what extent credit-based insurance scores are predictive of claims on automobile polices. The results of that analysis were then used to calculate the effects of scores on predicted claims, which were used as a measure of the likely effects of scores on the premiums consumers pay. The Commission staff then compared the average scores of different racial and ethnic groups, and the likely impact of differences in average scores on the premiums different groups would pay. The FTC staff also determined whether, and to what extent, scores remained predictive of claims when controls are included for race, ethnicity, and income.

The FTC staff also attempted to construct an alternative scoring model that would predict risk accurately while decreasing the differences in scores on average among racial and ethnic groups.[10] The agency staff created a baseline credit-based insurance scoring model that was as predictive as possible of automobile insurance claims. Several scoring models were then built that were intended to be predictive of claims, yet have smaller differences across racial and ethnic groups than the baseline scoring model. Two of these scoring models controlled for the race, ethnicity, and income of the consumers. Another scoring model explicitly avoided selecting credit-history variables highly correlated with race and ethnicity.

The FTC prepared a report describing the process used in its automobile insurance study and making findings and conclusions concerning the effect of credit-based insurance scores on consumers of automobile insurance. The main findings and conclusions of the Report are: (1) credit-based insurance scores are effective predictors of risk; (2) there is not sufficient evidence at this time to judge which of several alternative theories proposed for the correlation between credit-based insurance scores and risk, if any, is correct; (3) scores are distributed differently among racial and ethnic groups (namely, non-Hispanic whites and Asians on average have higher scores than African-Americans and Hispanics), and this difference in scores is likely to have an effect on the premiums these groups pay on average; (4) scores appear to have little effect as a proxy for membership in racial and ethnic groups; and (5) the FTC was not able to develop an alternative scoring model that would continue to predict risk effectively, yet decrease the differences in scores on average among racial and ethnic groups. As requested in your letter to the Commission dated July 3, 2007, the FTC submitted this report to Congress on July 19, 2007.

Concerns about the FTC Automobile Insurance Study

Your letter describes a number of specific concerns that some consumer groups and other members of the Commission have raised concerning the FTC automobile insurance study. Most

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[9] The techniques the Commission used to analyze the information in the FTC database are described more fully in Appendix D of the FTC Automobile Insurance Report.

[10] The measures that the Commission took to construct alternative scoring models are described in detail in Appendix E of the FTC Automobile Insurance Report.

of these concerns have their genesis in the data included in the FTC database. Specifically, some consumer advocates have raised the concern that the FTC database included information that insurance companies provided voluntarily rather than being provided pursuant to Section 6(b) orders[11] or other compulsory process. It is true that the FTC has used Section 6(b) orders to obtain reliable information for use in some of our research and policy development activities. But it is also true that the Commission has issued a number of significant reports based on industry-specific data that we obtained without using 6(b) orders. The critical question is not the particular method the Commission selected to obtain relevant information; instead, it is whether the data obtained is reliable.

I am confident that the information that we received voluntarily from the insurance companies was reliable for two primary reasons. First, the insurance companies provided the Commission staff with written assurances of the data's reliability. These assurances could be used to help establish criminal liability under 18 U.S.C. § 1001 if a company submitted false or manipulated data. Potential criminal liability would have a deterrent effect. Second, I am not aware of any evidence that suggests that the insurance companies submitted false or manipulated information to obtain a particular result. In fact, because insurance companies neither acquire information about the race, ethnicity, or national origin of their customers nor have access to such information in the SSA database, they could not have known what data to manipulate to try to obtain a particular result.[12]

Using Section 6(b) orders to obtain from insurance companies the information needed to create such a database rather than using information that some insurance companies previously collected likely would have caused substantial delay. If the Commission had issued Section 6(b) orders for the production of identical types of information from ten or more insurance companies,[13] the agency would have had to comply with the requirements of the Paperwork

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[11] Section 6(b) empowers the Commission to require the filing of "annual or special . . . reports or answers in writing to specific questions for the purpose of obtaining information" about "the organization, business, conduct, practices, management, and relation to other corporations, partnerships, and individuals" of the entities to whom the inquiry is addressed. 15 U.S.C. § 46(b).

[12] The basic findings of the FTC automobile insurance study are consistent with those of the Texas Department of Insurance, which obtained data directly from several insurance firms doing business in Texas. *See* Texas Department of Insurance, "Use of Credit Information by Insurers in Texas" (Dec. 30, 2004); Texas Department of Insurance, "Use of Credit Information by Insurers in Texas: The Multivariate Analysis" (Jan. 31, 2005) (supplemental report).

[13] For purposes of the Paperwork Reduction Act (PRA), 44 U.S.C. §§ 3501-3521, each subsidiary of a parent corporation that produces information may be treated as a separate entity, which increases the probability that the FTC would have had to have sent Section 6(b)

Reduction Act prior to the issuance of these orders. Based on Commission experience, the process associated with the issuance of such orders, including complying with the PRA, likely would have added at least six to nine months to the time required to collect necessary data. In addition, if the Commission had issued Section 6(b) orders, recipients could have challenged these orders prior to compliance, further delaying the receipt of necessary data. Finally, if the FTC had obtained data from a substantial number of insurance companies that maintain different data in different formats, the Commission staff would have had to have undertaken the time-consuming task of preparing information from multiple sources, likely maintained in different fashions, into a format suitable for analysis.

As reported in your letter, some consumer groups also have argued that the automobile insurance companies and the customers from whom data was obtained in the study were not representative of the full spectrum of insurance markets and consumers. There are hundreds of insurance companies that write automobile insurance policies in the United States. Because it is not practical to obtain insurance policy information from all of these firms, it was necessary to obtain such information from a subset of them. The FTC staff received automobile insurance policy information from 2001-2002 from five insurance companies that together wrote 27% of automobile insurance in the United States. These companies generally are representative of automobile insurance companies in the United States.[14]

In addition, the FTC staff did adjust the information in its database to ensure that it was representative of United States automobile owners. Like other businesses, automobile insurance companies compete with one another based on price, location, coverage, service, etc. These variations make it unlikely that the customers of any insurance company or even a group of companies will have the same racial or economic demographics of the entire country. The FTC staff recognized that this was the case and therefore used statistical weighting techniques to ensure that the sample used was racially and economically representative of United States consumers of automobile insurance.[15]

According to your letter, some consumer advocates further have criticized the data used in the FTC's study on grounds that it did not include data for consumers whose applications for insurance were denied. Insurance companies often do not retain insurance application data for any significant period of time. Consequently, even if this information would have been useful to

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orders to ten or more entities, thus triggering an obligation to comply with the PRA.

[14] The Commission was concerned that these insurance companies might not issue policies to a sufficient proportion of high risk consumers, but a robustness check of the data showed that this did not affect the results of the FTC's data analysis. *See* FTC Automobile Insurance Report, Appendix F at 6.

[15] The techniques that the Commission used to make the sample more representative are described in detail in the Report. *See* FTC Automobile Insurance Report, Appendix D at 5.

obtain, it would have been difficult, if not impossible, to do so.

Your letter also indicates that some consumer groups have asserted that the Commission staff did not review whether the data reflected policy holders who had been underwritten based on credit history, and as a result, some consumers who would have been adversely affected by scores may have been excluded from the data. The analysis in the study focused on predicted risk of losses, not premiums, and, therefore, if consumers whose premiums reflected the use of credit-based insurance scores were somehow excluded from the samples, this should not have had a significant impact on the analysis. The Report also concluded that the premiums of many policyholders are likely to increase when credit-based insurance scores are used, specifically, the premiums of consumers with low credit-based insurance scores, a class of consumers in which African-Americans and Hispanics are over-represented.

Finally, as your letter notes, some consumer advocates have criticized the study for not testing alternative models that did not use credit-based insurance scores. The Commission focused on alternative credit-based insurance scoring models, because Section 215 of FACTA specifically directed the agency to examine these types of models.[16]

Homeowners Insurance Study

As your letter notes, in addition to the automobile insurance study, the Commission is conducting another study of the effect of credit-based insurance scores on consumers of homeowners insurance. At this time, Tillinghast Consulting (the successor to EPIC) is poised to submit to the FTC staff a data set with homeowners insurance policy information for a random sample of the customers of insurance companies representing nearly half of the U.S. homeowners insurance market. If the FTC staff were to obtain this information, combine it with credit history and demographic information to create a database, and conduct the necessary econometric and statistical analysis of this information, the Commission likely could complete our homeowners insurance study and submit a report to Congress in late Spring of 2008.

Your letter urges the Commission to "utilize its full authority under 6(b) [of the FTC Act], as well as any other appropriate authority available to the FTC, to obtain comprehensive policy data by a large number of insurers to complete the second phase of the Section 215 report on homeowners insurance." To increase the level of public confidence in our study, I intend to ask the Commission to issue a resolution authorizing the use of Section 6(b) orders to obtain information from insurance companies. However, using Section 6(b) orders to obtain this information will have a substantial impact on the timing of the study and the report.

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[16] Section 215(a)(3) of FACTA directs the FTC to study the "extent to which, if any, the use of underwriting systems relying on [credit-based insurance scoring] models could achieve comparable results through the use of factors with less negative impact" on protected classes under the Equal Credit Opportunity Act.

As described above, in the automobile insurance study, the Commission staff obtained information from one entity, EPIC, which had previously collected that information, and, therefore, the FTC did not have to comply with the requirements of the Paperwork Reduction Act. By contrast, if the Commission were to issue Section 6(b) orders demanding the production of identical types of information from ten or more insurance companies, the FTC would have to comply with the PRA and obtain Office of Management and Budget (OMB) clearance prior to sending the orders. Based on the Commission's experience, it is likely that the process associated with the issuance of such orders, including complying with the PRA, would take at least six to nine months before the FTC would obtain OMB clearance allowing the orders to be issued.

Once clearance were obtained from OMB, the FTC would be able to send Section 6(b) orders to insurance companies and require the submission of data. The Commission would send these orders to a substantial number of insurance companies. The orders likely would require the companies to produce the name, address, SSN, and relevant insurance policy coverage and claims history information for tens of millions of consumers.[15] If no further legal action is needed to compel the production of information in response to these Section 6(b) orders, the insurance companies likely would submit information within two months of service.

After the FTC staff has received this information from insurance companies, it will need to complete three additional major tasks to create a database that can be used for the necessary econometric and statistical analysis. First, the Commission staff will evaluate and prepare for analysis the information received from multiple insurance companies. It is likely that these tasks will take the FTC staff between approximately three to six months to complete. Second, the Commission staff will need to add demographic information to the database, which likely will take about two months. Third, the FTC staff will add credit-based insurance scores and credit history information for a sample of these consumers. It likely will take approximately two months to add credit-based insurance scores and credit history information to the FTC database.

The FTC database thus will combine insurance company policy information, credit report information, and demographic information. With this database, the Commission staff will be able to commence doing the econometric and statistical analysis on the issues identified in Section 215 of FACTA and prepare a report describing the results of this research. Based on the agency's experience with the automobile insurance study, it likely would take six to nine months to analyze the data and draft a report for the Congress describing the results of the study.

In short, I intend to ask my colleagues to authorize the use of Section 6(b) orders in the

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[15] The information obtained thus will include personally identifiable information. The agency will take reasonable and appropriate measures to protect the security of this information. The security measures needed to protect the security of this massive amount of personally identifiable information may impose burdens and limitations which may affect the time needed to complete the study.

homeowners insurance study. If the Commission determines to gather information through this method, the amount of time required to complete the study will depend on a wide variety of contingencies, including whether insurance companies determine to challenge the Section 6(b) orders. Based on the estimated time to complete the various parts of the study described above, however, it is likely that the Commission would submit a report to Congress sometime between the summer of 2009 and the winter of 2010.

Conclusion

I appreciate having this opportunity to explain the methodology used in the FTC automobile insurance study and to describe the methodology that the Commission is likely to use in its homeowners insurance study.

We will continue to keep you apprised of our progress on our homeowners insurance study. If you or your staff have any additional questions or comments, please contact me or have your staff call Jeanne Bumpus, the Director of our Office of Congressional Relations, at (202) 326-2946.

Sincerely,

Deborah P. Majoras

Deborah Platt Majoras
Chairman

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The Honorable Melvin Watt
Chairman
Subcommittee on Oversight and Investigations
U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Testimony of Commissioner J. P. Schmidt, Hawaii Insurance Division
On Credit-Based Insurance Services
Testimony: October 2, 2007, 2 p.m.
2128 Rayburn House Office Building

Dear Chairman Watt and Committee Members:

Thank you for this opportunity to testify on credit-based insurance scoring and to explain why Hawaii's policymakers have banned this practice in the 50th State.

In 1987, the Hawaii Legislature amended the Hawaii Revised Statutes to prohibit discriminatory practices in the pricing of automobile insurance premiums.[1] The law applies to rating plans, ratemaking standards, and underwriting standards and bars use of race, creed, ethnic extraction, age, sex, length of driving experience, **credit bureau rating**, marital status, or physical handicap in the direct or indirect pricing of Hawaii's automobile insurance premiums.

Then, as now, arguments were made that credit scoring is an accurate predictor of the number of and total cost of claims consumers will file and thus an effective tool for insurers to match risk to premiums. Arguments were also proffered both for and against the premise that credit scoring results in unfair or discriminatory pricing for low-income and minority groups.

In its deliberations on this issue twenty years ago, the Hawaii Legislature determined that the use of credit bureau rating reports could result in discriminatory rating practices and acted to specifically include credit bureau rating in the list of prohibited criteria. Two decades later, a

[1] HRS §431:10C-207 Discriminatory practices prohibited.

report to Congress by the Federal Trade Commission[2] reports that credit-based insurance scores are distributed differently among racial and ethnic groups and that this difference is likely to result in higher insurance premiums, on average, that these groups pay.

While it has been actuarially demonstrated that there is a correlation between an individual's credit score and the propensity for that individual to be involved in future claim activity, that relationship provides only a portion of the information needed to develop and to regulate an insurance rate regulatory system. It is essential that policymakers have the flexibility to consider any corollary effects that may result from the criteria used in the insurance classification system. A good legal regulatory structure balances the various and varied factors providing appropriate consumer protection with as little government intrusion as possible. The result should be a healthy competitive market providing fair treatment and rates to consumers.

It was determined by the Hawaii Legislature that any benefits inuring to some consumers by allowing credit bureau scoring as a rating factor in automobile insurance pricing were outweighed by the potential for harm to a greater number of the State's citizens and to its economic well being. In this regard, the Legislature's policy decision accomplished a major goal of a risk classification system: to produce rates that are not unfairly discriminatory. In other words, a classification system should provide a means to pool the experience of insured risks based upon their expected levels of insurance risk.

It is essential to recognize and acknowledge that credit scoring, if allowed in a given jurisdiction, will perforce result in all insurers giving consideration to use of credit-based insurance scores regardless of whether they would have opted to use the criteria on their own.

If some insurers employ a system using credit scores while do not use credit scores in their rating and underwriting programs, consumers with more favorable credit scores will tend toward the insurer providing commensurate discounts. Other insurers are then forced to adopt a similar system or they will end up with a preponderance of the more "adverse" risks from a credit score standpoint. This concept, known as "adverse selection" will leave the "credit scoring" insurer with the more favorable risks. The result for the "nonparticipating" insurer would be an inadequate rate for the business it attracts (mostly consisting of insureds with less than stellar credit scores). The negative effects of an inadequate rate level include a decrease in competition or at its worse, the financial insolvency of the insurer with the noncompetitive rates.

Another important factor to consider is that credit scoring likely may present obstacles to employers – particularly small businesses – during less than favorable economic times, which would be counter to the economic goals of the state and nation. A small business owner may have to borrow funds during economic downturns in order to keep the business going (and to keep employees on the payroll). A rating system based upon credit scores may add additional

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[2] Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance – A Report to Congress by the Federal Trade Commission, July 2007

surcharges and burdens when those burdens are most potentially harmful, adding to the economic problems due to intolerable marginal cost increases associated with the purchase of insurance.

Hawaii is a State unlike any other. But one thing we hold in common with our 49 sister states is our firm belief in home rule. Legislative and regulatory processes must be tailored to best fulfill the needs of a particular region taking into consideration its demographics, business climate, and social structure. As in other areas of law, one size does not fit all in establishing a legal structure for auto insurance. This concept is embodied in the guidelines of the Actuarial Standards Board of the American Academy of Actuaries[3] which avoid placing undue restraints upon the actuary or lawmakers by not requiring a specific system of specific rating criteria while allowing the balance of numerous pertinent factors under tested actuarial guidelines.

In summary, twenty years of experience has provided no evidence that Hawaii's statutory exclusion related to the use of credit bureau ratings in the pricing or underwriting of insurance has diminished the efficacy of the Hawaii insurance market. The current automobile insurance environment in Hawaii is competitive and healthy. And while the argument continues over whether credit scoring discriminates unfairly against low-income and minority groups, I can assure you with 100% confidence that such discrimination does not exist today in the Aloha State.

Thank you, again, for the opportunity to address this honorable body and to share with you Hawaii's approach to – and experience with – this important insurance law policy.

Sincerely,

J.P. SCHMIDT
Insurance Commissioner

[3] Actuarial Standard of Practice (ASOP) Number 12

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Credit Based Insurance Scoring: Meeting The Mandate Of Fair, Legal, And Appropriate Underwriting And Rating Practices By Automobile Insurers

Testimony of Nathaniel S. Shapo

Partner, Katten Muchin Rosenman LLP

nat.shapo@kattenlaw.com

United States House of Representatives

Financial Services Committee

Oversight & Investigations Subcommittee

Honorable Melvin L. Watt, Chairman

Honorable Gary G. Miller, Ranking Member

October 2, 2007

Hearing: "Credit-based Insurance Scores: Are They Fair?"

Testimony of Nathaniel S. Shapo, Partner, Katten Muchin Rosenman LLP
House Financial Services Committee, Oversight & Investigations Subcommittee
Hearing on credit based insurance scoring
October 2, 2007

Introduction

Mr. Chairman, Ranking Member Miller, and members of the subcommittee, thank you for the opportunity and the privilege to appear before you. My name is Nat Shapo. I am a partner at Katten Muchin Rosenman LLP. I was the Illinois insurance commissioner from 1999 until 2003.

In summary, my views regarding the use of credit based insurance scoring and the FTC Study are as follows:

- The Federal Trade Commission study, "Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance" (the "FTC Study"), submitted to Congress in July 2007 to fulfill the FTC's obligations under Section 215 of the Fair and Accurate Credit Transactions Act of 2003, confirms that use of credit based insurance scoring in the underwriting and rating processes of automobile insurers is a salutary practice under which insurers have faithfully fulfilled their mandate under applicable laws to accurately and fairly assess and classify risk—and from which consumers greatly benefit through premiums which correlate with their risk to the common fund.

- Prevailing American law and public policy requires insurers to fairly discriminate between risks. It establishes a term of art: fair discrimination. In practice, under both the plain language of the state anti-discrimination statutes and the well-developed case law, this means that fair discrimination is an underwriting and rating practice which accurately predicts risk of future loss. This is fair both under the term of art of "fair discrimination" and common sense, because it results in each consumer paying her fair share. Conversely, illegal "unfair discrimination" is a risk classification scheme which is not supported by actuarial data or which explicitly discriminates against a protected class—usually race, religion, or national origin.

- The use of credit based insurance scoring, since it is an objective and more precise predictor of risk of future loss, is consistent with decades of case law interpreting the unfair discrimination standard embedded in state insurance codes. It is pro-consumer in practice: It benefits a majority of consumers while adhering to and enhancing compliance with established norms of risk classification. And it is consistent with federal public policy: The use of credit based insurance scoring has been explicitly contemplated by the U.S. Fair Credit Reporting Act for decades.

- The FTC Study establishes that credit based insurance scores provide an effective tool for determining risk of future loss, and that they do not inappropriately serve as a proxy for protected classes. This makes credit based insurance scoring practices an appropriate and pro-consumer risk classification method—recognized as "fair discrimination" under the law—and should be fostered, rather than impaired, through policymakers' prudent oversight of this important sector of commerce.

Testimony of Nathaniel S. Shapo, Partner, Katten Muchin Rosenman LLP
House Financial Services Committee, Oversight & Investigations Subcommittee
Hearing on credit based insurance scoring
October 2, 2007

Prevailing Policy Throughout The United States Pertaining To Risk Classification Is Firmly Based On Encouraging And Requiring Insurers To Use Actuarially Based Methods Of Grouping Insurance Consumers.

The laws pertaining to risk discrimination create terms of art: fair discrimination and unfair discrimination. A rich vein of case law posits that actuarial justification is the lodestar distinguishing between fair and unfair discrimination. "'[U]nfair discrimination' is a word of art used in the field of insurance which, '[i]n a broad sense ... means the offering for sale to customers in a given market segment identical or similar products at different probable costs' [citations omitted]." *Polan v. State of New York Ins. Dept.*, 768 N.Y.S.2d 441 (N.Y.A.D. 1 Dept. 2003). Maryland's highest court stated it simply: "Unfair discrimination, as the term is employed by the Insurance Code, means discrimination among insureds of the same class based upon something other than actuarial risk." *Insurance Com'r for the State v. Engelman*, 345 Md. 402 (1997). Similarly, the Massachusetts Supreme Court explained: "This statutory scheme requires the commissioner to treat equally insureds who are of the same risk classification. This may result in 'fair discrimination.'" *Telles v. Commissioner of Ins.*, 410 Mass. 560 (1991).[1]

Courts have explained that their application of the unfair discrimination laws, per the legislatures' intent, establishes a norm of fairness for consumers because they will pay in to the

[1] Courts throughout the United States have offered the same analysis of the unfair discrimination laws. *See, e.g., Thompson v. IDS Life Ins. Co.*, 274 Or. 649 (1976) ("The Insurance Commissioner is instructed to eliminate unfair discrimination, whereas the Public Accommodations Act prohibits All discrimination. The reason for the different standards, as the plaintiff recognizes in her brief, is that insurance, to some extent, always involves discrimination, to a large degree based on statistical differences and actuarial tables.Document2zzB00551976113997 The legislature specifically intended, in enacting [the unfair discrimination statutes], to only prohibit Unfair discrimination in the sale of insurance policies."); *N.A.A.C.P. v. American Family Mut. Ins. Co.*, 978 F.2d 287 (7th Cir. 1992) ("Insurance works best when the risks in the pool have similar characteristics. For example, term life insurance costs substantially more per dollar of death benefit for someone 65 years old than for one 25 years old, although the expected return per dollar of premium is the same to both groups because the older person, who pays more, also has a higher probability of dying during the term. Auto insurance is more expensive in a city than in the countryside, because congestion in cities means more collisions. Putting young and old, or city and country, into the same pool would lead to adverse selection: people knowing that the risks they face are less than the average of the pool would drop out. A single price for term life insurance would dissuade younger persons from insuring, because the price would be too steep for the coverage offered; the remaining older persons would pay a price appropriate to their age, but younger persons would lose the benefits of insurance altogether. To curtail adverse selection, insurers seek to differentiate risk classes with many variables. Risk discrimination is not race discrimination."); *Doukas v. Metropolitan Life Ins. Co.*, 950 F.Supp. 422 (D.N.H. 1996) ("From this court's review of New Hampshire law, it appears that an insurance company's failure to rely on actuarial principles or actual or reasonably anticipated experience may be inconsistent with New Hampshire law.")

common fund in relation to their likelihood of taking out in the form of a claim.

> Indeed, valid underwriting practices promote fairness to the policyholder in not requiring him or her to bear in premiums the costs of insuring others in higher risk categories, and solvency of the insurer, another goal of insurance regulation [citation omitted].
>
> Correspondingly, provisions barring discrimination against insureds, akin to [the unfair discrimination statute], have been authoritatively construed not to apply when differential treatment has a proper underwriting basis. Thus, the statutory provision prohibiting discriminatory property and casualty rates [citation omitted] has been interpreted as "seek[ing] to assure that the rate charged shall bear reasonable relation to or be commensurate with the risk assumed and adequate for the class of risk to which they apply" [citation omitted]. And no violation of the law prohibiting discrimination by insurers based upon race, color, etc. [citation omitted] was held to have been committed by cancellation of fire insurance policies on commercial properties in heavily black-populated areas of New York City which "were motivated by underwriting and business reasons and not by racial hostility" [citation omitted]. ...
>
> [A]ppropriate classification of risks is sanctioned and encouraged throughout the Insurance Law.

Health Ins. Ass'n of America v. Corcoran, 551 N.Y.S.2d 615 (N.Y.A.D. 3 Dept. 1990).

The Massachusetts Supreme Court, not known as a conservative friend of business, similarly and crisply explained that, by correlating risk to premium levels, risk discrimination based on actuarially sound classifications benefits consumers.

> The basic principle underlying statutes governing underwriting practices is that insurers have the right to classify risks and to elect not to insure risks if the discrimination is fair.... The intended result of the process is that persons of substantially the same risk will be grouped together, paying the same premiums, and will not be subsidizing insureds who present a significantly greater hazard.

Life Ins. Ass'n of Massachusetts v. Commissioner of Ins., 403 Mass. 410 (1988).

The questions posed in today's credit based insurance scoring debate echo past legal and policy controversies pertaining to automobile insurers' use of risk factors which some objected to as not intuitively related to prediction of future loss.

In *State, Dept. of Ins. v. Insurance Services Office*, 434 So.2d 908 (Fla.App. 1 Dist. 1983), the Florida appellate court overturned a proposed regulation by the insurance commissioner which would have prohibited the use of gender, marital status, and scholastic achievement as rating factors. The court found that actuarial soundness, and correlation—as opposed to causation—is the prevailing public policy under which the law evaluates the appropriateness of a rating factor.

> [T]he insurance companies urge that the word "equitably" [citation omitted] means "accurately" in the actuarial sense. The hearing officer agreed, finding that the most equitable classification factors are those that are the most actuarially sound. In making this finding, the hearing officer relied upon the testimony of the Department's own Chief Actuary and Director of the Division of Rating. The hearing officer further found that the classification factors of sex, marital status and

> scholastic achievement, in light of the present state of the art in the industry, enhanced the actuarial soundness of a rate classification for automobile insurance. Thus, as the hearing officer concluded, the Department has not established that the use of the criteria prohibited by Rule 4-43.03 necessarily results in unfair discrimination.
>
> We find it highly significant that in presenting its argument on this point the Department has changed its own interpretation of the word "equitably," [citation omitted], as well as its interpretation of the phrase "unfairly discriminatory," relevant to this proceeding. Historically, the Department has measured the equitableness of a rating factor by its predictive accuracy....
>
> Thus, by implication, the legislature approved the interpretation that rates based upon sex, marital status or scholastic achievement are unfair only if those rating factors are found to be actuarially unsound. [Citation omitted.] As previously stated, the evidence below overwhelmingly shows these factors are actuarially sound.

Similarly, the Louisiana appellate court held that classifications based on age and gender are appropriate because they are statistically sound. The court specifically recognized that discrimination by forming actuarially based groups will penalize some members of the groups who are in fact good drivers. The court explained that this result will always occur with the use of any rating factor, but as long as the classification is objective and actuarially sound, it is welcome under the law as a fair method of assessing risk. The court pointed out, as the FTC Study found with respect to credit scoring, that the factors in question benefited a majority of drivers who paid a fairer premium.

> The evidence taken by the Commissioner indicates that there exists a sound statistical basis for using classifications based on age and sex in fixing insurance rates. It further appears that any classification system which results in different classes paying different rates for the same protection is, to some extent, discriminatory. If, for instance, age and sex are not used as factors in establishing classifications in automobile insurance rates, women and all those over 24 years of age, or about 75% of the drivers, would pay a higher premium, while those under 25 years of age, about one-fourth of the drivers, would pay substantially less than they are now paying. The older and more experienced drivers would therefore be discriminated against by having to subsidize the higher risk class of younger drivers.
>
> [The unfair discrimination statute] requires that the classifications used in establishing rates be reasonable, and not unfairly discriminatory. We agree with the trial judge that classifications based on age and sex are not unreasonable, and, although there is discrimination against the good, young driver, it is not unfair or unreasonable.

Insurance Services Office v. Commissioner of Ins., 381 So.2d 515 (La. App. 1979).

Federal law has followed these principles in its forays into regulating risk classification. Several federal courts have noted that the legislative history of the Americans With Disabilities Act (ADA) demonstrates a federal adherence to the basics of the unfair discrimination methodology described above. For instance, in *Piquard v. City of East Peoria*, 887 F.Supp. 1106 (C.D.Ill. 1995), the court reviewed the ADA and its legislative history and found that Congress had incorporated into federal law the safe harbor for actuarial justification found in the state unfair discrimination laws.

Testimony of Nathaniel S. Shapo, Partner, Katten Muchin Rosenman LLP
House Financial Services Committee, Oversight & Investigations Subcommittee
Hearing on credit based insurance scoring
October 2, 2007

> What does state law say about underwriting, classifying, and administering risks? Much of state insurance regulation is based on model legislation drawn up by the National Association of Insurance Commissioners ("NAIC"), a national organization of state insurance regulators. [Citation omitted.] Since 1960, all 50 states and the District of Columbia have adopted provisions of the NAIC's Unfair Trade Practices Act ("UTPA") in various forms. [Citations omitted.] Section 4G(2) of the Model UTPA, which has been adopted in whole or in part by 49 states, prohibits: "Making or permitting any unfair discrimination between individuals of the same class and of essentially the same hazard in the amount of premium, policy fees or rates charged for any accident or health insurance policy or in the benefits payable thereunder, or in any of the terms or conditions of such policy ..."
>
> [Citations omitted.] Thus, under the ADA, as the EEOC explains and state law provides, benefit plan classification and administration of risks with regard to disabled persons requires the grouping of individuals of the same class and of essentially the same hazard in the amount of premiums, benefits payable, or any other terms or conditions of such benefit plan. [Citation omitted.]
>
> Section 3 of the NAIC's Model Regulation on Unfair Discrimination in Life and Health Insurance on the Basis of Physical or Mental Impairment prohibits:
> [R]efusing to insure, or refusing to continue to insure, or limiting the amount, extent or kind of coverage available to an individual, or charging a different rate for the same coverage solely because of physical or mental impairment, except where the refusal, limitation or rate differential is based on sound actuarial principles or is related to actual or reasonably anticipated experience.
>
> [Citations omitted.] The ADA's legislative history expressly adopts state insurance unfair discrimination regulation. Virtually all States prohibit unfair discrimination among persons of the same class and equal expectation of life. The ADA adopts this prohibition of discrimination. Under the ADA, a person with a disability cannot be denied insurance or be subject to different terms or conditions of insurance based on disability alone, if the disability does not pose increased risks.
>
> [Citations to House and Senate Reports.] The House and Senate Reports further state that: [W]hile a plan which limits certain kinds of coverage based on classification of risk would be allowed under this section, the plan may not refuse to insure, or refuse to continue to insure, or limit the amount, extent, or kind of coverage available to an individual, or charge a different rate for the same coverage solely because of a physical or mental impairment, except where the refusal, limitation, or rate differential is based on sound actuarial principles or is related to actual or reasonably anticipated experience.
>
> [Citations to House and Senate Reports.] These explanations by the House and Senate of the types of benefit plans and practices allowed and prohibited under Section 501(c) exactly mirror Section 3 of the NAIC's Model Regulation on Unfair Discrimination in Life and Health Insurance on the Basis of Physical or Mental Impairment. Thus, Congress expected that under the ADA, a benefit plan or practice which refuses an individual participation solely because of a disability must be supported by actuarial principles or related to actual or reasonably anticipated experience as required by State law.

Thus, when Congress legislated to protect people from discrimination based on an essentially immutable characteristic—a disability—it still applied the basic unfair discrimination principle with respect to insurance, allowing carriers to actuarially classify risk. When applying this

Congressional approach to insurance scoring models which utilize credit scores—far from an immutable characteristic—one would expect Congress to strongly support insurers' use of what the FTC has found, as discussed below, to be an actuarially sound method of assessing and grouping risk, particularly since use of credit based insurance scores by carriers has long been authorized under the federal Fair Credit Reporting Act.

In other words, if it is allowable to use disability—an immutable characteristic—as an actuarially justified classification factor under a federal statute which is designed to protect those with that characteristic, then federal public policy would seem to strongly suggest that an actuarially sound classification factor which is not an immutable characteristic and which is explicitly condoned under federal law should be fostered, not criticized.

The FTC Report—And Studies Regarding The Effects Of The Use Of Credit Score Data On Protected Classes By The Texas Department Of Insurance And The Federal Reserve—Clearly Demonstrates That The Use Of Credit Based Insurance Scores Meets The Standard Embodied In The Law For Appropriate Underwriting, And Produces Positive Results For Consumers.

The FTC recently performed an extensive, Congressionally mandated analysis of data pertaining to the use of credit based insurance scoring. The report concluded that this risk classification practice is an accurate predictor of future loss, and, consistent with the discussion above, that credit based insurance scoring benefits consumers in a manner consistent with the norms of fair discrimination embedded in prevailing public policy and law throughout the United States.

The FTC found:

> 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. The use of scores is therefore likely to make the price of insurance better match the risk of loss posed by the consumer. Thus, on average, higher-risk consumers will pay higher premiums and lower-risk consumers will pay lower premiums.

FTC Study, p. 3. In other words, credit based insurance scoring furthers the prevailing public policy objective of matching premiums paid into the common fund with risk of loss to the fund.

As discussed above, insurance risk classifications are judged by their overall effects on the members of the group formed by the classification. Every risk factor will result in discrimination against some members of the classification who are in fact good risks. Some 16 year olds are careful and skilled drivers, but using their age as a highly probative factor is acceptable because it produces actuarially effective results for the group as whole. The FTC Study demonstrates that credit based insurance scoring similarly produces this helpful result.

The FTC Study found that credit based insurance scoring results may produce further potential

benefits to consumers.

> Use of credit-based insurance scores may result in benefits for consumers. For example, scores permit insurance companies to evaluate risk with greater accuracy, which may make them more willing to offer insurance to higher-risk consumers for whom they would otherwise not be able to determine an appropriate premium. Scores may also make the process of granting and pricing insurance quicker and cheaper, cost savings that may be passed on to consumers in the form of lower premiums.

FTC Study, p. 3. Again, the findings of the FTC Study track the language in decades of case law pertaining to the positive results for consumers derived from desirable risk classification practices by insurers.

And, importantly with respect to the policy concerns regarding demographic effects of credit based insurance scoring—which largely spurred the Congressional mandate upon the FTC in the FACT Act to perform the study discussed herein—the FTC found that the use of credit based insurance scores does not serve as a proxy for race, and does not produce results which impact protected classes more severely than other underwriting and rating factors.

> 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 relationship between scores and claims risk remains strong when controls for race, ethnicity, and neighborhood income are included in statistical models of risk.... Several other variables in the FTC's database ... have a proportional proxy effect that is similar in magnitude to the small proxy effect associated with credit-based insurance scores. Tests also showed that scores predict insurance risk within racial and ethnic minority groups (e.g., Hispanics with lower scores have higher estimated risk than Hispanics with higher scores). This within-group effect of scores is inconsistent with the theory that scores are solely a proxy for race and ethnicity.

FTC Study, p. 4.

The findings of the FTC Study mirror those of the largest state study of credit based insurance scoring, a statutorily mandated review by the Texas Department of Insurance. The insurance commissioner, in his report to the governor and the legislature, wrote:

> Prior to the study, my 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. Hence, there would be evidence that credit scoring was a coincidental variable that served as a surrogate for an unlawful factor in rating and underwriting. If this were proven to have been the case, I would have had a legal basis to make the connection between disproportionate impact and intentional discrimination, and either ban credit scoring outright or adopt an allowable rate difference of zero, meaning no rate differences due to credit scoring.
>
> The study, however, did not support those initial suspicions. Credit scoring, if continued, is not unfairly discriminatory as defined in current law because credit scoring is not based on race, nor is it a precise indicator of one's race. Recall that not all minorities are in the worst credit score categories. Further, its use is justified actuarially and it adds value to the insurance transaction.

Cover letter from Texas Insurance Commissioner Jose Montemayor, Jan. 31, 2005, affixed to his report entitled "Use of Credit Information by Insurers in Texas."

Furthermore, the Federal Reserve study submitted to Congress pursuant to the FACT Act reached a similar result with respect to the question of credit history scores' effect on demographic groups.

> The credit history scores evaluated here are predictive of credit risk for the population as a whole and for all major demographic groups.... Results obtained with the model estimated especially for this study suggest that the credit characteristics included in credit history scoring models do not serve as substitutes, or proxies, for race, ethnicity, or sex.... There is no compelling evidence ... that any particular demographic group has experienced markedly greater changes in credit availability or affordability than other groups due to credit scoring.... Credit 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.... This study reviewed the extent to which the consideration or lack of consideration of certain factors by credit-scoring systems could result in a negative or positive differential effect for different populations. By law and regulation, an individual's personal characteristics—such as race or ethnicity, national origin, sex, and, to a limited extent, age—must be excluded from credit-scoring models. A concern exists that, despite that prohibition, a credit characteristic may be included in a model not because it helps predict performance but because it is a substitute, or proxy, for a demographic characteristic that is correlated with performance. The analysis of the data assembled for this report found that few credit characteristics, including those in the FRB base model, were correlated with personal demographics and that therefore they were unlikely to serve as proxies for demographic characteristics.... Reestimating the FRB base model in a race-neutral environment had little effect on credit scores. The result suggests that none of the credit characteristics included in the model serve, to any substantive degree, as proxies for race or ethnicity.

Board of Governors of the Federal Reserve System, "Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit."

Both Congressionally mandated studies under the FACT Act, as well as the Texas Department of Insurance report, thus demonstrate that the long-standing federal policy embedded in the Fair Credit Reporting Act, which explicitly contemplates that credit data will be used in the insurance risk classification process, does not result in improper detriment to protected demographic groups.

State Legislatures Are Conscientiously Considering And Addressing The Specific Concerns Raised By Consumers Regarding The Use Of Credit Based Insurance Scoring Through Reasonable Legislation Which Protects The Insurance Buying Public.

Insurance is surely a heavily regulated industry infused with the common good, and state governments shoulder the primary responsibility for regulating this essential form of commerce under the McCarran-Ferguson Act. State legislatures and insurance regulators throughout the

United States during this decade have been thoroughly debating specific concerns raised by consumers about the fair use of credit based insurance scoring models, and have been taking thoughtful and effective action by passing appropriate regulatory statutes.

Like any other innovation in commerce, credit based insurance scoring can manifest itself in ways which raise questions about fairness. A cluster of issues has been identified by policymakers as the most consistently expressed set of consumer concerns, including, but not necessarily limited to, calls for: laws instituting appropriate consumer disclosures; protections for consumers whose credit scores have suffered because of a medical emergency; preventing the use of credit as the sole factor in an underwriting or rating decision to the exclusion of all other risk classification tools; and ensuring that credit based insurance scoring decisions are made based on fresh scores.

A majority of states have passed laws—many based on the National Conference of Insurance Legislators' Model Act Regarding Use of Credit Information in Personal Insurance—regulating the use of credit based insurance scores which incorporate provisions protecting consumers with respect to these and other legitimate and well-expressed concerns of policymakers. This has had the effect of rounding sharp edges resulting from use of credit based insurance scoring which are the most likely to generate complaints from the insurance buying public.

These are reasonable restrictions which ultimately enhance the use of credit based insurance scoring, consistent with its promise to help automobile insurers meet the goal of implementing fair risk classifications for the benefit of consumers—rather than smothering the practice through draconian regulation. I urge the subcommittee to encourage the former rather than the latter approach to regulation of credit based insurance scoring, a tool which the FTC Study has shown is a positive commercial development for consumers.

States have to date balanced the market benefits of credit based insurance scoring with the need to respond to documented consumer problems. Congressional oversight of this important issue in interstate commerce is quite appropriate, but—consistent with the Fair Credit Reporting Act's affirmative authorization of the use of credit based insurance scores, and the FTC Study's conclusions in response to the mandate of the Fair and Accurate Credit Transactions Act that this risk classification method is consistent with controlling law, beneficial to consumers, and fair to protected classes—I do not believe that federal intervention to supplement the states' regulation of credit based insurance scoring is necessary in order to effectively regulate these insurer practices.

Conclusion

I believe that the FTC Study demonstrates that the use of credit based insurance scoring methods is beneficial to consumers and is consistent with insurers' obligations under well-established public policy that controls risk discrimination practices in underwriting and rating.

Testimony of Nathaniel S. Shapo, Partner, Katten Muchin Rosenman LLP
House Financial Services Committee, Oversight & Investigations Subcommittee
Hearing on credit based insurance scoring
October 2, 2007

The use of credit based insurance scores appears to be an example of insurers doing exactly what the law expects of them both in letter and spirit.

While some view the use of anything pertaining to credit scores to be somehow counter-intuitive and inconsistent with traditional notions of fair risk classification practices, all the evidence suggests the opposite.

- The use of credit based insurance scores is an excellent predictor of future risk, which is the essence of insurers' responsibility under the law.
- It is fair because it pairs premiums with an insured's likelihood to take money back from the common fund.
- It is—and has been for decades—explicitly authorized under federal law in the Fair Credit Reporting Act.
- Insurance risk classification principles revolve around pegging underwriting and rating decisions to correlation with risk of future loss, not causation, so actuarial results are dispositive and should settle the matter. Nevertheless, I do not find persuasive the argument that some have made questioning how a person's credit history could be relevant to her risk as a driver. The relationship between the rating tool and the risk seems quite logical to me: The types of personal characteristics which make a person a safe driver—patience, care, deliberate decision making, etc.; in sum, risk averseness—are the same types of traits which make a person likely to achieve a good credit score.

When an insurance practice is found to be objectively fair and beneficial to consumers, the insurance laws should not prohibit or substantially restrict it. The Fair Credit Reporting Act specifically contemplates the use of credit data by insurers in their classification of risk., and the strong import of recent studies pertaining to the practice is that this is a fair practice which benefits consumers while not harming protected demographic groups.

I therefore believe that credit based insurance scoring should be encouraged and facilitated under the law, not banned or substantially restricted, and I hope the subcommittee will consider my remarks—and, most importantly, the clear import of the conclusions reached by the FTC Study—in its oversight of this important issue.

I am deeply grateful for the honor of appearing before you today and would be pleased to answer any of the committee's questions.

HOUSE BILL REPORT
ESHB 2544

As Passed Legislature

Title: An act relating to using credit history for insurance purposes.

Brief Description: Restricting use of credit history.

Sponsors: By House Committee on Financial Institutions & Insurance (originally sponsored by Representatives Cooper, Benson, Santos, Clements, Simpson, McIntire, Armstrong, Hunt, Romero, Dickerson, Upthegrove, Chase, Ogden, Haigh, Conway, Kenney, Campbell and Linville; by request of Governor Locke, Insurance Commissioner and Attorney General).

Brief History:
Committee Activity:
Financial Institutions & Insurance: 1/30/02, 2/8/02 [DPS].
Floor Activity:
Passed House: 2/18/02, 93-4.
Passed Senate: 3/5/02, 36-11.
Passed Legislature.

Brief Summary of Engrossed Substitute Bill

- Prohibits insurers from cancelling or refusing to renew a personal insurance policy due to a person's credit history.
- Permits an insurer to consider credit history in the evaluation of a new customer applying for insurance, provided such history is considered in conjunction with other substantive factors.
- Prohibits an insurer from considering certain types of credit history information in the process of underwriting and rate setting.
- Requires insurers to make specified disclosures to a consumer if credit history leads to an adverse action against the consumer.
- Requires an insurer to file its insurance scoring model with the Insurance Commissioner.

HOUSE COMMITTEE ON FINANCIAL INSTITUTIONS & INSURANCE

Majority Report: The substitute bill be substituted therefor and the substitute bill do pass. Signed by 6 members: Representatives Cooper, Chair; McIntire, Vice Chair; Hatfield, Miloscia, Santos and Simpson.

Minority Report: Do not pass. Signed by 5 members: Representatives Benson, Ranking Minority Member; Barlean, Cairnes, Mielke and Roach.

Staff: Thamas Osborn (786-7129).

Background:

Credit reports have been used for many years by the insurance industry in making property and casualty underwriting decisions; more recently, the industry has used credit history information in the setting of insurance rates and the development of "credit scoring" models for underwriting and rate setting purposes. The credit reporting industry consists of over 600 credit bureaus that accumulate credit data on a local or regional basis. These bureaus, in turn, provide data to the three national credit reporting companies: TRW, Trans Union, and Equifax. It is these companies that generate the credit reports most often used by financial institutions, insurance companies, and other commercial entities.

Both the federal Fair Credit Reporting Act (15 USC, Section 1681) and the state Fair Credit Reporting Act (Chapter 19.182 RCW) explicitly allow consumer reporting agencies to release credit reports to insurance companies for insurance underwriting purposes. Accordingly, insurance companies have utilized these reports for many years as a factor to be considered in determining which individuals are eligible for coverage and/or what the terms of such coverage will be. The weight given to credit reports, in conjunction with other factors, varies widely within the industry, thus there is no one practice that can be ascribed to the industry as a whole.

In recent years, the review of an individual's credit report in the insurance underwriting process has given way to the consideration of the individual's "credit score." A credit score is a number generated via a computer program that analyzes the data in an individual's credit report. The computer program uses an algorithm to reduce credit report data to a single numerical score, ranging from 300 to 850. According to the proponents of credit scoring, an individual with a higher score poses a lower risk of loss to the insurance company than does an individual with a lower score.

Generally, credit scores are calculated either by the insurance company using its own computer model or by third-party vendors such as the Fair Isaac Company or Choice Point, who contract with insurers to do credit score calculations. Many different modeling programs are used throughout the industry, thus there is no uniformity between companies with respect to the criteria used in generating the score.

At present, there is no explicit state regulation of the insurance industry's use of either consumer credit information or credit scoring. However, the Office of the Insurance Commissioner (OIC) does have general legal authority to regulate the rate setting practices of those insurance companies doing business in Washington. This authority is quite broad and provides a basis for regulatory action whenever a rate setting practice can be proved to be "excessive, inadequate, or unfairly discriminatory." Furthermore, pursuant to administrative rule, the OIC requires that any rate setting process be "actuarially sound," which means that there must be a demonstrable statistical correlation between the premium rate and the actual risk of loss.

Summary of Engrossed Substitute Bill:

An insurer's decision to cancel or not renew an existing policy of personal insurance cannot be based - in whole or in part - on an insured's credit history. However, an insurer may use credit history as the basis for placing an insured with another company affiliated with the insurer.

An insurer is permitted to consider credit history in the evaluation of a new customer applying for insurance, provided such credit history is considered in conjunction with other substantive underwriting factors. An offer of placement with an affiliate insurer does not constitute a denial of coverage.

There are certain types of credit history information that can neither be considered in rate setting nor form the basis of an insurer's decision to deny coverage, including:

- An absence of credit history;
- The number of credit inquiries;
- Credit history related to medical care;
- Entries related to the initial purchase or finance of a house or car;
- Use of a particular type of credit, debit, or charge card;
- The dollar amount of a consumer's available credit.

An insured is provided with remedies if his or her insurance coverage is adversely affected by an inaccurate credit history.

An insurer that takes any adverse action against a consumer based on credit history must provide the consumer with written notice. The notice must identify those aspects of the consumer's credit history that played a significant role in the decision leading to the

adverse action. The insurer must also inform the consumer that the consumer is entitled to a free copy of his or her credit report.

An insurer must file its insurance scoring model with the Insurance Commissioner as a condition precedent to the consideration of credit history in either the setting of premium rates or in determining eligibility for coverage. Insurers are prohibited from considering specified categories of credit history information as part of the rate setting process.

The Insurance Commissioner is required to report to the legislature on the implementation of the act and regarding issues related to the use of credit history in personal insurance underwriting.

The provisions of the act pertaining to insurance underwriting are applicable to all policies of personal insurance issued or renewed after January 1, 2003.

The provisions of the act pertaining to premium rate setting are applicable to all personal insurance policies issued or renewed on or after June 30, 2003.

Appropriation: None.

Fiscal Note: Not Requested.

Effective Date: Ninety days after adjournment of session in which bill is passed.

Testimony For: This bill addresses a fairness issue regarding how insurance companies use credit scoring. Credit scoring is not uniform among companies, and how much weight each company places on credit scoring or how a particular credit report is scored is a mystery. Credit scoring should not be used without a fair indicator of how the number is apprized. Insurance rates should be based on the merits of one's actions. There have been hundreds of complaints filed in the OIC regarding insurance companies use of credit scoring for underwriting and rate setting purposes. For example, one woman who paid her premiums and never had an accident was told that her premiums went up because her credit rating was bad due to a period of unemployment. A woman who had her insurance premium rates increase by 46 percent, even though she paid all her premiums on time, discovered that her credit score was low due to a bankruptcy filed by her ex-husband. A couple was denied access to reasonable rates because they paid all their bills in cash and, therefore, had no credit history. There are many reasons for a low credit score that do not take into account individual circumstances or credit-worthiness. Using credit scoring to determine if a consumer qualifies for insurance and how much they will pay for coverage is a concern for several reasons. The factors used may disadvantage protected classes of people. Some ethnic groups and religious groups do not use credit and their credit scores may be low or non-existent because of this. Credit reports are not always accurate and it is very difficult to correct errors.

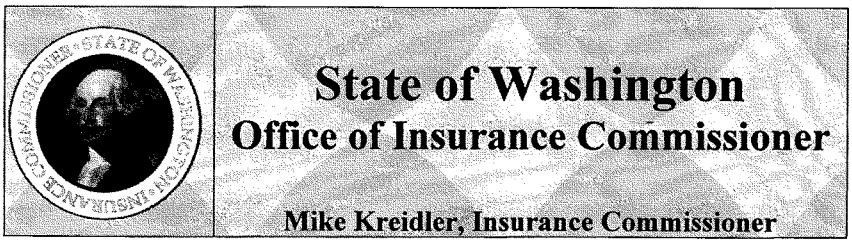
Credit scoring penalizes people who encounter temporary hardships. Consumers would like an outright ban on insurance credit scoring, however, this bill simply regulates the insurance companies use of credit scoring.

Testimony Against: The restrictions on insurers use of credit based insurance scores will require low risk consumers to pay staggeringly higher home owner and auto insurance premiums in order to subsidize the losses of higher risk policy owners. Using insurance scores for underwriting and rating has helped make insurance coverage more available for millions of drivers and home owners. Credit data helps insurers determine a fair pricing structure by better matching of rates with risk of loss. Any restriction that tends to impose uniformity on how insurers use credit based insurance scores would hamper their ability to enter new markets or take on more customers. Credit information provides an objective, unbiased tool for underwriting and rating risk. Insurance scores do not consider income, address, race, ethnicity, religion, gender, marital status, disability, nationality or age. Insurance scores have proven to predict future losses. The 20 percent cap is arbitrary and without any actuary support. Many insured will see a rate increase if the cap is implemented. For example, one company indicates that 80 percent of its customers have discounts of 25 percent or more; therefore, 80 percent will see their premiums go up. Insurance companies place risks in categories and then charge premiums for those categories. The problem for the industry is that they are not supposed to look at an individual; they are supposed to classify risks and make sure that within a risk category there is enough premium charged to pay the bills when a claim is made.

Testified: (In support) Representative Cooper, prime sponsor; Michael Kreidler, Insurance Commissioner; Ahndrea Blu, Governor's Office; Christine Gregoire, Attorney General; Robert Pregulman, WashPIRG; Mike Dunkin, Insurance Agent; Jenni D'aris and Ron Romer, citizens; Curtis Fackler, Payroll Plus; and Gene Forrester, Senior Citizens Lobby.

(With concerns) Bruce Pleasant, Allstate Agent; Bill Stauffacher, Independent Insurance Agents and Brokers; and Clark Sites, Professional Insurance Agents.

(Opposed) Michael Harrold, National Institute of Independent Insurers; Mike Kapphahn, Farmers Insurance; Larry Kibbee, Alliance of American Insurers; Scott Spriggs, Progressive Auto Insurance; Elizabeth Moceri and Jim DeBruler, Allstate Insurance; Jean Leonard, State Farm Insurance/Alliance of American Insurers; and Basil Badley, American Insurance Agency.



A Report to the Legislature:

Insurance Credit Scoring

Submitted By: The Office of Insurance Commissioner
December 2003

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Executive Summary

In 2002, the Washington State Legislature passed one of the toughest credit scoring laws in the nation. The law applies to personal auto and homeowners' policies. ESHB 2544 changed how insurers use credit history in Washington State. After January 1, 2003, insurance companies could not use credit history to cancel or non-renew a personal insurance policy (primarily auto and homeowners insurance). In addition, insurers cannot use the following attributes of credit history to deny insurance coverage:

- The absence of credit history;
- The number of credit inquiries;
- Collection accounts identified as medical bills;
- The purchase of a vehicle or house that adds a new loan to the consumer's existing credit history;
- A consumer's use of a particular type of credit or debit card; or
- The total line of credit available to a consumer.

After June 30, 2003, insurers could not use most of these factors to set premiums. The one exception – insurers can use the absence of credit history to set premiums if they provide statistical data that proves consumers without credit histories are more likely to file claims. Other consumer protections in the law include:

- Retroactive correction of premium if an insurer uses incorrect credit history for rating or underwriting; and
- Enhanced notice requirements so that consumers know what items in their credit history are affecting their insurance premiums.

Much has changed relative to insurance credit scoring since Washington's law was enacted. Many other states have acted to restrict how insurers use credit history. At least 32 laws have passed in the last two years related to insurance credit scoring.

Commissioner Kreidler serves as co-chair of the National Association of Insurance Commissioners Credit Scoring Working Group (CSWG). The CSWG has worked to educate regulators and legislators on effective ways to regulate insurance credit scoring and developed tools to educate consumers.[1]

In January 2003, the Commissioner reported to the Legislature that insurance credit scoring might have unequal effects on some minority groups when compared to whites. Washington State has also provided technical assistance to a group of states that will examine whether insurance credit scoring has a disparate or disproportionate impact on minorities or low-income people. The Federal Trade Commission (FTC) will also be looking at this issue.

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[1] The NAIC adopted a matrix titled Analysis of Regulatory Options and a consumer brochure titled Understanding How Insurers Use Credit Scoring.

With its recent reauthorization of the federal Fair Credit Reporting Act (FCRA), Congress has directed the FTC to examine the effects of credit-based insurance scores on the availability and affordability of property and casualty insurance.

The Legislature required the Commissioner to review how the OIC implemented ESHB 2544 and how the law has affected consumers. For the OIC, implementation had several steps. First, the OIC provided information to consumers and insurers about the law. The OIC used its website and communicated with the media to make sure consumers knew what their rights were under the new law.

Second, the OIC published rules to help insurers adjust their underwriting practices and rating plans. The OIC followed up with a technical advisory to remind insurers that they must implement changes to their rating plans before June 30, 2003. Then OIC instituted a "fast-track" filing review process for insurers that needed to revise their rating plans to comply with the law. Eventually, there was widespread compliance with the law.

The implementation process did reveal a technical flaw in the law that the OIC proposes to correct. OIC believes that the intent of the Legislature was to require every insurance organization to file their credit-based rating plans and to provide actuarial support for those plans. Some insurance organizations have argued that the filing requirements do not apply to insurers that offer products through a multi-company distribution network. The OIC recommends the enactment of legislation that makes it clear that entities that sell personal insurance products – regardless of their organizational structure – must comply with the law.

The effect of ESHB 2544 on consumers is hard to measure, for several reasons. First, restrictions on the use of credit history to set premiums have been in effect for about six months. It is too early to draw conclusions. Second, insurance credit scoring is only one factor insurers use to set insurance premiums.

Insurance credit scoring remains controversial. OIC received about 3,000 contacts from consumers about insurance credit scoring in 2003. Based on these contacts, the OIC has these observations:

- Cancellation and non-renewal due to credit history - one of the primary complaints of consumers in 2001 and 2002 – is no longer an issue in Washington State.
- Consumers are more aware that insurers use credit history to make pricing decisions.
- The "adverse action" notices provided by insurers to consumers need improvement. Insurers and vendors of insurance scoring models must work harder to provide useful information to consumers that explains how and the extent to which credit history affects insurance prices.
- The confidentiality of insurance scoring models inhibits the ability of the OIC to help consumers understand insurance credit scoring.

Introduction

In 2002, the Washington State Legislature enacted ESHB 2544.[2] This law restricts the use of credit history in personal lines insurance underwriting and ratemaking. The most common types of personal lines insurance are auto and homeowners insurance.

ESHB 2544 had a two-phased effective date:

1. Underwriting restrictions (denial, cancellation, or non-renewal of an insurance policy) took effect on January 1, 2003.

2. Rating restrictions took effect on June 30, 2003.

In response to the continuing debate regarding the validity of insurance credit scoring as an underwriting and rating tool and concerns about the impact of credit scoring on protected classes of people and the poor, the Legislature directed the Commissioner to provide two reports. The Commissioner delivered the first report to the Legislature in January 2003.

Summary of the First Report

The first report[3] was a review and analysis of insurance credit scoring including these topics:

- Based on demographic factors, the types of consumers who benefit from or are harmed by the use of credit history in personal insurance rating and underwriting.
- The extent to which the use of credit history affects rates charged to consumers.
- Whether insurance credit scoring results in discrimination against a protected class of people or the poor.

Washington State University Social & Economic Sciences Research Center (SESRC) prepared the first report. The SESRC report found several significant demographic patterns when insurance credit scoring was used in personal insurance underwriting and rating, including:

- **Age:** SESRC concluded that older drivers have better insurance credit scores and, as a result, lower insurance rates.
- **Income:** SESRC concluded that credit scores and, consequently, insurance premiums, improve as incomes rise.
- **Ethnicity:** While SESRC could not draw broad conclusions about ethnicity, SESRC did observe that if minorities had significant premium differences from whites, the premiums tended to be higher. This observation did not apply to Asian/Pacific Islanders.

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[2] http://www.leg.wa.gov/pub/billinfo/2001-02/House/2525-2549/2544-s_sl_04092002.txt
[3] http://www.insurance.wa.gov/publications/news/Final_SESRC_Report.pdf

- The SESRC analysis also considered gender, marital status and location and found that premium differences based on insurance credit scoring were infrequent.

Scope of Second Report

This document is the second report requested by the Legislature. It will:

- Comment on current issues related to the use of credit history in personal insurance underwriting and rating;
- Review how the OIC implemented ESHB 2544; and
- Comment on how ESHB 2544 has affected consumers to date.

History

Use of Credit History in Insurance Underwriting and Rating:

The use of credit history in insurance underwriting and rating has been the subject of increasing discussion and debate throughout the United States. The consumer lending industry has used credit scoring since the 1980s to predict whether a borrower would repay a loan. In the early 1990s, insurers began to use credit history to underwrite auto and homeowners insurance. Later in the decade, insurers began using credit history to set insurance prices. Most of the "personal lines" insurers (auto and homeowners) in Washington State currently use insurance credit scoring for rating and/or underwriting purposes.

Insurance credit scoring is a way for insurers to automate their underwriting processes. Data are used to create a score – much like getting a grade in school. These scores are called "insurance credit scores" because the score is often a combination of several types of data, including:

- Credit history;
- Loss history; and
- Other personal attributes, such as the insured's driving record.

The Issues

What Insurers say about Insurance Credit Scoring

Insurers say a correlation exists between credit history and insurance losses, and that this correlation justifies their use of insurance credit scoring. Other insurance industry arguments in favor of insurance credit scoring include:

- The use of credit information helps consumers who have good credit.
- Insurance credit scoring is "color blind" and does not discriminate against any protected class of people.
- There is no correlation between a person's income and their insurance credit score. In other words, high income does not always lead to a good score and low income does not always lead to a lower insurance credit score.

What Consumer Groups say about Insurance Credit Scoring

Consumer groups generally oppose the use of credit history by insurance companies for underwriting and rating purposes. Some of their arguments against insurance credit scoring include:

- Data in credit reports are often inaccurate, and the process for correcting errors is cumbersome and time-consuming.
- There is considerable variation in the insurance credit scoring models, making it difficult for consumers to understand how insurance credit scoring works or how they can improve their scores.
- The models are confidential, and insurers and some vendors of insurance scoring models are not very forthcoming about data or formulas used in the models.
- The use of credit history in insurance underwriting and rating results in higher premiums for certain minority groups and low-income people.

Activity in Washington State

In the 1990's

In August of 1996, Commissioner Deborah Senn issued Bulletin 96-2,[4] which instructed insurers to provide notice if they cancelled, denied or non-renewed insurance coverage based on credit history. This bulletin supported the provisions of the federal Fair Credit Reporting Act (FCRA), which requires insurers to provide notice when they take an adverse action against a consumer.

The bulletin, issued in response to consumer complaints, restated WAC 284-30-570,[5] and reminded each insurer that it must provide the "true and actual reason" for an underwriting action, including actions based on credit information. The bulletin told insurers to provide specific information about the attributes in the consumer's credit history that led to the adverse underwriting decision. The intent of the bulletin was to enable consumers to correct errors in their credit reports.

In 1996, the OIC had limited oversight over how insurers used credit history, since the federal FCRA allows insurers to use credit history for underwriting purposes. Without explicit statutory authority, such as that granted in ESHB 2544, it was up to the Federal Trade Commission (FTC) to determine whether insurers were providing inadequate notice.

Recent Activity

Consumer awareness of insurance credit scoring intensified when insurers began using it for rating purposes. In 2001, Commissioner Kreidler met with consumer advocates and the insurance industry to listen to their views on insurance credit scoring.

In the fall of 2001, the Commissioner held a series of public hearings across the state on insurance credit scoring. The Commissioner found overwhelming public concern about how insurers used credit history in underwriting and rating. Recurring themes that were cited in the public testimony included:

- Insurers would not explain how they used credit history or which pieces of the credit history were most important to their insurance scoring models. As a result, insurance agents felt helpless when a client had questions about how insurance credit scoring affected their premiums and consumers felt frustrated and confused.
- Consumers did not understand the relationship between credit history and the price they paid for auto or homeowners insurance.
- Personal crises, such as catastrophic medical bills, divorce and recent unemployment can cause credit problems. Consumers said it was unfair to be penalized with higher insurance premiums while working through a personal crisis.

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[4] http://www.insurance.wa.gov/oicfiles/techadvisories/96-02.pdf
[5] http://www.leg.wa.gov/wac/index.cfm?fuseaction=Section&Section=284-30-570

- Insurance scoring models penalized people who did not use credit. Ethnic groups and senior citizens said it was unfair to penalize a person who decides to manage their personal finances without borrowing money.
- Some people had no accidents, tickets or claims, but their insurance premiums went up or they were non-renewed based on their credit history.

The concerns expressed in these public hearings led to legislative action. In the 2002 legislative session, Commissioner Kreidler, Attorney General Christine Gregoire, and Governor Gary Locke jointly asked the Washington State Legislature to enact restrictions on the use of insurance credit scoring. In response, the Legislature enacted ESHB 2544. The law (codified in RCW 48.18.545[6] and 48.19.035[7]) has several key provisions:

- It prohibits insurance companies from canceling or non-renewing a person's insurance policy because of an insurance credit score.
- It requires other significant underwriting factors to be present in addition to a poor insurance credit score in order to deny an application for insurance.
- It prohibits the use of certain factors in insurance credit scoring formulas. These factors include: The number of credit inquiries; medical collections; the initial purchase or finance of a vehicle or home; type of credit, debit, or charge card; total amount of available credit; and the lack of credit history (unless actuarially justified using demographic data).
- It requires retroactive correction of premium if the consumer successfully disputes information included on their credit report.

[6] http://www.leg.wa.gov/RCW/index.cfm?fuseaction=section&section=48.18.545
[7] http://www.leg.wa.gov/RCW/index.cfm?fuseaction=section&section=48.19.035

Recent Action by the States

The use of credit history by insurance companies to make pricing decisions caught the attention of the public, insurance regulators, legislators and the media. As insurers increased their use of insurance credit scoring, legislators have responded. States across the country have passed laws on this subject. In 2002, thirty state legislatures considered laws related to the use of credit information for insurance purposes. Eventually, eleven states, including Washington, passed new laws. Legislative activity continued in 2003, resulting in at least twenty-one new laws in various states related to insurance credit scoring.

Washington's 2002 law was one of the first and most comprehensive pieces of legislation to address the problems with insurance credit scoring. This law was drafted using many of the terms and concepts in the federal FCRA. Other states have followed Washington's example[8] in key areas, including provisions that:

- Require insurers to retroactively correct premiums if an insurer uses incorrect credit history for rating or underwriting purposes.
- Require an insurer that takes an adverse underwriting or rating decision to tell the consumer about the most important factors in their credit history that lead to that decision.
- Require insurers to file their insurance scoring models with the respective insurance departments.
- Restrict the ability of an insurer to cancel or non-renew personal insurance based on credit history (although Washington's restrictions are tougher than most other states).
- Ban the use of credit inquiries and collection accounts identified with a medical industry code from insurance credit scoring models.

[8] The National Conference of Insurance Legislators (NCOIL) adopted the Model Act Regarding Use of Credit Information in Personal Insurance. This model law contained a number of provisions from Washington's laws and regulations. It is available at http://www.ncoil.org/.

Activity by the National Association of Insurance Commissioners (NAIC)

The National Association of Insurance Commissioners (NAIC) has looked at this issue several times. In 1997, the NAIC issued a paper on insurance credit scoring. The report made recommendations, but did not result in any widespread changes to insurance regulatory practices related to insurance credit scoring.

In December of 2001, with the encouragement of Washington State, the NAIC formed a working group to study these issues. The Credit Scoring Working Group (CSWG)[9] has continued to play a role in this debate. Commissioner Kreidler serves as co-chair of the CSWG. Significant accomplishments for the CSWG include:

- Working in partnership with the FTC to clarify that an insurer must send a notice if the insurer takes an adverse underwriting or rating action against a consumer.[10] Insurers had argued that rating actions were not covered by the federal FCRA.
- Using the resources of the American Academy of Actuaries (AAA) to review, evaluate and comment on existing studies of insurance credit scoring.[11]
- Developing a matrix of options for insurance regulators and legislators to consider as they work to solve issues that result from insurance credit scoring. The NAIC adopted this matrix, titled Analysis of Regulatory Options, on March 10, 2003.[12]
- Creating a brochure, titled Understanding How Insurers Use Credit Scoring, which was adopted by the NAIC on March 10, 2003. Based on this brochure, the OIC has updated its website[13] to provide better information to consumers about insurance credit scoring.

The CSWG continues to look at the uses of insurance credit scoring and the potential for disparate or disproportionate impact on protected classes and low-income people. A small group of states, led by Missouri, is working to complete a study regarding the potential disparate impact of credit scores on protected classes of individuals. Washington State has provided technical assistance to this group as it has produced a study design to examine if insurance credit scores correlate with income or ethnicity. The FTC will likely review this design when it studies the effects of credit scoring on the availability and affordability of financial products, which is discussed in the next section of this report.

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[9] Information about current activities of the NAIC-CSWG can be found at http://www.naic.org/consumer_protection/htm_files/credit_scoring_wg.htm.

[10] The FTC provided oral testimony at the NAIC winter 2002 meeting that affirmed the FTC's intent to adopt the interpretation of the FCRA presented in an informal staff opinion prepared by Hannah Stires. This opinion is available at http://www.ftc.gov/os/statutes/fcra/ball.htm.

[11] The report submitted by the AAA can be found at http://www.actuary.org/pdf/casualty/credit_dec02.pdf.

[12] http://www.naic.org/pressroom/releases/rel03/031003_credit_scoring_tools.doc

[13] http://www.insurance.wa.gov/factsheets/creditscoring.asp

Recent Action by Congress

The federal FCRA (15 USC sec. 1681) was first enacted in 1970, and Congress has passed significant amendments in 1996, 1998 and 2003. The FCRA permits insurers to obtain consumer credit information for insurance underwriting purposes. When an adverse action is taken against a consumer based upon information in their credit report, the FCRA requires certain disclosures. Under existing law, the insurer must:

- Provide the consumer with the name, address, and telephone number of the consumer reporting agency that made the report;
- Tell the consumer of their right to obtain a free copy of the credit report; and
- Tell the consumer of their right to dispute the accuracy of the credit report.

This year, Congress passed HR 2622[14] to reauthorize the FCRA on January 1, 2004. In response to public concerns about the use of credit history by financial institutions and the insurance industry, Congress has enacted some important new provisions. The following is a brief summary of some key amendments and how these changes will affect consumers in Washington State.

State Regulation of Credit-based Insurance Scoring is not Pre-empted by the FCRA[15]

HR 2622 does not limit, annul, affect, or supersede any state law regulating credit-based insurance scores used by insurers. This important amendment means that the provisions of Washington law will continue to protect consumers.

The FTC Must Study the Effects of Credit Scores and Credit-Based Insurance Scores on Availability and Affordability of Financial Products[16]

The new federal law requires the FTC to conduct a study of the effects of credit scores and credit-based insurance scores on the availability and affordability of financial products and services, including credit cards, mortgages, auto loans, and property and casualty insurance. The FTC must obtain public input on methodology and research design from state insurance regulators. The FTC study must examine:

- The statistical relationship between scores, quantifiable risks, and actual loss experience.
- Any negative or differential treatment of protected classes.

These questions are similar to those the Washington Legislature asked the OIC to answer in the first report to the Legislature. The OIC's answers were incomplete because the size of the data sample collected was comparatively small. However, the researcher's observation was that some minority groups tended to pay higher premiums. It is likely,

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[14] HR 2622 can be found at http://thomas.loc.gov/
[15] Section 212 (e)(3)(C)
[16] Section 215

since more data will be available, that the FTC study will answer the questions that the Legislature included in ESHB 2544.

Free Consumer Reports[17]

The new federal law requires nationwide consumer reporting agencies, including TransUnion, Experian, and Equifax, to provide free annual reports to consumers. This provision will enable consumers look at their credit report and correct data before it hurts their insurance credit score.

Credit Score Disclosure[18]

The new federal law requires mortgage lenders to disclose the credit score and up to four key factors that adversely affect the credit score. This provision is noteworthy because the FCRA will now require mortgage lenders to provide borrowers the same type of information that the Washington Legislature, when it enacted ESHB 2544, required insurers to provide to their customers.

Financial Institutions must Disclose when they make Negative Reports to a Consumer Reporting Agency[19]

The new federal law requires financial institutions to tell consumers that they are reporting negative information to a credit bureau. This provision should help consumers correct information earlier in the process.

Accuracy Guidelines and Regulations[20]

The new federal law requires federal banking agencies, the National Credit Union Administration and the FTC to establish guidelines for the accuracy and integrity of credit information. Federal regulators must also publish regulations that tell a consumer how to dispute inaccurate information directly with the entity that provided the information.

Prompt Correction and Disclosure of Results of Reinvestigation[21]

The new federal law requires "prompt" deletion or modification of inaccurate information by credit bureaus. It also requires the entity that provided the credit information to delete promptly or modify and permanently block reporting of that information.

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[17] Section 211
[18] Section 212
[19] Section 217
[20] Section 312
[21] Section 314

Reasonable Reinvestigation of Disputed Information[22]

Additional amendments raise the standard on reinvestigations from merely "shall reinvestigate free of charge" to "shall, free of charge, conduct a reasonable reinvestigation." This provides a stronger standard for enforcement by the FTC.

[22] Section 317

Implementation of ESHB 2544

Rule-making

On July 3, 2002, Commissioner Kreidler began the rule-making process, seeking comments and feedback from insurers and the public. On September 6, 2002, after extensive comments from insurers, vendors of insurance scoring models and the public, the Commissioner adopted rules[23] to implement RCW 48.18.545[24] and RCW 48.19.035.[25] The rules describe standards that apply to personal lines insurers that use credit history for underwriting or rating purposes. More specifically, the rules:

- Define and further clarify various terms used in the law.
- Provide specific direction regarding the type and extent of the notice that an insurer must be provide to consumers if the insurance company takes an adverse action against a consumer.
- Establish a process for insurers to follow when filing their insurance scoring models.
- Permit vendors that sell insurance scoring models to file those models on behalf of insurance companies.
- Establish procedures for insurers who elect to waive the confidentiality protection of the law and make their insurance scoring model a public document.
- Describe actions the Commissioner may take against an insurer that uses an illegal insurance scoring model.
- Direct insurers to submit specific types of data and statistical analyses if they use credit history in their rating plans.
- Provide guidance regarding when actuarial data based on demographic factors must be filed with the Commissioner.
- Provide a "Question and Answer" section that illustrates how the Commissioner would respond to various scenarios under the new law.

The OIC reviews insurance credit scoring models to ensure they do not contain credit attributes that are prohibited by law. As of Dec. 15, 2003, 184 insurance scoring models have been accepted by the OIC. However, fewer insurance scoring models are being used by insurers than this statistic suggests, since many insurers simply adopted models filed by Fair Isaac and Choice Point. This statistic points to a success in the rule-making process: WAC 284-24A-025 explicitly allows vendors of insurance credit scoring to file models. This rule reduced the costs -- in terms of time and expense -- to implement the law.

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[23] http://www.leg.wa.gov/wac/index.cfm?fuseaction=chapterdigest&chapter=284-24A
[24] http://www.leg.wa.gov/RCW/index.cfm?fuseaction=section&section=48.18.545
[25] http://www.leg.wa.gov/RCW/index.cfm?fuseaction=section&section=48.19.035

Of the rules filed, only WAC 284-24A-055 appears to be ineffective. This rule requires specific types of demographic data if an insurer wants to charge different premium based on a "no hit" or "no score" -- which translates to lack of credit history. Data requested in this rule, which was an attempt to implement RCW 48.19.035(3)(a),[26] are too sparse to provide useful information. In 2004, the OIC will begin the rule-making process and consider amending this section of the rule and the definition of "demographic factors"[27] to require insurers to submit statistics in larger data sets.

[26] (3) Insurers shall not use the following types of credit history to calculate a personal insurance score or determine personal insurance premiums or rates:

(a) The absence of credit history or the inability to determine the consumer's credit history, unless the insurer has filed actuarial data segmented by demographic factors in a manner prescribed by the commissioner that demonstrates compliance with RCW 48.19.020; . . ..

[27] http://www.leg.wa.gov/wac/index.cfm?fuseaction=Section&Section=284-24A-005

The Filing Process

Fair Isaac and ChoicePoint are companies that sell credit-based insurance scoring models to insurance companies. OIC began discussions with these companies in July 2002, shortly after the rule-making process began. Fair Isaac and ChoicePoint filed their insurance scoring models in September 2002, and both models were accepted by the OIC in October of 2002.

Most insurers that use insurance credit scoring for underwriting met the January 1, 2003 filing deadline. Insurers that use insurance credit scoring for rating purposes were slower in filing their models and rating plans. In January 2003, the OIC became concerned that there would be a large number of personal lines insurers out of compliance with the law by June 30, 2003. On January 16, 2003, the Commissioner issued Technical Assistance Advisory T-03-01,[28] which advised insurers to submit revised rating plans before February 28, 2003. The OIC suggested this timeline due to these factors:

- The OIC expected the normal review time might increase if a large number of insurers filed rating plans at one time and, presumably, close to the law's effective date of June 30, 2003.
- The OIC knew insurers need time to program computer systems when they change rates or rating plans. Lead-time of three to six weeks is common to program changes that affect renewals.
- Many insurers process renewals 45 days in advance of the renewal date, which means an insurer would have to complete all programming by May 15, 2003 to meet a June 30, 2003 effective date.
- Between programming time and the renewal-processing period, the OIC thought that many insurers would have to have their rating plan approved by April 2003.

The Technical Advisory worked. Insurers began filing their insurance scoring models and rating plans. The OIC worked with insurance companies to resolve compliance issues. Other steps the OIC's Rates and Forms Division took to speed the review process included:

- Prioritizing insurance scoring models and rating plans to the highest level.
- Communicating by e-mail and over the telephone when additional data or changes were needed to bring the filing into compliance with the law.
- Working collaboratively with the Association of Insurance Compliance Professionals to notify their members of the law and its requirements.

As of December 15, 2003, OIC has approved 118 rate filings that comply with our laws and rules. A few insurers missed the June 30 date, and the OIC initiated two disciplinary actions. The facts alleged by the OIC in these cases include:

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[28] http://www.insurance.wa.gov/oicfiles/techadvisories/T03-01.pdf

1. An insurer renewed 1,937 boat insurance policies after June 30, 2003 using rates based on an insurance scoring model that had not been filed with the OIC. The OIC believes the credit scoring laws apply to personal inland marine insurance[29] including boat owner's insurance. The OIC believes the insurer was in violation of the credit scoring law[30] and administrative rules[31] between June 30, 2003, and August 9, 2003.
2. A company had used a credit based "financial stability score" since January 1, 2003 to assign applicants for homeowners insurance to a particular rating tier. The scoring algorithm had not been filed with the OIC, as required by RCW 48.19.040. The OIC believes the insurer was in violation of the law from June 30, 2003 until October 20, 2003, which is the date rates derived from a filed insurance credit scoring model were approved by the OIC.

[29] See RCW 48.19.035(1) (d)(vi).
[30] See RCW 48.19.035(2).
[31] See WAC 284-24A-015(2).

Ambiguity in the Credit Scoring Law

During the implementation process, the OIC's Rates and Forms Division determined that one section of RCW 48.19.035 is not clear. This ambiguity, if not corrected, has the potential to create an "uneven playing field" that favors insurance holding companies or organizations that sell personal lines insurance using more than one company (insurer). Generally, there are three common methods of marketing personal lines insurance:

1. Operating with one insurance company and selling insurance to a narrowly defined target market.
2. Operating with one insurance company and selling insurance to a broadly defined target market using rating tiers.[32] Rating tiers allow an insurance company to have several price levels to insure people with a variety of risk characteristics.
3. Operating through a group of affiliated insurance companies and selling insurance to a broadly defined target market using different price structures in each company. This structure allows an insurance holding company or organization to have several price levels to insure people with a variety of risk characteristics.

A few insurance organizations operating under the third structure have argued that they use insurance credit scoring only for underwriting – which means placement in a particular company based on the risk characteristics of the individual. They contend they should not have to file their credit-based rating plans with the OIC. The OIC disagrees, for several reasons:

- The OIC believes the Legislature intended to require every insurance holding company or organization to file their credit-based rating plans and provide complete actuarial support for those plans. Any other outcome provides an unfair competitive advantage to insurance organizations that sell products through affiliated companies.
- Underwriting and rating are linked processes. An insurer does not decide how much premium to charge an individual until it evaluates that person's risk profile. To imply that affiliated companies are not using insurance credit scoring to make pricing decisions is inaccurate based on the "real world" practices of the insurance industry.

To clear up any ambiguity in the law, the OIC will propose an amendment to RCW 48.19.035. The key component of the proposed amendment (which begins on page 28 of this report) will explicitly state:

> *Each insurer that uses credit history or an insurance score to determine personal insurance rates, premiums, or eligibility for coverage must file all rates and rating plans with the commissioner. This requirement applies equally to a single insurer and two or more affiliated insurers.*

[32] RCW 48.18.545(1) (h) says: "Tier" means a category within a single insurer into which insureds with substantially like insuring, risk or exposure factors, and expense elements are placed for purposes of determining rate or premium.

To date, the vast majority of insurers have filed their rating plans in a manner consistent with the intent of the Legislature. The Commissioner respectfully asks for the Legislature's favorable consideration of this amendment so that all insurance companies can compete using the same set of rules.

How ESHB 2544 has Impacted Consumers

Rates and Rating Plans

Generally, personal lines insurance rates did not change much after the rating piece of the law took effect on June 30, 2003. While rates remained stable, premiums for individual consumers may have changed after insurers filed new rating plans. Some of these rating plans were filed to comply with the law, and others were filed to implement the business or marketing plan of the individual insurer. It would be impossible to isolate or speculate how the law influenced the business decisions made by over one hundred insurance companies.

Personal lines insurance rating plans are very complex. Most insurers start out with an insurance rate, and then multiply that rate by rating factors contained in their rating plan. This is why premiums can vary greatly among different policyholders. The complexity is increasing as insurers add more rating factors based on both personal characteristics of the insured and the nature of the risk.

Some common components of an automobile insurance rating plan include:

- Territory rating factors (based on the address of the insured).
- Credit based rating factors.
- Discounts based on the composition of the family (married, single, children in the household).
- Sports car surcharges (based on the performance characteristics of car).
- Driver class rating factors (based on the age and sex of the driver).
- A surcharge if the driver is inexperienced (based on the years of driving experience).
- Multi-car discounts.
- Account (auto/home) discounts.
- Merit (or rather, de-merit) plans for tickets and accidents.
- A surcharge if a personal car is used for business purposes.

For a number of insurers, the list of rating factors is much longer. The Commissioner is responsible for reviewing rates and rating plans to ensure that the resulting premium rates for insurance are not excessive, inadequate or unfairly discriminatory. [33] With the complexity of modern rating plans, the Commissioner must look for modern ways of examining data to make sure that the OIC is fulfilling its mission.[34]

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[33] See RCW 48.19.020.

[34] The OIC's mission is: "We protect consumers, the public interest, and our state's economy through fair and efficient regulation of the insurance industry."

The Commissioner is determined to ensure that insurance companies do not use insurance credit scoring to raise premiums for consumers unfairly.[35] The Commissioner's question to the insurance industry is simple: When applied in combination with other elements of a rating plan, does insurance credit scoring "double count" for factors already considered somewhere else in that rating plan?

An example may illustrate the OIC's concern. Young drivers are often surcharged based on age (by application of a driver class factor) or driving experience (by application of an inexperienced operator surcharge). Young people are also more likely to have lower insurance credit scores or no credit history. If an insurer increases premium based on age and driving experience, should they also increase premiums due to credit history?

To answer these types of questions, the Commissioner issued Technical Assistance Advisory T 01-02,[36] and adopted WAC 284-24A-045[37] and WAC 284-24A-050.[38] Insurers are now required to submit a multivariate analysis if the insurer uses credit history to segment and rate personal insurance business. In simple terms, a multivariate analysis tests other rating variables simultaneously with credit history to adjust for any interrelationship between insurance credit scores and other risk factors. Multivariate analysis isolates the effect of credit history on insurance losses independent of other rating variables.[39]

Some insurers have used multivariate analysis for years to refine their rating plans. They believe this tool is critical to accurate pricing. Not surprisingly, insurers who have not used this analytical tool in the past have discovered that their rating plans need some adjustments. Common areas where multivariate analysis suggests some rating plans may need changes include:

- Vehicle use (some insurers may not be charging enough premium for commute and business use).
- Territory (some insurers may need to re-vamp their territory rating factors).
- Age of driver (elderly drivers – particularly those over 75 years old – are showing adverse loss trends).
- Multi-car and account discounts (some insurers may need to adjust these discounts).

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[35] The standard for insurance rates in Washington (and many other states) is included in RCW 48.19.020. This law says that "Premium rates for insurance shall not be excessive, inadequate or unfairly discriminatory."

[36] http://www.insurance.wa.gov/oicfiles/techadvisories/T01-02.pdf

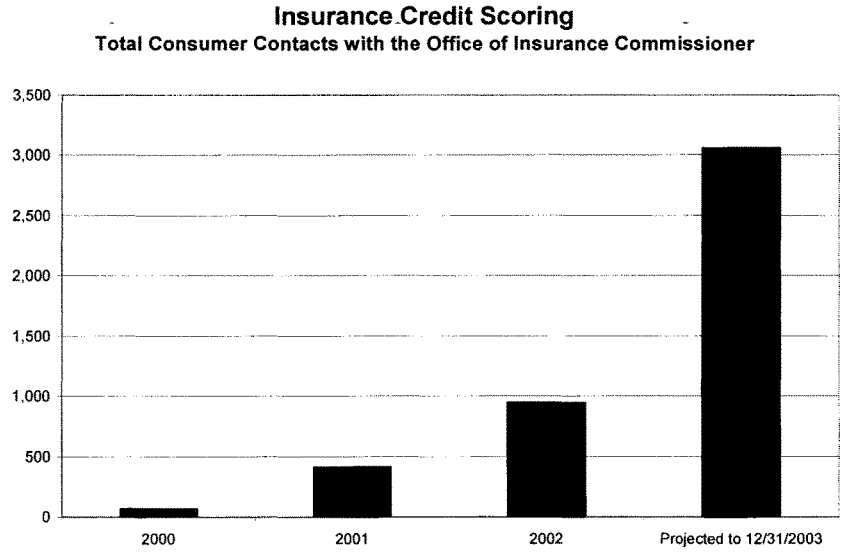
[37] http://www.leg.wa.gov/wac/index.cfm?fuseaction=Section&Section=284-24A-045

[38] http://www.leg.wa.gov/wac/index.cfm?fuseaction=Section&Section=284-24A-050

[39] In August 2002, the OIC participated in two seminars explaining Washington's Credit Scoring Laws. The presentation materials of Pinnacle Actuarial Resources (PAR) may help explain some of the pricing issues that occur when an insurer adds insurance credit scoring to the mix. This is not an endorsement of PAR's products or services. The presentation can be found at http://www.pinnacleactuarialresources.com/pages/services/Pinnacle%20WA%20Presentations.pdf.

What Consumers are Saying

By year-end 2003, the OIC will have received an estimated 4,493 contacts from consumers about insurance credit scoring over the last four years.[40] Sixty-eight percent (68%) of these contacts occurred in 2003.



Very few of the contacts were from happy consumers. The OIC believes the notice requirement in the law is one reason the contacts have increased in 2003. The law requires that insurers provide up to four reasons the consumer is not receiving the lowest rate for insurance. This law is not unique to Washington State -- it is part of the NCOIL model law and new FTC requirements for mortgage lenders. Some observations:

OIC believes some insurers were not providing "adverse action" notices under the FCRA before Washington's credit scoring law took effect.

In OIC's opinion, the federal FCRA has always required insurers to provide an adverse action notice. The OIC does not believe that all insurers were providing notice under the FCRA before ESHB 2544 took effect. Once state law required notice, insurers became more diligent about sending adverse action notices. Now, consumers are more aware that credit history is affecting their insurance premiums.

[40] Data from calendar year 2000 thorough November 2003, projected to year-end 2003. The breakdown is 298 formal complaints based on an alleged violation of law, 585 letters requesting information and 3610 telephone calls.

Insurers are adding more complexity to their rating plans and product lines.

More insurers are using credit history for pricing and market segmentation. This is called "tiering," where consumers are placed in rating tiers based on their insurance credit score. Each rating tier has a different price level.

At least one insurer in Washington has an auto insurance product that has 50 rating tiers. Only a handful of customers will qualify for the lowest rate, and the rest of their customers will receive "adverse action" notices. Even if the insurance premium differential is small, these notices still tell a customer that they have a problem with their credit history.

The notices provided by some insurers do not give useful information.

Insurers must provide up to four reasons why a consumer is not eligible for the lowest price.[41] Often, the reasons are cryptic and hard for the consumer to understand. These are typical reasons consumers are told their insurance credit scores could be better:

1. Absence of revolving credit account. Intuition may tell a consumer that opening a revolving credit account would improve their score. However, applying for new credit often lowers the insurance credit score.
2. Age of oldest account or revolving credit account. If questioned, insurers may tell the consumer that holding on to a credit card for a long time improves their score. On the other hand, this may mean the consumer must keep a credit card that they no longer want to use.
3. Age that consumer first opened a credit account. This means a consumer who opens a credit account early in life will get a better insurance credit score. This attribute may have negative implications for people who immigrate to this country. A person who immigrates to this country after their teens may always get a lower insurance credit score – no matter how well they manage their credit.
4. Unfavorable number of bank or revolving accounts. Consumers are often left to wonder what constitutes a good number of bank or revolving accounts.
5. Debt ratio (ratio of debt to credit limits). This ratio measures how much money a consumer borrows as compared to their available credit limits. Intuition may tell a consumer that opening a revolving credit account would improve their score by driving down this ratio. However, applying for new credit often lowers the insurance credit score.
6. Number of accounts opened in past year. Consumers are often left to wonder how many accounts are too many accounts.

Insurers also provide reasons related to account delinquencies, past-due payments, collection activity, and public records, such as bankruptcy. These reasons seem to be better understood by consumers.

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[41] http://www.leg.wa.gov/wac/index.cfm?fuseaction=Section&Section=284-24A-010

WAC 284-24A-010(2) requires insurers to provide clear information to consumers about the factors that adversely affect their credit history or insurance credit score.[42] OIC has received a number of complaints from consumers about adverse action notices sent by insurance companies. Many of the complaints are about the content of the adverse action notice. The basis for many of these complaints is the consumer's inability to determine which attributes on their credit report caused their insurance credit score to be less than perfect.

The OIC is currently reviewing a sample of complaint files to determine whether any laws or regulations have been violated. OIC is committed to working with insurers and vendors of insurance scoring models to improve the adverse action notices so that consumers have better information about the elements of their credit report that cause insurers to increase premiums.

Insurers do not provide advice to help consumers improve their insurance credit scores.

Insurers are not as experienced as lenders in explaining how credit history affects the price of their products. The OIC also believes that some insurers that buy insurance scoring models from vendors do not know what is in the "black box." Many of the contacts the OIC receives from consumers result from insurer's lack of knowledge about this scoring tool. Either the insurers or agents cannot explain the information on the adverse action notices or they cannot help consumers improve their insurance credit scores. The OIC believes insurers should provide both of these services.

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[42] WAC 284-24A-010 What must an insurer tell a consumer when it takes an adverse action? (1) An insurer must tell a consumer about significant factors that adversely affect the consumer's credit history or insurance score. As many as four factors may be needed to explain the adverse action.

(2) An insurer must explain what significant factors led to an adverse action in clear and simple language.

(3) An insurer may choose to tell consumers which factors positively affect a consumer's credit history or insurance score.

Other Issues: Confidentiality of Insurance Scoring Models

The OIC is growing more concerned about the confidentiality protections included in RCW 48.19.035(2). When the law was first enacted, the OIC believed the intent of the Legislature was to protect the intellectual property contained in the insurance scoring models. At that time, the models primarily contained credit history. For a number of insurers, this is no longer true.

It is becoming more common to include other rating variables in insurance scoring models. The OIC has received insurance scoring models that include rating variables such as:

- Age and marital status.
- Home ownership.
- Limits of coverage.
- Claim data.

If an insurer incorporates common or "traditional" rating and underwriting variables into the insurance scoring model, it can shield that information from both its competitors and public. The OIC believes the public's right to know how insurers determine personal insurance premiums outweighs the insurers' need to protect intellectual property included in the insurance scoring models.

The confidentiality provision of the law restricts the ability of the Commissioner to educate consumers about insurance credit scoring. The OIC would like to provide more advice to consumers. The OIC would like to explain which factors are contained in the insurance scoring models and how consumers can improve their insurance credit scores. The confidentiality provisions in RCW 48.19.035(2) prevent the OIC from fulfilling one of its fundamental strategic objectives -- to protect and educate consumers.

Recommendations

Amend the Credit Scoring Law to Level the Playing Field

The OIC hopes the 2004 Legislature will favorably consider the proposed amendment to the credit scoring law, which begins on page 28 of this report. This amendment will ensure that all companies that choose to use credit history to develop rating plans must:

- File those plans with the Commissioner;
- Provide appropriate actuarial and statistical support for those rating plans; and
- Operate on a level playing field with their competitors.

Review the Confidentiality Protections for Insurance Scoring Models

The OIC will continue to monitor how the confidentiality protections under RCW 48.19.035(2) are affecting consumers. The OIC may make specific recommendations for legislation in the future.

Proposed Revision to the Insurance Credit Scoring Law

AN ACT requiring all insurers to file credit based rating plans; amending RCW 48.19.035.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

SEC. 1. RCW 48.19.035 and 2002 c 360 § 2 is amended as follows:

(1) For the purposes of this section:

(a) "Affiliate" has the same meaning as defined in RCW 48.31B.005(1).

(((~~(a)~~))) (b) "Consumer" means an individual policyholder or applicant for insurance.

(((~~(b)~~))) (c) "Credit history" means any written, oral, or other communication of any information by a consumer reporting agency bearing on a consumer's creditworthiness, credit standing, or credit capacity that is used or expected to be used, or collected in whole or in part, for the purpose of serving as a factor in determining personal insurance premiums or eligibility for coverage.

(((~~(c)~~))) (d) "Insurance score" means a number or rating that is derived from an algorithm, computer application, model, or other process that is based in whole or in part on credit history.

(((~~(d)~~))) (e) "Personal insurance" means:

(i) Private passenger automobile coverage;

(ii) Homeowner's coverage, including mobile homeowners, manufactured homeowners, condominium owners, and renter's coverage;

(iii) Dwelling property coverage;

(iv) Earthquake coverage for a residence or personal property;

(v) Personal liability and theft coverage;

(vi) Personal inland marine coverage; and

(vii) Mechanical breakdown coverage for personal auto or home appliances.

(2) (a) Credit history shall not be used to determine personal insurance rates, premiums, or eligibility for coverage unless the insurance scoring models are filed with the commissioner. Insurance scoring models include all attributes and factors used in the

calculation of an insurance score. RCW 48.19.040(5) does not apply to any information filed under this subsection, and the information shall be withheld from public inspection and kept confidential by the commissioner. All information filed under this subsection shall be considered trade secrets under RCW 48.02.120(3). Information filed under this subsection may be made public by the commissioner for the sole purpose of enforcement actions taken by the commissioner.

(b) Each insurer that uses credit history or an insurance score to determine personal insurance rates, premiums, or eligibility for coverage must file all rates and rating plans with the commissioner. This requirement applies equally to a single insurer and two or more affiliated insurers. RCW 48.19.040(5) applies to information filed under this subsection.

(3) Insurers shall not use the following types of credit history to calculate a personal insurance score or determine personal insurance premiums or rates:

(a) The absence of credit history or the inability to determine the consumer's credit history, unless the insurer has filed actuarial data segmented by demographic factors in a manner prescribed by the commissioner that demonstrates compliance with RCW 48.19.020;

(b) The number of credit inquiries;

(c) Credit history or an insurance score based on collection accounts identified with a medical industry code;

(d) The initial purchase or finance of a vehicle or house that adds a new loan to the consumer's existing credit history, if evident from the consumer report; however, an insurer may consider the bill payment history of any loan, the total number of loans, or both;

(e) The consumer's use of a particular type of credit card, charge card, or debit card; or

(f) The consumer's total available line of credit; however, an insurer may consider the total amount of outstanding debt in relation to the total available line of credit.

(4) If a consumer is charged higher premiums due to disputed credit history, the insurer shall rerate the policy retroactive to the effective date of the current policy term. As rerated, the consumer shall be charged the same premiums they would have been

charged if accurate credit history was used to calculate an insurance score. This subsection applies only if the consumer resolves the dispute under the process set forth in the fair credit reporting act and notifies the insurer in writing that the dispute has been resolved.

(5) The commissioner may adopt rules to implement this section.

(6) This section applies to all personal insurance policies issued or renewed on or after June 30, 2003.

BARNEY FRANK, MA, CHAIRMAN

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August 28, 2007

The Honorable Deborah Platt Majoras
Chairman
Federal Trade Commission
600 Pennsylvania Avenue, NW
Washington, DC 20580

Dear Chairman Majoras:

We are writing to express concerns about the process the Federal Trade Commission (FTC) will use as it reviews the use of credit-based insurance scores to fulfill the congressional mandate under Section 215 of the Fair and Accurate Credit Transactions Act (FACTA). As the study progresses, we urge the FTC to use all available authority to require insurers to provide relevant data.

Section 215 of FACTA requires the FTC to review the impact of the use of credit-based insurance scores on the availability and affordability of automobile and homeowners insurance. The FTC has already publicly released a report detailing the results of the first phase of the Section 215 study, relating to automobile insurance. The FTC must still review the impact the use of these scores is having on homeowners insurance. We understand that the FTC is likely to release this second report in the Spring of 2008.

A number of consumer, community and civil rights groups have expressed concerns about the quality of the policy data collected and about the research methodology used to generate the first phase of the Section 215 report on automobile insurance. Among the concerns expressed have been: (1) the fact that the FTC relied exclusively upon voluntary insurance data from self-selected companies that are not representative of the full spectrum of insurance markets and consumers; (2) the fact that the FTC did not seek "application data" on consumers whose applications were denied (the absence of such data prevented the FTC from analyzing the impact of insurance scoring on the availability and affordability of automobile insurance and could understate the impact of insurance scoring on low-income and minority consumers); (3) the fact that the FTC did not review whether the data reflected policyholders who had been underwritten based on credit history (as a result, some consumers who would be adversely affected by the use of credit-based insurance scores may have already been eliminated from the data); and (4) the fact that the FTC did not consider alternative models that exclude the use of insurance scores completely yet still effectively predict risk.

Some of these concerns were also echoed in the Dissenting Statement filed by FTC Commissioner Pamela Jones Harbour. Commissioner Harbour's dissent raised concerns that the methodology used to generate the report adversely impacted the reliability of any findings outlined in the report, noting that the FTC could have served insurance companies with 6(b)[1] orders to obtain "a more accurate and complete data set, which would have provided a strong foundation for staff's complex economic analyses." Commissioner Jon Leibowitz, who voted with the majority to release the report, also pointed out that the data used was primarily provided by a subset of insurers that elected to submit their data for the study voluntarily.

We urge the FTC to address the criticisms that have been raised regarding the data quality and research methodology for the automobile insurance study. The FTC has used its 6(b) authority in the past when producing comprehensive reports on particular industry sectors, including the gasoline industry[2] and pharmaceutical industry[3]. The Commission also has the authority to issue Civil Investigative Demands and receive sworn testimony in pursuit of its investigations.[4] We ask the FTC to explain why, in striving to fulfill its statutory mandate under Section 215 of FACTA, the FTC chose not to employ these types of investigatory tools to study the use of credit-based insurance scores for automobile insurance. We also urge the FTC to utilize its full authority under 6(b), as well as any other appropriate authority available to the FTC, to obtain comprehensive policy data by a large number of insurers to complete the second phase of the Section 215 report on homeowners insurance.

We request that the FTC provide a written response in which the FTC: (1) explains its methodological approach to the automobile insurance study; (2) addresses the criticisms raised against this study; (3) indicates whether the FTC intends to issue 6(b) orders or use other compulsory process to obtain data for the homeowners insurance study; and (4) explains the methodology the FTC intends to utilize for data collection and analysis in the homeowners insurance study.

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[1] Section 6(b) empowers the Commission to require the filing of "annual or special . . . reports or answers in writing to specific questions for the purpose of obtaining information about 'the organization, business, conduct, practices, management, and relation to other corporations, partnerships and individuals' of the entities to whom the inquiry is addressed. 15 U.S.C. §46(b).

[2] *See* INVESTIGATION OF GASOLINE PRICE MANIPULATION AND POST-KATRINA GASOLINE PRICE INCREASES (May 22, 2006) available at: http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf. In this case, §6(b) orders were served on 99 companies in the oil industry.

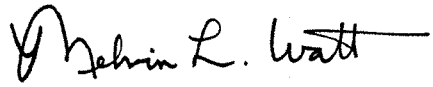
[3] *See* PHARMACY BENEFIT MANAGERS: OWNERSHIP OF MAIL-ORDER PHARMACIES (August 2005), available at: http://www.ftc.gov/reports/pharmbenefit05/050906pharmbenefitrpt.pdf. The Commission issued a report on pharmacy benefit managers' ownership of mail-order pharmacies. To conduct the underlying study, the Commission subpoenaed documents and information from nearly 20 industry participants.

[4] In the gasoline price manipulation study, the Commission issued 139 Civil Investigative Demands, as well as received sworn testimony from oil companies.

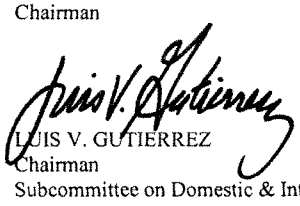
We appreciate the work that the FTC has done to date. We must, however, ensure that the FTC's study of the use of credit-based insurance scores is sufficiently rigorous and accurate to achieve the goals of Section 215 of FACTA. We urge the FTC to use all available investigatory measures to fulfill its statutory mandate under Section 215.

Thank you for your attention to this matter. We look forward to your response by September 17, 2007.

BARNEY FRANK
Chairman



MELVIN L. WATT
Chairman
Subcommittee on Oversight & Investigations



LUIS V. GUTIERREZ
Chairman
Subcommittee on Domestic & International Monetary Policy

cc: The Honorable Pamela Jones Harbour
The Honorable Jon Leibowitz
The Honorable William E. Kovacic
The Honorable J. Thomas Rosch

FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

THE CHAIRMAN

September 17, 2007

The Honorable Barney Frank
Chairman
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Frank:

I am writing in response to your letter of August 28, 2007 expressing concern about the methods the Federal Trade Commission (Commission or FTC) used in conducting, pursuant to the Fair and Accurate Credit Transactions Act (FACTA), its recent study of credit-based insurance scores and automobile insurance. Your letter also encourages the Commission to use all available authority to obtain relevant data from insurance companies in the agency's ongoing study of credit-based insurance scores and homeowners insurance. I am grateful for this opportunity to explain the methodology we used in our automobile insurance study and the methodology we will use to acquire and analyze data in our homeowners insurance study. As to the latter, I will ask my colleagues on the Commission to approve a resolution authorizing the use of Section 6(b) orders to obtain information from insurance companies for use in the study.

Under Section 215 of FACTA,[1] Congress entrusted federal agencies with the difficult task of examining the impact of credit scores and credit-based insurance scores on consumers. The statute requires the Commission and the Federal Reserve Board, in consultation with the Office of Fair Housing and Equal Opportunity at the Department of Housing and Urban Development, to study the impact of credit scores and credit-based insurance scores on consumers of credit and insurance, respectively. To comply with these requirements, the Federal Reserve Board has evaluated and reported to Congress on the impact of credit scores on consumers of credit.[2] The FTC has studied and reported to Congress about the effect of credit-

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[1] Section 215(a) of FACTA, 15 U.S.C. § 1681 note.

[2] *See* Board of Governors of the Federal Reserve System, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit* (August 2007), available at http://www.federalreserve.gov/boarddocs/RptCongress/creditscore/creditscore.pdf.

based insurance scores on consumers of automobile insurance.[3] The FTC continues to study the impact of credit-based insurance scores on consumers of homeowners insurance.

The FTC Automobile Insurance Study

The FTC's automobile insurance study required that the agency obtain and analyze a substantial amount of information related to automobile insurance policies, credit-based insurance scores, and demographic information related to consumers who purchased such policies. As in many studies, the Commission had to make a significant number of judgment calls requiring the application of significant technical expertise and experience in econometrics and statistics. In making these decisions, the FTC relied on the advice of a talented and dedicated team of career Ph.D. economists who consulted with numerous stakeholders, examined nearly 200 public comments concerning methodology and survey design, developed a database, painstakingly evaluated the underlying data, and conducted multiple, rigorous evaluations of the data. Although reasonable minds may differ on some of these judgment calls, I think that the methods used were sound and the conclusions reached were well-supported.

The Commission's automobile insurance study involved three main data and analysis steps: creating an FTC database of relevant information about consumers of automobile insurance; analyzing the information in that database; and assessing the viability of alternative credit-scoring models. In creating its database,[4] the FTC staff started with some of the information from a pre-existing database that EPIC, an actuarial consulting group, had created for purposes of an earlier study. In 2003, EPIC conducted a study of credit-based insurance scores and automobile insurance. A number of insurance companies submitted to EPIC a random sample of their automobile policy data, including claims data from 2001 and 2002. EPIC used this information to conduct an empirical analysis of the relationship between credit-based insurance scores and claims on automobile insurance policies. EPIC later published the results of its empirical research.[5]

The database the FTC staff created for use in its study began with a subset of the information in the EPIC database. Five insurance companies (representing about 27% of the

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[3] *See* Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* (July 2007) ("FTC Automobile Insurance Report"), available at http://www.ftc.gov/opa/2007/07/facta.shtm.

[4] The process the Commission staff used to create the database in its automobile insurance study is described in detail in Appendix C of the FTC Automobile Insurance Report.

[5] Michael J. Miller and Richard A. Smith, *The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity: An Actuarial Study by EPIC Actuaries, LLC* (June 2003).

automobile insurance market) that had submitted insurance policy information for the EPIC study agreed to provide voluntarily the same information for the FTC automobile insurance study. The five insurance companies submitted 2.5 million records concerning 1.4 million automobile insurance policies.

The FTC database was not limited to the information of these five insurance companies. The Commission staff also added credit-based insurance score and other credit history information about each of the customers to expand the database. To obtain this type of information, EPIC forwarded the database with insurance policy information to ChoicePoint, a firm with access to credit report information of consumers.[6] ChoicePoint appended credit-based insurance scores and other credit history information to the insurance policy information, replaced customer names and addresses with a new anonymous unique identifier, and returned the database to EPIC. EPIC standardized the coding of the data from the five insurance companies and combined all of this information to create a single database. EPIC forwarded this combined database to the Commission staff.

The FTC staff also added information to the database concerning race, ethnicity, national origin, and gender. The Social Security Administration (SSA) obtains and records racial, ethnic, national origin, and gender information of people who apply for a Social Security number (SSN). To match the insurance policy information in the FTC database with demographic information in databases at the SSA, the Commission retained Experian. From a random sample of 400,000 consumers in the FTC database,[7] Experian located the SSN or date of birth for about 325,000 consumers, and then forwarded that information and a unique anonymous identifier to the SSA. The SSA added information about race, ethnicity, national origin, and gender to the information it received from Experian; deleted the names, SSNs, and dates of birth; and sent the transformed database to the Commission staff.[8]

The FTC staff then used econometric and statistical techniques to analyze the information

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[6] ChoicePoint maintained this information separate from other information in its databases, including information it sells to the public.

[7] For budgetary reasons, the FTC purchased demographic information for a random sample of 400,000 consumers rather than for all consumers in its database.

[8] The FTC also hired ChoicePoint to match the addresses of the consumers in the database to United States Census geographic identifiers, which were used to bring in Census data on race, ethnicity, and income. Experian also matched the last names of consumers in the database with the list of Hispanic surnames that the United States Bureau of the Census maintains. Following this matching, Experian reported to the FTC which of these consumers had Hispanic surnames. Additional data were appended from several other sources.

in its database.[9] As a threshold matter, we first determined to what extent credit-based insurance scores are predictive of claims on automobile polices. The results of that analysis were then used to calculate the effects of scores on predicted claims, which were used as a measure of the likely effects of scores on the premiums consumers pay. The Commission staff then compared the average scores of different racial and ethnic groups, and the likely impact of differences in average scores on the premiums different groups would pay. The FTC staff also determined whether, and to what extent, scores remained predictive of claims when controls are included for race, ethnicity, and income.

The FTC staff also attempted to construct an alternative scoring model that would predict risk accurately while decreasing the differences in scores on average among racial and ethnic groups.[10] The agency staff created a baseline credit-based insurance scoring model that was as predictive as possible of automobile insurance claims. Several scoring models were then built that were intended to be predictive of claims, yet have smaller differences across racial and ethnic groups than the baseline scoring model. Two of these scoring models controlled for the race, ethnicity, and income of the consumers. Another scoring model explicitly avoided selecting credit-history variables highly correlated with race and ethnicity.

The FTC prepared a report describing the process used in its automobile insurance study and making findings and conclusions concerning the effect of credit-based insurance scores on consumers of automobile insurance. The main findings and conclusions of the Report are: (1) credit-based insurance scores are effective predictors of risk; (2) there is not sufficient evidence at this time to judge which of several alternative theories proposed for the correlation between credit-based insurance scores and risk, if any, is correct; (3) scores are distributed differently among racial and ethnic groups (namely, non-Hispanic whites and Asians on average have higher scores than African-Americans and Hispanics), and this difference in scores is likely to have an effect on the premiums these groups pay on average; (4) scores appear to have little effect as a proxy for membership in racial and ethnic groups; and (5) the FTC was not able to develop an alternative scoring model that would continue to predict risk effectively, yet decrease the differences in scores on average among racial and ethnic groups. As requested in your letter to the Commission dated July 3, 2007, the FTC submitted this report to Congress on July 19, 2007.

Concerns about the FTC Automobile Insurance Study

Your letter describes a number of specific concerns that some consumer groups and other members of the Commission have raised concerning the FTC automobile insurance study. Most

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[9] The techniques the Commission used to analyze the information in the FTC database are described more fully in Appendix D of the FTC Automobile Insurance Report.

[10] The measures that the Commission took to construct alternative scoring models are described in detail in Appendix E of the FTC Automobile Insurance Report.

of these concerns have their genesis in the data included in the FTC database. Specifically, some consumer advocates have raised the concern that the FTC database included information that insurance companies provided voluntarily rather than being provided pursuant to Section 6(b) orders[11] or other compulsory process. It is true that the FTC has used Section 6(b) orders to obtain reliable information for use in some of our research and policy development activities. But it is also true that the Commission has issued a number of significant reports based on industry-specific data that we obtained without using 6(b) orders. The critical question is not the particular method the Commission selected to obtain relevant information; instead, it is whether the data obtained is reliable.

I am confident that the information that we received voluntarily from the insurance companies was reliable for two primary reasons. First, the insurance companies provided the Commission staff with written assurances of the data's reliability. These assurances could be used to help establish criminal liability under 18 U.S.C. § 1001 if a company submitted false or manipulated data. Potential criminal liability would have a deterrent effect. Second, I am not aware of any evidence that suggests that the insurance companies submitted false or manipulated information to obtain a particular result. In fact, because insurance companies neither acquire information about the race, ethnicity, or national origin of their customers nor have access to such information in the SSA database, they could not have known what data to manipulate to try to obtain a particular result.[12]

Using Section 6(b) orders to obtain from insurance companies the information needed to create such a database rather than using information that some insurance companies previously collected likely would have caused substantial delay. If the Commission had issued Section 6(b) orders for the production of identical types of information from ten or more insurance companies,[13] the agency would have had to comply with the requirements of the Paperwork

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[11] Section 6(b) empowers the Commission to require the filing of "annual or special . . . reports or answers in writing to specific questions for the purpose of obtaining information" about "the organization, business, conduct, practices, management, and relation to other corporations, partnerships, and individuals" of the entities to whom the inquiry is addressed. 15 U.S.C. § 46(b).

[12] The basic findings of the FTC automobile insurance study are consistent with those of the Texas Department of Insurance, which obtained data directly from several insurance firms doing business in Texas. *See* Texas Department of Insurance, "Use of Credit Information by Insurers in Texas" (Dec. 30, 2004); Texas Department of Insurance, "Use of Credit Information by Insurers in Texas: The Multivariate Analysis" (Jan. 31, 2005) (supplemental report).

[13] For purposes of the Paperwork Reduction Act (PRA), 44 U.S.C. §§ 3501-3521, each subsidiary of a parent corporation that produces information may be treated as a separate entity, which increases the probability that the FTC would have had to have sent Section 6(b)

Reduction Act prior to the issuance of these orders. Based on Commission experience, the process associated with the issuance of such orders, including complying with the PRA, likely would have added at least six to nine months to the time required to collect necessary data. In addition, if the Commission had issued Section 6(b) orders, recipients could have challenged these orders prior to compliance, further delaying the receipt of necessary data. Finally, if the FTC had obtained data from a substantial number of insurance companies that maintain different data in different formats, the Commission staff would have had to have undertaken the time-consuming task of preparing information from multiple sources, likely maintained in different fashions, into a format suitable for analysis.

As reported in your letter, some consumer groups also have argued that the automobile insurance companies and the customers from whom data was obtained in the study were not representative of the full spectrum of insurance markets and consumers. There are hundreds of insurance companies that write automobile insurance policies in the United States. Because it is not practical to obtain insurance policy information from all of these firms, it was necessary to obtain such information from a subset of them. The FTC staff received automobile insurance policy information from 2001-2002 from five insurance companies that together wrote 27% of automobile insurance in the United States. These companies generally are representative of automobile insurance companies in the United States.[14]

In addition, the FTC staff did adjust the information in its database to ensure that it was representative of United States automobile owners. Like other businesses, automobile insurance companies compete with one another based on price, location, coverage, service, etc. These variations make it unlikely that the customers of any insurance company or even a group of companies will have the same racial or economic demographics of the entire country. The FTC staff recognized that this was the case and therefore used statistical weighting techniques to ensure that the sample used was racially and economically representative of United States consumers of automobile insurance.[15]

According to your letter, some consumer advocates further have criticized the data used in the FTC's study on grounds that it did not include data for consumers whose applications for insurance were denied. Insurance companies often do not retain insurance application data for any significant period of time. Consequently, even if this information would have been useful to

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orders to ten or more entities, thus triggering an obligation to comply with the PRA.

[14] The Commission was concerned that these insurance companies might not issue policies to a sufficient proportion of high risk consumers, but a robustness check of the data showed that this did not affect the results of the FTC's data analysis. *See* FTC Automobile Insurance Report, Appendix F at 6.

[15] The techniques that the Commission used to make the sample more representative are described in detail in the Report. *See* FTC Automobile Insurance Report, Appendix D at 5.

obtain, it would have been difficult, if not impossible, to do so.

Your letter also indicates that some consumer groups have asserted that the Commission staff did not review whether the data reflected policy holders who had been underwritten based on credit history, and as a result, some consumers who would have been adversely affected by scores may have been excluded from the data. The analysis in the study focused on predicted risk of losses, not premiums, and, therefore, if consumers whose premiums reflected the use of credit-based insurance scores were somehow excluded from the samples, this should not have had a significant impact on the analysis. The Report also concluded that the premiums of many policyholders are likely to increase when credit-based insurance scores are used, specifically, the premiums of consumers with low credit-based insurance scores, a class of consumers in which African-Americans and Hispanics are over-represented.

Finally, as your letter notes, some consumer advocates have criticized the study for not testing alternative models that did not use credit-based insurance scores. The Commission focused on alternative credit-based insurance scoring models, because Section 215 of FACTA specifically directed the agency to examine these types of models.[16]

Homeowners Insurance Study

As your letter notes, in addition to the automobile insurance study, the Commission is conducting another study of the effect of credit-based insurance scores on consumers of homeowners insurance. At this time, Tillinghast Consulting (the successor to EPIC) is poised to submit to the FTC staff a data set with homeowners insurance policy information for a random sample of the customers of insurance companies representing nearly half of the U.S. homeowners insurance market. If the FTC staff were to obtain this information, combine it with credit history and demographic information to create a database, and conduct the necessary econometric and statistical analysis of this information, the Commission likely could complete our homeowners insurance study and submit a report to Congress in late Spring of 2008.

Your letter urges the Commission to "utilize its full authority under 6(b) [of the FTC Act], as well as any other appropriate authority available to the FTC, to obtain comprehensive policy data by a large number of insurers to complete the second phase of the Section 215 report on homeowners insurance." To increase the level of public confidence in our study, I intend to ask the Commission to issue a resolution authorizing the use of Section 6(b) orders to obtain information from insurance companies. However, using Section 6(b) orders to obtain this information will have a substantial impact on the timing of the study and the report.

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[16] Section 215(a)(3) of FACTA directs the FTC to study the "extent to which, if any, the use of underwriting systems relying on [credit-based insurance scoring] models could achieve comparable results through the use of factors with less negative impact" on protected classes under the Equal Credit Opportunity Act.

As described above, in the automobile insurance study, the Commission staff obtained information from one entity, EPIC, which had previously collected that information, and, therefore, the FTC did not have to comply with the requirements of the Paperwork Reduction Act. By contrast, if the Commission were to issue Section 6(b) orders demanding the production of identical types of information from ten or more insurance companies, the FTC would have to comply with the PRA and obtain Office of Management and Budget (OMB) clearance prior to sending the orders. Based on the Commission's experience, it is likely that the process associated with the issuance of such orders, including complying with the PRA, would take at least six to nine months before the FTC would obtain OMB clearance allowing the orders to be issued.

Once clearance were obtained from OMB, the FTC would be able to send Section 6(b) orders to insurance companies and require the submission of data. The Commission would send these orders to a substantial number of insurance companies. The orders likely would require the companies to produce the name, address, SSN, and relevant insurance policy coverage and claims history information for tens of millions of consumers.[15] If no further legal action is needed to compel the production of information in response to these Section 6(b) orders, the insurance companies likely would submit information within two months of service.

After the FTC staff has received this information from insurance companies, it will need to complete three additional major tasks to create a database that can be used for the necessary econometric and statistical analysis. First, the Commission staff will evaluate and prepare for analysis the information received from multiple insurance companies. It is likely that these tasks will take the FTC staff between approximately three to six months to complete. Second, the Commission staff will need to add demographic information to the database, which likely will take about two months. Third, the FTC staff will add credit-based insurance scores and credit history information for a sample of these consumers. It likely will take approximately two months to add credit-based insurance scores and credit history information to the FTC database.

The FTC database thus will combine insurance company policy information, credit report information, and demographic information. With this database, the Commission staff will be able to commence doing the econometric and statistical analysis on the issues identified in Section 215 of FACTA and prepare a report describing the results of this research. Based on the agency's experience with the automobile insurance study, it likely would take six to nine months to analyze the data and draft a report for the Congress describing the results of the study.

In short, I intend to ask my colleagues to authorize the use of Section 6(b) orders in the

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[15] The information obtained thus will include personally identifiable information. The agency will take reasonable and appropriate measures to protect the security of this information. The security measures needed to protect the security of this massive amount of personally identifiable information may impose burdens and limitations which may affect the time needed to complete the study.

homeowners insurance study. If the Commission determines to gather information through this method, the amount of time required to complete the study will depend on a wide variety of contingencies, including whether insurance companies determine to challenge the Section 6(b) orders. Based on the estimated time to complete the various parts of the study described above, however, it is likely that the Commission would submit a report to Congress sometime between the summer of 2009 and the winter of 2010.

Conclusion

I appreciate having this opportunity to explain the methodology used in the FTC automobile insurance study and to describe the methodology that the Commission is likely to use in its homeowners insurance study.

We will continue to keep you apprised of our progress on our homeowners insurance study. If you or your staff have any additional questions or comments, please contact me or have your staff call Jeanne Bumpus, the Director of our Office of Congressional Relations, at (202) 326-2946.

Sincerely,

Deborah P. Majoras

Deborah Platt Majoras
Chairman

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.

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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

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.

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** 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.

NCOIL
National Conference of Insurance Legislators
...for the states

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October 2, 2007

The Honorable Melvin Watt
Chair, Subcommittee on Oversight & Investigations
2236 Rayburn House Office Building
Washington, DC 20515-3312

Dear Representative Watt:

As president of the National Conference of Insurance Legislators (NCOIL), I write to commend your interest in fair credit-based insurance scoring and to make you aware that states are taking strides to protect consumers whose credit histories are used in conjunction with insurance underwriting and rating. States have proven that they are best able to restrict how insurers use credit data.

An NCOIL model law has empowered 26 states, including North Carolina, to enact strong, consumer-friendly public policy. The NCOIL *Model Act Regarding Use of Credit Information in Personal Insurance* was adopted following more than two years of intense debate and discussion, and with the input of numerous stakeholders. Our model has been challenged by legislators and regulators across the nation—and is now the standard for state oversight of insurance credit scoring.

Insurers are prohibited, under the NCOIL model law, from denying, canceling, or non-renewing coverage due only to credit history. They are barred in most circumstances from taking an adverse action because a consumer has a "thin" credit file, or—like many financially prudent senior citizens—has no credit card at all.

Consumers who fall prey to extraordinary life events—death of a spouse, extended illness, and divorce, among others—may find relief under the NCOIL model, which encourages insurers to treat these victims, and their related credit difficulties, with compassion.

Consumers who wisely "shop around" for the best deals on auto and home loans are protected under the NCOIL model, which prevents insurers from counting these multiple credit inquiries negatively.

Consumers of all races, religions, incomes, addresses, and ethnicities can be confident that, under the NCOIL model law, no insurer can use these factors to calculate their insurance scores.

States relying on the NCOIL model legislation mandate that insurers use new credit data—rather than ancient history—and give consumers up to four specific reasons why their credit backgrounds led to adverse actions. The NCOIL model also includes critical provisions regarding disclosure and dispute resolution, and outright prohibits credit reporting agencies from selling insurance-related info to third parties that do not deserve it.

We, as fellow lawmakers, understand your concern with an insurer practice that, if not carefully regulated, has the potential to hurt consumers. But we emphasize that our states have done well to protect constituents from credit-based abuse, and we have done so against the backdrop of healthy insurance markets.

EXECUTIVE DIRECTOR: SUSAN F. NOLAN NATIONAL OFFICE: 385 JORDAN ROAD, TROY, NY 12180; TEL: 518-687-0178; FAX: 518-687-0401 WEBSITE: WWW.NCOIL.ORG
E-MAIL: INFO@NCOIL.ORG WASHINGTON OFFICE: 501 PENNSYLVANIA AVENUE, NW, SUITE 900, SOUTH BUILDING, WASHINGTON, DC 20004; TEL: 202-220-3014; FAX: 202-330-5004

We ask that you consider what states have already accomplished when moving forward with your deliberations. We also ask that you enter this letter into the official record of the October 2 Subcommittee on Oversight & Investigations hearing entitled *Credit-Based Insurance Scores: Are They Fair?*.

Please feel free to call the NCOIL National Office at 518-687-0178 should you have any questions. We look forward to speaking with you further.

NCOIL is an organization of state legislators whose main public policy concern is insurance legislation and regulation. Many legislators active in NCOIL either chair or are members of the committee responsible for insurance legislation in their respective state houses across the country. More information is available at www.ncoil.org.

Sincerely,

Senator Alan Sanborn, MI
NCOIL President

cc: House Committee on Financial Services

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October 1, 2007

The Honorable Melvin Watt
Chairman, Oversight & Investigations Committee
House Financial Services Committee
Washington, DC 20515

The Honorable Gary Miller
Ranking Member, Oversight & Investigations Committee
House Financial Services Committee
Washington, DC 20515

Dear Sirs:

Many businesses use credit scoring as a cost/effective measurement of risk, for example in lending, employment, consumer credit and insurance. Credit has long been used to assist commercial insurers to assess the risk of their business insureds, in recognition that as a general matter, the financial health of a business is a good predictor of how safe a business is likely to be.

Successive Congresses have recognized these benefits and preserved them in the FCRA and FACTA through the permission they granted for the continued use of credit information, in the context of specified consumer protections. The FCRA and FACTA, specifically allow insurers to use credit information for rating and underwriting. And, their documented experience is that credit scoring is one of the most effective risk measurement tools for auto and homeowners insurance.

Over the last decade, the personal lines of insurance have performed extremely well for consumers and insurers, with stable rates and good availability (excepting only high catastrophe prone areas). Residual markets, a good bellwether of how healthy the markets are, have been shrinking and have remained at all time lows. This has benefited traditionally high rated territories, such as urban areas, with improvements in cost and availability, compared to the pre-credit scoring days.

Some personal lines companies report that credit scoring has greatly improved the accuracy of risk measurement, resulting in greater availability of insurance and more competition for consumers. Credit based insurance scoring has allowed those companies to confidently price and write almost any risk because they have a more precise way to measure and price comparative differences. One company has reported that with credit based insurance scoring it has been able to offer insurance to 96% of all applicants but if denied the use of credit, it would be able to quote only 65-70%.

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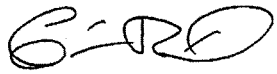
The price is often reduced for better risks, as well. Some companies have publicly stated that if they had to abandon credit scoring, 50-70% of their policyholders would see rate increases. Thus, we think that both availability and affordability have been improved as a result of using credit scoring.

We believe there are important benefits to the use of credit-based insurance scores and urge you to consider these benefits as you examine this issue more closely moving forward.

Sincerely,



Cesar Redmond
HAP Institute Board Member

WRITTEN TESTIMONY FROM THE AMERICAN INSURANCE ASSOCIATION, THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES AND THE PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA DELIVERED TO THE OVERSIGHT AND INVESTIGATION SUBCOMMITTEE OF THE HOUSE FINANCIAL SERVICES COMMITTEE

OCTOBER 2, 2007

Introduction

The American Insurance Association, National Association of Mutual Insurance Companies and the Property Casualty Insurers Association of America thank you for the opportunity to offer our perspective on the Federal Trade Commission's (FTC) report, entitled Credit Based Insurance Scores: Impacts on Consumers of Automobile Insurance.

As you are aware, the Fair and Accurate Credit Transaction Act (FACT Act) of 2003 which permanently reauthorized the Fair Credit Reporting Act preemptions, called for a study on the financial services industry's use of credit scores and credit-based insurance scores.

The FTC and the Board of Governors of the Federal Reserve System (FRB), in consultation with the Office of Fair Housing and Equal Opportunity of the Department of Housing and Urban Development were mandated to collect the data and conduct separate studies of the banking and insurance industries. Earlier this week, the FTC released its report on automobile insurance and it is anticipated that the FRB's study on the banking and mortgage industries will be issued later this year.

The FTC's study was designed to explore the effect that credit information has on the availability and affordability of insurance. The study considered the statistical relationship between credit information and the risk of loss. It also examined the extent to which, if any, the use of credit scoring models, credit scores, and credit-based insurance scores affect the availability and affordability of insurance by racial and ethnic minority groups and low-income groups.

To put this issue into perspective it is important to understand that the use of credit information by personal lines insurers is nothing new. For more than thirty years, federal law has authorized personal lines insurers to use credit information for underwriting and rating. However, in the 1990s with the advent of sophisticated scoring models which analyze how certain credit characteristics relate to loss ratios for automobile and homeowners insurance, this practice became very common. The models are used to generate credit-based insurance scores which many insurance companies use to provide additional information that is helpful in making more accurate underwriting and rating decisions.

Studies

Over the past decade there have been numerous studies on insurers' use of credit information and the findings of the FTC study reaffirm the strong connection between credit information and the risk of loss. The study also confirmed that the use of insurance scores helps to increase the availability and affordability of insurance for most consumers. The FTC's initial conclusion says it all – "credit-based insurance scores are effective predictors of risk under automobile policies."

These findings support what the insurance industry has long maintained – that insurance scores provide an objective and reliable tool that insurers use with other information to better predict the likelihood of future claims and the cost of those claims.

A recent report published by the Arkansas Insurance Department found that 89% of auto policies either received a discount or were treated neutrally, based on their insurance scores. Additionally, the Texas Department of Insurance conducted a study on insurers' use of credit information and reached very similar conclusions to the FTC's - that credit was a strong predictor of risk.

Now there should be no doubt about the value of using this highly predictive underwriting and rating tool. Using credit information makes underwriting and pricing more accurate and results in many consumers paying less for their automobile and homeowners insurance policies.

Consumers want to pay an insurance premium that matches their risk of loss. To achieve the goal of pricing based on an individual's risk of loss, insurers simply want to use the most accurate, statistically valid tools available and credit information has proven to be one of the best predictors of loss. With the findings of the FTC, legislators and regulators should be very comfortable with insurers' use of insurance scoring.

The FTC report's findings are consistent with the earlier studies. Its major conclusions are as follows:

- 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. The use of scores is, therefore, likely to make the price of insurance better match the risk of loss posed by the consumer. Thus, on average, higher-risk consumers will pay higher premiums and lower-risk consumers will pay lower premiums.

- Use of credit-based insurance scores may result in benefits for consumers. For example, scores permit insurance companies to evaluate risk with greater accuracy, which may make them more willing to offer insurance to higher-risk consumers for whom they would otherwise not be able to determine an appropriate premium. Since scores also may make the process of granting and pricing insurance quicker and cheaper, cost savings may be passed on to consumers in the form of lower premiums.

- 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 relationship between scores and claims risk remains strong when controls for race, ethnicity, and neighborhood income are included in statistical models of risk.

This last point explicitly invalidates the notion that insurers target minorities for higher insurance rates through the use of insurance scores. The FTC study demonstrates that by looking at an insurance score there is no way to determine a person's race, ethnicity or economic status. People within all racial and ethnic groups examined in the study have good, average and bad credit records. The FTC study reaffirmed this fact. However, a specific high or low score will offer strong evidence as to the likelihood of that person filing an insurance claim. Being able to make this distinction regarding risk of loss allows insurers to charge each individual an appropriate rate. The bottom line is that insurers underwrite individuals, not ethnic or income groups, and the use of credit information results in each individual's premium more accurately reflecting his risk of loss.

Credit is a quality that each individual has the ability to control and change, if he so desires. As consumers exercise the personal responsibility that it takes to develop and maintain good credit, we find these same individuals have fewer and less costly insurance claims. Credit information provides an indication as to how a person manages financial risk. It is possible that people who manage their personal finances responsibly also manage other important aspects of their lives responsibly. Careful behavior leads to fewer accidents and that merits lower premiums because the consumer represents less risk.

Over the years, the insurance industry has found that insurance scores have helped to expand the availability of insurance in many markets, increased competition among insurers and even been shown to be more predictive than other, more traditional, rating variables, such as driving record.

Previous studies have found that the average loss per vehicle for people with the worst scores are double that of people with the best scores and drivers with the best scores are involved in 40 percent fewer accidents than those with the worst scores. These findings are consistent with the conclusions of the FTC regarding the predictive power of credit information.

Based on real world experience and backed up by studies such as the FTC's, insurers have found that the use of credit information is one of the most accurate ways to differentiate between lower and higher insurance risks. And, any small "proxy effect" mentioned in the FTC study not explainable by risk, may well be statistically insignificant.

Critics have unfairly criticized the FTC's methodology. A comprehensive response has already been given by the FTC Chairman and two other commissioners. In addition, we would add that the data voluntarily provided by the insurance industry, along with actuarial expertise, is the largest database of its kind and would needlessly cost taxpayers and policyholders hundreds of thousands of dollars to replicate. To do yet another study to please certain advocacy groups angry with the FTC's conclusions simply because they don't support the pre-determined conclusions they have tried to perpetuate would be an unjustified waste of taxpayer and policyholder money.

Extensive Regulation

In addition to carefully reviewing credit-based insurance scoring under existing insurance regulatory and anti-discrimination laws, virtually every state has enacted or implemented special regulation of credit-based insurance scoring. Of these, 26 states have enacted laws or adopted regulations based in part on the National Conference of Insurance Legislators' (NCOIL) Model Act on Credit. The NCOIL model provides for special treatment of special life circumstances, such as divorce, death of a spouse, medical catastrophe, temporary loss of employment or identity theft. Insurers will also reconsider a score when there is an error found on a credit report.

These important safeguards balance insurers' need to use an actuarially sound variable while preserving consumer rights and protections, such as a prohibition on insurance scores being the sole determining factor for coverage or non-renewal, consumer disclosure at the time of application and an adverse action notice requirement. The NCOIL model is now considered standard practice in the market. In finding the right public policy mix, most states have rejected outright bans, although often proposed, and in one case the public, itself, has rejected a ban through referendum (Oregon).

Proactive Response

As good corporate citizens, insurance companies have worked hard to reach out to, and serve local communities all across the country and, in particular, have made special efforts to do business in economically disadvantaged areas. Insurers have partnered with community-based organizations, social service and civil rights groups to help improve communities and ensure that the lives and property of all residents are safe, secure and well protected against the risk of loss.

Some insurance organizations have taken steps to help consumers become more knowledgeable about their financial futures through financial literacy programs. Insurers want consumers to have access to information, be equipped to make informed decisions and establish financial security through responsible use of credit. Given the fact that credit information is used in ever-expanding aspects of today's economy, consumers are encouraged to actively manage their credit history because, in the end, they will see the benefits. See the attached information in English and Spanish as examples of the proactive efforts of insurers in this area.

Conclusion

In Commissioner Jon Leibowitz's concurring statement, he ends with "We can, and must, do more." The industry is of the same mind set. Congress must reach out to those individuals that have "poor credit", regardless of their race or ethnic group, to educate them and help them develop "good credit" skills. The problem is not that the industry uses this data as a predictor of risk; the problem is that there are consumers that have not learned or choose not to control their credit consumption.

The FTC's study, like prior government and private studies, has validated insurers' use of credit-based insurance scores. The FTC's job, as required by Congress, has been done and done well. Now, we urge

a cooperative approach on how insurers can work with government and other groups to improve knowledge of credit scoring and how to improve credit scores among all groups, just as we must continue to focus on reducing unnecessary losses.

Thank you for your consideration of this matter. Each of the trade associations stand prepared to more fully discuss these findings with you and your colleagues.

Janet Murguia, President

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November 30, 2007

Chairman Melvin L. Watt
Ranking Member Gary G. Miller
Subcommittee on Oversight and Investigations
U.S. House of Representatives,
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Watt and Ranking Member Miller:

Thank you again for inviting the National Council of La Raza (NCLR) to provide expert testimony for the hearing "Credit-Based Insurance Scores: Are They Fair?" Below are responses to follow-up questions we received from the Subcommittee in a letter dated October 26, 2007.

1. **Please explain the unique problems to the Latino community as a result of the use of credit-based insurance scores.**

The industry-wide use of credit-based insurance scoring results in many Latinos paying more than they should for auto insurance. Moreover, Hispanics are also more likely than their White peers to be adversely affected by the widespread use credit-based insurance scoring. Latinos have a lower median age and are more likely to be foreign-born than their White or Black peers. A recent study by the Federal Reserve found:

"Evidence also shows that recent immigrants have somewhat lower credit scores than would be implied by their performance. This finding appears to derive from the fact that the credit history profiles of recent immigrants resemble those of younger individuals, whose credit performance tends to be poor relative to the rest of the population. Expanding the information supplied to credit-reporting agencies to include rent, other recurring bill payments, nontraditional uses of credit, and the credit histories of the foreign-born in their countries of origin may provide a broader picture of the credit experiences of recent immigrants and other individuals."

(Source: Page 6, Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit, August 2007)

2. What is your basis for the statement on page 4 of your testimony that credit scores are poor predictors of actual creditworthiness for Latino borrowers?

As noted above, the Federal Reserve study documents that the predictive quality of credit scores is poor in the case of immigrants (i.e., immigrants consistently perform better than their credit score would predict). That fact, together with the fact that about 55% of Latino adults are foreign-born compared to about 4% of White non-Hispanics, strongly suggests that credit scoring models poorly serve the majority of Latino borrowers.

3. What, in your view, are some of the inaccurate assumptions built into credit scoring models?

With respect to Latinos, the principal problem with credit scoring models is that they penalize individuals who are risk averse and those who either cannot or choose not to open conventional credit accounts. The credit scoring system does capture and report data on those individuals who have a verifiable record of poor credit management. But the system also works against individuals acting financially responsible. Individuals, such as many immigrant Latinos, may choose not to accumulate debt or expose themselves to the risk of being trapped by predatory lenders in a cycle of unmanageable debt. Many Latinos also do not wish to be hit with excessive creditor fees. However, some scoring models heavily weigh payment behavior on standard credit card accounts. Further, for a variety of both voluntary and involuntary reasons, Latinos are substantially less likely than their White and Black peers to have credit card accounts.

The Federal Trade Commission (FTC) study also found that consumers for whom scores were not available appeared riskier when scores were used than when scores were not. The assumption within insurance scoring models that no credit record, rather than a record of relatively poor repayment of debt, warrants a "high risk" designation is unfair and problematic.

4. According to your testimony, studies show that 50%-70% of credit reports contain inaccurate information. Have your members shared with you how easy (or difficult) it is to correct inaccurate credit information?

Members of the NCLR Homeownership Network (NHN) provide homeownership and credit counseling services to thousands of low- and moderate-income Latinos each year. They report varying experiences when trying to resolve errors on their clients' credit reports. Experiences vary based on the type of error and the credit bureau. For example, payments mistakenly reported as late or accounts that do not belong to the client seem to be quick fixes. Depending on the bureau, such a problem could be corrected in under 45 days or up to 90 days. A revised credit report should be provided to document that the error has been corrected. NHN counselors report that their most difficult cases, including instances of identity theft or the lack of cooperation from the credit bureau, can take several months to resolve.

5. Please explain your criticisms of the FTC report.

The FTC report is flawed primarily because it is based on highly selective data from the insurance industry. Moreover, even though the data are poor, the FTC conclusions were

presented in a definitive manner. For example, the FTC study found that less than 10% of Latinos do not have credit files. Further, the FTC study found that it was more difficult to find credit reports for African Americans than for Latinos. According to the study, credit reports could not be located for 9.2% of the Hispanic population compared to 9.7% of African Americans and 7.8% of non-Hispanic Whites.

Most relevant and credible studies to date that include or analyze credit scores by race, ethnicity, and nativity show that a substantial share of Latinos (20% or more) do not report having credit scores. This is largely due to a substantial share of foreign-born U.S. residents being unbanked or underbanked. Notwithstanding this, the FTC concluded – based on these data – that not having a credit score was unlikely to be an important source of difference in auto insurance premiums among racial and ethnic groups.

Again, we thank you for giving us the opportunity to provide remarks before the Subcommittee and look forward to working with you to address these important challenges.

Sincerely,

Eric Rodriguez
Deputy Vice President

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

OFFICE OF
THE COMMISSIONER

November 26, 2007

The Honorable Melvin L. Watt
Chairman
Subcommittee on Oversight & Investigations
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Watt:

I am writing in response to your questions to follow-up on the Federal Trade Commission's October 2, 2007 testimony concerning the agency's report addressing the impact of credit-based insurance scores on consumers of automobile insurance.[1] I welcome this opportunity to provide additional information about the Commission's study and report on this important topic.

1. How many times in the past five years has there been a dissenting statement to an FTC report?

In the past five years, Commissioners have issued concurring statements in connection with 4 of the 53 reports the agency has issued. During the same time period, Commissioners have issued dissenting statements in connection with 3 reports the agency has issued.

2. On page 4 of your testimony, you refer to several "judgment calls" made by the Commission in the application of its technical expertise and statistical analysis to the data, and that "reasonable minds" may differ on these judgment calls. Please describe these judgments and the reasons behind the FTC's ultimate decisions.

I consider the most important decisions which required the judgment of the Commission's experts to be: (1) how to create an appropriate dataset; (2) how to assess the effect of scores; and (3) how to build the Commission's own scoring models.

a. How to Create an Appropriate Dataset

To conduct the empirical analysis mandated by the Fair and Accurate Transactions Act of 2003 ("FACT Act"), the FTC staff had to create a database including automobile insurance policy and claim history information about consumers. One critical question was whether this type of information should be obtained voluntarily from a consortium of insurance companies or

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[1] Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* (July 2007).

whether it should be obtained from insurance companies through the use of compulsory process. For the reasons set forth more fully in the separate statements issued with the report and prior communications with Congress, the FTC staff determined that the policy and claim information obtained voluntarily from the group of insurance companies was an appropriate core for the database used in the study.

When combined with data from a number of other sources, this policy and claim information allowed the Commission to address the questions specified in Section 215 of the FACT Act. For example, because insurance firms do not maintain information about the race and ethnicity of individual policyholders, the FTC staff also had to decide what race and ethnicity information to obtain and how to incorporate it into the database. The Commission staff decided to obtain race and ethnicity data from three other sources: (1) Social Security Administration (SSA) records, (2) a Hispanic surname match, and (3) Census information aggregating race/ethnicity information by geographic area. The Commission staff used this additional data to determine (or, where necessary, to predict) the race or ethnicity of each individual in the dataset. Incorporating these three additional sources helped FTC staff enrich the overall dataset. In addition, the Commission staff applied weights to ensure that the data was nationally-representative with regard to geography, race, ethnicity and income. *See* Appendix D of the Report.

The dataset created for the FTC study gave the agency the necessary tools to research the issues set forth in section 215 of the FACT Act – in particular, the statistical relationships between race, ethnicity, income, auto-insurance risk, and credit-based insurance scores. Using this rich collection of data, the FTC was able to examine the impact of the use of credit-based insurance scores, and to evaluate the extent to which scores act as a proxy for protected classes of consumers.

b. How to Assess the Effect of Scores

In analyzing the effects of credit-based insurance scores, the FTC staff had to make several decisions regarding how to measure the impacts of scores on consumers. First, the Commission staff developed models of insurance claims risk, which required a number of decisions regarding how to properly incorporate numerous control variables. *Id.*[2] Once these models had been created, the economists measured the effect of scores on predicted risk – i.e., the expected total dollars paid for claims likely to be made by a given policyholder. Commission staff concluded that this calculation of risk serves as a good substitute for insurance premiums, because premiums should be roughly proportional to claims risk posed by consumers. *See* Section V.A. of the Report.

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[2] To cite another decision, the Commission staff had to determine how to analyze the different categories of coverage (e.g., comprehensive, collision, etc.) – for instance, whether to run a separate model for each coverage category or a single combined-coverage model. For most of the analyses, the FTC staff presented results either by coverage category, or aggregates derived from separate analyses by coverage (although, for completeness, the agency staff did compare these results against a single combined-coverage model).

c. How to Build Scoring Models

In attempting to create an alternative model that might minimize the proxy effects associated with race, ethnicity and income, the agency first had to obtain from a third-party data broker detailed credit history information for each auto insurance consumer in its database. Then the Commission staff had to develop a methodology for building scoring models. This was a particularly challenging task, because there was no existing standard approach within the insurance industry. After discussing numerous approaches with experts, the FTC staff settled on a model which incorporated aspects of a number of different score-building methodologies. It crafted its model to be as objective and "mechanical" as possible, in order to minimize the subjective judgments which characterize some of the approaches studied.

3. Does the FTC find it acceptable that the use of credit-based insurance scores results in an increase in insurance premiums for 64% of all African-Americans and 53% of all Hispanics as indicated at page 7 of your testimony?

In the report, the FTC made no judgments as to whether the results of its study were acceptable, leaving to the Congress the judgment as to what policy changes, if any, would be in the public interest in light of its report. The FTC prepared a report that simply provided lawmakers with information to assist them in assessing the need for making changes in the law.

4. You state at page 8 of your testimony that there is some "proxy" effect of using credit-based insurance scores, but that it is "relatively small." What do you mean by "relatively small?" What does the FTC believe is an acceptable level of "proxy" effect?

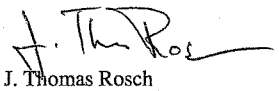
In the study, the FTC staff first calculated predicted losses from claims for racial and ethnic groups of consumers without using any credit-based insurance scores. The Commission staff then calculated predicted losses from claims for these groups with the use of credit-based insurance scores. The difference between these two calculations shows the overall effect of using credit-based insurance scores. The FTC study found that the overall effect of using credit-based insurance scores was an increase in the amount of predicted losses from claims of 10.0% for African-Americans and 4.2% for Hispanics.

The "proxy" effect of credit-based insurance scores represents the portion of the overall effect that is attributable to race, ethnicity, and income. To separate out this proxy effect from the remainder of the overall effect, the FTC staff added controls for race, ethnicity, and income. In the FTC study, adding credit-based insurance scores and controlling for race, ethnicity, and income resulted in a net increase in the amount of predicted losses from claims of 8.9% for African-Americans (1.1% less than without controls) and 3.5% for Hispanics (0.7% less than without controls). These proxy effects account for a proportion of the overall effect that is in line with the proxy effects associated with other commonly-used automobile insurance risk variables, such as geography, tenure, and prior claims. Although the FTC report therefore described the proxy effect found as "relatively small," it did not offer views as to what proxy effect, if any, would be acceptable.

Conclusion

I appreciate this opportunity to respond to your questions about the FTC's report on the important topic of the impact of credit-based insurance scores on automobile insurance consumers. If you or your staff have additional questions or comments, please contact me or have your staff contact Jeanne Bumpus, the Director of our Office of Congressional Relations, at (202) 326-2946.

Sincerely,



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The Honorable Melvin Watt
Chairman
Subcommittee on Oversight and Investigations
U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

ATTN: Terrie Allison

Re: Response of Commissioner J. P. Schmidt, Hawaii Insurance Division
To Follow Up Questions On Credit-Based Insurance Services
Relating To Testimony: October 2, 2007

Dear Chairman Watt and Committee Members:

Thank you for this opportunity to provide additional information on credit-based insurance scoring and Hawaii's experience..

As I stated in my testimony, in 1987 the Hawaii Legislature amended the Hawaii Revised Statutes to prohibit discriminatory practices in the pricing of automobile insurance premiums.[1] The law applies to rating plans, ratemaking standards, and underwriting standards and bars use of race, creed, ethnic extraction, age, sex, length of driving experience, **credit bureau rating,** marital status, or physical handicap in the direct or indirect pricing of Hawaii's automobile insurance premiums.

You requested additional information in response to three questions:

[1] HRS §431:10C-207 Discriminatory practices prohibited.

1. Since the ban on credit scoring in Hawaii, what are permissible factors to underwrite and rate auto insurance?

The State of Hawaii decided that underwriting and ratemaking for auto insurance should be primarily based on factors affecting the insured's vehicle and actual driving. Other factors may be considered so long as they are not unfairly discriminatory.

Insurers consider the insured's driving record, average miles normally driven, whether the car is used to drive to work, for leisure or as a part of the insured's work. Insurers also consider the vehicle's make and model, equipment and the performance characteristics of the car, as well as the ratio of vehicles to drivers in the household (e.g. 2 drivers and 5 vehicles in the household compared with 5 drivers and 2 vehicles).

2. In your capacity as the State Insurance Commissioner, explain the potential negative effects of credit scoring for small business, the recently divorced and persons facing high medical bills.

When considering policy decisions in a complex area such as insurance, the legislature considers the corollary effects of a particular rule or statute. The use of credit scores in ratemaking or underwriting may provide some people with lower rates, but may unfairly burden many others.

Small businesses are the life's blood of our economy. They are particularly susceptible to outside forces that they do not control. For instance, in a general economic downturn, a small business often needs to borrow money to continue operations purchase supplies and keep people employed. The additional burden of increased transportation insurance costs, due to credit scoring, adds an unnecessary burden at the worst possible time.

In almost every divorce, the debt of the couple becomes a problem, due to the division of finances. This has no connection to the couples driving habits, but will likely adversely affect their credit scores. Again this places an additional burden on individuals without a rational basis.

A study by Harvard Medical School in 2005 found that about half of the bankruptcies in the United States were caused by medical bills. Once again, these financial problems have no connection to a person's driving habits, and place an additional burden on that person at the worst possible time.

3. On Page 3 of your testimony, you refer to the Hawaii insurance market as "competitive" and "healthy". Please elaborate. Have you noticed any downturns in the market since the ban of credit scoring for auto insurance?

After the passage of the laws that included the ban on use of credit reports in auto insurance in 1987, Hawaii has experienced both good and bad markets. There is no evidence that the ban on credit reports had any effect on the market. There were far more important factors that determined whether we had a healthy competitive market with reasonable rates for our citizens.

In the mid-1990s the auto insurance market in Hawaii was in trouble. We had the second highest average auto insurance premiums in the nation. The legislature enacted a series of reforms, primarily removing numerous mandates and simply requiring basic insurance and allowing individuals to choose additional coverages. As a result of the reforms, over the next 5 years, Hawaii's premiums dropped the most of any state, falling to 21st in the nation. The ban on credit reports had no impact for good or bad on this improvement in the market.

Thank you, again, for the opportunity to address this honorable body and to share with you Hawaii's approach to – and experience with – this important insurance law policy.

Sincerely,

J.P. SCHMIDT
Insurance Commissioner
State of Hawaii

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December 3, 2007

Honorable Melvin L. Watt
United States House of Representatives
c/o Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

RE: Oct. 2 hearing, "Credit-Based Insurance Scores: Are They Fair?"

Dear Chairman Watt:

Thank you for the opportunity and privilege to testify in front of your subcommittee on Oct. 2 regarding "Credit-Based Insurance Scores: Are They Fair?" What follows are my answers to your additional follow up questions for the record in your letter dated Oct. 26.

1. Before the advent of credit scoring for insurance, how did the insurance industry price for risk?

The insurance industry has priced for risk the same way both before and after the advent of its increased use of credit based information in the last decade: Carriers—following established norms of law and public policy by matching the premiums they charge with the insured's risk of future loss—work to identify and integrate accurate rating factors into their pricing models.

In following this path, insurers today use credit based insurance scores in the same way that they use other rating factors. They do so by using credit based information in addition to—but not instead of—other familiar factors, such as driving record, claims history, age, and gender, all of which have been shown to correlate with likelihood of insured loss. As a result, consumers put in to the common fund, in the form of premiums, in an amount proportional to what they are expected to take out, in the form of claims.

The use of credit based insurance scores in insurance underwriting and rating has been affirmatively legal under the Fair Credit Reporting Act since the 1970s, and insurers have found substantial evidence in recent years that, when added to their algorithms along with other factors, credit information increases carriers' ability to accurately evaluate insurance risk. Credit based insurance scores are thus an enhancement—but not a replacement—to insurers' established methods of pricing risk.

Such activity is repeatedly condoned and encouraged under the law, whereby insurers group people into objective categories which on average are predictive of the likelihood of insured losses. For instance, nearly a quarter century ago, in *State, Dept. of Ins. v. Insurance Services Office*, 434 So.2d 908 (Fla.App. 1 Dist. 1983), the Florida appellate court held that insurers' use of gender, marital status, and scholastic achievement as rating factors was appropriate and justified:

> Historically, the Department has measured the equitableness of a rating factor by its predictive accuracy.... Thus, by implication, the legislature approved the interpretation that rates based upon sex, marital status or scholastic achievement are unfair only if those rating factors are found to be actuarially unsound. [Citation omitted.] As previously stated, the evidence below overwhelmingly shows these factors are actuarially sound.

Putting this into broader context, objectively grouping people into categories is neither an uncommon nor a nefarious practice, but rather is used frequently in many fields as a natural and positive outgrowth of the information society. For instance, politicians rely on similar data analysis techniques to make predictions about how Americans will exercise their constitutional right to vote.

The current edition of the New Yorker magazine describes how Sen. Obama's presidential campaign mines data about voters to predict their likely choices at the ballot box—while explicitly comparing the process to credit scoring:

> Strasma's firm [working for the Obama campaign] builds profiles of voters that include more than a thousand indicators, long strings of data—everything from income to education to pet ownership—that he calls "demographic DNA." ... When the demographic DNA is combined with polling and interviews with Iowa voters, Strasma is able to create the political equivalent of a FICO score—the number that creditors use to determine whether a consumer is a good bet to repay a loan. Strasma's score tells the campaign of the likelihood that a specific Iowan will support Obama.

Ryan Lizza, "The Relaunch; Can Barack Obama Catch Hillary Clinton?" The New Yorker, Nov. 26, 2007, p. 83.

2. Do you believe that there are negative effects on consumers from the use of credit-based insurance scores? If so, please describe.

As discussed in my written and verbal testimony, negative effects on consumers from the use of any insurance risk factor—judged by prevailing and longstanding norms of United States law

Nathaniel S. Shapo's answers to follow up questions for the record dated Oct. 26, 2007 House Financial Services Committee, Subcommittee on Oversight and Investigations Honorable Melvin L. Watt, Chairman Oct. 2, 2007 Hearing: "Credit-Based Insurance Scores" Are They Fair?"

and public policy—are those that result in insureds being charged rates which do not correlate with their likelihood of insurance loss, as evaluated by objective and quantifiable criteria. Based on the findings of the Congressionally mandated FTC Study, the legislatively mandated Texas Department of Insurance study, and other publicly available information, credit based insurance scoring does not have negative effects on consumers.

These studies demonstrate that most people pay less because of credit based insurance scores, and that the use of credit based information achieves more precise insurance risk grouping. The FTC concluded that "scores permit insurance companies to evaluate risk with greater accuracy," and the Texas Commissioner of Insurance reported that "its use is justified actuarially and it adds value to the insurance transaction."

Credit based insurance scoring thus has positive rather than negative effects on consumers.

Actuarially justified rating factors lead to many consumers paying less for insurance because they are better matched with their risk of insurance loss. As a result of this same process, some consumers will pay more because *they* are better matched with *their* risk. This pattern occurs with all risk factors, and is desirable under the law and public policy—as the Louisiana appellate court explained in a discussion consistent with the basic holdings and findings of all courts who have interpreted the controlling statutes pertaining to this subject.

> The evidence taken by the Commissioner indicates that there exists a sound statistical basis for using classifications based on age and sex in fixing insurance rates. It further appears that any classification system which results in different classes paying different rates for the same protection is, to some extent, discriminatory. If, for instance, age and sex are not used as factors in establishing classifications in automobile insurance rates, women and all those over 24 years of age, or about 75% of the drivers, would pay a higher premium, while those under 25 years of age, about one-fourth of the drivers, would pay substantially less than they are now paying. The older and more experienced drivers would therefore be discriminated against by having to subsidize the higher risk class of younger drivers.
>
> [The unfair discrimination statute] requires that the classifications used in establishing rates be reasonable, and not unfairly discriminatory. We agree with the trial judge that classifications based on age and sex are not unreasonable, and, although there is discrimination against the good, young driver, it is not unfair or unreasonable.

Insurance Services Office v. Commissioner of Ins., 381 So.2d 515 (La. App. 1979).

Katten
Katten Muchin Rosenman LLP

Nathaniel S. Shapo's answers to follow up questions for the record dated Oct. 26, 2007
House Financial Services Committee, Subcommittee on Oversight and Investigations
Honorable Melvin L. Watt, Chairman
Oct. 2, 2007 Hearing: "Credit-Based Insurance Scores" Are They Fair?"

December 3, 2007
Page 4

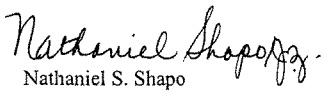
Similarly, the FTC Study concluded that (a) the use of credit based insurance scoring is an efficient and precise practice (having "a sound statistical basis," in the parlance of the case above); that (b) benefits a majority of consumers through lower premiums, meaning that it properly protects most drivers from "having to subsidize the higher risk class," as explained in the Louisiana case.

Credit based insurance scoring thus results in positive effects for consumers under the objective methods of evaluation encouraged by the law, as applied in courts throughout the United States. *See also Health Ins. Ass'n of America v. Corcoran*, 551 N.Y.S.2d 615 (N.Y.A.D. 3 Dept. 1990) ("[A]ppropriate classification of risks is sanctioned and encouraged throughout the Insurance Law."); *Life Ins. Ass'n of Massachusetts v. Commissioner of Ins.*, 403 Mass. 410 (1988) ("The intended result of the process is that persons of substantially the same risk will be grouped together, paying the same premiums, and will not be subsidizing insureds who present a significantly greater hazard.")

Because, as the FTC and Texas studies demonstrate, credit based insurance scoring is an excellent predictor of future loss, the practice is consistent with, and indeed, a manifestation of the legal and policy framework under which insurers function as a regulated industry. As a practical matter, this means that credit based insurance scoring is an appropriate and beneficial method of risk classification which has positive effects on consumers.

Please feel free to contact me at nat.shapo@kattenlaw.com or at 312.902.5273 if I can provide the subcommittee any further information or analysis regarding the regulation of credit based insurance scoring.

Sincerely,



Nathaniel S. Shapo

cc: Honorable Gary G. Miller, Subcommittee Ranking Member

MIKE KREIDLER
STATE INSURANCE COMMISSIONER

STATE OF WASHINGTON

OFFICE OF
INSURANCE COMMISSIONER

Phone: (360) 725-7000

November 30, 2007

The Honorable Melvin L. Watt, Chairman
House Oversight and Investigations Subcommittee
2236 Rayburn House Office Building
Washington, D.C. 20515-3312

Dear Chairman Watt:

Thank you again for the opportunity to testify before the Oversight and Investigations Subcommittee on October 2, 2007 during the hearing entitled, "Credit-based Insurance Scores: Are They Fair?"

On October 26th, you asked me to provide a written response to several follow-up questions for the hearing record.

The questions and my answers are listed below.

1. On page 3 of your testimony, you state that credit scoring unfairly discriminates against protected classes and the economically disadvantaged. Please explain in greater detail.

As I indicated in my testimony, the Federal Trade Commission study indicated that "African-Americans and Hispanics are strongly over-represented in the lowest deciles and under-represented in the highest deciles." When compared to all people, these two protected classes will be more likely to have higher rates because their scores are lower, and they are less likely to be able to access lower rates associated with higher credit scores. Furthermore, a 2005 Texas Department of Insurance study found that these two classes of people (and others) have poorer credit scores when compared to the greater population as well. Based on this information, it seems clear to me that credit scoring harms those African-Americans and Hispanics seeking to purchase automobile insurance. In my mind, that is discrimination.

I do not appear to be alone in questioning the impact of credit scoring on certain classes of people. The Florida Office of Insurance Regulation issued a regulation in 2006 that required property and casualty insurers to demonstrate that their credit scoring methodology *does not* disproportionately affect persons of any race, color, religion, marital status, age, gender, income, national origin, or place of residence. I believe this is another strong statement questioning whether credit scoring discriminates against protected classes, and I welcome the effort.

2. Do consumers generally understand how credit scoring affects insurance rates?

I asked staff in my Consumer Protection Division this very question. These are the folks who have fielded the thousands of calls the agency has received since insurers started using credit-based insurance scoring. Their answer was "no." There is great consumer suspicion about the "hidden and cloaked" scoring process in Washington State, and

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consumers continue to question the validity of any relationship of credit scores to risk in both automobile and homeowners insurance.

3. Please explain the impetus behind the Washington Law (effective January 1, 2003) limiting credit-based insurance scores and the law's key provisions.

As I stated in my testimony on October 2nd, since my election as insurance commissioner, I have had concerns about credit scoring, the impact it has on consumers, and the potential disparate impact on protected classes of people. I am not alone in my concerns. Credit scoring creates more confusion and even outright anger than any other issue I've faced since taking office. Since it surfaced in the year 2000, my office has received nearly 5,000 calls from consumers about it. While there are a variety of issues that concern consumers about credit scoring, some of the more prevalent problems are as follows:

- Consumers do not understand why their credit history should impact how much they pay for insurance rates;
- Each insurance company uses credit information differently; and
- Consumers' insurance rates increased because of the use of credit scoring or a credit factor.

To address some of my concerns with credit scoring and how companies were using it, I proposed legislation back in 2002, which our state legislature enacted into law. At the time, it was one of the strongest laws in the nation regulating how credit scoring could be used, and it set a national precedent. As of today, 48 states have joined our state and have enacted some level of regulation over this practice. While I favored an outright ban of credit scoring, I knew we wouldn't succeed in that endeavor. With this in mind, we targeted the most unfair aspects of credit scoring in our legislation.

Under our state's law, as of January 1, 2003, insurance companies cannot use consumers' credit history to cancel or non-renew a personal insurance policy (primarily auto and homeowners insurance). In addition, insurance companies cannot use the following six attributes of credit history to deny insurance coverage:

- The absence of credit history;
- The number of credit inquiries;
- Collection accounts identified as medical bills;
- The initial purchase or finance of a vehicle or house that adds a new loan to a person's existing credit history;
- The use of a particular type of credit card, debit card, or charge card; and the total available line of credit a person holds.

Additionally, after June 30, 2003, insurers cannot use the above attributes to set premiums – with one exception. Insurers may use the absence of credit history to set premiums, if they provide statistical data that proves consumers without credit histories are more likely to file claims. Two other important consumer protections in the law are that:

- Insurers must retroactively correct a premium if the company uses incorrect credit history for rating or underwriting; and
- Insurers must send enhanced "adverse action" notices to consumers so they know what items in their credit history are affecting insurance premiums and what they could do to improve their score.

4. On page 3 of your testimony, you cite six credit factors that cannot be used to deny insurance coverage or set premiums – such as absence of credit history, number of credit inquiries, medical bill collections and others. Are there other factors you would like to see banned?

If it were feasible, I would ban *all* credit attributes, not just the six listed in my testimony.

5. On page 4 of your testimony, you indicate disappointment with the FTC report. Please elaborate.

As I indicated in my testimony, I am disappointed in the FTC study. Our greatest hope was that the study would shed light on whether or not credit scoring discriminates against protected classes of people. In Washington State, our 2002 law attempted to look at the unfair discrimination issue by requiring my office to report back to the Legislature. In 2003, we issued a report that looked at the effect of credit scoring on auto insurance and pricing. One of the key questions in our study was, "Does credit scoring discriminate against the poor and people of color?" While our report suggested there might be a problem in this area, our small sample size and relatively small ethnic minority population made the results "inconclusive."

We were helping to organize a multi-state effort to examine this issue with a sample large enough to draw some valid conclusions. But when Congress tasked the FTC to study whether the use of credit based insurance scores "could result in negative or differential treatment of protected classes under the Equal Protection Act," we held off on our study so as to not duplicate efforts. We hoped that, with this charge, the FTC study would give us a well-reasoned, comprehensive study that would help answer the unfair discrimination question.

Three years later, we have a study by the FTC that seems to devote substantial time telling us what many already knew – that there is a correlation between credit scores and increased losses. But in my mind, it doesn't help answer the question of unfair discrimination; in fact, it seems to raise more questions than it answers. The study found that "African-Americans and Hispanics are strongly over-represented in the lowest deciles and under-represented in the highest deciles." Yet, the study also concluded that credit scoring was not a proxy for race. I don't know how to reconcile these two findings. It seems to me that, if these two groups are over-represented in the lowest scoring deciles (higher insurance rates) and under-represented in the highest scoring deciles (lower insurance rates), the use of credit scoring *does* cause harm to these groups.

I also have concerns with the sample and integrity of the data used in the FTC study. It is my understanding that only a handful of companies voluntarily provided data, and they would not identify themselves or confirm the integrity of the data sample. Commissioner

Pamela Jones Harbour eloquently addresses these concerns (and more) in her dissenting statement, and I concur with her thoughts on this issue.

6. On page 5 of your testimony, you indicate that insurance companies are considering factors such as income or education when pricing insurance, in addition to credit history. Why is the consideration of these factors a bad thing?

I believe the question as posed here is incorrect. On page 5 of my testimony, my concern was that companies were considering factors like "*education* and *occupation*". So I will respond in that context.

I believe the use of education and occupation can be a "bad thing," as it also may have a disparate effect on protected classes. It seems fairly obvious that occupation and education level are correlated with income, which can affect the availability and affordability of personal insurance. For instance, according to 2006 U.S. Census Bureau statistics*, Hispanics – of any race – are much less likely across all age levels to obtain a high school diploma or Bachelor's degree when compared to all races. It stands to reason then that Hispanics may have a lower income, which could cause higher personal insurance premiums using credit-based insurance scores.

Using the same analysis above, I think it is also fair to say that if Hispanic people attain lower levels of education, it may likely adversely affect their income level as well. This may bring about the same disparate impact on the Hispanic population when compared to all races.

An additional concern I have with the use of occupation is that it is virtually impossible to define occupation groups objectively and apply those definitions consistently. For instance, we have seen insurance scoring models that put "elected official" and "politician" into separate occupational classes – which leads to the possibility that the same person could be charged two different premiums, depending on how his or her occupation is described. My office has also seen a similar situation with "accountant" and "accounting." When you consider these situations, it seems virtually impossible to use an objective and well-defined classification system for occupations. So, in my opinion, the use of occupation is problematic beyond the potential disparate impact it may have on protected classes.

7. Please elaborate on your three recommendations on page 6 of your testimony.

My three suggestions were to restore "adverse action" notices, make "adverse action" notices more meaningful, and require insurers to prove their models do not unfairly discriminate.

<u>"Adverse action" notices</u>

In order to offer more specific detail regarding changes in "adverse action" notices, I asked my legal division to provide the following clarity and analysis to help consumers better understand how credit scoring affects the availability and affordability of their insurance:

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* http://www.census.gov/population/www/socdemo/educ-attn.html

In *Safeco v. Burr, 127 S. Ct. 2201; 2007 U.S. Lexis 6963 (2007)*, the U.S. Supreme Court made several rulings, one of which was that carriers need only send adverse action notices to consumers when the price they charge is higher than would be charged to an applicant having a "neutral" credit score. The court was not clear what it meant by "neutral" score, although apparently the carrier alleged that it ran the subject applicant through its rating system without considering his credit history and also ran him through its rating system considering his credit history, with the result that the rate it charged him considering his credit history was no higher than the rate it would have charged him without such consideration.

As Justice Stevens and Justice Ginsberg said in their concurring opinion:

> As a matter of federal law, companies are free to adopt whatever "neutral" credit scores they want. That score need not (and probably will not) reflect the median consumer credit score. More likely, it will reflect a company's assessment of the creditworthiness of a run-of-the-mill applicant who lacks a credit report. Because those who have yet to develop a credit history are unlikely to be good credit risks, "neutral" credit scores will in many cases be quite low. Yet under the Court's reasoning, only those consumers with credit scores even lower than what may already be a very low "neutral" score will ever receive adverse action notices.*
>
> While the [majority] Court acknowledges that "the neutral-score baseline will leave some consumers without a notice that might lead to discovering errors," *ante*, at 16, it finds this unobjectionable because Congress was likely uninterested in "the theoretical question of whether the consumer would have gotten a better rate with perfect credit." The Court's decision, however, disserves not only those consumers with "gilt-edged credit report[s]," *ante*, at 16, but also the much larger category of consumers with better-than-"neutral" scores. I find it difficult to believe that Congress could have intended for a company's unrestrained adoption of a "neutral" score to keep many (if not most) consumers from ever hearing that their credit reports are costing them money. In my view, the statute's text is amenable to a more sensible interpretation.

It will now take Congressional action to overcome the effect of this court decision and restore the intended effect of adverse action notices – the legislative history of the Fair Credit Reporting Act indicates it was Congress's intent that consumers learn when their credit history causes adverse actions so that they can inquire into the elements of the information compiled on them by the credit rating companies, rectify mistakes, and alter their behavior to create a better credit score. This intent has been thwarted by the Court's decision.

The definition of "adverse action" in the FCRA is not specific with respect to what benchmark an action must be measured against when determining whether it is adverse.

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* Companies that automatically disqualify consumers who lack credit reports will never need to send any adverse action notices. After all, the court's baseline is "what the applicant would have had if the company had not taken his credit score into account," *ante*, at 15, but from such companies, what the applicant would have had is no insurance at all. An offer of insurance at any price, however inflated by a poor and perhaps incorrect credit score, will therefore never constitute an adverse action.

That left the Court free to reach the conclusion it did. However, the law in the state of Washington is very specific. It provides in pertinent part in RCW 48.18.545(1)(a):

> Adverse actions include, but are not limited to:
> (i) Cancellation, denial, or nonrenewal of personal insurance coverage;
> (ii) Charging a higher insurance premium for personal insurance than would have been offered if the credit history or insurance score had been more favorable [emphasis added]

Enactment by Congress of this or similar language to define adverse action in the insurance context would correct the unfortunate result of this recent U.S. Supreme Court decision.

Require insurers to prove their models do not unfairly discriminate

As I referenced earlier, the Florida Department of Insurance Regulation recently promulgated a rule (§69O-125-006, F.A.C.) placing upon the insurer the burden of demonstrating that the credit scoring methodology is not unfairly discriminatory. It also defines "unfairly discriminatory" and "disproportionate impact" in this context. If companies want to use credit or insurance scores, then make the company prove it does not unfairly discriminate against protected classes.

Thank you again for giving me the opportunity to testify before the Committee and to respond to these additional questions. Please let me know if you would like to discuss this matter further.

Sincerely,

Mike Kreidler
Insurance Commissioner