Insurers' Use of Credit Scoring for Homeowners Insurance In Ohio
A Report to the Ohio Civil Rights Commission

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1. EXECUTIVE SUMMARY

Insurance companies in Ohio have increasingly used consumer credit information – in the form of insurance credit scoring – to determine if they will offer a consumer a residential property insurance policy and how much to charge for the policy offered. Insurance credit scoring is the use of a mathematical formula to translate information in a consumer's credit report into a numerical value, and insurance credit scoring is now used by the majority of Ohio insurers for residential property insurance in a variety of ways – for underwriting (including rating tier selection), rating (or premium development), coverage eligibility, marketing, and payment plan eligibility.

There is little public information available about insurers' use of consumer credit information in Ohio. This occurs because most insurers use consumer credit information for underwriting. Underwriting is generally the insurers' process of determining whether or not to offer coverage to a consumer and, if offered, what type of coverage and what type of rate level or market tier to offer. Insurers' underwriting practices are codified in rules called underwriting guidelines. These guidelines are not typically filed with the Ohio Department of Insurance, and that agency has historically not requested them from insurers. As a result, insurers typically file little information about their use of consumer credit information with the Ohio Department of Insurance.

In contrast to underwriting guidelines, insurers do submit rate filings to the Ohio Department of Insurance. The rate filings contain base rates and rating rules. Rating is the process of developing a premium for a specific consumer based upon that consumer's personal or property characteristics using the base rate, rating factors and rating rules set forth in the rate filing.

In the past, insurers had two or three rate levels or rating tiers. The preferred rates had the most restrictive underwriting guidelines and the lowest rates. The standard rates had slightly less restrictive underwriting guidelines and somewhat higher rates. The non-standard rates had the least restrictive underwriting guidelines and the highest rates. It was common for insurers to have a separate insurance company for each rate level. Stated differently, each insurance company had one set of rates and represented one tier.

With the advent of insurance scoring, many insurers have increased the number of rate levels or rating tiers to 20 or more, with multiple rating tiers being written (or sold) in one insurance company. In some cases, the rules governing eligibility (or assignment of a consumer) for rating tiers are still contained in underwriting guidelines and, consequently, not filed with the

Ohio Department of Insurance and not available to the public. In other cases, the rules are part of the rating manual, where the insurance score is the last factor applied to the premium in the rate development and the insurance score (or the insurance score in combination with other factors, such as claim history) determines the rating tier factor applied to the premium. If the rating tier is applied as a rating factor, then the rate filing includes information about the rating tier eligibility and rate differential by rating tier.

Our review of filings at the Ohio Department of Insurance revealed information about only three insurers' use of insurance credit scoring – Allstate, Farmers and Grange Mutual. Farmers' use of credit scoring has the greatest potential impact on consumers – nearly a 4:1 difference in rates between best and worst credit scores. Allstate's use of credit information also has a major impact – nearly a 2:1 impact between best and worst credit scores for homeowners and 2.5:1 for tenants insurance. We believe the Grange Mutual information, found in a 1999 filing, is out of date. Based upon our interviews, we also believe that Westfields' and Travelers' use of credit information has a large impact on Ohio consumers.

The insurance industry argues for use of the insurance credit scoring with claims of a correlation between consumer credit information and risk of claims. The "correlation" means that certain credit characteristics can "predict" which consumers are more likely to have an insurance claim. The industry relies upon a number of its own secret studies to support this claim. There has been no meaningful opportunity for independent review or analysis of these studies because the underlying data are never made available to independent reviewers (where independent is defined as someone not in the employ of the insurance industry). Other information that is available to the public contradicts and calls into question the alleged correlation.

In addition, consumer organizations have argued that credit scoring itself is correlated to certain underwriting or rating factors that are prohibited, such as race. The industry argues that the use of credit scoring does not discriminate or have a disparate impact on poor and minority populations. Again, however, the industry relies upon its own secret studies. Other data and information strongly suggest insurers' use of credit has a disparate impact on poor and minority populations. Finally, the industry argues that, since race is not a factor considered in the credit scoring models, even if credit scoring has a disparate impact on protected classes, such a result is fair insurance discrimination and not unfair discrimination.

Based upon all the available information, it is our opinion that insurers' use of insurance credit scoring for underwriting, rating, marketing and/or payment plan eligibility very likely has a disparate impact on poor and minority populations in Ohio. Consequently, it is our opinion that insurers' use of insurance credit scoring makes insurance less available and/or more expensive for poor and minority populations in Ohio.

2. INTRODUCTION: INSURANCE CONCEPTS

In this section, we discuss basic insurance terminology and concepts. (See Appendix 1 for a listing of documents and resources for each section of this report.)

2.1 Types of Insurance

There are many types of insurance sold. The types of insurance are generally broken down into two major categories: life/health (L&H) and property/casualty (P&C). Life/health coverages include life, health and disability insurance. Property/casualty coverages are generally broken into personal and commercial lines. Personal lines are those coverages purchased by individuals, including private passenger automobile and homeowners insurance. Commercial lines are those coverages purchased by businesses and include commercial multi-peril (property and liability), medical malpractice, workers' compensation, and commercial automobile insurance. This report focuses on residential property (homeowners) insurance.

Residential property insurance is considered a "line" of insurance. Within each line are a variety of coverages. For residential property insurance, the consumer typically selects one of the major coverages. An important characteristic of coverages is whether they provide first party or third party coverage. First party coverage pays for personal injury or property damage to the insured. Third party coverage pays for personal injury or property damage that the insured causes to a third party.

Residential property insurance is a broader term for insurance most people know as homeowners insurance. The coverages are:

> *Dwelling* – This is first-party coverage. This coverage pays for damage to your house. An important factor for dwelling coverage is whether the coverage is for replacement value or actual cash value. The replacement value policy pays the replacement cost of the home, while the actual cash value policy only pays the actual market value of a home. If a $100,000 home is totally destroyed, for instance, but costs $125,000 to rebuild, the replacement value policy would pay $125,000 but the actual cash value policy would only pay $100,000.
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> *Personal property* – This is first-party coverage. This coverage pays either the actual cash value or replacement cost of your personal property (excluding autos) that are damaged, stolen, or destroyed.
>
> *Liability* – This is third-party coverage. This coverage pays the other person (the third party) if you cause injury to the person or the person's property.

Medical Payments – This is third-party coverage. This coverage pays the other person (the third party) for medical expenses incurred from an injury on your property.

Loss of use – This is first-party coverage. This coverage pays for your living expenses, including rent, during the time your house is being repaired.

A *Homeowners* policy refers to a multi-peril policy that provides all five coverages. A *Dwelling*, or *Fire*, policy normally provides only the dwelling coverage. A *Renters* policy normally provides all coverages other than dwelling.

2.2 Types of Insurers

Insurance companies that sell private passenger automobile and homeowners insurance differ based on the type of *ownership* of the company and the method of *sales*.

The two main types of ownership are stock companies and mutual companies. Stock companies are publicly owned companies whose stock generally trades in one of the stock markets. Stock companies are owned by their shareholders – the purchasers of the company's stock. Allstate is a stock company. Mutual companies are owned by their policyholders. State Farm Mutual Automobile Insurance Company is a mutual company.

Insurers also differ by how they sell their policies. *Direct writers* do not use agents to sell their policies. Two examples are USAA and GEICO. These companies sell insurance over the phone through sales representatives. Most insurers, however, sell their policies through agents. *Captive agent* insurers sell their policies through agents who only sell for that company. State Farm, Farmers, and most Allstate agents are captive agents. *Independent agent* insurers sell their policies through independent agents that represent more than one insurer. Progressive, SAFECO and Travelers are examples.

2.3 Market Segments

Most insurance markets consist of several submarkets: preferred, standard, nonstandard, residual, and surplus lines. *Preferred* companies have the lowest rates and sell to the consumers perceived to represent the lowest risk. *Standard* companies have higher rates and sell to consumers perceived to represent average risks. *Nonstandard* companies have the highest rates of these three types of companies and sell to consumers perceived to represent the highest risk. The preferred, standard and substandard markets are known collectively as the "voluntary market" or the "admitted market." Those consumers unable to obtain coverage in these three markets must turn either to a residual market mechanism or to surplus lines companies.

Residual market mechanisms were created to provide some type of insurance to those consumers who could not obtain it in the voluntary market. Most states have some residual market for private passenger automobile insurance. The automobile insurance residual markets are typically called "insurance plans" or "risk pools." For residential property insurance, some

states have “FAIR” plans, which are similar in structure to automobile insurance risk pools. Most FAIR plans were created in the 1960’s and 1970’s following the incidence of urban riots and charges of insurance redlining. A number of coastal states now have property insurance residual markets for catastrophe events, including hurricane and earthquake. These residual markets are relatively new, some having been created in the last few years.

Not all states have residual market mechanisms and many of those that do limit the types of coverages available. Residual market mechanisms operate in one of two ways. In some, consumers are insured through a pool with state-set rates and all insurers share the profits or losses from all such policies. Alternatively, these consumers are assigned to an insurance company that must accept the risk at a state-set rate and the profit or loss on the policy. Consumers normally pay higher rates in a residual market and receive limited benefits.

Surplus lines carriers, also known as "off shore" and "non-admitted" insurers, are not regulated by the state. These insurers are permitted to insure only those consumers who are unable to purchase coverage in the admitted market. These insurers present several disadvantages to the consumer. Rates are usually much higher than admitted companies, policy forms are not regulated, no state guaranty coverage is provided if the company goes broke, and the absence of solvency regulation increases the chances that the company will be unable to pay its claims.

Most insurance "companies" are really a group of insurance companies. Normally, an insurer group owns preferred, standard, and nonstandard companies with correspondingly higher rates. Each of the companies in the insurer's group has decreasingly restrictive underwriting guidelines. When a consumer goes into State Farm, for instance, he or she may be placed in State Farm's preferred company if the consumer meets the most restrictive underwriting guidelines. Otherwise, State Farm will insure the consumer in either it’s standard company or substandard company, or deny coverage altogether.

For most consumers, auto and homeowners coverage is obtained in the standard and preferred markets. These two markets normally sell the large majority of insurance policies in a state. For consumers forced into the substandard, residual, or surplus lines markets, however, insurance is unavailable in the standard and preferred markets. The insurance availability problem includes both the inability to obtain insurance at all and the inability to purchase insurance in the standard and preferred markets.

2.4 Underwriting Guidelines

Underwriting is the process by which an insurer determines whether it will accept or reject an applicant and, if acceptable, at what price. *Underwriting guidelines* are the standards on which the insurer makes the underwriting decision. Insurers provide underwriting guidelines to insurance agents (or sales representatives for direct writers) for the agent to make the initial decision as to whether to offer coverage and at what price. An underwriter in the insurer’s home office reviews applications to ensure they meet the underwriting guidelines. Insurers also use underwriting guidelines to determine whether the company will renew an existing policy.

Underwriting guidelines range from very detailed and objective written rules (*e.g.*, limitations on insuring homes under a specified value) to broad and subjective forms of guidance for the agent or underwriter (*e.g.*, limitations on insuring consumers with "bad morals"). Some of the more common underwriting guidelines for auto and homeowners insurance are listed in Table 1 below.

Table 1
Top Underwriting Guidelines
For Auto and Homeowners Insurers

Auto	**Homeowners**
Credit history	Credit history
Driving experience	Made previous homeowners claim
Cancelled/refused by another company	Minimum coverage / value of the home
No prior insurance	Age of home
Age	Location of the home
Occupation	Lifestyle
Residential stability	Marital status
Employment stability	Employment stability
Not-at-fault accidents and claims	
Marital status	
Purchase of other insurance	
Previous insurer was nonstandard	
Type of car	

Not all discrimination is wrong or illegal. Some discrimination is clearly proper, like refusing to sell homeowners insurance to the class of consumers who have been convicted of arson. Other discrimination is clearly *improper*, like refusing to sell to the class of African-American consumers. Those practices in the middle require a two-step analysis. First, does the underwriting guideline violate broad public policy, or is the guideline simply a surrogate for another prohibited characteristic? Second, does the underwriting guideline identify a characteristic of the consumer, vehicle or property that is demonstrably and uniquely related to risk of loss? The second test typically requires detailed insurance data upon which to perform statistical and actuarial analyses. The data must be sufficiently detailed to enable the analyst to identify the unique contribution of the underwriting guideline or rating factor in question. Identifying the unique contribution is necessary to ensure that the underwriting guideline is simply not correlated (*i.e.*, a surrogate) for another known underwriting guideline or rating factor – including prohibited rating factors. Such an analysis enables the analyst to determine whether the practice *unfairly* discriminates against consumers who do not satisfy the underwriting guideline.

Finally, the *ways* insurers use underwriting guidelines to discriminate is not limited to the mere denial of coverage. Insurers use underwriting guidelines to discriminate against consumers in the following ways:

- Refusal to sell a policy at all.
- Charging a higher premium for the same coverage.
- Refusal to sell a replacement value policy.
- Requiring higher deductibles.
- Exclusion of specific coverages.
- Different benefits for the same price.
- Poorer service.
- Paying less for similar claims
- Conditioning payment plan eligibility

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Underwriting guidelines are important because they determine both the availability and affordability of insurance to groups of consumers. Insurance data are critical in the review of underwriting guidelines because the data will show whether the underwriting guideline properly identifies a group of consumers for whom the expected costs of the transfer of risk are higher or lower.

2.5 Rating Factors and Premium Calculations

Calculating a premium for auto and homeowners insurance is a two-part process. First, the underwriting process determines the *base rate* for the coverage. The base rate for each company will differ, as will the base rate for the different insurers within the company group. Thus, the base rates between Allstate and State Farm will differ, but the base rates between State Farm's preferred and substandard companies will also differ.

Second, the premium calculation involves the application of a series of rating factors to the base rate. *Rating factors* are the factors that change the base rate because the insurer or state has determined that the factor represents a difference in risk. For instance, a brick home represents a lower risk for fire than a wood frame house, so a discount factor is applied to the base rate for brick homes. Rating factors can cause the rate to increase (*surcharges*) or decrease (*discounts*).

Rating factors differ by state and by insurer. Common rating factors for auto insurance include coverage amount, territory (usually county of residence), use of car (pleasure only, business use), age of drivers, type of car, amount of deductibles, surcharges, and various discounts. Common rating factors for homeowners insurance include coverage amount, territory (usually county), type (brick or frame), amount of deductibles, and various discounts.

2.6 Rate Standards

Rates are developed to meet both legal and *actuarial* standards. In some instances, the legal and actuarial standards differ. When that occurs, the legal standards take precedence.

The common legal standard is that rates must be just, reasonable, adequate, not excessive and not unfairly discriminatory for the risks to which they apply. Rates satisfy that standard if the rate is a sound estimate of future costs of coverage offered and if consumers of the same class and essentially the same hazard are offered the same rates.

Rates are generally developed by actuaries working for, or on behalf of, insurance companies. A certified actuary is a person who is a member of the Casualty Actuary Society ("CAS"), but membership is usually not mandatory. Membership in CAS is based upon passing a series of tests. It is important to point out that membership in CAS does not impart consistent or good judgment to actuaries. Two actuaries analyzing the same data can, and often do, come up with widely divergent rate results. While ratemaking is a complex subject and activity, a consumer advocate can often identify the key ratemaking assumptions and question those assumptions.

2.7 Rate and Risk Classifications

The ratemaking analysis first produces *average statewide rate change indications by coverage*. For example, the ratemaking analysis may initially produce a 5% average statewide increase for bodily injury liability. The insurer then selects the average statewide rate change by coverage it will use or proposes to use. It is common for insurance companies to select rate changes significantly different from the actuarially indicated rate changes. There is generally little or no explanation provided by insurance companies for their selection of rates significantly different from the actuarially indicated rates.

The statewide average rate change is then *distributed to the various risk classifications*, such as different driver classes, increased limits factors and rating territories. If some parts of the state (rating territories) have better than average loss experience for a particular coverage, these rating territories should get a lower rate change than the statewide average for that coverage. Of course, if one rating territory gets a lower than average rate change, another rating territory must get a higher-than-average rate change.

Failure to reflect differences in costs among risk classifications, as well as attempting to charge different rates based upon a rating factor that is unrelated to differences in costs, is *unfair discrimination*. However, it is important to point out that an actuarially sound rate must be legal. For example, insurance companies are prohibited from discriminating on the basis of race, religion or national origin. Thus, even if cost differences based upon these characteristics could be demonstrated, it would be illegal and actuarially improper to treat consumers differently based upon any of these prohibited characteristics. State legislatures routinely pass laws expressing public policy regarding the nature of insurance risk classification. It is important to mention this because risk classifications are not natural or pre-ordained; rather, there are many ways of grouping consumers for the purposes of ratemaking that are fair.

3. INSURERS' USE OF CONSUMER CREDIT INFORMATION AND CREDIT SCORING

Credit reports are one type of "consumer report" whose use is covered by the Fair Credit Reporting Act ("the FCRA"). Other types of consumer reports used by insurers include motor vehicle reports and claims history reports. Although insurers have looked at consumer credit reports for many years, the use of credit reports to produce an insurance credit score is relatively new. According to one of the credit scoring model vendors, insurers used consumer credit reports as early as the 1970's to identify consumers who posed high likelihood of fraud or arson. The first insurance credit scoring models were developed in the early 1990's by Fair, Isaac and Company, the company that had developed credit scoring models for lenders. The original credit scoring models predicted the likelihood of a loan default. The original insurance credit scoring models predict likelihood of an insurance claim. Scoring models have since been developed by Fair, Isaac and ChoicePoint to predict frequency of claims, likelihood of a consumer renewing a policy and likelihood of a response to direct marketing.

Allstate was an early user of insurance credit scoring, utilizing a model for automobile insurance in 1994. The adoption of insurance credit scoring was slow through the 1990's, but grew exponentially by the end of the century. Today, almost every insurer uses some form of credit scoring for private passenger automobile insurance and the vast majority of insurers use it for residential property insurance.

Insurers use insurance credit scoring for a variety of purposes, including underwriting for overall eligibility, underwriting for rating tier eligibility, as a rating factor, determining payment plan eligibility and pre-screening for direct marketing.

Under a provision of the FCRA, as amended (effective 1997), insurers can obtain a list of consumers based upon certain credit characteristics without the consumers' permission, as long as the insurers provide a firm offer of insurance to the consumers on the list. That firm offer is subject to other insurer underwriting guidelines. This activity is called pre-screening and has been subject to virtually no oversight by insurance regulators.

A consumer credit report contains a listing of information about some of a consumer's credit activity, including a list of accounts (or trade lines), payment history, amount owed on a particular date, account credit limit, late payments, delinquencies, defaults, bankruptcies, other so-called public records, liens and some personal information. An insurance credit score is a value generated by applying a mathematical model to the specific characteristics of a consumer's credit report. See Appendix 1 for a number of descriptions and examples of insurance credit scoring and for resources on the FCRA.

Insurance companies in Ohio have increasingly used consumer credit information – in the form of insurance credit scoring – to determine if they will offer a consumer a residential property insurance policy and how much to charge for the policy offered. Insurance credit scoring is the use of a mathematical formula to translate information in a consumer's credit report into a numerical value. Insurance credit scoring – or insurance scoring, for short – is now used by the majority of Ohio insurers for residential property insurance and is used in a variety

of ways – for underwriting (including rating tier selection), rating (or premium development), coverage eligibility, marketing, and payment plan eligibility. Table 2 below lists the major writers of residential property insurance in Ohio and their use of consumer credit information as of November 2002.

There is little public information available about insurers' use of consumer credit information in Ohio. This occurs because most insurers use consumer credit information for underwriting. Underwriting is generally the insurers' process of determining whether or not to offer coverage to a consumer and, if offered, what type of coverage and what type of rate level or market tier to offer. Insurers' underwriting practices are codified in rules called underwriting guidelines. These guidelines are not typically filed with the Ohio Department of Insurance, and that agency has historically not requested them from insurers. As a result, insurers typically file little information about their use of consumer credit information with the Ohio Department of Insurance.

In contrast to underwriting guidelines, insurers do submit rate filings to the Ohio Department of Insurance. The rate filings contain base rates and rating rules. Rating is the process of developing a premium for a specific consumer based upon that consumer's personal or property characteristics using the base rate, rating factors and rating rules set forth in the rate filing.

In the past, insurers had two or three rate levels or rating tiers. The preferred rates had the most restrictive underwriting guidelines and the lowest rates. The standard rates had slightly less restrictive underwriting guidelines and somewhat higher rates. The non-standard rates had the least restrictive underwriting guidelines and the highest rates. It was common for insurers to have a separate insurance company for each rate level. Stated differently, each insurance company had one set of rates and represented one tier.

With the advent of insurance scoring, many insurers have increased the number of rate levels or rating tiers to 20 or more, with multiple rating tiers being written (or sold) in one insurance company. In some cases, the rules governing eligibility (or assignment of a consumer) for rating tiers is still contained in underwriting guidelines and, consequently, not filed with the ODOI and not available to the public. In other cases, the rules are part of the rating manual, where the insurance score is the last factor applied to the premium in the rate development and the insurance score (or the insurance score in combination with other factors, such as claim history) determines the rating tier factor applied to the premium. If the rating tier is applied as a rating factor, then the rate filing includes information about the rating tier eligibility and rate differential by rating tier.

Table 2
Use of Credit Information for Homeowners Insurance by Ohio Insurers

Insurer	Use	Notes
State Farm	None	Underwriting based primarily on claims history.
Nationwide	Eligibility	Agent sees only "eligible" or "ineligible" on rating screen.
Allstate	Rating	Per 4/30/01 filing, credit used for Financial Stability Rating Class. Discounts range from 0% to 47% -- nearly 2:1 potential spread. Different factors for tenants and condo policies. Tenant spread is 0% to 60%.
Cincinnati	Pay Plan	Full annual premium payment required based on credit
Westfield	Rating	Tier selection
Grange Mutual	Rating	Per 7/1/99 filing, discounts of 0%, 2%, 5%. Currently uses three tiers, which may vary from percentages in 99 filing.
Farmers	Rating	Per 2/16/02 filing, discounts range from 0% to 72% -- nearly 4:1 potential rate difference based on credit score.
Erie	None	Underwriting based primarily on claims history
Liberty Mutual	None	Underwriting based primarily on claims history and type of dog. Offers discounts for university- and employer-affiliation.
Motorist Mutual	Eligibility	
Central	Eligibility, Rating	Credit Score cutoff used to determine eligibility and/or tier selection.
Travelers	Rating	Tier selection.
State Auto	Eligibility	
Ohio Casualty	Rating	Nine tiers based on credit.
Encompass	Eligibility, Rating	Had four tiers based on credit. Agent now sees acceptable / unacceptable.

Our review of filings at the Ohio Department of Insurance revealed information about only three insurers – Allstate, Farmers and Grange Mutual. Farmers' use of credit scoring has the greatest potential impact on consumers – nearly a 4:1 difference in rates between best and worst credit scores. Allstate's use of credit information also has a major impact – nearly a 2:1 impact between best and worst credit scores for homeowners and 2.5:1 for tenants insurance. We believe the Grange Mutual information, found in a 1999 filing, is out of date. Based upon our interviews, we also believe that Westfield's' and Travelers' use of credit information has a large impact on Ohio consumers.

4. WHY INSURERS USE CONSUMER CREDIT INFORMATION AND CREDIT SCORING

Insurers use insurance credit scoring because insurers are permitted to obtain and use consumer credit and other reports for insurance underwriting pursuant to the FCRA, and because, according to insurers, insurance credit scoring is predictive of the likelihood of a consumer making an insurance claim.

Insurers argue that their use of insurance credit scoring benefits consumers in many ways. They argue that, because insurance credit scoring is predictive of claims, insurers can offer lower rates to consumers with good credit scores and higher rates to consumers with poor credit scores. From an actuarial perspective, this allows fairer pricing than without credit scoring. Insurers argue that if credit scoring is prohibited, high cost customers will be subsidized by low-cost customers.

Insurers also claim that insurance scoring allows them to write more business than they would otherwise be able to because they are better able to price business that they would otherwise be to uncertain about to write.

Insurers claim that their use of insurance credit scoring promotes competition in insurance markets because it allows more and smaller insurers to write more types of business. See Appendix 1 for a list of many statements by insurers and insurance trade associations on how they use consumer credit information and the benefits to consumers. The following, taken from a brochure produced by the American Insurance Association, is representative.

> An insurance score uses information from your credit report to predict how often you are likely to file claims, and/or how expensive those claims will be. The way you handle your credit says a lot about how responsible you are. Insurance companies want to reward responsible people by offering them better insurance products and by charging them lower rates. That's why insurance scores are so useful.
>
> It is important to understand that an insurance score is not the same thing as a credit score. Both are derived from the information found in your credit report, but they predict very different things. A credit score predicts how likely you are to repay a loan or other credit obligation. When you are applying for a loan or some other form of credit, the bank will consider your credit history as well as other factors in determining whether you are likely to repay your debt. While banks and other lenders will look at your income when making decisions, insurers *do not.*
>
> When you apply for insurance, the insurance company orders credit information from one or more of the three major U.S. credit bureaus. This information is entered into a computer program that

generates an insurance score. Most of these programs, or "models," look at things like payment history, collections, credit utilization and bankruptcies. For example, if you have never been late paying your mortgage, you will probably have a better score than a person who pays late. If you have "maxed out" credit cards, that will negatively affect your score. When you apply for coverage and your insurance company orders your score, the credit bureau will make a note in your file that the insurance company looked at the record.

What does my credit history have to do with how I drive my car?
Having a good insurance score does not necessarily mean you are a good driver or a more responsible homeowner. However, research has shown that consumers with better insurance scores generally file fewer claims and have lower insurance losses. That is not to say that all people with low insurance scores are higher risks. For instance, if you add a 16- or 17-year-old driver to your auto insurance policy, your premiums will very likely increase. This is because, as a group, younger drivers have more claims and losses than those with more experience. That does not mean that all 17-year-olds are bad drivers. Research shows, though, that drivers in that age group are more likely to have losses, so they pay more in premiums.

It's the same thing with insurance scores- research shows that people with certain patterns of behavior in their credit history are more likely to result in losses for the insurance company. As a result, they pay higher premiums, or, in extreme cases, they might have trouble getting insurance from some companies.

What kinds of things affect my insurance score?
Insurance scores are based on information like payment history, bankruptcies, collections, outstanding debt and length of credit history. For example, regular, on-time credit card and house payments affect a score positively, while late payments affect a score negatively.

Payment History
Bankruptcies
Collections
Length Of Credit History
Amount Of Outstanding Debt
New Applications For Credit
Types Of Credit In Use
Credit Report Information Used In Insurance Scores

Do credit-based insurance scores discriminate against certain ethnic or income groups?

No. Insurance companies do not consider the following information in the calculation of your insurance score:

Income	Ethnic group	Religion
Gender	Marital status	Nationality
Disability assistance	Address	Public
Sources of income		

4.1 Other Reasons Why Insurers Might Use Credit Scoring

Consumer advocates suggest a number of additional reasons why insurers use insurance credit scoring.

First, credit scoring allows insurers to price based on the profitability of the consumer, as opposed to pricing based on expected risk of loss. This rationale assumes that credit scoring is correlated to profitability.

As shown above, important consumer credit characteristics are related to the income level of the consumer. Thus, credit scoring is, for insurers, an easy and quick method of underwriting and rating by consumer income. Moreover, insurers have apparently determined than underwriting and rating by income is the key to greater profitability.

At a hearing before the Florida Insurance Commissioner's Task Force on Insurance Credit Scoring, Progressive Insurance stated that the four most important factors it uses to determine the premium for a consumer are the consumer's prior bodily injury limits, whether the consumer had prior insurance, the credit score and driving record. Three of the four factors are strongly related to the consumer's income.

The Georgia Insurance Consumer's Advocate described the problem with rating based on income in a letter commenting on a recent Allstate filing to the Georgia Insurance Commissioner. The Advocate wrote the following about a surcharge Allstate wanted to charge consumers who only purchased minimum limits liability private passenger auto insurance coverage.

> This is another rating factor we believe has no potential for loss prevention or encouraging consumers towards less risky behavior. Further, we believe it is counter to the public policy declaration by the General Assembly that effective January 2001, $25,000 is sufficient to meet the state financial responsibility requirements. It doesn't make sense that the legislature should set the minimum requirements and then an insurance company can penalize consumers for complying. Clearly, a consumer's decision to

> purchase higher coverage is based on individual motivations and has little behavioral impact on risky activity.
>
> Finally, it appears the proposed rating factor could have a disproportionate impact on less-affluent consumers by shifting greater premium responsibility to lower limit consumers and away from the more-affluent, higher-limit consumers. Less affluent folks who purchase lower limit insurance may do so in order to be financially responsible with their other debts and obligations.

The fact is that, while profitability and risk of loss are related, they are not the same. Two consumers may pose the same risk of loss, but present different profitability to the agent and insurer. The consumer who only wants to insure one vehicle at the minimum limits will be less profitable than the consumer who wants to insurer multiple vehicles at high limits and who wants property and life insurance. Many insurers simply do not want to write insurance for the poorest consumers.

The emphasis on rating factors that are largely income-related should be quite troubling to policymakers and consumers. But the problem is exacerbated with credit scoring because credit scoring enables insurers to move away from pricing based upon risk to pricing based upon what the market will bear. The second additional reason suggested by consumer advocates is that credit scoring has allowed insurers to revolutionize the risk classification process.

Instead of three rating tiers (or price levels) — preferred, standard and non-standard — insurers utilize credit scoring to create literally dozens of rating tiers. This proliferation of rating tiers is possible only because of credit scoring's numerical scale. As credit scoring becomes more widely used, consumers will be identified for higher rates because of their place on the credit scoring scale.

Writing in *American Agent and Broker*, New York agent Charles Wells states, "Over the past couple of years, we have seen more people put into nonstandard auto not only because of their driving records, but also for lack of financial prowess." We used to think about nonstandard auto markets as the home for bad drivers. But with the advent of credit scoring, there are now more nonstandard drivers – an increase unrelated to the overall number of accidents.

Second, some insurers are moving to credit scoring as a defensive measure. Insurers often act with a herd mentality and that appears to be the case with credit scoring also. Some insurers fear that failure to use credit scoring will result in adverse selection against their companies.

Third, insurers' use of credit scoring can allow insurers to avoid rate regulation in some states. Through the introduction of numerous rating tiers based on credit scores and determination of tier eligibility through underwriting, insurers can easily raise rate levels without making a rate filing. In most states, insurer changes to underwriting guidelines receive no

scrutiny. Consequently, an insurer could simply raise the cutoff score for rating tier eligibility by, say, ten points, and effectively create a 10% rate increase without any regulatory oversight.

Fourth, for some larger insurers, the use of credit scoring is seen as the tool to transition from an insurance company to a financial services company. The use of credit scoring enables an insurer to develop a book of insurance customers most likely to purchase other financial products, including life insurance, retirement products and traditional banking products.

Fifth, credit scoring can be used to preclude certain types of customers – redlining – by using credit for prescreening purposes. The FCRA allows insurers to get mailing lists of consumers based on credit characteristics without the permission of consumers.

Finally, credit scoring can also be used for redlining by developing models that predict policy retention, thereby allowing insurers to focus marketing efforts on consumers least likely to shop around for insurance and most likely to stay with the same insurer.

5. WHY IS THERE A CORRELATION BETWEEN CREDIT HISTORY AND CLAIMS EXPERIENCE?

Insurers answer this question in the following way. Although they do not know exactly why insurance credit scores are predictive of claims, they are convinced that this relationship exists. And while it is often comforting to be able to explain why such a relationship exists, an explanation – or in more technical terms, a demonstration of causality – is not necessary. The industry argues that we don't know why bad credit "causes" higher claims, but the correlation is there. The industry further argues that, according to actuarial standards of practice, a demonstration of correlation is sufficient because a demonstration of causality may be impossible.

When pushed for an explanation, the insurance industry explains the correlation to result from individual responsibility. The argument goes something like this: A consumer with a good credit score is financially responsible, and a consumer who manages his or her financial assets well is likely to manage their other assets – home and car – well.

In our view, the industry rationale for the use of credit scoring is inadequate and the financial responsibility explanation amounts to a "blaming the victim" strategy. These issues, along with the problems with credit scoring, are discussed in detail in the next sections below.

6. UNFAIR DISCRIMINATION — THE QUESTION OF CORRELATION

The industry argues that their use of credit scoring is fair. From an actuarial and insurance regulatory perspective, insurers argue that the use of insurance credit scoring is fair because there is a statistical relationship between scores and risk of loss. The industry points to a variety of studies performed either by the scoring modelers (like Fair, Isaac), insurers themselves or insurance trade associations. None of these studies, however, has been independently reviewed – where independence means by someone not employed by insurers and reviewed

means verification of data, methodology and results. Reviewed also means analysis to identify whether insurance credit scoring is correlated with other rating factors – permitted or prohibited – such that the correlation between credit scoring and risk of loss is, in fact, a spurious correlation.

Credit is unlike other rating factors in terms of the regulator's evaluation of the relationship between credit information and risk of loss. There has been no independent analysis of the alleged correlation because the only entities who have access to both the insurance data and the consumer credit information are the scoring vendors and insurers. This is a radical departure from regulatory practice. With any other rating factor, the information necessary for a regulator to evaluate an alleged relationship to risk of loss is available through statistical reporting. Thus the regulator can collect the insurance information and do an independent analysis – this is not possible with credit scoring and regulators have taken the word of the industry when they claim there is a correlation.

The "evidence" supporting the correlation claim comes almost exclusively from insurers, insurer trade associations and credit scoring vendors who refuse to divulge the methodology of their studies, details of the study results and/or the underlying data for independent verification. For those studies about which some information is known, the industry claims become more suspicious. For example, Fair, Isaac and Company continues to bring out the Tillinghast "study" as support for the correlation – even though the National Association of Insurance Commissioners Credit Reports subgroup dismissed the "study" as "counterproductive and misleading."

The industry cites a study by the Virginia Bureau of Insurance to support both the correlation claim and the claim that credit scores are not correlated with race or income. This study consisted of Fair, Isaac and Company providing the Virginia Bureau of Insurance with average credit scores for a number of ZIP Codes and then that agency analyzed the average credit scores versus race and other demographic factors. The shortcoming of this study is that there is no verification of the credit scores and Fair, Isaac and Company was in a position to create the desired outcome with the data it provided to the Virginia Bureau of Insurance. The industry, moreover, fails to mention this caution in the report:

> The Bureau has concerns about the long-term effect that the use of credit scores may have on Virginia consumers. As the number of insurers that use credit history as an underwriting tool increases, there may be an increase in the number of consumers that will be refused coverage, cancelled, non-renewed, or charged higher premiums due to their adverse credit history.

The industry studies are also suspect because they generally rely upon a univariate analysis with loss ratios as the dependent variable. Stated differently, the studies simply relate one variable – credit score – to loss ratio. This type of analysis is insufficient to determine if credit history is actually related to loss ratio or really just related to other rating factors which have a demonstrated relationship to risk of loss. The univariate loss ratio analysis of credit history is insufficient because such an analysis is predicated on the assumption that all other

relevant rating factors are reflected in the premium (*e.g.* denominator of the loss ratio) and that these factors are accurately priced. This is simply not the case. Rather, a multivariate analysis focusing on exposures and claims is necessary. Multivariate means that other rating factors are included, so the unique contribution of credit history (if any) to explaining risk of loss is identified.

There is a growing body of information casting doubt on the insurers' correlation claim. For example, if consumers who have filed for bankruptcy in the past five years are far more likely to have claims than consumers who have not filed for bankruptcies, then we would expect an increase in loss ratios if the number of bankruptcies increases dramatically. Personal bankruptcies did increase dramatically during the 1990's, yet private passenger auto insurance loss ratios *declined.* The following data show a *negative* correlation – just the opposite of the positive correlation claimed by the insurance industry.

Year	Private Passenger Auto Countrywide Incurred Losses to Earned Premium	Countrywide Non-Business Bankruptcies	Private Passenger Auto Florida Incurred Losses to Earned Premium	Florida Bankruptcy Cases Filed
1985	75.9%	297,885		
1986	73.8%			
1987	71.1%	473,000		
1988	72.0%	526,066		
1989	73.8%	580,459		
1990	73.6%	660,796	68.0%	
1991	68.6%	812,685	66.8%	43,400
1992	66.8%	899,840	76.4%	52,400
1993	67.1%	852,306	72.1%	46,600
1994	67.6%	788,509	70.1%	41,900
1995	66.8%	806,816	69.6%	43,400
1996	66.7%	989,172	64.3%	51,900
1997	62.7%	1,263,006	60.6%	67,400
1998	62.4%	1,379,249	61.4%	76,400
1999	65.2%	1,352,030	69.7%	79,200

Another blow to the correlation claim comes from a recent study by the nation's largest mortgage insurers, MGIC Investment Corp, which evaluated thousands of home loans during the 1989 to 1991 recession. The study found that some borrowers with the best Fair, Isaac and Company scores faced more serious risk of delinquency and foreclosure than borrowers with the poorest scores because local economic conditions are the most important factor in determining likelihood of delinquency and foreclosure. Consumers with high credit scores in a region with weak economic conditions were more likely to encounter problems than consumers with lower scores in a region with stronger economic conditions.

The revelations from this study are a major blow to the correlation claim because the credit scoring models are developed on a national basis. However, economic conditions vary greatly by geographic region. For example, surveys of mortgage delinquencies by the Mortgage Bankers Association of America show major differences across the country. In the fourth quarter of 2000, for example, delinquencies in the South were almost 60% higher than in the West.

Insurers argue that a simple correlation is sufficient justification for the use of any characteristic of the consumer, vehicle or property as an underwriting or rating factor. But the existence of a correlation between a rating factor and risk of loss does not mean that insurers should always be permitted to use that characteristic in underwriting or rating. For example, we do not permit race as a rating factor, but there is a correlation between race and risk of loss for life insurance. There must be more to a rating factor than simple correlation to justify its use – particularly when it is something as enormous as consumer credit information. The issues of risk classification are discussed further below.

7. UNFAIR DISCRIMINATION—DISPARATE IMPACT UPON PROTECTED CLASSES

Insurers also argue that there is no evidence that insurance credit scoring has a disparate impact on poor and/or minority consumers. The industry points to three studies supporting this claim – the American Insurance Association study on credit scoring and income, the Virginia Bureau of Insurance study of credit scoring by ZIP codes, and Progressive's study of credit scores by ZIP Codes grouped by minority population.

The "study" by the American Insurance Association concludes that credit scores are relatively constant over different income classes. Again, however, the industry will not provide the information necessary for an independent researcher to replicate the results of the study. Regardless, the reliability of the insurers' studies must be strongly questioned because of the large amount of evidence – and common sense – contradicting the insurer studies' conclusions.

On the issue of credit scoring versus income and race, the Executive Vice President of Fair, Isaac and Company, Peter McCorkell, admitted that 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.

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

> Having a poor credit record is a relatively common problem in today's society. Using the combined results from the CCS (i.e., African-Americans, Hispanics and Whites) we estimate that:
>
> 30% of these groups have "bad" credit records
> 13% of these groups have "indeterminate" credit records
> 57% of these groups have "good" credit records
>
> Credit problems persist across income groups. We estimate that:
>
> 36 % of consumers with incomes under $25,000 had "bad" credit records
> 33 % of consumers with incomes of $25,000 to $44,999 had "bad" credit records
> 25 % of consumers with incomes of $45,000 to $64,999 had "bad" credit records
> 22 % of consumers with incomes of $65,000 and $75,000 had "bad" credit records
>
> Minority borrowers are more likely than white borrowers to experience credit problems. For African-Americans we estimate that:
>
> 48% of African Americans have "bad" credit records
> 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.

Statistics from 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 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.

8. PROBLEMS WITH CREDIT SCORING — BLAIMING THE VICTIM

Insurers often argue that credit scores predict insurance claims because credit scores measure a consumer's financial responsibility. This is not the case. A credit score, or an insurance score, is a product of the presence (or absence) of both positive and negative factors. A consumer can have a bad credit score even though he or she has no negative information (bankruptcy, delinquency) on his or her credit report. Rather, a consumer can get a bad credit score – with resulting higher auto and homeowners insurance rates – because of the absence of "positive" factors – the absence of a real-estate secured loan, the absence of certain other types of credit, the absence of credit information.

Equating "financial stability" or "financial responsibility" with a good credit score is not only factually incorrect, it represents the insurers' contemptible practice of blaming the victims of insurers' use of consumer credit information. Several studies have shown that the major causes of bankruptcy are economic or medical catastrophes in the consumer's family – job loss, dread disease, divorce – and not "financial irresponsibility." Further, insurers' use of consumer credit information discriminates against certain groups of consumers who live in certain areas because the financial institutions used by these consumers – pay day loans, check cashing, rent to own – do not report to credit bureaus and, consequently, the consumer credit reports are missing information. Again, it is important to stress that a bad credit score can result from the absence of positive information as well as the presence of negative information.

The inherent unfairness of insurance credit scoring – and the demonstration of the blaming-the-victim strategy – is illustrated by the impact of the September 11 terrorist attacks. After the September 11 attacks, tens of thousands of people working for airlines or travel support industries lost their jobs – throughout the country. Many of these people lost their health insurance in addition to their paycheck. Clearly, many of the newly unemployed started charging more on their credit cards, and encountered more financial strain. Similarly, many have and will likely be delinquent on some credit cards or loans or file bankruptcy because they lost their jobs. And these people – indirect victims of a terrorist attack – will also face higher auto and homeowners insurance premiums. Did these people become worse drivers because they lost their jobs? The answer is clearly no. But this kind of unfair treatment of consumers at the hands of credit scoring repeats itself again and again.

When asked to explain why credit scoring predicts losses, insurers argue that a consumer's credit history describes the consumer's management of financial resources and someone who manages his or her financial resources well is less likely to have insurance claims. This is a classic case of blaming the victim. Studies have shown that the major reason why consumers file for bankruptcy is because of a major economic or medical event – such as losing a job or a family member getting a dread disease. For example, *The Washington Post* has reported a recent study concluding a majority of consumers experience financial problems as a result of a catastrophic economic event. In a study by Harvard law professor Elizabeth Warren, about 600,000 personal bankruptcies in 1999 were estimated to be caused by illness or injury to a family member coupled with insufficient or no health insurance coverage.

A December 2001 article in *insurer.com* reported that more than 725,000 laid-off workers had lost their health insurance since March 21, 2001. Again, these victims of an economic recession will face financial stress not only because they have lost their income, but also because they lost their most important safety net – health insurance. Yet, these victims of economic conditions will be further penalized with higher auto and homeowners premiums.

Consumers who are the victims of identity theft suffer higher insurance premiums because of credit scoring. Typically, identity thieves use the stolen information to commit financial crimes, such as check or credit card fraud. In over half of the reported cases of identify theft, the victim did not notice the theft for at least a month after theft occurred. This means that victims of identify theft will suffer higher insurance premiums before they can repair the damage to their credit reports.

In summary, credit information is generated by consumers for purposes other than insurance, such as:

- A decision to seek another credit card
- A decision to use one or more credit cards
- A decision to pay in cash or get a loan
- A decision to get a gas station card
- A decision to pay in cash or use charge cards
- A decision to rent or buy

— and credit information is impacted by things beyond control of consumer, such as:

- Bank decisions to lower or tighten credit standards
- Terrorist attacks
- Recession/Inflation/Overall Economic Conditions

The bottom line is that insurers' use of credit scoring is inherently unfair to consumers. Credit information is gathered primarily for purpose of evaluating credit worthiness, not insurance issues.

9. PROBLEMS WITH CREDIT SCORING—RELIABILITY OF MODELS AND DATA

Credit scores can vary dramatically depending upon which credit reporting agency provided the credit information. It is important to note that consumers can suffer not only from the presence of inaccurate information in their credit files, but also from the *absence* of accurate information in their credit files. The best credit scores depend not only on the absence of negative information – bankruptcies and delinquencies – but also on the presence of positive information – certain types of credit and payment history. Thus, the validity of credit scores relies upon complete, as well as accurate, information. This is a significant issue because the three major credit reporting agencies do not have identical information for all consumers. Consequently, a consumer's credit score can vary significantly depending upon which credit reporting agency provided the credit information. At a hearing before the Georgia Insurance Commission on insurers' use of consumer credit information, a representative of the credit scoring model vendor ChoicePoint stated that, "Our score ranges from 300 to almost a thousand, so it's almost a 700-point range, but you could have a hundred, a hundred-and-fifty point change from bureau to bureau depending on variances in the data." A recent study by the Consumer Federation of America further documented the disparity of scores across credit bureaus.

The problem with incomplete data was highlighted in 1999 when the Federal Trade Commission and federal banking regulators discovered that some consumer lenders were not reporting account information to the credit reporting agencies because they did not want competitors to market to their customers. The practice of withholding data skews credit scores. Lenders withholding data accounted for 50% of the credit card market.

The reliance on credit reports by insurers is also unfair to lower-income consumers because many low-income consumers utilize non-traditional financial institutions that do not report to credit reporting agencies – such as rent-to-own and payday loans. Thus, lower-income consumers are penalized because their credit activity does not show up in the credit reports used by insurers.

Credit scores can be manipulated by people familiar with the scoring models. In a two-part series, Kenneth R. Harney described a service called "rapid rescoring" that, for a fee, helps consumers improve their credit scores by simply gaming the system. The articles cite an example of a woman who improved her credit score from 580 to 780 – from bad to "A-plus" – without any change in her behavior. The article cited one rapid rescorer who helped consumers raise their scores simply by shifting credit card debt from one card to many cards, "That may mean transferring the $900 balance on a $1,000 limit credit line to another with a $10,000 limit. The $900 on the $1,000 limit account is treated as a negative by the FICO score model. But the same $900 on a $10,000 limit card looks like a responsible management of credit."

The bottom line is that credit scores can be manipulated without any change in the consumer's behavior. This is exactly what an insurance rating factor should NOT be. The rating factor should provide an incentive for the consumer to pursue less risky behavior, not an incentive to manipulate the rating factor.

10. PROBLEMS WITH CREDIT SCORING—PUNISHING CONSUMERS FOR BANKS DECISIONS

Another example of the unfairness of credit scoring to insurance consumers comes from California where the state legislature passed a law in 2001 preventing banks from inducing college students into unsupportable credit card debt. The sponsor of the bill applauded passage for "recognizing that something must be done to stop the credit card industry from preying upon young people in college." The legislation prohibits the distribution of free gifts to college students who apply for a credit card and will require debt education in college and university orientation.

As the California law points out, consumers should not be punished for the business decisions of banks. In 1990, banks sent out one billion credit card offers. By 1997, the number of offers had grown to 3.7 billion. Clearly, lenders were encouraging consumers to take on credit cards and credit card debt. In fact, most credit card offers are accompanied by notes telling consumers that "It's a good idea to carry more than one Master Card®" or "Do not hesitate to accept this card just because you already carry a credit card from another bank. . . . it costs you nothing to accept." We now know that it does cost you something to accept because your credit score – and your auto and homeowners insurance premium – may go up because you have more credit cards than the credit scoring models view as ideal.

11. PROBLEMS WITH CREDIT SCORING—VIOLATING INSURANCE PRINCIPLES

Insurers' use of consumer credit information – particularly in the form of credit scoring – is not only inherently unfair, but violates basic risk classification principles.

Insurers do not charge the same rate or same premium for everyone – consumers are grouped into different risk classifications for purpose of allocating premium required by the insurer to individual consumers. In theory, this process is guided by the American Association of Actuaries' "Risk Classification Statement of Principles."

The statement is somewhat self-serving to the industry because it essentially provides an actuarial justification for what the industry does. The standards are very broad. However, we can show that insurers' use of credit scoring conflicts with these industry standards for risk classification.

The document offers three reasons for risk classification:

1. Protect insurance system financial soundness by preventing adverse selection.
2. Be fair, meaning that a statistical correlation exists and that prices reflect costs.
3. Permit economic incentives to operate, meaning incentives for insurers to sell insurance at a profit.

The document also notes that competition for the lower risks will be the most intense.

When the document refers to availability of coverage, it is only from the perspective of insurers and means insurers' ability to charge differently for whatever risk classes are created.

The document discusses a number of operational considerations including:

- Absence of ambiguity – definition of classes should be clear and objective, no ambiguity should exist concerning the class to which the risk belongs, and the classes should be collectively exhaustive and mutually exclusive.
- Manipulation – system should minimize the ability to manipulate or misrepresent a risk's characteristics so as to affect the class to which it is assigned.
- Measurability – variables used for classification should be susceptible to convenient and reliable measurement

The document also notes that hazard reduction incentives are desirable but not necessary, and that a causal relationship between the rating factor and losses is not necessary

Finally the document discusses public acceptability of risk classification schemes and offers the following. Risk classification systems should —

- Not differentiate unfairly among risks.
- Be based upon clearly relevant data.

- Should respect personal privacy.
- Should be structured so that risks tend to identify naturally with their classification.

As we have seen, insurance credit scoring as an underwriting guideline or rating factor does not meet at least three of the public acceptability guidelines. Moreover, we have also shown that insurance credit scoring also fails even the standards for a rating factor because the use of credit history is ambiguous, subject to manipulation and not susceptible to reliable measurement.

The decisions about what factors, and what characteristics of the consumer, to use for purposes of assigning premium are probably the most important insurance decision. And there is no natural set of rating factors and risk classifications. There are many ways to cut up the pie – to group consumers for purposes of assigning premium – that would meet industry standards.

As a society, we have decided, at least for private passenger automobile and residential property insurance, that we do not want everyone paying the same rate – an average premium for every driver – nor do we want the other extreme of consumers completely paying for their accidents out of pocket – the pay-as-you-go system. Rather, as a society, we have decided that some risk classification is desirable.

We believe these should be the guiding principles for risk classification:

1. To roughly assign premium to consumers in relation to expected costs of that consumer on the system. Avoid adverse selection and promote general fairness. As a society we don't do average pricing nor pay as you go. Credit history is not needed to avoid adverse selection or to ensure industry financial stability.
2. Promote loss prevention – absolutely key!
3. Promote beneficial competition and limit selection competition. Selection competition as a market failure.
4. Promote fairness and availability, which often means broader risk classifications than desired by the industry.
5. Understandable to the Public – we think that consumers are more likely to treat insurance companies fairly when it comes to claims if they feel that the insurance company has treated them fairly when it comes to charging premiums.

Insurance credit scoring clearly does not meet the reasonable standards for an underwriting or rating factor because there is no overall benefit to the system – in fact, there is a net cost to the system – and there is no loss prevention associated with the credit history risk classification.

The ability of a rating factor to promote loss prevention is essential. One of the goals – perhaps the most important goal – of a risk classification system is provide incentives to consumers to pursue less risky behavior and avoid more risky behavior. By providing such incentives – such as surcharges for speeding or discounts for installing anti-theft devices or wind

resistant construction – individual consumers benefit through lower rates and society benefits through lower loss of life and property.

Credit scoring fails this essential test of a rating factor because it provides no incentive to the consumer for loss prevention. Insurers use of credit scoring simply redistributes premium from one group of customers to another. In fact, insurers' use of credit scoring adds cost to the overall system because insurers must pay for obtaining consumer credit reports and for licensing credit scoring models.

The industry claim that insurance scoring allows them to write more business should be view with great skepticism. The same claim could be made for any rating factor and was probably used to justify using age and value of home as rating factors – that age and value of the home preserved the loss ratio in preferred tier and allowed placement of risks more appropriately in standard and non standard tiers. Insurers used these rating factors for years until fair housing groups sued insurers because the use of these rating factors/underwriting guidelines was unfairly discriminatory to poor and minority communities. Insurers stopped using these guidelines and acknowledged that, as a result, they would write more business in poor and minority communities.

12. CONCLUSION: OHIO HOMEOWNER INSURERS' USE OF CREDIT SCORING LIKELY HAS A DISPARATE IMPACT ON POOR AND MINORITY POPULATIONS IN OHIO

Based upon all the available information, it is our opinion that insurers' use of insurance credit scoring for underwriting, rating, marketing and/or payment plan eligibility very likely has a disparate impact on poor and minority populations in Ohio. Consequently, it is our opinion that insurers' use of insurance credit scoring makes insurance less available and/or more expensive for poor and minority populations in Ohio.

Appendix 1

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