

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

Testimony as Delivered

by

Robert P. Hartwig, Ph.D., CPCU

President & Economist

Insurance Information Institute

New York, NY

National Association of Insurance Commissioners

Property and Casualty Committee

Market Regulation and Consumer Affairs Committee

April 30, 2009

Arlington, VA



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

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

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

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

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

Current Economic Conditions

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

¹ Contact information: Tel: (212) 346-5520; Email: bobh@iii.org.

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

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

What's Different About This Recession: Credit Market Conditions

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

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

The Economic Crisis and Consumer Credit Profiles

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

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

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

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

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

Does Scoring Work When the Economy is in Recession?

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

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

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

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

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

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

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

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

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

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

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

Higher Premiums and Unfair Subsidies

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

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

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

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

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

Less Insurance

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

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

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

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

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

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

Summary

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

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

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

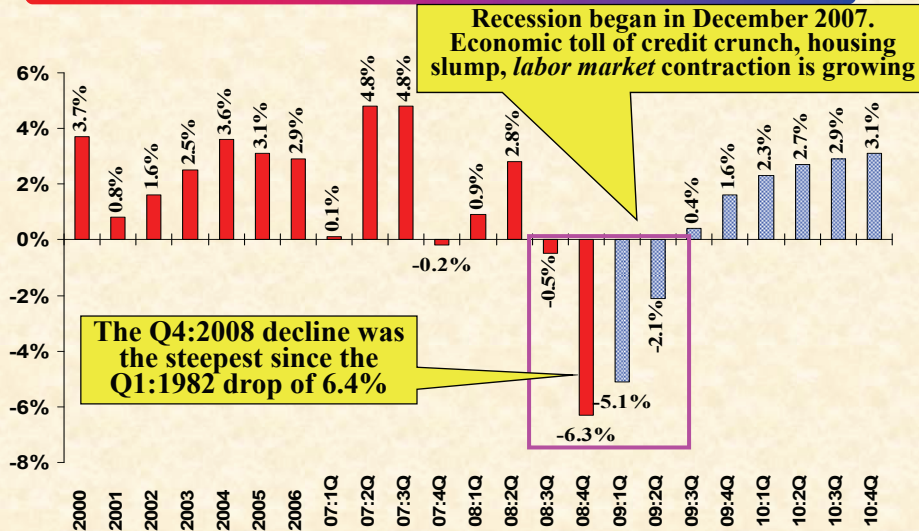
Finally, calls to ban, severely restrict or suspend the use of credit-based insurance scores during the current financial crisis are misguided, distortionary and unfair to the millions of policyholders who impose few costs on the system. Insurance scoring is a proven risk management tool. Property/casualty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

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

Figure 1.



Real GDP Growth*

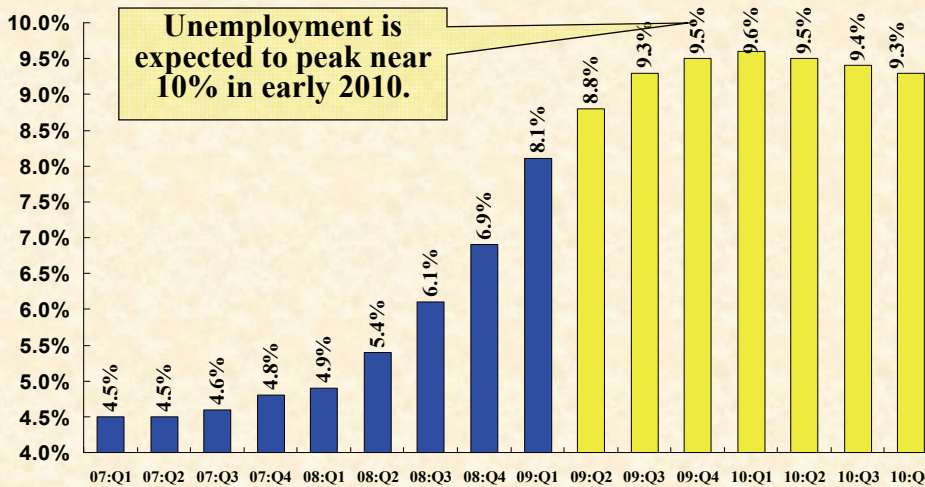


*Yellow bars are Estimates/Forecasts from Blue Chip Economic Indicators.
Source: US Department of Commerce, Blue Economic Indicators 4/09; Insurance Information Institute.

Figure 2.



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



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

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

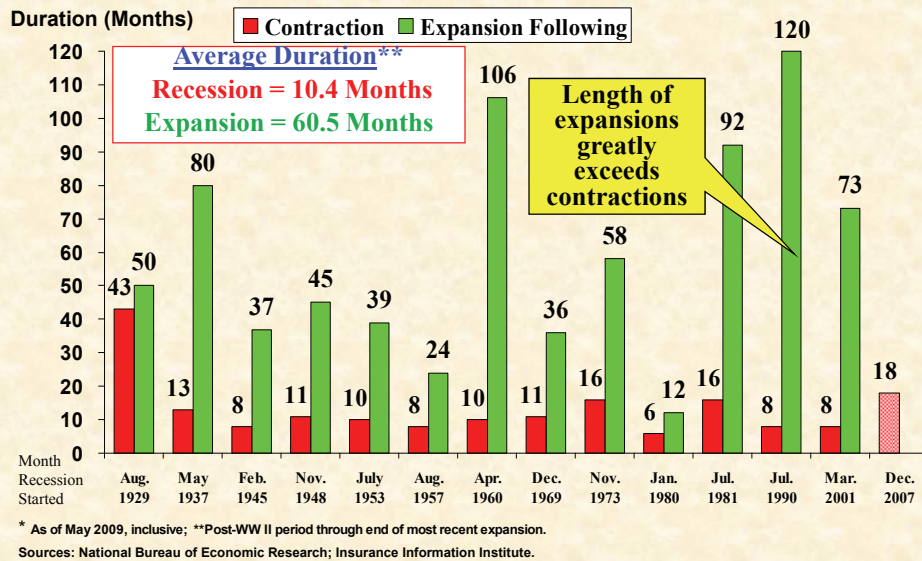
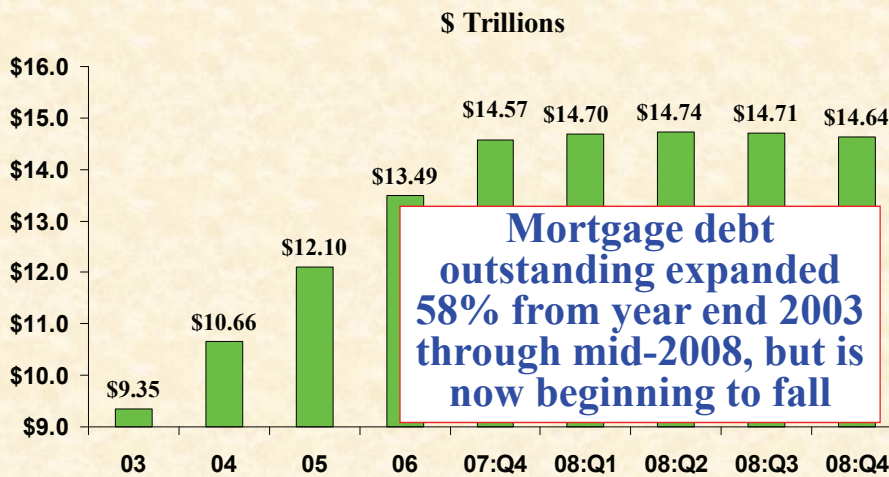


Figure 4. *Mortgage Debt Outstanding: 2004- 2008¹*



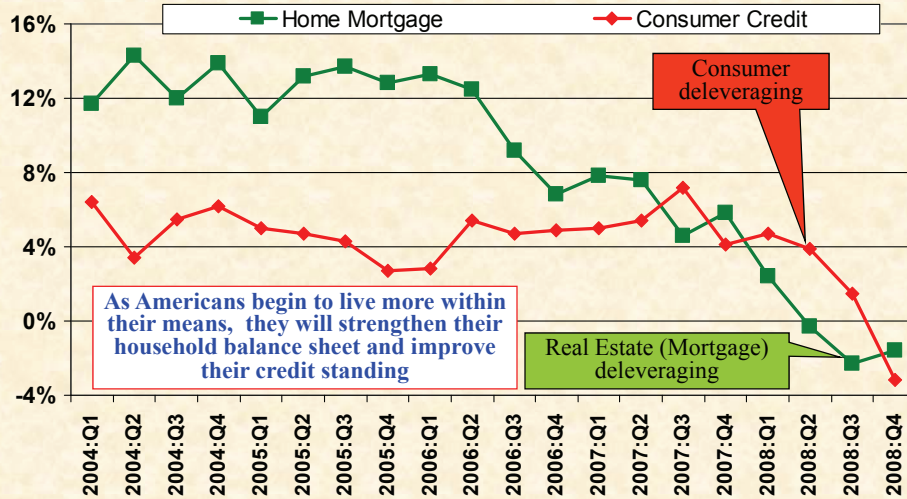
¹End of period.
 Sources: Board of Governors of the Federal Reserve, <http://www.federalreserve.gov/econresdata/releases/mortoutstand/>; Insurance Information Institute.

Figure 5.

Households Are Now Rapidly “Deleveraging” (Shedding Debt)



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



As Americans begin to live more within their means, they will strengthen their household balance sheet and improve their credit standing

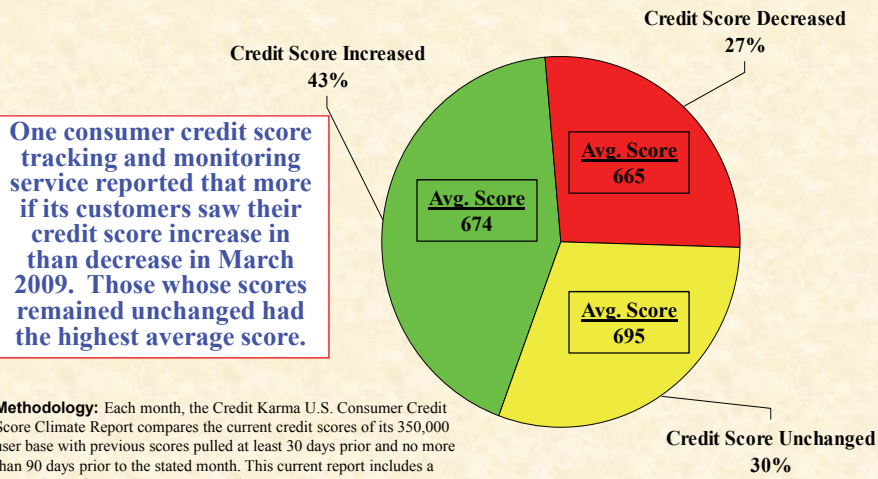
Consumer deleveraging

Real Estate (Mortgage) deleveraging

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

Figure 6.

Credit Monitoring Service Report: Many Scores Rose in March 2009



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

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

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