

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

**NAIC HEARING  
APRIL 30, 2009**

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

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

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

### Automobile Insurance.

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

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

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

### Homeowners Insurance

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### **Conclusion**

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

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

## EXHIBIT 1

### COMPANY PROFILE

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

### BACKGROUND

#### Lines of Business

This insurer uses CBIS for auto and homeowners business.

#### Duration

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

### DATA REVIEW

#### Consider Whether CBIS Have Been Changing

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

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

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

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

#### Consider Impact of CBIS Ban

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

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

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

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

## **CONSUMER-ORIENTED EFFORTS**

### Notice - Expanded Reasons

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

This insurer has opted to use expanded reasons countrywide.

### Extraordinary Life Circumstances

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

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

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

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

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

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

### Consumer Complaints

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

### Education

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

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

## EXHIBIT 2

### UNFAIR DISCRIMINATION AS ACTUARIAL STANDARD

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

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

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

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

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

### **EXHIBIT 3**

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

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

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

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

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

## EXHIBIT 4

### EXAMPLES OF CONSUMER INFORMATION

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

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

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

## EXHIBIT 5

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

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

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

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

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

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

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

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