

MINUTES OF THE HOUSE COMMITTEE ON INSURANCE.

The meeting was called to order by Chairperson Patricia Barbieri-Lightner at 3:30 on March 18, 2003 in Room 526-S of the Capitol.

All members were present.

Committee staff present: Bill Wolff, Legislative Research
Ken Wilke, Revisor of Statutes
Renaë Hansen, Secretary

Conferees appearing before the committee: **Bill Sneed**, Legislative Council, State Farm
Dave Hanson, Legislative Counsel, National Association of Independent Insurers
Brad Smoot, Legislative Council, The American Insurance Association
Martha Neu Smith, Executive Director, Kansas Manufactured Housing Association
Karen Hiller, Executive Director of Housing and Credit Counseling, Inc
Jarrold Forbes, Kansas Insurance Department

Others attending: 34 total, some of whom signed the roll.

Continued Hearing on:

Sub SB 144- Enacting the Kansas Insurance Score Act.

Proponents:

Bill Sneed, Legislative Council, State Farm, (Attachment #1), spent time talking about the opponents studies and refuting the position that was talked about on March 13, 2003, and allowed the committee to read his proponent written testimony. Also a company brochure explaining credit scoring and how it is used for auto insurance was passed out which can be obtained from the conferee. Additionally, proposed amendments also attached were discussed and an explanation as to why the amendments were offered.

Questions were posed by: Representatives Mario Goico, Nile Dillmore, Nancy Kirk, Patricia Barbieri-Lightner, and Scott Schwab.

Dave Hanson, Legislative Counsel, National Association of Independent Insurers, (Attachment #2), commended the Insurance Committee for putting together the task force to study Credit Scoring and working diligently to consider the bill presented by that task force. He believes this is a significant piece of legislation and that all parties involved worked hard to come to the table and make some compromises on both sides in order to help this bill come together in an acceptable form to all.

Questions were posed by: Representative Eber Phelps.

Brad Smoot, Legislative Council, The American Insurance Association, (Attachment #3), presented testimony explaining how the credit scoring task force came about, and then why it is important to pass this legislation to regulate credit scoring. Included were two brochures presented to the representative that would help them explain to the public about credit scoring: what it is, and how it works. Credit scoring gives people who deserve to have the best deal, the best deal. They endorse the NCOIL model legislation of which Sub **SB144** models. This bill is a compromise between the parties involved. This bill provides the insurance department

CONTINUATION SHEET

MINUTES OF THE HOUSE COMMITTEE ON INSURANCE at 3:30 p.m. on March 18, 2003 in Room 527-S of the Capitol.

ability and authority to enforce credit scoring and to educate the public on its use. Provisions that deal with thin files, and medical files, inaccurate information, disclosure requirements insurance companies must provide to their customers, and an appeals process for the consumer.

Questions were posed by: Representatives Eber Phelps, Nile Dillmore, and Nancy Kirk.

Written testimony was presented on behalf of, Larry Magill, Kansas Association of Insurance Agents, (Attachment #4).

Opponents:

Martha Neu Smith, Executive Director, Kansas Manufactured Housing Association, (Attachment #5), is registered as an opponent to **Sub SB 144**, but their true opposition is to the practice of insurance credit scoring. Points were presented that stated their opposition to credit scoring. Since Credit Scoring will not be eliminated recommendations for the bill before you were presented.

Questions were posed by: Representatives Eber Phelps, Scott Schwab, and Ray Cox.

Comments were offered by Representative Nancy Kirk.

Karen Hiller, Executive Director of Housing and Credit Counseling, Inc., (Attachment #6), commended the insurance committee for addressing this issue of insurance credit scoring. They believe that credit scoring does in fact bring up insurance rates for a certain sector of the population in a way that does not correlate to their behavior for insurance claims. In addition, is it appropriate to endorse the practice of credit scoring by regulating it.

Questions were posed by: Representatives Nile Dillmore, Mario Goico, Ray Cox, and David Huff.

Two written opponent testimonies were presented: Barb Conant, Kansas Trial Lawyers Association (Attachment #7), and Mark and Faith D. Loretto, Kansas Constituent, (Attachment #8).

Jarrold Forbes, Kansas Insurance Department, responded to comments made by the opponents of **Sub SB 144**. He stated that there is a correlation between good behavior in taking care of your credit and the responsibility with which you will carry out your relationship with insurance companies. The bill allows for the correction of unfair reporting by allowing the consumer a process to contest the report and change or repair its contents. In addition, if the rate is changed due to this process companies have to give the difference back to the consumer. If nothing changes except your credit report they can not change your rate. There has to be another factor involved. This bill asks for education to consumers on credit reporting. Jarrold continued to reiterate the Insurance Departments position.

Questions were posed by: Representatives Nancy Kirk, Ray Cox, and Nile Dillmore.

The hearing was closed on **Sub SB 144**.

SB 66- Title Insurance; prohibiting certain actions.

Representative Stephanie Sharp moved to amend SB66, seconded by Representative Bonnie Sharp.

Discussion: Stephanie Sharp- This bill removes the 80/20 split and it says that a title insurance company cannot have complete reliance on one real estate company for its business.

Representative Joe Humerickhouse was recognized for discussion. Due to the controversial nature of this bill, the total vertical integration allowed on by the bill, and the lack of accountability as far as costs and service to the average customer, controversy as to whether it will help or stifle competition, controversy as to the impact it will have on the average customer and the cost, along with the fact that there is an attorney generals

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opinion due on this issue, a motion was made.

Representative Joe Humerickhouse made a substitute motion to table the SB66 until the first day of session 2004, seconded by Representative Bob Grant.

A discussion followed on whether a substitute motion would be heard. It was decided that since the motion had received a second, a vote would be called.

The motion to table passed 9-8.

Meeting Adjourned.

Next meeting March 20, 2003.

HOUSE INSURANCE COMMITTEE GUEST LIST

DATE: March 18, 2003

NAME	REPRESENTING
<i>Jerry Wells</i>	KID
<i>David Jones</i>	KID
David Hanson	KS Insur. Assns & NAIF
Keith Bradshaw	Budget
Kevin Davis	Am. Family Ins.
Gick Wilson	Farmers Alliance
Tim Holverson	KC Regional Assoc. of Realtors.
Diane Ruggiero	KC Regional Assoc of Realtors
Jerry Preece	Preece + Nichols Realtors
<i>Mark Smith</i>	KMHFA
Marilyn Stanley	Housing & Credit Counseling, Inc.
Zain Filler	Housing & Credit Counseling, Inc.
John R. Hulbeck	Title Midwest, Inc.
John Stauffer	Title Midwest, Inc.
James McBride Jr	Mortgage Protection Ins. SER., Inc.
Brad Amost	AIA
Tom CACHES	CDIA
Robert Krapp	INK Network Manager

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Memorandum

TO: THE HONORABLE PATRICIA BARBIERA-LIGHTNER, CHAIR
HOUSE INSURANCE COMMITTEE

FROM: WILLIAM W. SNEED, LEGISLATIVE COUNSEL
THE STATE FARM INSURANCE COMPANIES

RE: SENATE BILL 144

DATE: MARCH 13, 2003

Madame Chair, Members of the Committee: My name is Bill Sneed and I represent State Farm Insurance Companies ("State Farm"). We appreciate the opportunity to appear in support of SB 144. As you are aware, SB 144 is an attempt to regulate the use of credit information by insurance companies. It passed the Senate 39-0.

Numerous studies by independent analysts, government agencies, credit report vendors and insurers have demonstrated that credit information can be highly predictive of the future risk of loss. Because of some concern, the Legislature created a task force who, during the summer and fall of 2002, studied this issue and again as you are aware, filed a report with this Committee.

As evidence by the report issued by the Task Force, the use of credit information should be continued in the State of Kansas.

Senate Bill 144 is an attempt to provide some regulatory guidelines on the use of credit information by insurance companies.

Although stated in the Task Force Report, we believe it important to reiterate several basic components within this subject matter.

Credit scoring is a misnomer. It implies that underwriting and rating decision are based solely on credit information. Secondly, credit scoring measures lending risk. Lending risk is the probability of late payment or no payment. Credit-based insurance scoring is more descriptive. Credit-based Insurance scoring uses a variety of factors not just credit information. Finally, credit-based insurance scoring predicts future insurance losses not lending risks.

There is a strong correlation between credit-based insurance scoring and loss ratios in both auto and homeowners' insurance. The correlation has been supported by studies

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Attachment # #1

commissioned by the Virginia Bureau of Insurance and the Casualty Actuarial Society as well as studies performed by Tillinghast-Towers Perrin and The American Insurance Association.

There is a distinct decline in relative loss ratios as credit-based insurance scores improve. The relationship between credit standing and relative loss ratios is well established-State Farm routinely validates its own models. It recently revalidated its auto insurance underwriting model, based on a sample of more than half a million insured autos. As with previous validations, this one verified that insurance scores are very effective at predicting future auto insurance risk. In their validation study, even after all other risk factors were reflected in the premiums charged, consumers with the lowest range of scores had a loss ration more than double that of the highest scoring group.

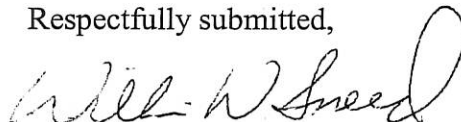
Customers should be charged premiums based on their expected losses so that those with lower expected insurance losses should not be required to subsidize those with higher expected insurance losses. By incorporating certain credit and prior claim characteristics into insurance scoring models, insurers can identify consumers who are likely to have better loss experience than their driving or claim histories may suggest. At the same time, insurers can also identify consumers who are likely to have worse loss experience than their driving or claims histories suggest. In this way, insurance scoring helps insurers charge the appropriate premium so that better insurance risks are not required to subsidize risks with higher expected losses.

There has been some discussion as to whether or not the use of credit information by insurance companies should be banned or more strictly restricted than what is found in SB 144. Banning the use of credit information will:

1. Force good drivers and responsible homeowners to subsidize those with poor loss histories by hundreds of millions of dollars each year;
2. Force insurers to exclude a reliable and proven underwriting factor, credit information, from their determination of loss propensity; or,
3. Force insurers to do more extensive underwriting and pricing at the front end and thus curtail the use of binding insurance without extensive examination by the underwriting department.

We appreciate the opportunity to speak in favor of SB 144. We respectfully request that the Committee act favorably on this bill.

Respectfully submitted,



William W. Sneed

WWS:pmk

1 culate an insurance score in underwriting or rating personal insurance,
2 unless the insurer does one of the following:

3 (1) Treat the consumer as if the applicant or insured had neutral
4 credit information, as defined by the insurer; or

5 (2) exclude the use of credit information as a factor and use only other
6 underwriting criteria.

7 (f) Take an adverse action against a consumer based on credit infor-
8 mation, unless an insurer obtains and uses a credit report issued or an
9 insurance score calculated within 90 days from the date the personal
10 insurance policy is first written or notice of renewal is issued.

11 (g) ~~(1) Except as provided in paragraphs (2) and (3), use credit in-~~
12 ~~formation unless not later than every 36 months following the last time~~
13 ~~that the insurer obtained current credit information for the insured, the~~
14 ~~insurer recalculates the insurance score or obtains an updated credit~~
15 ~~report.~~

16 ~~(2) The insurer shall:~~

17 (A) Re-underwrite and re-rate the consumer's personal insurance
18 policy, at the annual renewal of such policy, based upon a current credit
19 report or insurance score for such consumer, if requested by the con-
20 sumer. Such consumer's current credit report or insurance score shall be
21 used if the result of the re-underwrite and re-rate reduces the consumer's
22 rate. Such consumer's current credit report or insurance score shall not
23 be used to increase the consumer's rate. The insurer shall not be found
24 to be in violation of rate filings by adjusting an insured's rate in accordance
25 with this subparagraph. Nothing in this subparagraph shall require an
26 insurer to recalculate a consumer's insurance score or obtain the updated
27 credit report of a consumer more frequently than once in a twelve-month
28 period.

29 ~~(B) Have the discretion to obtain current credit information upon~~
30 ~~any renewal before the 36 months, if consistent with such insurer's un-~~
31 ~~derwriting guidelines.~~

32 (3) No insurer shall be required to obtain current credit information
33 for an insured, if:

34 (A) The insured is in the most favorably-priced tier of the insurer,
35 within a group of affiliated insurers. However, the insurer shall have the
36 discretion to order such report, if consistent with such insurer's under-
37 writing guidelines;

38 (B) credit was not used for underwriting or rating such insured when
39 the policy was initially written. However, the insurer shall have the dis-
40 cretion to use credit for underwriting or rating such insured upon re-
41 newal, if consistent with such insurer's underwriting guidelines; or

42 (C) The insurer re-evaluates the insured beginning no later than 36
43 months after inception and thereafter based upon other underwriting or

(1) Treat the consumer as otherwise approved by the Commissioner,
if the insurer presents information that such an absence or
inability relates to the risk for the insurer:

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3

U

Regardless of the requirements of this section, the insurer shall

1

2

despite the requirements of subsection(g)(1)

1-3

6 requested by the consumer for such consumer's own credit information;
7 (2) any inquiry relating to insurance coverage, if so identified on a
8 consumer's credit report;

(3) any collection account with a medical industry code, if so identified on the consumer's credit report; or

11 (4) any additional lender inquiry beyond the first such inquiry related
12 to the same loan purpose, if coded by the consumer reporting agency on
13 the consumer's credit report as being from the ~~given loan industry~~ and
14 made within 30 days of one another.

15 Sec. 5. (a) If it is determined through the dispute resolution process
16 set forth in the federal fair credit reporting act, 15 USC 1681i(a)(5), that
17 the credit information of a current insured was incorrect or incomplete
18 and if the insurer receives notice of such determination from either the
19 consumer reporting agency or from the insured, the insurer shall re-
20 underwrite and re-rate the consumer within 30 days of receiving the notice.
21 After re-underwriting or re-rating the insured, the insurer shall make
22 any adjustments necessary, consistent with such insurer's underwriting
23 and rating guidelines.

24 (b) If an insurer determines that the insured has overpaid the premium,
25 the insurer shall refund to the insured the amount of overpayment
26 calculated back to the shorter of either the last 12 months of coverage or
27 the actual policy period.

28 Sec. 6. If an insurer writing personal insurance uses credit information
29 in underwriting or rating a consumer, the insurer or its agent shall
30 disclose that it may obtain credit information in connection with such
31 application. The insurer shall further notify such consumer that an internal
32 appeal process exists as provided by paragraph (b) of section 7 and
33 amendments thereto. The disclosure shall be made either on the insurance
34 application or at the time the insurance application is taken. Such
35 disclosure shall be either written or provided to an applicant in the same
36 medium as the application for insurance. The insurer need not provide
37 the disclosure statement required under this section to any insured on a
38 renewal policy if such consumer has previously been provided a disclosure
39 statement.

40 Sec. 7. (a) If an insurer takes an adverse action based upon credit
41 information, the insurer shall provide written notification to the consumer
42 a notice that:

43 (1) An adverse action has been taken, in accordance with the require-

home mortgage or auto lending

NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

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House Insurance Committee Testimony on Substitute Senate Bill 144

March 18, 2003

Madam Chairperson and Members of the Committee:

Thank you for this opportunity to present information on behalf of the National Association of Independent Insurers, a national trade association with 715 member insurers. The member companies include some of our domestic companies and numerous out of state companies writing property and casualty insurance in Kansas. As the member companies are very concerned with this issue, not only in Kansas, but in a number of other states, we have suggested that other states may want to consider following the lead you provided last year in adopting the legislative resolution for a task force study of credit-based insurance scoring. NAII commends your Task Force for its extensive hearings and thorough deliberations, which led to the Task Force report submitted to you earlier in this legislative session. We believe that the recommendations of the Task Force were well reasoned and reflected a balanced and equitable approach to addressing this issue.

We also commend Commissioner Praeger and her staff for promptly addressing this complex issue, considering input from interested parties and bringing proposed legislation to you. We agree with Commissioner Praeger in her assessment that the provisions of the Bill represent a good compromise in that no one got everything they wanted. Even so, this Bill will help achieve a priority goal of providing a frame work and essential tools for the Commissioner to regulate credit-based insurance scoring in Kansas.

We support the Bill and would urge your favorable consideration of it. As was discussed previously, a technical amendment to change the reference from "farm owners" at the end of subsection 3(1) on page 2 to "farmowners" is needed. We would also suggest a technical amendment on page 5 of the Bill in the reference to "rate filings" to clarify the reference by inserting "such insurer's" as reflected in the attached balloon. Our member companies have raised several other recommendations, generally involving the provisions on page 3 of the Bill dealing with treatment of "no hits" and "thin" files and re-rating to include the language recommended by the Task Force taken from the NCOIL Model, which we believe would enhance the consistency of these provisions as explained last Thursday by Evan McKee of Progressive Insurance.

Again, we appreciate your consideration of this very important legislation and would urge its passage.

Respectfully,



DAVID A. HANSON

House Insurance
Date: 3/18/03
Attachment # 2

1 (1) An adverse action has been taken, in accordance with the require-
2 ments of the federal fair credit reporting act as set forth in, 15 USC
3 1681m(a); and

4 (2) explains the reason for such adverse action.

5 (b) Each reason must be provided in sufficiently clear and specific
6 language so that a person can identify the basis for the insurer's decision
7 to take such adverse action. An insurer shall provide a procedure whereby
8 a consumer may review an adverse action based on credit information.
9 Such procedure shall be consistent with the provisions of K.S.A. 40-2,112
10 and amendments thereto. The insurer and the insurer's agent shall be
11 immune from any action arising from information provided to the insured
12 through such process. The insurer shall not be found in violation of ~~rate~~ such insurer's
13 filings by adjusting an insured's rate in such a manner.

14 (c) The use of generalized terms such as "poor credit history," "poor
15 credit rating," or "poor insurance score" shall be deemed not to comply
16 with requirements of this section.

17 Sec. 8. (a) Each insurer that uses insurance scores to underwrite and
18 rate risks shall file the procedure required by paragraph (b) of section 7,
19 and amendments thereto, and such insurer's insurance scoring models or
20 other insurance scoring processes with the insurance department. A third
21 party may file with the insurance department such third party's scoring
22 models or other scoring processes used on behalf of an insurer. Any filing
23 that includes insurance scoring may include loss experience justifying the
24 use of credit information.

25 (b) Except for the procedure required by paragraph (b) of section 7,
26 and amendments thereto, any filing relating to insurance scoring models
27 or other insurance scoring processes shall be considered to be a trade
28 secret and confidential under the open records act.

29 Sec. 9. The commissioner of insurance may conduct research, hold
30 public hearings, make inquiries and publish studies relating to the pur-
31 pose of this act.

32 Sec. 10. (a) An insurer shall indemnify, defend, and hold agents
33 harmless from and against all liability, fees, and costs arising out of or
34 relating to the actions, errors, or omissions of an agent who obtains or
35 uses credit information or insurance scores, or both, for an insurer.

36 (b) The provisions of subsection (a) shall not be available whenever
37 the agent fails to:

38 (1) Follow the instructions of or procedures established by the in-
39 surer; and

40 (2) comply with any applicable law or regulation.

41 (c) Nothing in this section shall be construed to provide a consumer
42 or other insured with a cause of action that does not exist in the absence
43 of this section.



A Statistical Analysis of the Relationship Between Credit History and Insurance Losses

Prepared by: Bureau of Business Research
McCombs School of Business
The University of Texas at Austin

March 2003

A Statistical Analysis of the Relationship Between Credit History and Insurance Losses

Dr. Bruce Kellison
Dr. Patrick Brockett
Seon-Hi Shin
Shihong Li

Bureau of Business Research
The University of Texas at Austin
March 2003

About the Bureau of Business Research

Research and services at the Bureau of Business Research (BBR) focus on the competitiveness of Texas industries. By providing essential research and information about Texas industries, the BBR has linked the academic community and the public since 1927. Located within the McCombs School of Business at The University of Texas at Austin, the BBR conducts applied economic research on the organizational and resource strategies of Texas industries, with an emphasis on the high-technology sector. The BBR also houses significant information resources through its affiliation with the State Data Center Program and the U.S. Bureau of the Census. For more information, please visit the BBR website at www.utexas.edu/depts/bbr/.

Acknowledgements

Appreciation is expressed to the insurance company representatives who participated in or facilitated the study. Other individuals who provided valuable assistance include Janice Steffes, Denise Davis, Steve Collins, and Bill Paxton. Thanks also to BBR staff members Julia Apodaca, Dorothy Brady, and Sally Furgeson for their help in preparing the report.

A Statistical Analysis of the Relationship Between Credit History and Insurance Losses

Executive Summary

At the request of Lt. Governor Bill Ratliff in 2002, the Bureau of Business Research (BBR) examined the relationship between credit history and insurance losses in automobile insurance. With the assistance of the leading automobile insurers in Texas, the BBR research team constructed a database of automobile insurance policies from the first quarter of 1998 that included the following 12 months' premium and loss history. Choicepoint, a commercial firm that provides underwriting information products for the U. S. property and casualty personal lines insurance market, then matched the named insured on the policy with his or her credit history and supplied a "credit score" using an insurance credit scoring methodology it markets to automobile insurers. This credit score and its relationship with prospective losses for the policy were then examined.

Using logistic and multiple regression analyses, the research team tested whether the credit score for the named insured on a policy was significantly related to incurred losses for that policy. It was determined that there was a significant relationship. In general, lower credit scores were associated with larger incurred losses. Next, logistic and multiple regression analyses examined whether the revealed relationship between credit score and incurred losses was explainable by existing underwriting variables, or whether the credit score added new information about losses not contained in the existing underwriting variables. It was determined that credit score did yield new information not contained in the existing underwriting variables.

What the study does not attempt to explain is why credit scoring adds significantly to the insurer's ability to predict insurance losses. In other words, causality was not investigated. In addition, the research team did not examine such variables such as race, ethnicity, and income in the study, and therefore this report does not speculate about the possible effects that credit scoring may have in raising or lowering premiums for specific groups of people. Such an assessment would require a different study and different data.

A Statistical Analysis of the Relationship Between Credit History and Insurance Losses

Introduction

Over the past decade, the insurance industry has begun using credit histories to create “credit scores” for individuals who apply for, or renew, automobile insurance policies. These scores (“high” if a person’s credit history is good, “low” if it is not good) are then used in rate-making decisions, presumably raising premiums for individuals with poor credit history and lowering premiums for those with good credit history. Additionally, such scores may be used by some insurers in underwriting procedures, including placement of policyholders within insurance company groups, or even in denying or canceling insurance.¹

There is a public policy debate over whether a statistically significant relationship exists between credit history and insurance loss, and the debate concerns not only the existence of such a relationship, but also the effect that the use of credit scoring might have on various subgroups of the population. The insurance industry has conducted or sponsored a number of studies that claim to demonstrate that, statistically, the poorer an individual’s credit history, the higher the expected losses that the individual will generate for the insurance company, thereby justifying a higher premium for people with poorer credit histories and a lower premium for people with better credit histories. Consumer groups have questioned the basis of this alleged relationship and assert that there is no relationship between an individual’s credit history and the propensity to file insurance claims. Additionally, others maintain that if there is a relationship, it is due to other variables and that no underlying causal or direct link exists.

In the summer of 2002, then-Lt. Governor Ratliff asked the Bureau of Business Research (BBR), as a nonpartisan and independent research unit, to investigate whether a statistically significant relationship exists between credit score and insurance loss and to report the result of the investigation to the Legislature. To effect this assessment, a random sample of automobile insurance policies, including loss histories, premiums, and other variables, were obtained from several of the largest companies writing automobile insurance coverage in Texas. These policies were then matched with the credit history of the named insured on the policy to create a database including both policy information and credit information (including a summary “credit score”). Information about race, ethnicity, or income was not included in the data collected by the BBR for the study, and consequently no conclusions will be drawn about the effect of credit scoring on various racial, ethnic, or income sub-groups in the population.

Methodology

In order to establish whether a statistically significant relationship exists between a person’s credit history and his or her potential to produce insurance losses, it was necessary to match a large database of insurance policies with the corresponding credit histories of the named insured

¹ A company group is a collection of insurance companies sharing the same managerial control. For example, some company groups have both a standard market subsidiary company and a county mutual (non-standard market) subsidiary company. These two companies would be considered part of the same company group.

in each policy. Then, controlling for other underwriting characteristics such as age, gender, prior driving record, and vehicle type, multivariate regression analyses were used to test whether adding credit information to a variety of other underwriting characteristics improved the accuracy of loss prediction.

In this study, insurance companies selling in the Texas automobile market were ranked according to the amount of their premiums written in the state. The insurers comprising the top 70 percent of the market (in descending order, starting with the largest companies) were then asked to provide a random sample of new or renewing automobile policies from the first quarter of 1998 (January 1, 1998 through March 31, 1998). This examination period was chosen chiefly for two reasons. First, most of the insurers from whom data were requested were not using credit scoring at that time in rate-making or underwriting decisions, which meant that premium data collected were not affected by credit history. Second, loss information, including paid losses and reserves for losses, could be obtained for a one-year period with ease. Even slow-paying claims would then have some chance of being recorded in the database. Five insurers, including those with both standard and non-standard subsidiaries (county mutuals), supplied data for the study, with the number of policies produced by each insurer corresponding to its market share. (For example, if Insurer A had a 10 percent market share of the dollar value of premiums written in Texas, it was asked for a number of policies that would total 10 percent of the resulting sample.) Data on the following variables were requested from the insurers:²

- Age of insured
- Gender of insured
- Marital status of insured
- Location where automobile(s) driven
- Use of automobile(s) (i.e., business use, pleasure, to and from work)
- Prior driving record of insured drivers
- Annual mileage driven
- Make and model of automobile(s) covered
- Age of automobile(s)
- Premium³
- Incurred losses⁴

A total of 175,647 separate policies were submitted by the participating insurance companies and transferred to a commercial firm (Choicepoint) that provides underwriting information products for the U. S. property and casualty personal lines insurance market. Choicepoint obtained the credit history for the policies' named insured by matching on name, address, or Social Security number. (Such individual identifying characteristics were removed from the data by Choicepoint prior to transmittal to the BBR.) Of the policies transferred to Choicepoint, 22,321 (12.7 percent) did not have sufficient or matchable information or credit history to create a credit score.⁵ Thus, the final database contained 153,326 policies with credit scores matched and 22,321 without credit scores. For non-standard market insurance company (county mutual) data, the "no-hit" rate was slightly higher (at 14.4 percent) than for standard insurance market company data (12.3

² Not all companies provided all requested information.

³ Premium data were for exactly one year of coverage from policy inception or renewal date.

⁴ Incurred losses included actual losses and reserves for losses for a 12-month period after the inception or renewal date in the first quarter of 1998.

⁵ Choicepoint did not go to secondary or tertiary credit vendors to try to increase the "hit" rate. This was partially due to time and financial constraints, but also because a consistent data record for each named insured was needed to perform tests on the data.

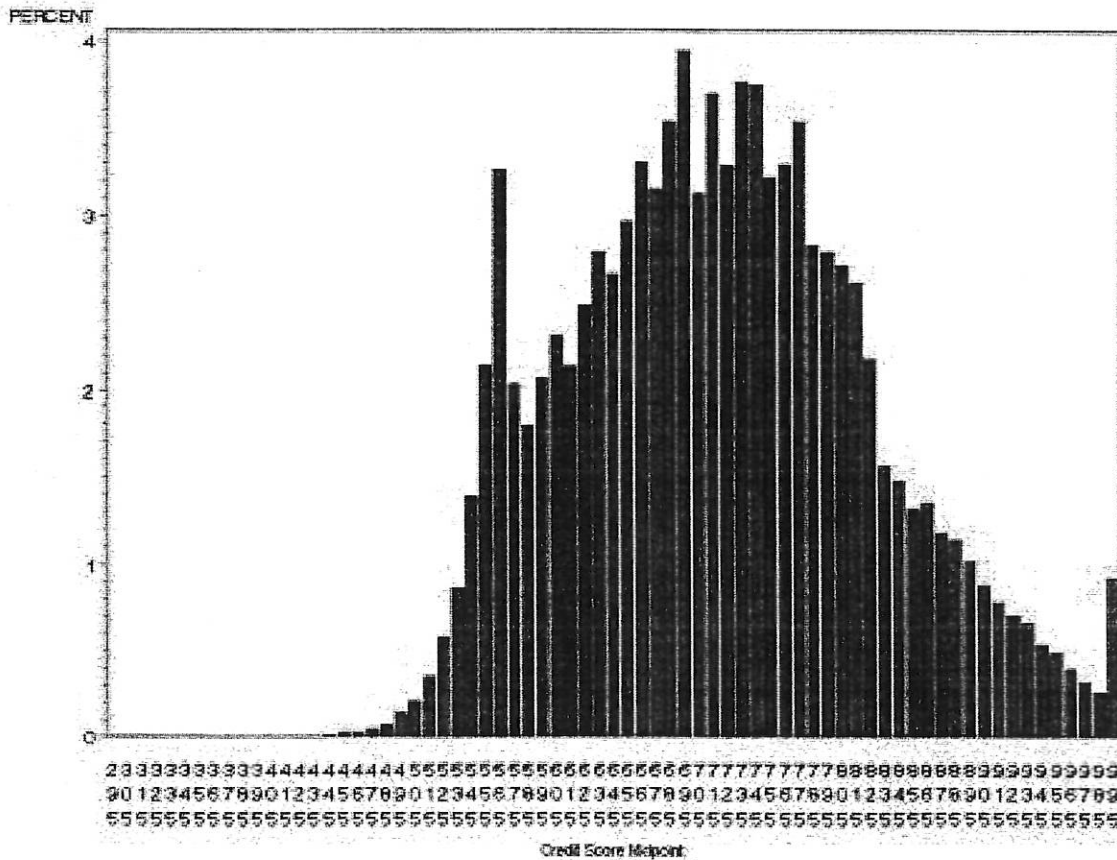
percent), which may be because of the “safety valve role” that the non-standard market insurers play in the proper functioning of the automobile insurance market in Texas.⁶

Choicepoint’s credit data on each named insured included a total of 445 credit variables along with a summary “credit score” created by Choicepoint.⁷ Charts 1, 2, and 3 contain distributions of credit scores in the database. The distribution of credit scores within an insurer’s clientele (also known as an insurer’s “book of business”) will vary according to the strategic plan of the insurer. Chart 1 shows the distribution of scores for the entire sample of policies from both standard and non-standard insurers. Chart 2 shows the distribution of scores for policies from the non-standard insurers participating in the study. Chart 3 shows the distribution of scores for policies from the standard market insurers participating in the study. Credit scores for the standard market (mean=733.0) are significantly higher than the credit scores for the non-standard market (mean=657.7). This most likely represents the safety valve role that the non-standard market insurers play in Texas, providing insurance for those unable to obtain insurance in the standard market.

⁶For more information on the role played by non-standard market companies in Texas, see “An Economic Overview of the County Mutual Insurance Market in Texas,” Patrick L. Brockett and Chris Sapstead, Working Paper, Center for Risk Management and Insurance, University of Texas at Austin, 1999.

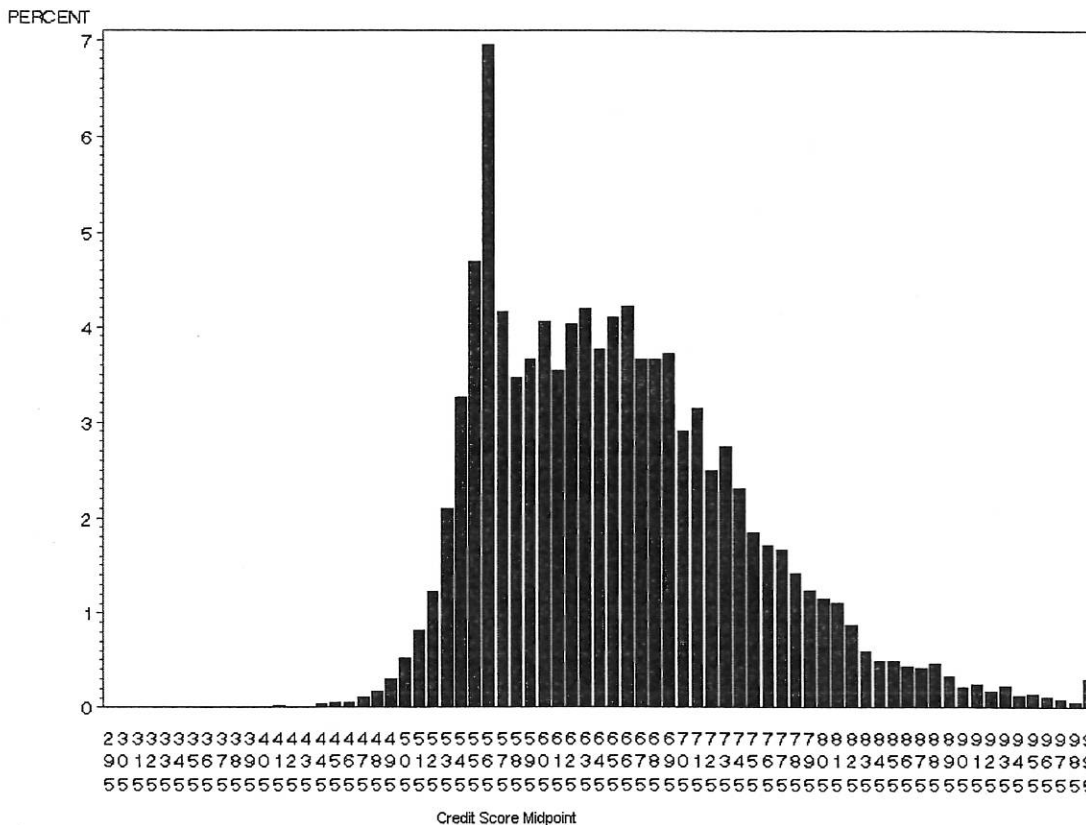
⁷A credit score typically is a number between 200 and 1000 that reflects the strength of a person’s credit history. It is created either by the credit vendor or the insurance company. Many insurance companies use their own algorithms to customize credit scores based on their particular market segments. The score used in this study should not be considered definitive, only representative of scores created by a major vendor in the market.

Chart 1
Credit Score Distribution for the Total Market Data Set



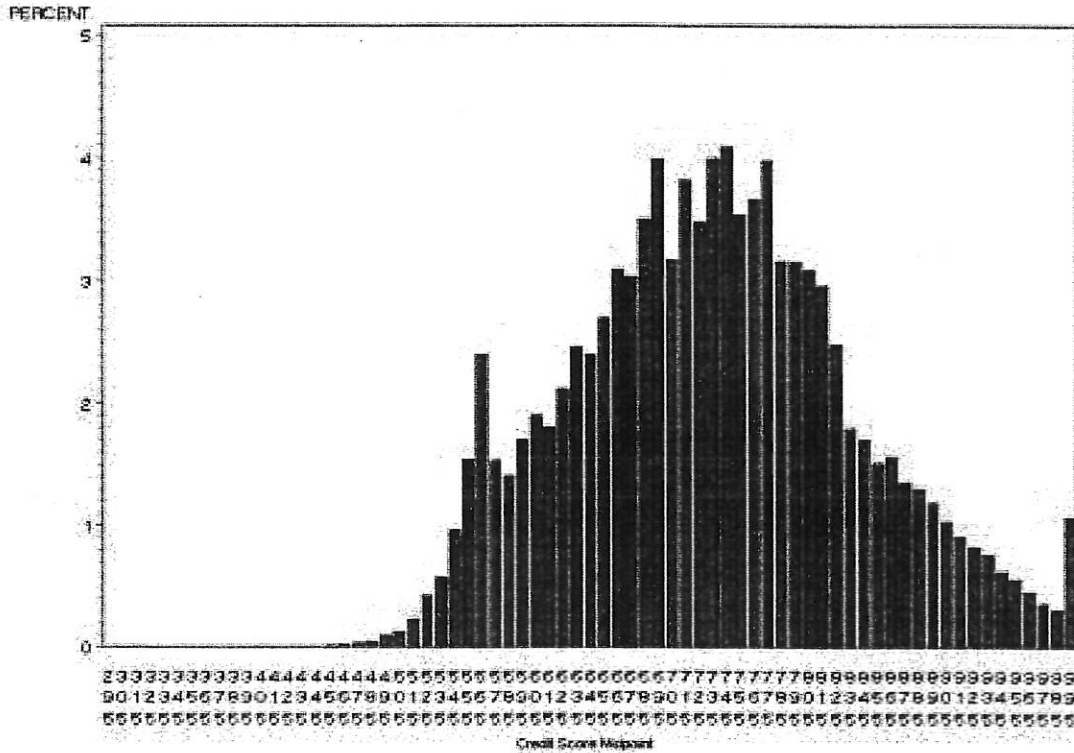
Mean: 719.5
 Standard Deviation: 106.9
 Range: 295-997
 Sample size: 153,326

Chart 2
Credit Score Distribution for the Non-Standard Market Data Set



Mean: 657.7
 Standard Deviation: 93.5
 Range: 383-997
 Sample Size: 29,086

Chart 3
Credit Score Distribution for the Standard Market Data Set



Mean: 733.0
 Standard Deviation: 104.6
 Range: 295-997
 Sample Size: 124,240

Loss Ratio

For every dollar in premiums that automobile insurance companies receive, they plan on spending a certain amount of money to pay claims and loss adjustment expenses. The remaining amount is available for administration costs, taxes, profit, and commissions. The ratio of incurred losses plus loss adjustment expenses to earned premiums is called the **loss ratio** and is a frequently used measure of performance for a group of automobile insurance policies.⁸ For the companies writing policies in Texas that were examined in this study, the average individual insurance company loss ratio varied from 58 percent to 74 percent, with an average of 61 percent across all companies in the database. Because different insurers have different underwriting guidelines and different risk profiles for their businesses, the “target” loss ratio will differ from insurer to insurer depending on the strategic positioning and the returns needed to accomplish strategic objectives (i.e., insurers writing higher risk business may strategically require higher rates of return or profit,

⁸Formally, the loss ratio for a policy is defined as the sum of actual paid losses, loss expenses, and loss reserves divided by the earned premium. This ratio takes into account the “best expectation” of the ultimate claim cost for a claim that has not yet fully settled and been paid and the actual premium that has been “earned” in the sense that the coverage was actually provided for the time interval.

resulting in a lower target loss ratio). In a simplified fashion, the insurer sets premiums (using underwriting criteria such as age, type of automobile, coverage, deductible, territory where driven, age and gender of driver, etc.) in such a manner as to accommodate the underwriting characteristics while targeting the insurer's anticipated loss ratio. If the underwriting characteristics for a group of policies indicate that an expected loss will exceed that supported by the premium, then the premium is raised for this group of policies. If the underwriting characteristics indicate that an expected loss will be less than that supported by the premium, then the premium can be lowered until the expected loss ratio is, on the average for the group being priced, equal to the target loss ratio.

Within a given insurer, policies are grouped together according to the underwriting characteristics of the policy with the intent of making policies within a group as homogeneous as possible. For any such group of policies, a loss ratio exactly equal to the insurer's target loss ratio means that the insurance company has correctly priced its premiums for this group to account for the expected losses in that group and the strategic goals of the insurer. A loss ratio for an underwriting group that is greater than the insurer's target loss ratio means that the losses for the group exceed the amount that the premiums can support within the strategic positioning of the insurer. Similarly, a ratio for an underwriting group that is less than the insurer's target loss ratio indicates that premiums were set too high relative to the losses and expenses (including profit) and the insurer's strategic goals (as demonstrated by the loss ratio).

Because of the random nature of individual accidents, it makes sense to only measure the average loss ratio for large groups of policies and not for individual policyholders. (About 80 percent of policies show no claim during a given year and hence have a loss ratio of zero, but the average for a group of policies will be non-zero.) However, some groups of drivers may exhibit higher accident frequencies than other groups and submit claims at a higher rate. For instance, younger drivers tend to have more accidents as a group than older drivers. If premiums were not adjusted upward for younger drivers, the loss ratio for the group would be higher than the target ratio. Theoretically, however, when premiums are raised for younger drivers, the loss ratio for younger drivers as a group adjusts downward. This adjustment process continues until the target loss ratio for an insurance company is achieved. When this occurs, the loss ratio for younger drivers should approximate the loss ratio for older drivers, since increased losses are already compensated for by increased premiums. If done correctly, this adjustment process makes the loss ratio for the insurer constant across all groups of drivers, with no group of drivers being charged premiums disproportionate to its anticipated losses.

In a world with perfect information, the premiums charged by the insurer would be adjusted upward or downward by actuaries to account for increased or decreased loss expectancy for the group of drivers being priced, so that each group has a loss ratio equal to the insurer's target loss ratio. Thus, the expected loss ratio for policies within a class of policies defined by their underwriting characteristics has already, to the best ability of the insurer's actuaries in a cost-effective manner, accounted for underwriting variables such as age, gender, territory driven, deductible, make, model and year of car, number of cars and drivers, and so forth, such that the expected loss ratio of this class will approximate the insurer's target loss ratio. Indeed, if there were systematic deviations from the target loss ratio for a given underwriting class, the premiums for this class would be adjusted to remove this systematic bias. Any variation in loss ratio within the class should be due strictly to random or non-systematic error. Conversely, if an analysis of a particular potential underwriting variable shows that it is significantly related to the loss ratio for the insurer, then this variable's influence on losses has not been accounted for by previous adjustments in premiums, and the inclusion of this variable as another underwriting variable adds value when determining the appropriate premium.

Thus, for a particular insurer, the usefulness of adding an additional underwriting variable beyond those that have already been priced and included can be assessed by ascertaining whether the variable is significantly related to the loss ratio. For example, consider proposed underwriting variable A. The current loss ratio has already incorporated the existing underwriting variables such as age, gender, make, model and year of car, and usage of the automobile, and insurance selections such as coverage amounts and deductibles through adjustments of the premiums. The statistical relationship between proposed underwriting variable A and the loss ratio will reveal whether including variable A into a new underwriting classification scheme is actuarially justified or whether the information underwriting variable A contains is already incorporated into the premium. If the information about losses due to underwriting variable A is already incorporated into the premium, there will be no statistical relationship between the loss ratio and variable A.

Relative Loss Ratio

As mentioned earlier, different insurers have different target markets and different risk profiles, and consequently different target loss ratios. The above discussion implies that for any one particular insurer, the loss ratio incorporates the multitude of underwriting variables and is an appropriate variable for assessing the statistical usefulness of a new potential underwriting variable such as credit score. However, one must be careful when aggregating across insurers. If one insurer or group of insurers had both a lower average credit score for its clientele and a higher average loss ratio than the automobile insurance industry as a whole, then an examination of credit scores versus loss ratios might indicate a relationship due to an insurer effect rather than due to an intrinsic relationship between credit score and loss ratio. The way to avoid this problem is to use a **relative loss ratio** for each policy, where relative loss ratio is defined as the loss ratio for the policy divided by the average loss ratio for the insurer issuing the policy. In this manner, each policy is adjusted to reflect the individual issuing insurer's characteristics. Doing so avoids potentially spurious findings due solely to insurer differences. If there were no insurer differences in target loss ratios, this adjustment would not have any effect on the outcome of the statistical analysis. But if there were differences, using relative loss ratios rather than (absolute) loss ratios for assessing the statistical impact of using credit scoring eliminates this source of bias.

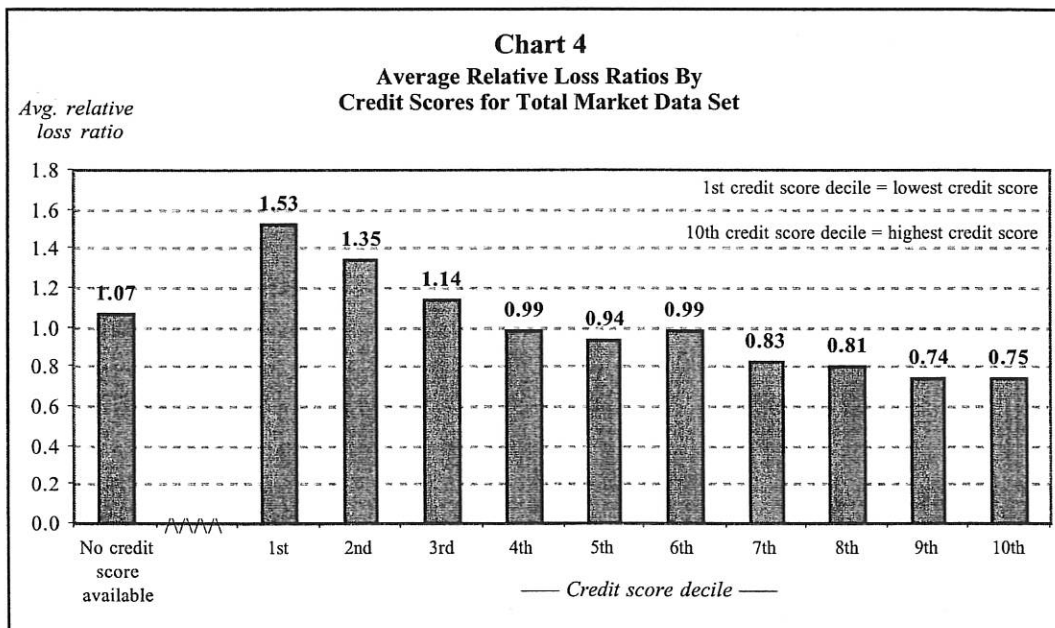
In the analysis that follows, the assessment of the relationship between credit scoring and insurance losses, after accounting for other underwriting variables, will be accomplished by relating the relative loss ratio to the credit score. This will be done for groups of policies. If a group of policies has been priced to reflect the expected losses for the group, then the average relative loss ratio will be 1.0 (i.e., the average loss ratio for members of the group will be the same as the target loss ratio for the issuing insurer).

Deleted Files

The database contained a small number of policies that were clearly anomalous and consequently were deleted before undertaking any data analysis. A total of 157 policies and credit histories with the following characteristics were deleted from the database: earned premium equal to or less than zero; incurred loss less than and not equal to zero; or no automobiles or a negative number of automobiles covered during the policy period. In addition, 57 other policies with loss ratios equal to or greater than 100 were deleted. For example, some policies that were deleted in this category were reported to have loss ratios in the hundreds of trillions of dollars. These deletions represent a statistically insignificant percentage (.0012 percent) of all policy records in the database, but an analysis without deleting these anomalous policies affected averages in an unwarranted fashion. The net sample on which tests were conducted was 175,433 policies, of which 22,284 were policies for which there was too little credit information available to generate a credit score (the "no hit group") and 153,149 policies with credit scores matched.

Research Findings

Chart 4 graphically illustrates the main finding of the study. The database of policies was sorted by credit score into ten groups of equal size. (Hereafter, the ten groups are referred to as “deciles.”) All but one of the deciles contained 15,315 policies (one decile contained 15,314 policies).⁹ The average relative loss ratio is given in Chart 4 for each of ten credit score deciles and the group of policies with no associated credit score.¹⁰ The chart reveals that the three deciles containing policies with the lowest credit scores have average relative loss ratios greater than 1.0. The seven deciles containing policies with the highest credit scores have average relative loss ratios less than 1.0. For the named insureds in the lowest 10 percent of the credit scores, the relative loss ratio for their policies averaged 53 percent higher than expected, whereas for the named insureds within the highest 10 percent of the credit scores, the relative loss ratio averaged 25 percent lower than expected. (Recall that a relative loss ratio of 1.0 is the average or expected relative loss ratio obtained when ignoring credit scoring altogether.) The group of policies with no credit history available has an average loss ratio of 1.07, or 7 percent higher than the average relative loss ratio for the dataset.



Statistical analyses confirmed the visual relationship apparent in Chart 4. A regression analysis of the relative loss ratio on credit score was highly significant ($p < .0001$). This indicates that there is less than a 1 in 10,000 chance that the relationship observed between credit score and relative loss ratio could be due to chance alone. Breaking the loss into frequency of loss and severity of loss, two additional analyses were performed. A logistic regression analysis was conducted to determine whether the existence of a positive claim (incurred loss greater than zero) was significantly related to credit score. Each policy was classified as to whether a positive loss or no

⁹The 22,284 policies with no credit score available were placed in their own group and analyzed along with the other ten groups.

¹⁰The standard deviations of the relative loss ratios for each of the deciles, including the “no credit score available” category, from left to right, are: 6.1, 6.9, 6.3, 5.7, 5.1, 5.3, 5.8, 5.0, 4.9, 4.4, 4.9. Not only does the average relative loss ratio tend to decrease with increasing credit score, but the uncertainty in predicting the relative loss ratio (standard deviation) also tends to decrease with increasing credit score.

loss was experienced. This classification variable was then related to credit score using logistic regression. It was found that there was a statistically significant relationship between credit score and the likelihood of a positive claim being filed ($p < .0001$). Another analysis was performed to ascertain if the size of the claim was related to credit score. For this analysis, a regression of the relative loss ratio on credit score was performed using only those policies having a positive relative loss ratio. Again for this regression the credit score was significant ($p < .0001$), indicating that the size of the loss is also significantly related to credit score. Finally, using the data grouped by credit score deciles exhibited in Chart 4, the correlation between credit score and relative loss ratio was calculated. The correlation (r) was .95, which is statistically and substantively significant. Thus, the analyses show that both the likelihood of a positive claim, and the size of the claim should it occur, are significantly related to credit score, even accounting for other underwriting variables and differences in individual insurance company target loss ratios.

Chart 5 shows the average relative loss ratio distribution for each credit score decile among policies in the sample taken from standard market insurers. The distribution is similar to that shown in Chart 4, with policies in the three lowest credit score deciles showing an average relative loss ratio significantly higher than the seven highest deciles. Again, for the grouped data in Chart 5, the correlation between credit score and relative loss ratio, .95, was highly significant.

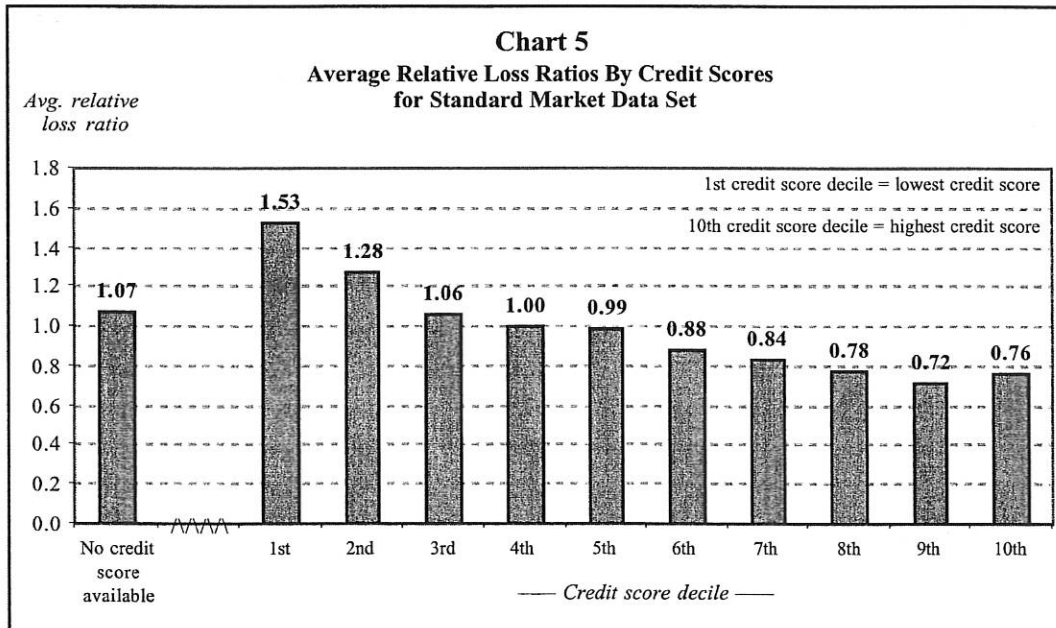
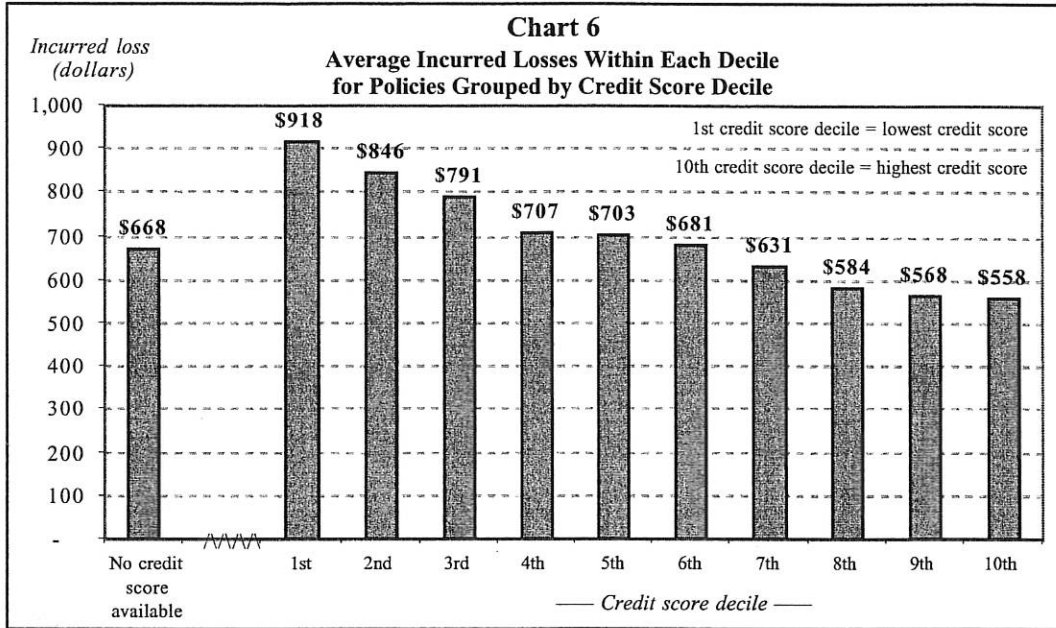
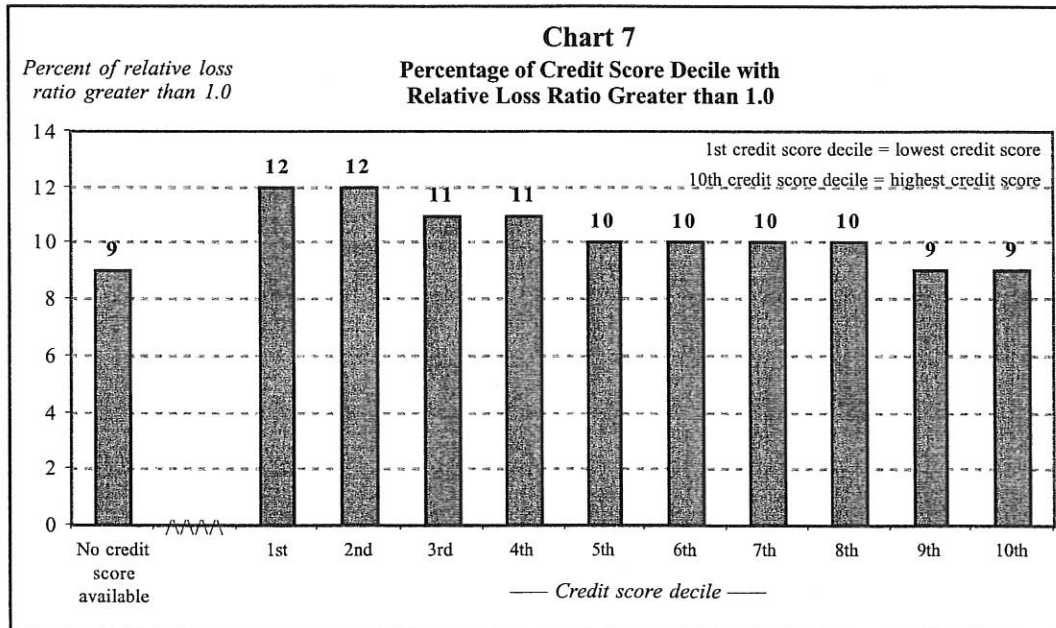


Chart 6 shows the average incurred dollar loss for each policy in each decile. Over the entire data set, the average loss per policy was \$695, but for those policies in the lowest 10 percent of credit scores, this average loss was \$918, whereas within the highest credit score decile, the average loss per policy was \$558. Thus, the average loss per policy is higher for the lowest credit score deciles and lower for the higher credit score deciles.¹¹

¹¹ The dollar losses shown for each decile are incurred losses for the policies and do not consider premiums. The extent to which each decile group is profitable or not for the insurance company depends upon the company being able to charge premiums that exceed these losses plus other expenses. Also, while Chart 6 shows the average incurred loss for named insureds whose credit scores fall into the decile listed, it does not address the issue of whether existing underwriting characteristics account for this variability. This was accounted for in Chart 5.



Another way of showing that policies belonging to named insureds with lower credit scores have a higher probability of incurring losses is to look at the distribution of relative loss ratios in each credit score decile in the sample. Chart 7 shows the percentage of policies within each credit score decile with a relative loss ratio greater than 1.0. As can be seen, named insureds in the lowest two credit deciles are about 33 percent more likely to have a relative loss ratio greater than 1.0 than are those with credit scores in the top two deciles ($12/09=1.33$). A relative loss ratio of 1.0, as described in the Methodology section (above), is the target toward which individual insurers aim for specific classes of insured drivers.



Limitations of the Study

While this study found that poor credit history strongly relates to insurance losses in the automobile insurance industry, it was not designed to, nor does it, answer a number of important public policy questions. Certain critics argue that credit information collected by the three main credit bureaus (TransUnion, Experian, and Equifax) can contain inaccurate information on consumers and their credit histories, which would then compromise any subsequent credit score created by third-party commercial firms like Choicepoint for use in the insurance industry, not to mention credit scores created by insurance companies themselves. In the present study, if the credit information provided to Choicepoint for the random sample of policies contains inaccuracies, then the credit scores generated for the named insureds will be inaccurate, as well. It was beyond the scope of this study to examine the accuracy of the credit report supplied, but this certainly is important if wide-scale adoption of credit history in underwriting is undertaken.

An important proviso regarding inferences that can be drawn from this study concerns the credit score itself. The analysis in the study used the credit score created by Choicepoint. Individual insurance companies can (and do) use individual credit histories and variables contained therein to create their own credit score models and credit score values for use in underwriting. To the extent that individual insurance companies create a "better" (more predictive) credit score, the relationship found in this study may be weaker than that observed by such insurance companies. Conversely, to the extent that insurance companies use credit histories and less predictive credit scoring models than that furnished by Choicepoint, the relationship found in this study may be stronger than that observed by such insurers. To the extent that individual insurers use different formulas, results presented here should be viewed as illustrative of the relationship that can be determined between credit scoring and losses. Without access to individual insurance companies' proprietary credit scoring models, the findings presented here can only suggest the potential for a correlation between credit score and losses. This analysis is based on the Choicepoint model and cannot predict the relationship that would be exhibited by individual insurers' credit scoring models.

Another factor that should be pointed out relates to the use of credit scoring in policies having multiple drivers. As is the general practice in the insurance industry, the credit score generated by Choicepoint, which was used in the analysis presented, was based on a credit match with the identifying characteristics of the named insured (e.g., the social security number of the named insured). For multiple driver policies, each driver might have a different credit score and different incurred losses, and yet their individual losses are aggregated and associated solely with the credit score of the named insured. Consequently, it is possible for a named insured (a father, for example) to have a very good credit history, while the young son driving on the policy has a bad driving record with many incurred losses. In such a case, a "good" credit score would be associated with a policy having high incurred losses. In this regard, the current study should be interpreted as showing a significant relationship between the credit score of the named insured and losses for everyone on the policy and not as showing a relationship between the credit score of an individual driver and the losses of that particular driver. The fact that there was a significant relationship found in this study even using "noisy data" indicates that perhaps an even stronger relationship would occur if every driver's credit and record were examined separately. This was not possible in this study, nor is it insurance industry practice.

A common criticism of credit scoring and its use in underwriting decisions is that it may discriminate against low-income and/or minority applicants, and that its use, in effect, amounts to "red lining." Some within the insurance industry have maintained that their underwriting and rate-making practices are blind with regard to ethnicity and income. The database used in this

study did not contain information on named insured income, ethnicity, or physical address (other than rather gross delineation of rating territory for some but not all insurers), so the results of this study cannot and do not address this issue.

Conclusion

This study analyzed a large random and representative sample of automobile insurance policies from the Texas market to determine if: 1) credit history and losses were statistically related and 2) whether such a relationship, if it exists, is explained by standard underwriting variables. The analysis found that incurred losses on individual policies are statistically significantly related to the credit score of policy's named insured (see Chart 6). Additionally, incorporating underwriting variables used by the companies through the use of relative loss ratios, it was found that there was still a statistically significant relationship between credit score and the relative loss ratio for policies (Charts 4, 5), so standard underwriting variables do not explain the observed statistically significant relationship between credit scores and losses. (The correlation between credit score and relative loss ratio is .95, which is extremely high and statistically significant.) The lower a named insured's credit score, the higher the probability that the insured will incur losses on an automobile insurance policy, and the higher the expected loss on the policy.

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Statement of Brad Smoot
Legislative Counsel
The American Insurance Association
House Insurance Committee
Regarding 2003 Senate Substitute for Senate Bill 144
March 13, 2003

Madam Chair and Members:

The American Insurance Association is a trade group of 413 property & casualty insurers who provide auto, home, workers compensation and general liability coverage for thousands of Kansans and their business. We appreciate this opportunity to comment on Senate Sub for SB 144, a bill regulating the use of credit-based insurance scoring.

We thank the Kansas Legislature for establishing the Task Force on Credit Scoring to study this issue in depth. It is a new topic for most lawmakers and consumers and deserves the time and attention that the Task Force was able to provide. After several days of meetings, hours of expert testimony and review of written information, the Task Force agreed on several basic concepts which the Kansas Insurance Department incorporated in SB 144. AIA agrees with the Task Force conclusions and recommendations and with a few exceptions we generally support Senate Sub for SB 144.

Attached to our statement are two documents. The first is a Consumer Alert from the National Association of Insurance Commissioners explaining insurance scoring, how it is used and what credit factors may affect an insurance score. The one page Alert also recommends that consumers know their credit history, take charge of their credit history and get more information about how their credit information is being used. The second attachment is one of our publications that describes credit-based insurance scoring, including how to find out about your credit history and how to improve it. Both are short and easy to read.

Before my appointment to the Credit Scoring Task Force, I knew nothing about the issue. But, I did attend all the meetings and reviewed much of the material provided by the experts and the Insurance Department. Like many of you, I wondered why my credit history would be a predictor of future insurance losses. As I thought about it and visited with people, I realized that careful and responsible behavior is a trait of risk adverse individuals, whether they are managing their money and credit or driving their cars or maintaining their homes. The expert testimony we heard in Task Force meetings and the studies establishing the statistical correlation reaffirmed that notion. A recent University of Texas study on this point is available to the Committee. For years, insurers have rated risks based on similar statistical correlations that to some may not seem "intuitive" either.

House Insurance
Date: 3/18/03
Attachment # 3

Why should smokers have higher auto insurance rates and women have lower rates than men? We're just used to these factors and, in time, we can get used to credit history as an underwriting and rating tool.

There are several issues that deserve your attention. First, and foremost, we should want insurers to use the most effective and accurate rating techniques they can find. As consumers, we deserve to be rated on our risk of loss. We want that assessment to be as objective as possible and not based on our ethnicity, address, marital status, income or other discriminatory factors. We want our insurers to give us the best deal we can get. We want carriers to compete for our business. Use of credit information in insurance underwriting and rating is one of the most cost-effective and objective tools available. AIA believes use of credit information in rating personal lines of insurance increases competition and benefits consumers.

Second, lost in the discussion so far are those millions of insurance customers who are currently benefiting from use of their credit information. It is faulty logic to assume that credit information only hurts. In fact, credit information helps hundreds of thousands of Kansans. At least half have average or better credit-based insurance scores. Those people are getting better rates than they might otherwise. Many insurance consumers with less than great driving records can get coverage or better rates because of their better than average credit-based insurance score. Those whose rates may go up because of poor credit history will complain. Those who get preferred rates because of their good credit record will not call to thank anyone. But, we must not forget those who benefit just because they are not vocal. If you were to ban or substantially restrict the use of credit-based insurance scoring, you most certainly would here from large numbers of these consumers.

Third, AIA and its members operate in all fifty states. Uniformity or at least similarity among laws and regulatory schemes is very important to consistent and efficient operations. For these reasons, we endorsed the National Conference of Insurance Legislators (NCOIL) model credit scoring bill. To a large measure, Senate Sub for SB 144 follows that model. However, in several important respects it does not. In Section 3(a), the bill defines adverse action very broadly ("anything other than the best possible rate"). Section 3(l) expands the scope of the bill beyond personal lines of insurance to cover farmowners insurance, a form of commercial insurance. Section 4 contains several deviations from the NCOIL model, including the ban on the use of credit scoring as the "sole" reason for refusing to quote [Section 4(b)]; omission of the NCOIL provision regarding use of "no hit" files under certain circumstances [Section 4(e)]; and a "one way street" provision allowing policyholders to request review of credit scores and receive lower rates but never higher rates [Section 4(g)]. Section 7(b) omits NCOIL language which allowed carriers to use four standardized explanations when notifying customers of adverse action.

The Oklahoma House of Representatives has just passed the NCOIL version and other states are considering it. While our member companies will, of course, abide by the Kansas law, we would prefer that Senate Sub for SB 144 follow the model bill more closely. Should this committee wish to make more than technical modifications to Senate Sub for SB 144, we hope you will consider amendments more in keeping with the NCOIL model.

In summary, use of credit information is widespread in the insurance business and elsewhere. When used in conjunction with other recognized rating factors it can be a valuable tool for underwriting and rating a person's risk of loss or claim. Because it relies on a strict formula that evaluates empirically derived data, subjectivity is minimized, allowing for a more objective and impartial underwriting and pricing decision. Credit-based insurance scoring allows consumers to pay premiums more in line with their own risk. Millions of Americans are benefiting from its use and will be harmed if it is removed or overly restricted. The Task Force recommendations are based on volumes of information, reflect a good balance of competing interests and should generally be given great weight. With the exceptions we have noted, Senate Sub for SB 144 reflects that balanced approach while creating several valuable consumer protections. AIA believes that credit-based insurance scoring should be regulated by the states and that model language should be used whenever possible to improve efficiency and compliance.

Thank you for this opportunity to comment.



Consumer Alert from the NAIC

Credit Scoring: How Does it Affect You?

If you are shopping for auto or homeowners insurance, or if your current policy is up for renewal, your insurance company may be looking at your credit history. Here are some tips from the National Association of Insurance Commissioners (NAIC) to help you understand how your credit information may be used and how it may affect your insurance premiums.

1. What is Credit Scoring?

A credit score is a snapshot of your credit at one point in time. The credit information from your credit report is put through a mathematical formula (credit scoring model) that assigns weights to the various factors and summarizes your credit information into a three-digit number ranging from zero to 999. Generally, the higher the number, the more financially responsible the consumer.

2. How is Credit Scoring Used?

If your insurance company relies on credit scoring, they may use it in two ways:

- **Underwriting** — Deciding whether to issue you a new policy or to renew your existing policy.
- **Rating** — Deciding what price to charge you for your insurance by placing you into a specific rating “tier” or level.

Some insurers use credit information along with other more traditional rating factors, such as motor vehicle records and claims history. Other insurers may use credit alone to determine your rate.

3. What Affects a Credit Score?

There are several factors that determine credit scores. Each factor is assigned a weighted number that, when applied to your specific credit information and added together, equals your final three-digit score. Following is a list of common factors:

- **Major negative items** — Bankruptcy, collections, foreclosures, liens, charge-offs, etc.
- **Past payment history** — Number and frequency of late payments.
- **Length of credit history** — Amount of time you’ve been in the credit system.
- **Homeownership** — Whether you own or rent.
- **Inquiries for credit** — Number of times you’ve recently applied for new accounts, including mortgage loans, utility accounts, credit card accounts, etc.
- **Number of open credit lines** — Number of major credit cards, department store credit cards, etc., that you’ve actually opened.
- **Type of credit in use** — Major credit cards, store credit cards, finance company loans, etc.
- **Outstanding debt** — How much you owe compared to how much credit is available to you.

4. Know Your Credit History

There is a good chance your current or prospective insurance company is looking at your credit. Therefore it is a good idea to review your credit history to make sure it’s accurate. Request a copy of your credit history from Equifax www.credit.equifax.com, Experian www.experian.com or Trans Union www.transunion.com. You can also contact the Federal Trade Commission for consumer brochures on credit at www.ftc.gov.

The Fair Credit Reporting Act requires an insurance company to tell you if they have taken an “adverse action” against you, in whole or in part, because of your credit report information. If your company tells you that you have been adversely affected, they must also tell you the name of the national credit bureau that supplied the information so that you can get a free copy of your credit report and correct any errors.

5. Take Charge of Your Credit History

If your insurance company is using your credit score to evaluate your rates, you can take steps to improve your premiums.

- Get a copy of your credit report and correct any errors. Notify your insurance agent and company of any errors.
- Improve your credit history if you’ve had past credit problems. If your credit score is causing you to pay higher premiums, ask your insurer if they will re-evaluate you when your credit improves.

6. Get More Information

Insurance rates based on credit information can vary from company to company, so if you feel your premiums are too high, shop around. Some states have regulations in place for how — and if — insurance companies may use credit scores. If you have questions about credit scoring in your state, contact your state insurance department. You can link to your insurance department’s Web site by visiting www.naic.org. Click on “State Insurance Regulators — Web Sites,” then click on your state.

The National Association of Insurance Commissioners is a voluntary organization of the chief insurance regulatory officials of the 50 states, the District of Columbia and four U.S. territories. The overriding objectives of state regulators are to protect consumers and help maintain the financial stability of the insurance industry. If you would like to be removed from the “Consumer Alert” media list, please contact Michele Compton at (816) 783-8003 or mcompton@naic.org.

3-4



American Insurance Association

CREDIT-BASED INSURANCE SCORES

WHAT YOU NEED TO KNOW

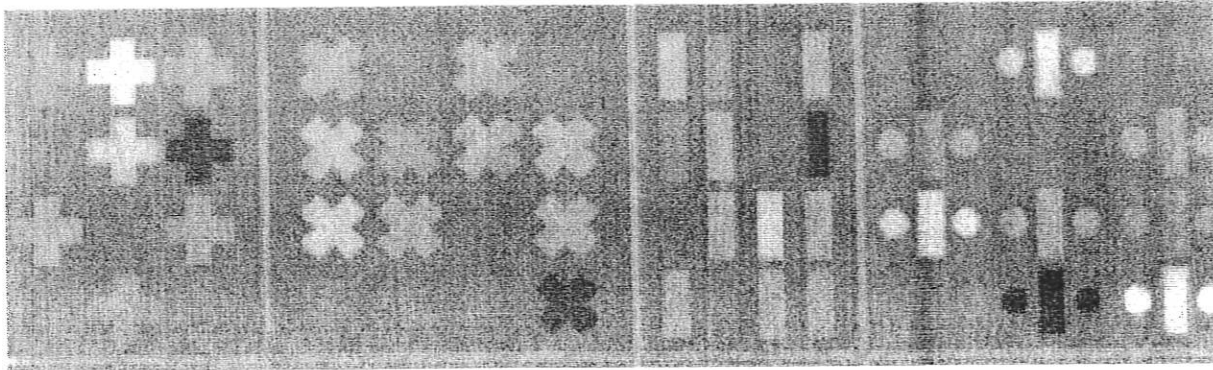
HAVE YOU EVER APPLIED FOR A CAR LOAN, A MORTGAGE, OR A CREDIT CARD?

If so, you know that the way you have managed your credit in the past is very important. The information contained in your credit report can have a major influence over many parts your life, including your auto and homeowners insurance.

Many insurance companies use a credit-based "insurance score" when evaluating insurance applications or policies. This brochure was designed to give specific answers to questions about insurance scoring, including how and why it is used.

What is a credit-based insurance score? Why do insurance companies use them?

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.

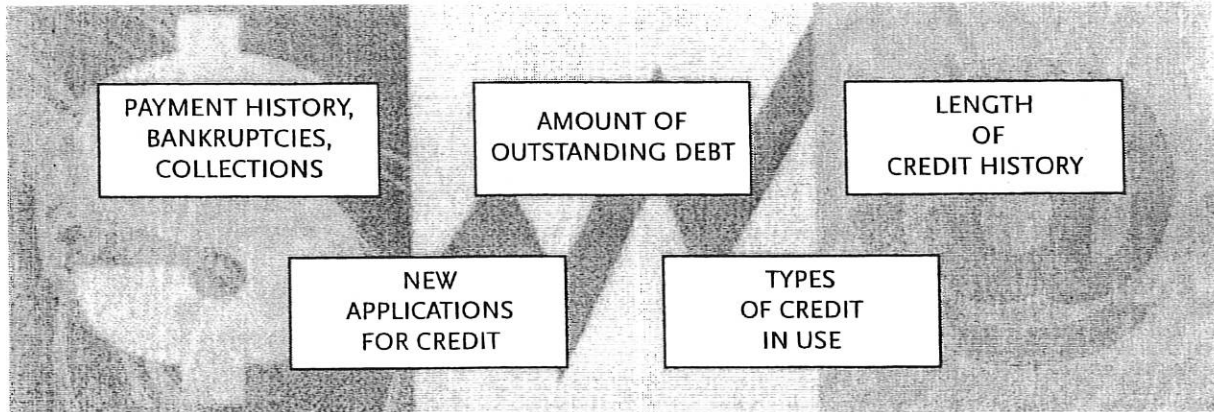
For instance, if you add a 16- or 17-year-old driver to your auto insurance policy, your premiums will very likely increase. This is because, as a group, younger drivers have

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.

CREDIT REPORT INFORMATION USED IN INSURANCE SCORES



Any time someone looks at your credit report, the credit bureaus record this activity – they refer to it as an “inquiry.” The number of inquiries on your record can also affect your insurance score. There are several types of inquiries, but under the models used by most insurance companies, the only inquiries that affect your insurance score are those you initiate. Every time you apply for credit, whether a department store charge card, a new car loan, or “easy financing” on new bedroom furniture, an inquiry is noted on your record. Applying for a lot of credit in a short time shows that you might be taking on more than you can handle. ▼

Credit-based insurance scores look at patterns of financial management. Applying for one credit card is unlikely to have much effect on an individual’s score. But applying for several lines of credit in a short period probably will have an impact.

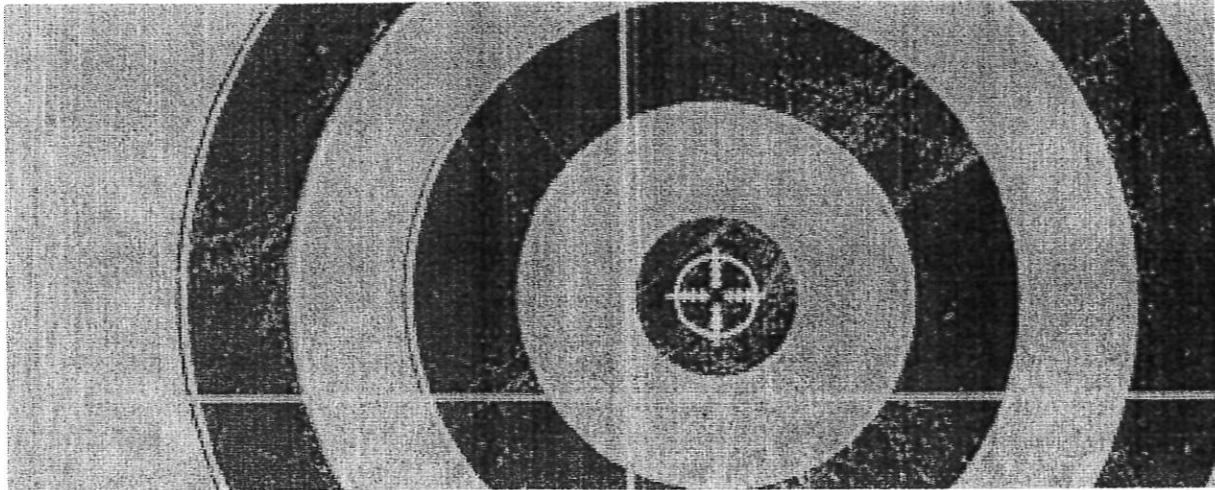
One way to improve your insurance score is to limit the number of self-initiated inquiries in your credit report. This can be done by only applying for credit when you really need it. For example, an unsolicited “pre-approved” credit card notice in the mail would not affect your score, because you did not initiate the offer. If you fill out the form and send it back, though, you are applying for new credit. An inquiry will then be posted in your credit history, which may have an effect on your score. ▼

If you are shopping for a car or a house, you may fill out lots of applications within a short period to find the best deal. This shows that you are a responsible consumer. Under most of the models used by insurance companies, applying for several car or mortgage loans over a certain amount of time will only count as one inquiry. Also, most models do NOT consider inquiries you initiate when you are shopping for insurance.

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
- ▶ ADDRESS
- ▶ PUBLIC ASSISTANCE SOURCES OF INCOME



Can my insurance score help me save money on insurance?

Yes. Credit-based insurance scores allow companies to charge lower premiums to customers who are better risks. For most people, a better insurance score, combined with a good driving record, helps them qualify for a better rate.

In recent years, some states have enacted legislation dealing with insurance scores. This information is available from each state's Insurance Department.

Do I have any rights if I am denied insurance based on my credit history?

Absolutely. If an insurance company takes an "adverse action" against you (such as denying you coverage) as the result of information contained in your credit report, you may obtain a copy of your credit report free of charge from

the bureau that provided the information. Again, if you believe there are errors in the report, you should immediately notify the credit bureau – the credit bureau must promptly correct errors.

Can I get a copy of my credit report before I apply for insurance?

For a small fee, each of the three major credit bureaus will send you an updated copy of your credit report.* If you believe there are errors in the report, you should immediately notify the credit bureau. If the information is incorrect, the bureau is required to promptly correct any errors.

Contact information for the three major credit bureaus is listed at the end of this brochure.

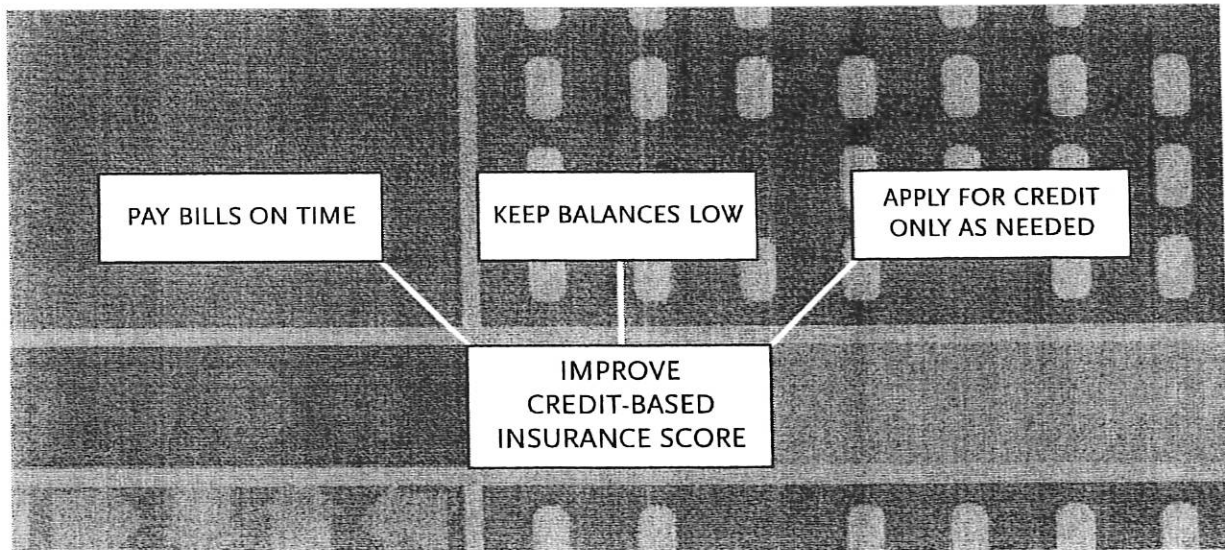
* Some states have laws which permit consumers to receive one free copy of their credit report each year. As of Jan. 1, 2002, those states were: CO, GA (allows two per year), MA, MD, NJ and VT.

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How do credit-based insurance scores benefit consumers?

- ▶ Credit-based insurance scores can help you qualify for lower premiums, because insurance companies charge lower premiums to customers who are considered more responsible.
- ▶ The use of credit-based insurance scores has allowed more companies to offer more products to more people. Since insurance scores have been used, competition in the auto insurance market has increased significantly - and competition quite often leads to more choices and lower costs.
- ▶ The Federal Fair Credit Reporting Act (FCRA) provides numerous consumer protections. These include:
 - ▶ *The right to obtain a free copy of your credit report if you are adversely affected (for example, denied coverage) based on information in your credit report*
 - ▶ *The right to contest any inaccuracies in your credit report and have inaccurate information removed*
- ▶ Insurance scores can be improved. By using credit wisely – paying bills on time and exercising responsibility in other financial activities – you can usually qualify for lower rates.**

***Insurance companies have different policies with regard to how often they will recheck your insurance score. Check with your insurer to find out their policy.*





American Insurance Association

Contacts and other resources:

Consumer Data Industry Association (CDIA)
(www.cdiaonline.org)

Contact CDIA for information on the credit report dispute resolution process.
Phone 202-408-8011

Federal Trade Commission (FTC)
(www.ftc.gov)

Visit the FTC's website for information on credit and your rights under the Fair Credit Reporting Act (FCRA).

Equifax (www.equifax.com)

For a copy of your report, call 1-800-685-1111.
To dispute information in your report, write to:
P.O. Box 740241, Atlanta, GA 30374

Experian (www.experian.com)

For a copy of your report, call 1-888-397-3742.

Trans Union (www.tuc.com)

For a copy of your report, call 1-800-888-1213.
If you have a copy of your report and wish to discuss it, call 1-800-916-8800.
To dispute information in your report, write to:
P.O. Box 34012, Fullerton, CA 92831
(for residents of the Western & Southwestern U.S.)
P.O. Box 2000, Chester, PA 19022
(for residents of all other regions)

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AMERICAN ACADEMY *of* ACTUARIES

**THE USE OF CREDIT HISTORY
FOR PERSONAL LINES OF
INSURANCE;
REPORT TO THE
NATIONAL ASSOCIATION OF
INSURANCE COMMISSIONERS**

**American Academy of Actuaries
Risk Classification Subcommittee of the
Property/Casualty Products, Pricing, and Market
Committee**

November 15, 2002

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Purpose

The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

The Risk Classification Subcommittee of the Academy is charged with assisting legislators, regulators, and other interested parties in evaluating actuarial practices related to the affordability and availability of insurance in urban areas and risk classification issues in general.

The Credit Scoring Working Group of the Market Regulation & Consumer Affairs (D) Committee of the National Association of Insurance Commissioners (NAIC) requested that the Risk Classification Subcommittee provide assistance to the Credit Scoring Working Group. Specifically, the Risk Classification Subcommittee was asked to provide the following support.

1. Review and critique four papers that have been published in regard to the use of credit history for rating and underwriting personal lines of insurance. These four papers are:
 - The Impact of Personal Insurance Credit History on Loss Performance in Personal Lines by James E. Monaghan (2000);

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- Insurance Scoring in Personal Automobile Insurance - Breaking the Silence by Conning & Company (2001);
 - Predictiveness of Credit History for Insurance Loss Ratio Relativities by Fair, Isaac (1999); and
 - Use of Credit Reports in Underwriting by the Commonwealth of Virginia, State Corporation Commission, Bureau of Insurance (1999).
2. Provide guidelines/parameters on how the NAIC could conduct a study of credit scoring, including suggestions on how the NAIC could determine (by study) causality (the relationship between credit history and risk of loss) and whether insurance scoring disproportionately affects protected classes and whether it disproportionately affects low-income groups.
 3. Provide "best practices" that states could use in reviewing rating plans that use credit history in combination with other rating factors, for states that have prior approval rating laws.

This report provides our findings regarding items 1 and 3, and provides our initial advice and guidance in regard to item 2.

The subcommittee was not asked to evaluate the effectiveness of credit history as a tool in the underwriting and rating of personal lines of insurance, and therefore such an evaluation is not an element of this report. However, the subcommittee believes that credit history can be used effectively to differentiate between groups of policyholders and therefore it is an effective tool. This recognition is based on review of the four papers listed above, especially the Monaghan paper, and on the subcommittee's members' personal knowledge as obtained through the development and/or review of rating models based on credit history.

Review of Four Papers

Each of the four papers is reviewed. We first identify the major points and conclusions that are made in each paper, then review and discuss these major points and conclusions, and then provide an overall summary of the study.

Summarizing these papers very briefly:

- The Monaghan paper, written by an insurance company actuary, provides an analysis of the effectiveness of using credit characteristics to predict future loss ratios for private passenger automobile and homeowners insurance.
- The Conning & Company paper provides a disinterested overview of the use of credit history by personal lines insurers, based on review of the available literature and discussion with various parties.
- The Fair, Isaac paper, by a prominent provider of insurance scoring models, is a comprehensive response to issues that have been raised by insurance regulators and others in regard to the use of credit history.
- The Virginia Bureau of Insurance paper is a regulator's survey and discussion of the use of credit history in one state.

The Impact of Personal Credit History on Loss Performance in Personal Lines

James E. Monaghan; 2000

Study's Major Points and Conclusions

1. Eight credit information variables are identified which show strong power to predict loss ratios. This demonstrates correlation between certain credit information at the time a policy is written as new business, and future loss ratios.

The eight credit information variables are:

- Amounts past due
 - Derogatory public records (bankruptcies, tax liens, civil judgments, and so forth)
 - Collection records (generated when an account is referred to a collection agency)
 - Status of trade lines (a "trade line" is a credit account or loan account)
 - Age of oldest trade line
 - Non-promotional inquiry count (number of credit inquiries arising from activity or request of the consumer)
 - Leverage ratio on revolving type accounts (the leverage ratio is the ratio of debt to account limits)
 - Revolving account limits
2. The statistical models do not demonstrate causality.

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Although the cause-and-effect relationships are speculative, there are reasonable causal links between credit characteristics and insurance risk.

Actuarial Standard of Practice No. 12 states that causality cannot be made a requirement for risk classification systems. It is sometimes impossible or impractical to prove cause-and-effect relationships. Risk classes should be neither obscure nor irrelevant, but they need not exhibit a cause-and-effect relationship.

The following list includes some examples of possible causal links between certain credit information and insurance loss experience:

- Maintenance: How responsibly one manages financial credit might also correspond to how they maintain and operate a car.
- Moral Hazard: How responsibly one manages financial credit might also correspond to how they maintain and operate a car.
- Claims Consciousness: Persons in certain financial situations might be more inclined to file claims.
- Fraud: Similarly, persons in certain financial situations might be more likely to be induced into fraud.
- Stress: persons in certain financial situations might be more stressed.

It is likely that all of these and other factors create a cumulative effect.

3. Multivariate analysis was performed and presented which demonstrates that different credit profiles predict different loss ratios, even when other factors (such as driving record, age of driver, and so forth) are held constant.

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Credit characteristics were compared by type of rating territory (urban versus other) in several states. This demonstrated that the distribution of credit characteristics by type of territory is relatively uniform. In other words, urban territories had approximately the same percentage of risks with poor credit characteristics as did other territories. Similar results were found for other underwriting criteria, including: number of vehicles, number of drivers, residence type, residence stability, job stability, prior insurance, gender, and marital status.

Multivariate analysis also was performed to demonstrate that there are many credit variables that have independent relationships with loss ratios

4. The study is extended to include an analysis of credit history versus homeowners insurance loss ratios, with similar results.
5. Whether or not credit information should be used. There are issues to consider other than loss performance.
 - Questions remain about whether credit information should be applied to renewals, and if so, how often should it be re-checked? Should premium be changed solely due to credit information? Each evaluation creates an inquiry in the credit file.
 - There is concern with using a classification variable that is “under the control of the insured.” In this case, however, it is doubtful that insureds would manipulate the class plan because they already are affected by their credit histories in other ways.
 - There is the need for a good measure of the accuracy of credit information. Insurers should inform customers of how to resolve inaccuracies, and then take into account any corrections.

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- Privacy concerns need to be addressed when considering the use of credit history in personal lines of insurance. Unlike the use of accident history, for which the negligence of the insured can usually be determined, a poor credit history is not necessarily due to negligence on the part of the insured.

Review and Discussion of Major Points and Conclusions

The study is based on data and information for new auto policies written by one insurance company in 1993 and the earned premium and loss information, for these policies from accident years 1993 through 1995. Credit information at new business time was matched with the experience data. Credit information was matched with premium and loss experience for 170,000 policies. Total premium volume was \$394 million. Credit information had not been used during this historical period for rating or underwriting.

Only new business was studied, so this study does not directly address renewal strategies, although there is no particular reason to think that the results would not generalize to renewal business. Credit information was collected only on the named insured, one person. As a result, the credit relationships might not be appropriate for recently married couples if each partner had different credit characteristics.

The author describes that drivers with past accidents and violations who are in the "best" group, as regards credit characteristics, have a lower overall loss ratio than do those good drivers who are in the "worst" group, as regards credit characteristics. In other words, he explains that for the purpose of forecasting future loss ratios, credit history is more important than past driving experience. However, the loss ratios of these two groups are probably not comparable because of the premium surcharges that would have applied to the drivers with past accidents and violations who are in the "best" credit group.

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The author provides a comparison of urban and non-urban territories that shows no clear-cut difference in distribution of credit information by type of territory. This point may be valid. From an actuarial point of view, however, there is no need to have similar distributions of credit characteristics by type of territory. The value of the use of credit history is that it enables the insurance company to more equitably rate drivers within any given territory.

The section of the paper that discusses the multivariate analysis is important because it demonstrates that the credit characteristics are adding predictive power above and beyond the existing variables. It also demonstrates that a large number of credit characteristics are adding predictive power, *independent* of one another.

Summary Review of Paper

The Monaghan study has the following strengths and weaknesses.

Strengths

- The study uses loss ratio and multivariate analysis to demonstrate that the credit characteristics are adding predictive power, above and beyond the existing variables.
- The study provides a good discussion of causality and how it relates to actuarial standards.
- The study addresses public policy issues that are important to the acceptance of the use of credit history, beyond causality.

Weaknesses

- The database does not allow for the analysis of renewal business.
- The database is confined to the experience of one insurance company from 1993 through 1995.

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- The study was intended for a wide audiences, and therefore does not provide in-depth analytical detail. The multivariate analysis presented in the study is bivariate (two variables) and does not evaluate the importance of credit characteristics versus a combination of other rating variables.
- Many of the study conclusions are stated without providing the results of the underlying analysis. For example, tables are provided to demonstrate that credit characteristics do not appear to have a disparate impact by age of driver or by type of rating territory and then the statement is made that this also holds true for many other underwriting characteristics.

Insurance Scoring in Personal Automobile Insurance—Breaking the Silence

Conning & Company; 2001

Study's Major Points and Conclusions

1. In their underwriting and pricing process insurers seek to charge rates that are equitable, adequate and not unfairly discriminatory. These objectives are sometimes difficult to achieve because of regulatory constraints and insurers' own desires not to discriminate unfairly or act in a manner that is inconsistent with socially acceptable standards.

From the company perspective, pricing equity and accurate cost projections are crucial. Credit data can be used to create scores that in fact provide additional predictive information about future losses. However, using credit history is often perceived to be in conflict with what society considers as fair, particularly if the individual's score is affected by catastrophic events such as divorce, medical problems or loss of a job.

2. The use of credit data in decision-making, along with having more easily accessible and reliable data, has led to the rapid growth in automated underwriting systems that minimize subjective judgment by relying on more objective, rigorous, data-driven decision processes. Automated systems are more predictive, reliable and can improve the integrity of risk classification systems.

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3. More than 90 percent of insurers responding (from the top 100 personal lines companies) indicated that they currently use credit data. The following also were found as a result of that survey:
 - More than 50 percent of these respondents began using it in 1998 or later.
 - Ten percent use it for pricing only; 38 percent for underwriting only, and 52 percent for underwriting and pricing.
 - Forty-six percent use the named insured with the highest score; eight percent use the average score for all listed drivers; and 15 percent use the named insured with the lowest score.
 - Seventy percent order scores for more than 75 percent of new applicants; ten percent order scores for between 50 and 75 percent of new applicants; five percent order scores for between 25 and 50 percent of new applicants; and 15 percent order scores on fewer than 25 percent of applicants.
 - Fourteen percent use credit history on annual renewal; 33 percent during re-underwriting, and 38 percent do not use it at all in the renewal process.
4. Scoring models have evolved through time. Today, they are more complex, hard to duplicate and difficult for consumers and regulators to understand. If not developed properly and maintained, they have the potential to create long-term legal, social and financial problems for insurers.
5. Insurers appear to be focusing their use of credit data and insurance scoring on four strategic goals: (1) more refined risk classifications; (2) customer valuations to drive target marketing; (3) pricing and underwriting proficiency; and (4) increased retention.

To the extent that insurance scoring can predict which insureds are more likely to have a loss, it can minimize subsidies between classes. The objective decision-making embodied in

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the use of insurance scoring makes the evaluation of customers for direct marketing easier and more pointed. The scoring systems have been derived to match actual loss ratio performance to risk characteristics and sort through the data and price more efficiently. The use of these models has allowed companies to compare results for profitable customers and thereby target renewal discounts to retain the more profitable customers.

6. The use of credit data in underwriting and pricing of personal automobile insurance has sparked an intense debate that centers mostly on the following factors relating to statistical correlation between credit data and loss ratio: (1) benefits to consumers, (2) discrimination, and (3) socially acceptable criteria.

There are at least three studies that show a statistically significant relationship between credit data and loss ratio performance. These studies show that this correlation can change in time – but this correlation, however strong, cannot establish a causal relationship. The use of credit data has allowed insurers to establish that some insureds, traditionally classified as “standard,” can qualify as “preferred” when evaluated by these models. Studies have shown that even insureds with prior violations or accidents but having good credit behavior can have better loss ratio performance than insureds who have no accidents or violations but who have poor credit.

The debate about the social acceptability of credit has been the subject of at least five studies. Based on these studies, the author notes that the evidence about the relationship of credit to income is mixed, but not conclusive, and may reflect differences by ethnicity and socioeconomic group.

The authors also looked at various credit parameters, ranging from the less severe (payments more than 60 days delinquent) to the more severe (bankruptcy), for which data were available from secondary sources. Based on these parameters, they found:

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- If a key measure of credit quality is having a debt payment that is 60 days or more past due, then it seems reasonable to conclude that the use of credit characteristics has a disparate impact on lower income households.
- There is a significant variance between the mean and median income of bankruptcy filers (at the time of bankruptcy) compared to the state's mean and median income.

With regard to the accuracy of credit data, Conning looked at various major studies compiled regarding the accuracy. These studies included compilations by *Consumer Reports*, *USA Today*, *U.S. News & World Report*, and the Public Interest Research Group. Each of these studies showed high percentages of errors but none of the studies made any attempt to measure the impact of using the data. Additionally, Conning identified the source of errors, including applicants themselves, store personnel, failure of creditors to report data, and an increase in the incidence of identity theft. While the available data leads to the conclusion that the data itself is not completely accurate, the degree of inaccuracy is difficult to determine due to the differences in definitions used by proponents and critics.

7. To minimize risks associated with the use of credit data, insurers must proactively educate three key stakeholders: consumers, regulators and distributors. Consumers are increasingly concerned about how personal information is being used. They are concerned that inaccurate information may be used to deny them insurance. These concerns are disparate and significant when examined by ethnic group. Conning believes that these facts are an issue with which insurers need to be concerned.
8. The convergence of the financial services sectors, although not advancing as rapidly as initially expected following enactment of the Gramm-Leach-Bliley Act, will present insurers with both opportunities and challenges in connection with their use of credit data and insurance data. Opportunities exist in coordinating multi-line underwriting decisions, cross-selling of other financial products and enhanced retention, response, and referral. Challenges

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will arise in assessing the value of the models to enhance the competitive position of insurers as they get more complex. They will also make it harder for insurers to know their competitive position. The hiring of staff skilled in developing and enhancing these models will become more difficult. Additionally, the perception of these models as "black boxes" will lead to increased pressure to open them to the regulators and consumers, while seeking to maintain the intellectual property and confidentiality in order to sustain a competitive edge.

Review and Discussion of Major Points and Conclusions

The authors reviewed existing literature and discussion about the use of credit scores, and attempted to summarize its findings. They did not conduct original research and therefore it is difficult to critique their individual findings. In our opinion, the authors' findings are reasonable and provide a good overview of the issues.

Summary Review of Paper

The Conning study has the following strengths and weaknesses.

Strengths

- The authors are unbiased observers and have reviewed the arguments offered by each side and attempted to evaluate the validity of the claims.
- The authors appear to have conducted a thorough analysis of the available literature and interviewed insurers and agents about the use of credit.
- The Conning study concludes that the use of credit information has merit because it appears to have a correlation to loss ratio performance and does not appear to overlap other

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variables used by insurers. However, it is unable to eliminate the possibility that scoring models do not have a disparate impact related to income level.

Weaknesses

- Research is all secondary with regard to the technical questions about relationship to loss ratio and potential disparate impacts based on income or ethnic group. The authors are drawing their conclusions based on a review of studies and analyses produced by others. As a result, they cannot evaluate the methods by which the data was compiled.
- The Conning study neither discusses the methods used to develop the models nor gives a thorough presentation of how companies are actually using the models.
- The study does not distinguish between score-based or rule-based models in application. The rule-based model gives a set of conditions that result in either a credit or surcharge for each condition that is present or absent. A score-based model will provide an aggregate score resulting from all of the risk parameters but does not permit the recipient of the score to understand which items were the drivers of the score.
- The study does not discuss the possible differences between univariate and multivariate models.
- The authors do not investigate whether or not the initial segregation of risks in model development such as preferred, standard, or non-standard categories, perhaps produces disparate impact.

Predictiveness of Credit History for Insurance Loss-Ratio Relativities

Fair, Isaac; 1999

Study's Major Points and Conclusions

1. The accuracy of credit data should not be a matter of concern.

If credit data were widely inaccurate, scores also would be inaccurate. The fact that insurance scores are so predictive of insurance loss performance testifies to the overall accuracy of the credit information.

Several studies are referenced that show very low error rates for credit data. In fact there are much lower error rates than motor vehicle reports (MVRs), which are readily accepted and routinely used for auto insurance.

2. The Fair Credit Reporting Act (FCRA) permits the use of consumer credit reports for underwriting insurance. It gives consumers certain protections, including notification requirements, free access to their credit reports, and in the case of an adverse action based on a consumer report, correction procedures.
3. Specific credit variables and model scores are highly effective at predicting insurance loss ratio relativities.

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The Fair, Isaac study gives examples of five specific credit variables and how they are related to personal property and automobile insurance loss ratios. The credit information further separates insurance policies by loss ratio above and beyond the separation that is provided by the other rating variables that are commonly used. The actual model scores also are very effective at predicting loss ratio relativities. Fair, Isaac commissioned Tillinghast-Towers Perrin to validate the relationship. (1996 paper, appended to NAIC white paper.) The general statistical techniques are well known but the exact models are proprietary.

4. Statistical models do not determine causality. Statistical techniques demonstrate statistical relationships, but do not determine causal relationships. But in other fields, such as medicine, the discoveries of statistical relationships have been considered valuable and useful, even without the establishment of causal relationships. One can speculate that those who manage their credit risk well also may manage their insurance risk well.
5. The Fair, Isaac scoring models are not unfairly discriminatory. In compliance with the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA), the Fair, Isaac scoring models avoid the use of many factors, including: income, location, nationality, net worth, race, color, religion, and disability.

A study by the American Insurance Association concluded that using insurance scores does not discriminate against low-income groups, and that insurance scores are not significantly correlated with income.

6. The use of Insurance Bureau scores (scores based on Fair, Isaac models) enables insurers to improve the speed, objectivity, and consistency of their underwriting.

Insurance Bureau scores are used by many insurers in the United States and Canada. Insurance Bureau scores are widely available, so they enable insurers of all sizes to use credit

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information with efficiency, objectivity and consistency. Because they are objective, their use can eliminate subjective human judgment.

Scores can be used for the following multiple purposes:

- Underwriting evaluation for various insurance programs;
 - Sales management (for example, by monitoring the average scores by agent);and
 - Management information (for example, monitoring changes in average scores).
7. Credit scores, unlike Insurance Bureau scores, were developed to predict credit risk and are not appropriate for the purpose of predicting insurance risk.

Review and Discussion of Major Points and Conclusions

1. The accuracy of credit data should not be a matter of concern.

This conclusion is based on studies by Arthur Andersen (for the Associated Credit Bureaus), TransUnion (a credit report company), and a comparison with the accuracy of motor vehicle records (MVRs), which was evaluated in a study by the Insurance Research Council.

There are many ways to evaluate the accuracy of credit data and these studies are just a few. It is unclear in the TransUnion study, for example, how many important credit report inaccuracies might have gone undisputed.

Further, the error rates measured by the credit data studies and the MVR study are not directly comparable. Fair, Isaac states "In view of the error rate of MVRs, the credit report error rate should not be an issue," but this seems to be too strong a conclusion.

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2. FCRA permits the use of consumer credit reports for underwriting insurance, and gives consumers certain protections, including notification requirements, free access to their credit reports, and in the case of an adverse action based on a consumer report, correction procedures. Evaluation of the legal ramifications of the FCRA is outside the scope of this review.
3. Specific credit variables and model scores are effective at predicting insurance loss ratio relativities. The Fair, Issac study provides many results (statistical relationships), showing that both individual credit characteristics and insurance scores are closely related to loss ratios. However, little or no in-depth data analysis is directly included in the paper, and therefore it is not possible to comment on the validity of these results. For example, Fair, Issac's conclusions regarding loss ratios are based on the implicit assumption that all other elements of the rating structure are correct, meaning that all groups of consumers would have identical loss ratios if it were not for their different credit scores. To the extent that there are overcharges and undercharges in the rating plans (due to factors other than credit rating), this could distort the indicated credit score differentials. There is also a potential for distortion due to the fact that not all companies use the same rating plan or have the same overall loss ratio. These possibilities would have been explored more carefully in a more in-depth study.
4. Statistical models do not determine causality. This is an appropriate conclusion. It should not be necessary to demonstrate causality. Actuarial Standard of Practice No. 12 states that causality cannot be required for risk classification systems. It is sometimes impossible or impractical to prove cause-and-effect relationships. Risk classes should be neither obscure nor irrelevant, but they need not exhibit a cause-and-effect relationship.
5. The Fair, Isaac scoring models are not unfairly discriminatory. The Risk Classification Subcommittee accepts Fair, Isaac's statement that its models do not use certain factors

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including income, location, nationality, net worth, race, religion, and disability. There is no way for the subcommittee to verify this statement without reviewing Fair, Isaac's models. However, this statement cannot be generalized to other models that are in use. Also, the paper does not address the question of whether or not any of the credit variables used, or the overall insurance score, might be a surrogate or a proxy for any prohibited factor or factors. Our subcommittee has not reviewed the study by the American Insurance Association that is cited by Fair, Isaac.

6. The use of Insurance Bureau scores (scores based on Fair, Isaac models) enables insurers to improve the speed, objectivity, and consistency of their underwriting. The Insurance Bureau scores most likely enable insurers to improve their underwriting in this way, but no evidence is presented to indicate that insurers use the Insurance Bureau scores in an objective and consistent manner.
7. Credit scores, unlike Insurance Bureau scores, were developed to predict credit risk and are not appropriate for the purpose of predicting insurance risk. Although this was not a major point in the Fair, Isaac study, the distinction between credit (lending) scores and insurance scores is important. The study does not present any information about the relationship between credit scores and insurance scores.

Summary Review of Paper

This study, by a prominent provider of insurance scoring models, is a response to issues that have been raised by insurance regulators and others in regard to the use of credit history for insurance underwriting. It provides a comprehensive review of these issues, but does not provide any in-depth analysis or discussions of the underlying insurance scoring models. It has the following strengths and weaknesses:

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Strengths

- The study provides a good practical description of how and why insurance companies use insurance scores.
- The study discusses issues of concern, such as causality, data accuracy, FCRA, discrimination, and the difference between insurance and credit scores.
- It provides understandable results showing how loss ratios are related to credit variables and insurance scores.

Weaknesses:

- The study provides little description of the underlying data analysis.
- It does not provide any multivariate analysis, to determine if credit history might be essentially replacing another variable.

Use of Credit Reports in Underwriting

Virginia Bureau of Insurance (1999)

Study's Major Points and Conclusions

1. Approximately 50 percent of auto insurers and 60 percent of homeowners insurers responding to the Virginia Bureau of Insurance survey use some form of credit scoring with new business underwriting, representing 36 percent and 49 percent of the respective market shares in Virginia.
2. Of the insurers using credit history, roughly 30 percent may decline new business solely on credit history, and one percent may non-renew solely on credit history.
3. There is a statistical correlation between credit score and policy loss performance.
4. Credit scoring is an ineffective tool for "redlining" because income and race alone are not reliable predictors of credit score.
5. The level of consumer complaints involving the use of credit reports is very low (less than one percent of all complaints). However, the Virginia Bureau of Insurance is concerned that the number of complaints, new business declinations, and non-renewals will increase as more insurers use credit reports.
6. Almost two-thirds of agents (63 percent) responding to a bureau survey were in favor of a law prohibiting insurers from refusing to issue or renew policies due to adverse credit reports.

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7. None of the credit variables used in the Fair, Isaac models appear to be unfairly discriminatory.

Review and Discussion of Major Points and Conclusions

1. Approximately 50 percent of auto insurers and 60 percent of homeowners insurers responding to the Virginia Bureau of Insurance survey use some form of credit scoring with new business underwriting, representing 36 percent and 49 percent of the respective market shares in Virginia. This conclusion was based on a survey of the following:

- A) Top 100 Virginia market share auto insurers (89 percent of the market responded).
- B) Top 100 Virginia market share homeowners insurers (82 percent of the market responded).

The conclusion is probably a reasonable estimate of what the market is doing. However, there may be a bias in responding. For example, companies using credit scoring as a potentially sole criterion for the acceptance or rejection of a potential policyholder may have tended to decline to respond. Also, since the actual survey is not part of the published paper, it is not possible to assess how to fully assess the responses. Also, it is difficult to project the findings forward in time to 2002, because companies have had more opportunity to respond to the marketplace and to decide how best to use credit history.

2. Of the insurers using credit history, roughly 30 percent may decline new business solely on credit history, and one percent may non-renew solely on credit history. (See comments regarding item 1)

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3. There is a statistical correlation between credit score and policy loss performance. This conclusion was based on company filings in which there was a proposal to use credit score as a factor in rating. The study includes no actual data, so it is not possible to comment on the quality of the supporting evidence. The fact that there were at least 50 survey respondents using credit history, who apparently submitted filings with appropriate support for the use of credit history, indicates that there is a correlation. The inclusion of some summarization of data seen by the bureau of insurance would have strengthened this study.

4. Credit scoring is an ineffective tool for “redlining” because income and race alone are not reliable predictors of credit score. This conclusion is based on the following:
 - A) TransUnion data apparently consisted of credit scores aggregated by Virginia ZIP codes and;
 - B) 1989 Census data by ZIP code apparently included average household income and racial mix.

The data is reviewed on an aggregate basis, by ZIP codes, and there is no attempt to match the credit scores of individual consumers with their income and race. As with item 3 the paper does not include any of the supporting data, so it is not possible to comment directly on the conclusion. The level of consumer complaints involving the use of credit reports is very low (less than one percent of all complaints). However, the Virginia Bureau of Insurance is concerned that the number of complaints, new business declinations, and non-renewals will increase as more insurers use credit reports. This conclusion is based on telephone and written complaints received by the Bureau’s Property and Casualty Consumer Services Section during a five-month period, March to August of 1999.

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The implication is that the insurance buying public does not perceive a problem. Less than one percent of complaints seems low, but as the bureau indicates in the study, there is insufficient information to conclude whether or not this level will be maintained.

Furthermore, even if the level of complaint increases significantly, it will be difficult to assess what it means because using credit reports will, by design, adversely affect a significant number of consumers.

5. Nearly two-thirds of agents (63 percent) responding to a bureau survey were in favor of a law prohibiting insurers from refusing to issue or renew policies due to adverse credit reports. This conclusion is based on a survey of 1,129 agents.

It is not clear that the 63 percent is representative of agents in total. Because of this there may be a greater tendency for the strongly opinioned to respond to the survey. For example, since it is not stated in the paper exactly how the survey was conducted, it is not known to what degree there was follow-up with the non-responding agents.

6. None of the credit variables used in the Fair, Isaac models appears to be unfairly discriminatory. The basis for this conclusion is not clear. There was at least one interview with representatives of Fair, Isaac, and the study seems to contain the suggestion that the Bureau was allowed to see the actual list of credit variables used by Fair, Isaac.

It is not possible to verify this conclusion, because its basis is unclear. Further, the conclusion appears to apply only to Fair, Isaac models and there is no information regarding the variables used in other insurance scoring models.

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Summary Review of Study

The Virginia Bureau of Insurance (1999) draws some significant conclusions about the use of credit history in the underwriting of auto and homeowners insurance in Virginia. These conclusions are based upon data from rate filings and TransUnion, and several surveys implying reliability and thoroughness.

Because the paper includes only a limited amount of the data, however, it is difficult for readers to assess the validity of the conclusions. The inclusion of some summarized data displaying the correlation between credit score and loss performance, and data supporting the ZIP code analysis, would have strengthened the study.

Recommendations Regarding a Study by the NAIC

Causality

The NAIC asked that the subcommittee provide advice for how the NAIC could conduct a study to determine causality between credit history and risk of loss. The Risk Classification Subcommittee does not recommend that the NAIC conduct a study to determine if there is a *causal* relationship between credit history and future insurance claims experience, because in our opinion it would not be possible to prove a *causal* relationship. The NAIC could conduct a study to evaluate the strength of any *statistical* relationships between credit history and insurance claims experience. In the subcommittee's opinion, any finding of *causality* in any context or field of study is a statement of a *theory* or *conjecture* based on the observation that there is a strong statistical relationship between the "cause" and the "effect."

If the NAIC chooses to develop opinions about the relationships that may exist between credit histories and driving record, we recommend that the NAIC consider that both credit history and insurance claims experience may be manifestations of one or more other personal characteristics. For example, the frequency of a person becoming momentarily inattentive might be highly correlated with both credit history and with driving record. Alternatively, perhaps one or more characteristics, such as aggressiveness, the willingness to take risks, or the ability to make quick judgments, are correlated with both credit history and with driving record. As far as we know, no one has identified which relevant personal characteristics might be correlated with both credit history and driving record, but it is not necessary to identify those characteristics to measure their impact. In our opinion, these personal characteristics would be difficult to identify and to directly measure otherwise, insurance companies likely would be using them in their risk classification systems.

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An effective risk classification system is one that effectively differentiates between groups of policyholders who will have different levels of loss experience in the future. Each criterion in the risk classification system should contribute to the ability to differentiate among different levels of future loss experience. The contribution of each criterion can be measured statistically. Although the NAIC did not ask the subcommittee to review the validity of using credit history as a rating tool for personal lines of insurance, the subcommittee's opinion is that credit history can be used to effectively differentiate between groups of policyholders. This opinion is based on review of the Monaghan paper and on our general knowledge of rate filings that have been submitted in many states.

Causality is not a requirement for any element in a risk classification system. For example, drivers with past accidents and driving violations have been shown to have higher rates of accidents in the future, and therefore driving record is a useful and commonly accepted element of risk classification systems for automobile insurance. However, histories of past accidents and violations do not *cause* driver to have more accidents. The rating practice that does exist is based on the fact that, as a group, drivers who have been accident-prone in the past are likely to be accident-prone in the future.

Impact of Credit-Related Insurance Rating for Policyholders without a Credit History

In regard to the protected classes as defined by the NAIC (race, religion, and ethnicity), the subcommittee understands that the NAIC may have a concern that certain groups traditionally avoid the use of credit, and that credit-related insurance rating and underwriting practices might therefore tend to cause affordability and availability problems for these groups because of the lack of credit history. To the extent that the NAIC has this concern, we recommend that the NAIC conduct a survey of insurance companies to determine how insurance rates and underwriting decisions are affected by a lack of credit history. Although some rating plans may

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adversely affect a consumer who does not have credit history, there are a number of rating plans that treat such consumers as “average” or “preferred” for eligibility and rating.

Absence of Conclusions regarding Disproportionate Impact of Insurance Rating based upon Credit-Related Factors

None of the four papers that the subcommittee reviewed contained the necessary information for us to evaluate whether credit-related insurance scoring results in a disproportionate impact for protected classes or for low-income policyholders. The Monaghan paper provides the most detailed analysis of the use of credit history, but the Monaghan paper is based on insurance data and insurance databases do not include information about race, religion, ethnicity, or income.

Only the Virginia study attempted any treatment of this subject. The results of that study included an indication that income and race are not reliable predictors of credit scores, but that study relied on aggregate data by ZIP codes rather than a rigorous analysis that matches the credit history and demographics of individuals.

Designing a Study to Evaluate Whether the Use of Credit History Disproportionately Affects Protected Classes or Low-Income Groups

The Risk Classification Subcommittee looks forward to providing assistance and commentary should the NAIC decide to undertake a study. The subcommittee role, however, will be limited to providing advice and guidance. The subcommittee would not undertake development of the actual study specifications, and it would not perform the analysis of the data.

The subcommittee considers this report to be the first step in providing such assistance, and provides this report with the understanding that there will be opportunities to provide additional assistance and commentary as the NAIC develops its plans.

Defining Study Objectives

We recommend that the NAIC define its objectives for any study that it intends to undertake, so that any potential study can be designed to meet its objectives as efficiently and effectively as possible. This includes, among other things, the following:

- Defining what is meant by “disproportionate impact”;
- Defining the magnitude that any disproportionate impact would need to reach in order to merit regulatory concern, if any;
- Deciding what further information, if any, would be needed if it is determined that there is a disproportionate impact; and
- Deciding how the protected classes and low-income consumers would be subdivided for analytical purposes.

Following is some discussion of each of these points:

We interpret “disproportionate impact” to mean that a rating tool results in higher or lower rates, on average, for a protected class, controlling for other distributional differences. We would expect that many rating tools would have disproportionate impact, because protected classes (and all other classes) are likely to have different demographics than the general population. For example, if any protected class has a younger average age than the general population, the use of age as a rating variable would have a disproportionate impact on that class (resulting in higher rates, on average). As another example, to the extent that lower-income families are less likely to own expensive cars, charging lower premiums for less expensive cars will have a disproportionate impact on low-income drivers (resulting in lower premiums, on average.)

Disproportionate impact is different from *disparate* impact. *Disparate* impact is a concept that

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has been widely discussed in the context of federal civil rights legislation. This is outside of our area of expertise, but we understand, for example, that a hiring practice is said to result in disparate impact if it results in substantial disproportionate impact and there is not a business necessity for the practice. Thus, disparate impact is determined using a two-step process, and the determination of disproportionate impact against members of a protected class is only the first step of that two-step process.

While designing a regulatory study, a primary consideration should be the potential usefulness of its results. This requires that there be some determination, prior to the study, of the magnitude of disproportionate impact that would trigger regulatory concern. The decision regarding the magnitude would then influence the size of the population that would need to be sampled in order to generate statistically significant findings.

In designing a regulatory study, it will be important to decide what further information, if any, would be needed if it is determined that there is a disproportionate impact of a magnitude sufficient to trigger regulatory concern. For example, a study that only estimates *disproportionate* impact will not necessarily tell whether there is *disparate* impact and it likely will not provide sufficient information for regulators to determine whether the disproportionate impact is in line with a disproportionate level of insurance losses for the affected protected class. If the NAIC found a material disproportionate impact on a given protected class, and wanted to find out if that disproportionate impact was consistent with insurance loss experience for that class, then the study would need to include the collection of insurance experience in addition to the credit and demographic information. When designing a regulatory study, it will be important to decide what categories of protected classes and low-income groups will be examined for disproportionate impact. The NAIC should identify which racial categories it will evaluate. The 2000 Census form identified the following five races:

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- White;
- Black;
- American Indian or Alaska Native;
- Asian; and
- Pacific Islander;

(The Census form also permitted the write-in of other races.)

The NAIC should identify which religions it will evaluate. Depending on how religious groups are defined, there could be many hundreds of different religions. For example, each “major” religion consists of many sects or denominations. The NAIC will need to define exactly which groups are important to the study. The NAIC should identify which ethnic backgrounds it will evaluate. Depending on how ethnicity is defined, there could be dozens or hundreds of ethnicities. The NAIC will need to define exactly which ethnic groups are important to the study.

The NAIC should define the low-income group(s) that it will evaluate. For example, the NAIC might decide to use the “poverty thresholds” used by the U.S. Census Bureau, which are defined based on the number of people in the family unit and the number of related children under the age of 18. Alternatively, the NAIC might decide to use a simpler measure, such as total family income regardless of family size and number of children.

Other Considerations

Depending on the objectives and design of the study, the NAIC may need to conduct the study for a *very substantial* population. Consider an example. Suppose that a protected class constitutes ten percent of an entire population. It follows that an unbiased sample of 5,000 would be expected to have about 500 members of the protected class. Depending on the standards of materiality and the degree of confidence selected, this might be an adequate

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sampling to determine whether or not an insurance rating system has a disproportionate impact on the protected class. But a sampling of the same size would be woefully inadequate to determine whether the degree of disproportionate impact was in line with loss experience, even if several years of insurance experience were available.

The data for this study would need to meet several standards, one that is objective and one that is subjective. Clearly, there would need to be a sufficiently large body of data so that indications of *material* disproportionate impact would be statistically reliable. If a disproportionate impact of five percent was considered to be material, then a larger body of data would be necessary to identify that difference than if a materiality standard of 25 percent was selected. The more difficult standard with which to comply, because it would be somewhat subjective would be keeping data unbiased. With a perfectly unbiased sample, statistical variation would be the only reason to expect that the results obtained from a sample population would be different from that of the entire population. Unfortunately, it may be very difficult and expensive to obtain data that will be sufficiently unbiased to satisfy decision-makers.

At this time, the Risk Classification Subcommittee is unaware of any proprietary or open public databases that contain the necessary protected class data to ascertain the existence of disproportionate impact. Unless suitable databases can be found and utilized, an NAIC study to estimate disproportionate impact would need to develop its own data.

Depending on the objectives of the study, and the availability of proprietary or open public databases, the NAIC may decide to conduct a study based on aggregated consumer data rather than on data that is at the level of individual consumers. In this case, we would recommend that the NAIC consider reviewing consumer data at the level of "ZIP + 4" rather than by ZIP code. The ZIP + 4 level of detail is more refined than the ZIP code level of detail, and therefore is likely to be more homogeneous in terms of its population.

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In addition to costs, the major hurdle would be to obtain the necessary credit and protected class information in a way that the study will not draw erroneous conclusions based on a biased sampling. Any procedure that relies upon individual consumers to reveal or release credit or protected class information is likely to encounter a lack of cooperation. The question that would then arise is whether or not the conclusions drawn from data on those consumers who did cooperate could be extended to the entire population.

Recommended Best Practices for Reviewing Rating Plans Based on Credit History

The subcommittee recommends that regulators should review rating plans that use elements of credit history using the same basic standards that apply for the review of any other rating factor or rating plan. The differences that regulators are likely to encounter are that:

- It appears more likely that insurance companies will request “trade secret” status for their models. The subcommittee recommends that such requests should be treated in accordance with the regulator’s standard procedures for dealing with requests for confidentiality for rate filings.

- The justification underlying the initial filing of an insurance rating plan using multiple elements of credit history is likely to be more complex than most rate filings that regulators will receive.

Consistent with practices with other newly filed rating plans, the regulator should expect a complete description of the rating model and how the model was developed, and justification for the selected criteria used in the model and for the rating factors that result from the model. If this is not provided with the original filing of the model, then the regulator wishing to analyze the model should ask for the explanations. As with other rate filings, small companies may sometimes submit filings based on rating plans of competitors, justifying their plan to use credit history by citing the plans used by one or more larger insurance companies. Regulators should treat such filings in accordance with their customary procedures for dealing with filings from small insurers with limited data.

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There are three main areas of additional concern when reviewing a rate filing containing a credit scoring model that regulators may wish to consider. The first concern is the potential complexity of the model itself and the relationships between the factors used in the model and the other factors used in the pricing process. The second concern is the insurer's use of the model results and whether the proposed model rating values are reasonably related to loss experience. The third concern is how the introduction of a credit scoring model or proposed changes to the model values affect the values of the other rating factors.

The first concern is the complexity of the model and the relationships between the various factors used in the pricing process. A filing of a rating model using credit history should contain the model or any changes to the previously filed model. While the actual model formulae vary widely by insurer and may be relatively simple or quite complex, a common feature of rating models using credit history is that they base their results on a number of different factors included in a risk's credit history. The use of multiple model factors necessitates not only a review of the individual factors and their influence on the model's results but also a review of the factors in combination. The reason for this is that some of the factors contained in these models may be interrelated.

An analysis of a single model factor will show whether that factor has relevance and will provide a weight to the factor. A model that uses the weights from individual factor analyses could yield too much influence on the premium structure, if the factors are interrelated. The weight given a factor is dependent on the relationship of this factor to the other factors in the model. The insurer should provide sufficient documentation as to the methods used to adjust the model when there are interrelationships among model factors.

The second concern is the reasonableness of the rating values associated with the credit scoring formula and the range of model results associated with each rating value. The proposed rating

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values should match or not exceed the indications from loss experience, with reasonable allowances for smoothing of results. The insurer should also provide sufficient loss experience to determine the reasonableness of the model ranges associated with each rating value and the relationship between the rating values and loss experience.

The third concern relates to the possible correlation of rating models using credit history with other rating factors used by the insurer. Such correlations could exist with any rating factor. For example, there is an indicated correlation with age, as credit tends to improve with age. As a result, some insurers only apply credit based models to persons over a specific age or adjust the model weight depending on age. These are only two of the possible solutions for handling correlation between different rating variables. There is also the possibility that these models may have differing effects upon policyholders in different rating territories. It may be useful to obtain the average impact of the proposed model on individual driver classifications and by territory. The regulator may wish to request statistical information on the correlations between the credit based model and the insurer's other rating variables, and how all the variables have been adjusted to handle correlations between rating variables, whether credit based or not. When a rating model using credit history is implemented, it should be done in such a fashion that each current rating classification has been considered in relation to the model.

In summary, the Risk Classification Subcommittee does not believe that models using credit history require the application of different regulatory standards than other rating plans using other traditional policyholder characteristics. The main differences in the treatment of such filings will probably arise from the necessity to examine interrelationships among so many rating variables and the complications that these analyses will entail.

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Risk Classification Subcommittee

The Risk Classification Subcommittee of the American Academy of Actuaries was re-established in May 2002 for the purpose of assisting the NAIC's Credit Scoring Working Group.

The subcommittee consists of the following volunteers and staff:

Chairman: Walter Wright, MMC Enterprise Risk Consulting, Inc.

Members: Leo Bakel, State Farm Insurance Companies
James Monaghan, MetLife Auto and Home
Chet Szczepanski, Pennsylvania Insurance Department
Rae Taylor, Oregon Insurance Division
Alan Wickman, Nebraska Department of Insurance
Pat Woods, Insurance Services Office, Inc.

Affiliate Member:

George Dieter, Travelers Insurance Company

American Academy of Actuaries Staff:

Greg Vass, Senior Casualty Policy Analyst

The subcommittee appreciates the opportunity to provide assistance to the Credit Scoring Working Group.

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**Testimony on Insurance Credit Scoring
Before the House Insurance Committee
By Larry Magill
Kansas Association of Insurance Agents
March 13, 2003**

Thank you Madam Chair and members of the committee for the opportunity to appear today in support of Senate Bill 144. I am Larry Magill representing the Kansas Association of Insurance Agents. KAIA was formed in 1992 by the merger of the Independent Insurance Agents of Kansas and the Professional Insurance Agents of Kansas. We represent 425 independent agencies with 150 branch locations and approximately 2,500 employees, most of them licensed agents. As agents, we are in the forefront of explaining credit scoring to consumers and deflecting their anger in those instances where they learn that they are being charged two and three times what they had been paying because of a credit score.

Last year, KAIA requested introduction of Senate Concurrent Resolution 1623 creating a task force to study credit scoring. We hoped that it would allow meaningful discussion of appropriate regulation of credit scoring among all the stakeholders: the legislature, the Department, agents, insurance companies and consumers during the interim, and it did.

We commend the work of the Credit Scoring Task Force lead by Mike McGrew and with Senators Teichman and Feleciano representing the Senate and Representatives Boston and Garner for the House. The staff of the insurance department did a superb job providing voluntary support for the study and the report is an excellent beginning. Commissioner Praeger's legislative staff, almost all new since the inauguration and with very little time, has pulled together an excellent beginning bill, based on the NCOIL (National Council of Insurance Legislators) model.

Why Regulate Credit Scoring?

Consumers understand and accept the relationship between a bad driving record, their MVR, claims, teenage drivers and the other factors historically used by the industry to rate automobile insurance but have a much harder time understanding a "credit score" and its relevance. That is especially true when a bank agrees to lend them hundreds of thousands of dollars to buy a home but an insurance company refuses to insure or treats them as substandard for a score the company can't or won't explain and the consumer doesn't understand. It is particularly confounding to the consumer when the same insurance company rates them as "preferred" for auto insurance but "sub-standard" for homeowners.

De facto Rate Deregulation for Personal Lines

Credit scoring and multiple tiered rate structures of insurance companies have allowed some consumers' insurance rates to skyrocket, at times doubling or more, when normal base rate increases would never have been allowed to increase that much. In other words, while base rate increases, those that require prior approval of the Insurance

Department, may increase 10 to 15%, an individual consumer's cost can now increase 100% because of their credit score. A member called me last November to tell me that she had a client's homeowners insurance premium increase from \$718 per year to \$2,250 per year due to their credit score. I believe this particular insurer had recently implemented a 9 tier homeowners rating system.

Plus credit scoring has had another effect on a consumer's ability to shop for insurance. Where agents once could use comparative rating software and rate a consumer with every company they represent, they can't any longer. Each insurer may use a different credit scoring algorithm and credit scoring service and the agent has to individually rate and score the consumer with each carrier. It's a slow, time consuming and expensive process.

No Issue of Greater Concern to Our Members

Based on the huge response to our fax-back survey in November and the calls and comments of members, no other issue carries as much importance for our members and creates more "heart burn" for them in dealing with their customers. We sent a fax-back survey to our members on November 11th, and within days had over 147 responses from a single request. That is 35% of our membership and a phenomenal response. They overwhelmingly support seeking reasonable statutory or regulatory control over credit scoring in Kansas.

I've also been encouraged by the interest shown the issue by legislators who have been contacted by constituents upset over credit scoring. Many of them heard about it while campaigning last fall.

KAIA Survey Results

Attached to my comments is a copy of the survey results. These survey results will likely differ significantly from what insurers and credit scoring companies will tell you happen. But this is the real world.

Note the number of "always" responses to questions 3, 4 & 5. Agents are very frustrated by their inability to explain to the consumer how the scores are determined or how the consumer can correct the problem. It isn't as simple as "don't speed"!

Look at the number who said insurance companies never notify consumers of the fact that a score will be obtained or that their score caused their premium to increase. 67% of our members indicate that insurers only notify consumers that a score will be obtained "some" or "never". 68% indicate that only "some" or "never" is the consumer told that their score resulted in a higher premium. Even given the possibility that agents aren't aware of what companies are telling the agents' clients, this is appalling.

Note the answers to question 12, 60% of the time credit score is "always" or "frequently" the only factor considered.

State Activity Sweeping the Country

Last fall the Kansas Insurance Department provided the NAIC's Compendium of State Laws on Credit Scoring as of May, 2002 and it showed that most states have either passed regulations or laws dealing with credit scoring. It shows that 32 states considered legislation last session and testimony given by the Alliance of American Insurers to the task force indicated that eight states had passed legislation: Arizona, Colorado, Idaho, Maryland, Minnesota, Missouri, Rhode Island and Washington. Roughly 30 states, according to the NAIC, have specific references to credit reports either in statute or regulation now. Kansas is not one of them.

Our National association has monitored results in all 50 states as well and this continues to be the hottest topic discussed at our IIABA State Legislative meetings. My guess is that legislation would have passed in far more states last session, but independent agent associations held off making a "full court press" to see what develops from the industry as a compromise.

KAIA Amendments to Substitute for SB 144

When the Senate worked this bill, KAIA participated in discussions with the insurance companies and the Insurance Department and agreed to the compromises that led to Senate Substitute for SB 144. Like any good compromise, there's a lot that we're not that happy about but it's an important start for the Department and a huge improvement over the present.

Why an Appeal Process is Important

One of the compromise elements in Substitute for SB 144 is the requirement that the insurers offer an appeal process, that they file it with the Department and grants them some immunity for making exceptions to their rating plan by ignoring a credit score if it can be shown that there are extenuating factors.

For example, the models don't take into account the value of a home relative to the mortgage amount. A low mortgage balance compared to the home's value is not a plus and yet being a smart consumer and refinancing your home to take advantage of lower interest rates is a minus due to length of credit relationship and loan balance compared to original loan amount. In addition, in this example, you may only owe \$100,000 on a \$200,000 house but for scoring purposes they will "ding" you for not having paid down much of the re-financed mortgage. Or if you decide to finance your carpet purchase with a Home Depot charge account to obtain an additional 10% savings on a large purchase and then close out the account, they will "ding" you for activity, "ding" you for number of credit accounts, and probably "ding" you for canceling the card once the carpet is paid off.

Some small town banks will not report credit because of the "close" nature of the community and the fallout that may occur from a negative credit report. They have to report the "bad" if they want to report the "good" so they don't report any of it. This means for those individuals that have good credit histories, they don't receive the benefit.

Another example is someone using a credit card that awards frequent flyer miles. The consumer has a large balance each month relative to their credit limit but pays it off each month. Nevertheless this is a negative because of balance compared to credit limit.

A final example involves a large group of aircraft owners. They pay collectively about \$200,000,000 annually to insure their planes and the agency handling the group last year had total bad debt expenses of \$18,000, or 0.009%. Yet the company recently canceled a cross-selling homeowners program for this group of consumers because most of them had bad credit scores. Obviously this is a high-income group with correspondingly high debt, but not bad credit risks.

“Safe” Annual Recheck

Another of the changes we obtained from the NCOIL draft was a provision that a consumer can ask for the carrier to re-score them once a year without risk of it triggering an increase in premium. Since consumers aren't given the details of how their score is determined, they could never be sure that their score had improved, even if they had taken steps to improve it. This allows them to request re-scoring without having to play “Russian Roulette” with their insurance costs.

Farmowners Included

We felt that the act should apply to family farms and succeeded in adding farmowners to the definition of personal insurance for the purposes of this act. We are agreeable to a further clarification of the intent to just include farmowners coverage within the personal insurance definition that Farmers Alliance has requested.

Other Changes

The effective date was moved up slightly to January 1, 2004, the refusal to quote was added as a trigger for the act to clarify that an application doesn't have to be submitted to involve the act and specific penalties were incorporated by referencing the Adverse Underwriting Decisions act.

Summary

Other than the change to “farmowner”, a term-of-art in insurance, we do not support any other amendments to the bill.

We started this process with the hope of working through all these issues and coming to consensus on legislation that wouldn't prohibit credit scoring but would moderate its worst effects. We think Substitute for SB 144 is a worthy effort in that regard. We urge you to pass the bill out favorably.

We would be happy to respond to questions or provide additional information. Thank you for your time and attention to this issue.

KAIA Member Credit Scoring Survey

Dear KAIA Member:

As a result of KAIA's successful lobbying efforts last legislative session, SCR 1623 was passed calling for the creation of a Task Force to study credit scoring and report back to Legislative leaders in January.

The Task Force has met twice, once to organize its work and once to hear from insurance companies, credit bureaus and credit scoring companies. KAIA will offer our input on November 25th at its next hearing where they expect to hear from the public on credit scoring.

Please take a few minutes and complete the enclosed survey and fax it back. Of course, any additional information you want to send along, such as actual examples, would be very helpful. We all know credit scoring can be a huge problem for agents, but just exactly what would you want changed? Here's your chance to tell us.

	Yes	No
Do you think KAIA should propose regulations that control the use of credit scoring for purposes of automobile and homeowners insurance?	134	15
On average, do you think your lower income clients have as good a credit scores as your higher income clients? Please elaborate: _____ _____	48	99
Have you felt that people in certain areas of town fall into predictable credit score ranges and therefore insurance price ranges? _____ _____	73	72

How often have you experienced any of the following:	Always	Frequently	Some	Never
1. Vastly different scores and treatment for the same customer for homeowners and automobile insurance based on credit scores?	4	58	69	16
2. Significantly different scores within a short time period for the same consumer?	0	32	81	29
3. Inability to explain to the consumer why their credit score is what it is?	47	60	34	10
4. Inability to explain to the consumer how they can improve their credit score?	44	49	37	17
5. Inability to explain the credit scoring process to the consumer?	45	51	36	18
6. Insurance Companies notifying consumers of the fact that a score will be obtained?	20	27	56	43
7. Insurance Companies notifying consumers that their score resulted in a higher premium than the consumer would otherwise have qualified for?	7	41	42	58
8. Thin files where consumers lack enough credit history to have as good a score as they would otherwise have?	7	76	57	7
9. Medical problems that caused a poor credit history?	8	32	80	25
10. Delays for your customers to obtain a copy of the information causing the poor credit score once requested by the consumer?	11	28	54	44
11. Errors on your customers credit score or the information used to develop the credit score?	2	19	78	36
12. Instances where the only criteria considered by the insurer was the credit score?	16	75	38	22

If possible, please attach copies of documents that would be helpful in making your points. All personal information should be blacked-out and KAIA will keep any identifiable personal information confidential. **Please fax back to KAIA at 785-232-6817.** Thank you for your help.

Name _____ Agency _____

Phone _____ Email _____

4-5



214 SW 6th St., Suite 206
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785-357-5256
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**TESTIMONY BEFORE THE
HOUSE
INSURANCE COMMITTEE**

TO: Representative Patricia Barbieri-Lightner, Chairwoman
And Members of the Committee

FROM: Martha Neu Smith, Executive Director

DATE: March 18, 2003

RE: Sub.SB 144 – Insurance Credit Scoring

Madam Chair and members of the Committee my name is Martha Neu Smith and I am the executive director of the Kansas Manufactured Housing Association (KMHA). KMHA is a statewide trade association representing all facets of the manufactured housing industry.

Thank you for the opportunity to comment.

While KMHA is registered as an opponent to Sub. SB 144 our true opposition is to the use of insurance credit scoring. Let me explain why.

First, the fact that there is no way for a consumer to find out what an insurance credit score measures, because the way they are calculated is a "trade secret". Second, the insurance credit score is calculated based on information found on an individual's credit report, which has been known to contain inaccurate information on a regular basis. And third, how can we be sure insurance credit scoring is not being used to discriminate against a certain segment of today's society?

Fundamental to the discussion of auto and homeowners insurance is recognizing the essential nature of these products. Being able to drive means you can commute to a job, go to a grocery store, take your kids to school or the doctor – essentially, driving means you can function in the Kansas economy. Not to mention, Kansas' law requires auto liability insurance.

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Mortgage lenders require homeowners insurance. In addition to paying the note and taxes, homeowners insurance is a requirement for virtually all mortgage agreements. Homeowners insurance is the way families assure themselves they have a place to live should they experience a catastrophic event like a fire or severe storm. More fundamentally, it is the way families protect their single most important asset – their home and the equity they have accumulated in it.

There are only a handful of products and services that have similar importance to families as auto and homeowners insurance. That is why the availability and cost of these products have been the subject of state regulatory oversight for years.

By now I am sure you have heard what insurance credit scoring is all about. An insurance credit score is determined by running information found on your consumer credit report through a secret insurance industry formula. Other entities like banks and mortgage companies also use credit history to determine credit worthiness, but the lending credit score is not the same as an insurance credit score. The insurance industry has created their own way to compute a credit score, and they have kept the formulas top secret. For the consumer this is like being required to play a game, but never given the rules. How can the consumer possibly win?

Not knowing the elements of the formula only makes consumers more suspicious. Claiming confidentiality, the data insurers say justify the use of credit scoring and the factors are not released to the public – the claims of confidentiality undermine consumer confidence. More importantly, for essential kinds of insurance coverage like homeowners and auto insurance, it is unacceptable that insurers hide behind a claim of confidentiality.

The second reason KMHA is opposed to the use of insurance credit scoring, is the issue that your score is based on information contained in your individual credit reports that may or may not be accurate. Several organizations have conducted studies and surveys to measure the frequency of credit report errors. The results:

A 1998 study by the Public Interest Research Group called Mistakes Do Happen found that 29% of the credit report reviewed contained serious errors that could clearly result in the denial of credit or other benefits. For this study, “serious” errors would include: accounts that are incorrectly marked “delinquent”; credit reports that contained credit accounts that do not belong to the consumer, and reports listing public records or judgments that belong to someone else.

Consumers Union conducted two surveys on credit reports in which consumers were asked to review their credit reports for accuracy. The 2000 survey found that more than 50% of credit reports contained inaccuracies with the potential to

result in a denial, or a higher cost of credit. The errors included mistaken identities, misapplied charges, uncorrected errors, misleading information, and variation between information reported by the various credit repositories.

The Consumer Federation of America also conducted an analysis and found similar problems with accuracy. What I haven't found is a study by anyone that demonstrates the accuracy and dependability of information contained in credit reports.

Again, another reason KMHA would like insurance credit scoring banned

Third, how can consumers be sure that insurance credit scoring is not being used to discriminate against a segment of society? I realize that SB 144 requires the insurers to file their methodology with the Insurance Department; however, by just examining their methods will not produce proof that insurance credit scoring doesn't discriminate. Only through full disclosure or the constant collection and close examination of data will reveal any flaws in the system.

For example the State of Maryland did a study on the impact of credit scoring on lower-income or minority consumers. The study examined two zip codes, one low-income, higher minority, the other, high income, and low minority.

In examining the credit score distributions of the two areas, not surprisingly, the lower income area had a higher occurrence of lower scores, and fewer higher scores. The study points out the problem that insurance credit scoring creates for those who may already have difficulty affording insurance and supports arguments that insurers use credit scoring as a way to identify higher income customers. (Attached)

Another example of why an insurer filing their methodology is not enough can be seen in what happened in the State of Hawaii. Hawaii essentially prohibits the use of credit information in the underwriting of auto insurance, however, in the April 3 edition of the Honolulu Advertiser, it was announced that seven auto insurers recently agreed to pay more than \$115,000 in fines for illegally using criteria (including credit histories) barred under state law. The announcement followed a department investigation that began in August 2001. The companies fined represent nearly 2/3 of the auto market, and the fines ranged from \$5500 to \$40,000. Fines against four additional companies are still pending resolution, and the department has suggested that it might seek fines for each policy violation if insurers dispute the initial fines.

These are our reasons for opposing insurance credit scoring, however, it is clear that the use of insurance credit scoring is not going to be eliminated so regulation is the next step. Sub. SB 144 provides the Insurance Commissioner the authority to regulate the use, however, KMHA would make the following suggestion to improve the bill:

- Exclude the use of guaranteed business debt, provided it is coded as such
- Exclude the use of information related to identity theft
- Clarify that insurance credit scoring cannot be the sole reason in underwriting or rating risk. This point is not clear after reading page 4, line 41, the bill states "*if an insurer takes an adverse action based upon credit information...*" and again on page 5, line 7 "*an insurer shall provide a procedure whereby a consumer may review an adverse action based on credit information.*"
- Direct the Insurance Commissioner to conduct a study on whether the use of credit scoring has an adverse impact on any demographic group and submit it to the 2005 Kansas Legislature

I respectfully ask you to consider the above changes with respect to Sub. SB 144. Again, thank you for the opportunity to comment.

Attachment

Maryland Department of Insurance Findings

This information is compiled in the Maryland Insurance Department's Use of Credit History by Insurers by Steve B. Larsen in 2002.

I'll let these numbers speak for themselves.

Exhibit D - Demographic Data on Credit Scores, Race, and Income

Zip Code	21210	21217
Median Household Income	\$45,998.00	\$14,813.00
Population Composition		
White	12,002	3,665
Minority	265	48,072
Average Insurance Premium	\$972.00	\$1,357.00
Credit Ranges		
297-600	7.6%	31.4%
601-700	35.4%	43.6%
701-825 (The "700 Club")	45.7%	18.2%
826-997	11.5%	5.6%



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Greater Topeka, Douglas, Flint Hills
and Riley Counties

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Kansas House Committee on Insurance Testimony on Subst. SB 144 March 18, 2003

I am Karen Hiller, Executive Director of Housing and Credit Counseling, Inc., a Kansas nonprofit that provides tenant-landlord, consumer credit and homebuyer counseling and education services through four offices in northeast Kansas and statewide.

Housing and Credit Counseling, Inc's position on this bill is in opposition. Before I explain why, please let me give you kudos for addressing this practice. The practice of using credit scoring for setting auto and homeowners insurance rates is a very significant one for consumers in Kansas.

After consideration of how the practice of insurance credit scoring could be effectively regulated, HCCI has concluded that it is impossible to fairly regulate.

The bill before you has many exceptions to provide protections to the innocent, but each one is impossible to apply fairly. For instance, is the protection for medical bills just for debt owed directly to the medical community...or for any debt incurred within 2 years of the medical event? Do we want people to pay other bills and not pay medical to protect their insurance rates?

Housing and Credit Counseling, Inc. has a Consumer Credit Counseling Service division that assists over 2000 Kansans per year who have credit problems and want to get out of debt with dignity without going bankrupt. These are not deadbeats, they are not "users" of "the system". Our sister CCCS in Salina/Wichita assists a similar number per year. 100% of these clients - 4000 Kansans per year, plus another 2000 from prior years that are in long-term debt repayment programs - are ALL people who are harmed by this practice.

The practice of using credit scoring is costing these Kansans' insurance rates to be as much as doubled -- \$1000 per year per household in additional insurance premiums for many - money that is desperately needed to pay bills, buy school lunches, and repair cars.

You have and will receive other excellent testimony about various aspects of this issue.

Let me see if I can "put a face" on this story by telling about just one HCCI client - Marilyn.

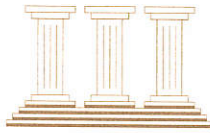
Marilyn could easily be anyone's daughter or friend, her children anyone's beloved grandchildren. When Marilyn came to our office in Topeka, she was 24 - young, attractive, cute and well-behaved 4 and 5 year old children, recently divorced. Marilyn had married young, just before she turned 18, and had made many young, foolish errors with money management. After 6 years of marriage, she had realized that the marriage would not work, that her husband would not take responsibility for any of their debts. She alone would have to restart her life, and work to overcome her obstacles and

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achieve her goals. She was determined to raise her children right, and she wanted to buy a home. She came to CCCS for help. Her bills were so much higher than her income that the counselor advised her of her various options, but shared with her that he didn't see how she would be able to pay off on her own. Marilyn went home, determined. She had already cut everything she could. Then she cut more. She cut off her phone and cable service. She rented out a room to her brother. She took on housecleaning jobs. She came back. We set up a repayment program for her. Today, only 5 years later, she is debt free and owns her home. She is a success.

Why should people like Marilyn be charged higher insurance rates? We are not talking about just a few, we are talking about thousands.

Thank you for your time and attention. I would be happy to address any of the issues I have mentioned, or address other aspects of this legislation.



KANSAS TRIAL LAWYERS ASSOCIATION

Lawyers Representing Consumers

TO: Members of the House Committee on Insurance

FROM: Barb Conant
Kansas Trial Lawyers Association

RE: 2003 SB 144/Insurance Credit Score

DATE: March 18, 2003

Chairman Barbieri-Lightner and members of the House Committee on Insurance, I am Barb Conant, director of public affairs for the Kansas Trial Lawyers Association (KTLA). KTLA is a statewide, nonprofit organization of lawyers who represent consumers and advocate for the safety of families and the preservation of the civil justice system. We appreciate the opportunity to express our opposition to SB 144.

As advocates for consumers, KTLA monitors national consumer issues as well as those that impact the civil justice system. As legislative and public awareness about the practice of insurance credit scoring has grown, consumer groups and state regulators across the country have sounded alarms about the risks that the practice of insurance credit scoring places on consumers. Those alarms concern the secret process under which credit scores are calculated which leads to discrimination and does not assure consumers that their insurance credit scores are accurate or fairly applied. For those reasons we oppose SB 144.

No one disagrees that credit information is extremely sensitive data. It is a reflection of our reputation, our trustworthiness and deserves our most diligent protection. Most Kansans are not aware that insurance companies are using their data to set the price of their homeowners' and automobile insurance. They probably won't be aware of the practice of credit scoring until they are denied coverage or are faced with a huge increase in their premiums.

If legislation is passed in Kansas to allow the practice of insurance credit scoring, it should provide Kansas with strong consumer protections and should demand public disclosure of insurance credit score formulas and the factors considered in the calculation. SB 144 keeps the process secret, offers minimal consumer protections and does not include sufficient education requirements.

Currently, consumers are completely in the dark about the underwriting factors used by insurance companies to create a credit score. There is no way to know for sure what insurance credit scores measure because the insurance companies refuse to reveal this information. They claim that the equation is an accurate predictor of your insurance. But how does your credit history predict that you will be involved in an auto accident? How does your credit information predict that your basement will flood or your house will be damaged by hail?

Since the insurance credit score process is cloaked in secrecy, we cannot be sure that the insurance credit scores are not being used to discriminate against certain groups of people. At particular risk of being harmed by the practice are senior citizens, minorities, small business owners, people with little-to-no

Terry Humphrey, Executive Director

credit history, victims of identity theft, people who have been laid off, divorced and those who have had a medical catastrophe. These are individuals who may use cash instead of credit cards, have never taken out a large loan or who have been forced to depend on credit to meet their family's financial needs.

Since the insurance credit score process is cloaked in secrecy, we cannot be sure that the information used is accurate. The U.S. Public Interest Research Group (PIRG), a state-based non-profit, non-partisan, consumer and environmental watchdog group, has studied the accuracy of consumer credit reports. In its most recent report, *Mistakes Do Happen*, PIRG found that 29% of credit reports surveyed contained errors serious enough to cause the denial of credit, insurance, employment or other benefits. Consumers Union, publishers of *Consumer Reports Magazine*, found similar results in its studies.

Since the insurance credit score process is cloaked in secrecy, detecting errors can be difficult at best. When errors are discovered, there should be a process in place for consumers to appeal the decision of the insurance company. The appeals process contained in SB 144 is weak and only codifies the current practice of appealing through the insurance company.

Since the insurance credit score process is cloaked in secrecy, consumers are uninformed about how their personal information is used, how it relates to the likelihood that they will file a claim or exactly how the credit score affected their insurance premiums. SB 144 only requires an insurance company to disclose to consumers that it **may** use credit information in determining rates. It does not require the insurance company to publicly educate consumers about the practice or its use. More importantly, when a credit score adversely affects a person's premiums there is no requirement that the consumer be given adequate information or educated about its impact.

If legislation is passed in Kansas to allow the practice of insurance credit scoring, it should include strong enforcement mechanisms to assure that the insurance companies comply with Kansas law. Not only does SB 144 not contain enforcement provisions, it expressly denies consumers a private right of action. Enforcement should include requiring insurance companies to make public the models, factors and criteria used in determining the scores. Under SB 144, insurance companies are only required to file that information with the Insurance Commissioner. There is not requirement that the information be analyzed or audited by the Department of Insurance to guarantee that it is being used appropriately and fairly. There are no penalty provisions in SB 144 for companies which do not comply with Kansas law.

There are many questions and concerns surrounding the practice of insurance credit scores. We are just beginning to become aware of a practice that seems to defy common sense. Until the process behind the practice is open for public scrutiny, consumers cannot be sure that their best interests are being protected. SB 144 maintains the secrecy that creates our questions and our distrust about the practice. Until that cloak of secrecy is removed, we cannot be assured that consumers are well protected and that financially vulnerable Kansans are not put at an additional risk. For those reasons, we urge the committee to oppose SB 144.

MARK AND FAITH LORETTO
1259 SW HIGH AVENUE
TOPEKA, KANSAS 66604
(785) 234-6297

March 18, 2003

Rep. Patricia Barbieri-Lightner, Chairperson
House Insurance Committee
Room 115-S
State Capitol
Topeka, KS 66612

Dear Rep. Barbieri-Lightner

I am writing to express my opposition to the current practice among some insurance companies of using credit scores as a factor in determining premium rates and to request a greater degree of accountability than is provided by SB 144. My recent experiences strongly suggest that this practice provides insurers with wide latitude to raise rates without any clear, reasonable explanation.

A month ago we received a renewal notice for one of the three vehicles we have covered by Farmers Insurance. (We have three older vehicles—the newest, a mid-90's Aerostar, is the only vehicle with collision coverage—and have had accident-free discounts for years. So compared to many families, I expect that we have relatively low auto insurance premiums.) An insert in the renewal notice indicated that we had received an "adverse" action with respect to our premium rates due to our credit rating. When I called my insurance agent's office, I was told that our credit rating had gone from a "C" to a "D" on an "A" to "Z" scale, and that we shouldn't be concerned because we were still in the top 5% of all credit scores. Nonetheless, the premium for that one vehicle would be going up \$36 per year due to this change in our credit rating. They could not tell me what specific factors in our credit history would have caused the change, and said I would have to contact the credit rating agency (TransUnion) to get our credit report in order to answer that question.

Once I received my online credit report and score, I could not discern anything in the records that would explain any reduction in our credit score. We only have a house mortgage (very low by today's standards), a home equity loan, and two credit cards on which we pay the entire balance each month. The entries in the credit history for all other accounts (both old, closed accounts and open, but unused accounts) indicated there are no balances at all. All the entries indicate that we have not had any late payments during any of the periods reported. I called the customer service line for TransUnion on two occasions for further explanations. I was told that they could not identify changes in our credit score or how Farmers used the information to downgrade their view of our credit rating, but was also told that we have a high credit score. On both occasions, the customer service representatives acknowledged that they could not see anything about our credit report or score that would suggest a basis for increasing our auto insurance premiums. The second customer service representative also indicated that she had heard from a number of individuals with excellent credit histories who were complaining about rate increases from Farmers Insurance based on credit scores. Because my insurance agent has been out of the office due to family emergencies, I have not yet received a detailed explanation of specific items in our credit history that would support a premium increase. It is not clear how much specific information the agent will be able to provide.

Therefore, it appears we will see an increase in our auto premiums as a result of some arcane, unintelligible calculation that no one can explain with any specificity, despite a credit history and score that both TransUnion and the insurance agency have acknowledged is high. While the increases are within our means (probably less than \$100 per year for coverage for three vehicles), I object to any increase under these circumstances as there no discernible justification for it.

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March 18, 2003

To the extent that SB 144 provides some regulation of this practice, it is a step forward. However, it is difficult to accept that formulas establishing some sort of credit "score" bear any reasonable relationship to the risk an insurance company assumes in insuring vehicles or other property. Moreover, if my understanding of the bill is correct, it doesn't provide any clear parameters for use of credit scores other than preventing them from being the *sole* factor used in establishing rates. That provides little comfort since an insurance company can readily point to a variety of factors that are used in setting rates without clearly identifying the weight given to a credit score or providing sufficient information to allow consumers to evaluate the reasonableness of the determination. If even a score in the top 5% isn't enough to preclude a rate increase, use of credit scores will provide a handy means for insurance companies to "adjust" the premiums of virtually every consumer. Moreover, I am concerned that families who are suffering from job losses or other financial distress due to the current economic downturn may experience sharp spikes in their insurance premiums if the effects of those financial difficulties are eventually reflected in their credit scores.

For these reasons, I encourage you to prohibit use of credit scores in establishing insurance premiums. At a minimum, I would request that SB 144 be amended in the following ways:

1. Limit the use of credit scores. Consideration should be given to limiting the weight that can be given to credit scores or permitting their use only for very low scores. If our experience is any indication, credit scores may be used as the basis for rate increases for all but the top 1-4% of consumers. I see nothing in SB 144 that would prevent a continuation of that practice.

2. Amend Section 7 to require greater specificity in the data about adverse actions that must be provided to the affected consumer. The information provided to a consumer should identify each record in the consumer's credit history that was part of the basis for the adverse action. The consumer should be informed of particular actions that the consumer would need to take in order to qualify for a more favorably priced tier of insurance rates. Absent that kind of specific information, consumers will not be able to take steps to improve their credit score and insurance premiums or to assess the reasonableness of any increases in their premiums.

2. Amend Section 8 to require approval of insurance scoring models. Each insurance scoring model should be filed and approved by the Insurance Commissioner.

3. Amend Section 9 to require additional reporting about the impact of credit scoring on consumers. Each insurer using credit scores as an underwriting factor should be required to provide annual reports to the Insurance Commissioner containing summary data that will enable consumers and legislative leadership to evaluate the extent to which credit scores have resulted in increased premiums or denial of coverage.

3. Amend Section 13 to require more specific regulatory criteria. The Insurance Commissioner should be required to adopt regulations specifically identifying those elements of a credit history that can be given an adverse weight in any insurance credit score formula, as well as those elements that must be given a positive weight in scoring models.

Thank you for your consideration of these concerns.

Sincerely,



Faith D. Loretto