

SUPPLEMENTAL MATERIALS
OF
AMERICAN INSURANCE ASSOCIATION
ON
CREDIT-BASED INSURANCE SCORING
NAIC APRIL 30, 2009 HEARING
MAY 15, 2009

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DEFINING KEY TERMS THAT CAME UP REPEATEDLY IN THE HEARING

During the April 30, 2009, NAIC hearing on credit-based insurance scoring (CBIS), discussion turned from the present economic climate to social propriety of CBIS. “Discrimination,” “proxy,” “disparate impact,” “proxy effect,” “unfair discrimination,” and “disproportionate impact” – there are many concepts that arise in this context. While they may on the surface seem like subtle differences, it is crucial for all those involved in discussing the policy and legal issues to have a common vocabulary on this important aspect of the issue.

We caution that no statement included herein may be taken out of context. This is a summary, not exhaustive treatment, of the subject, which we reserve the right to supplement at any time.

Discrimination / Intentional (“Overt”) Discrimination

Definition

A definition for the commonly understood meaning of discrimination is found at dictionary.com: “treatment or consideration of, or making a distinction in favor of or against, a person or thing based on the group, class, or category to which that person or thing belongs rather than on individual merit.”

Discussion

Because intentional (“overt”) discrimination occurs when a person is treated a particular way based on a prohibited factor and because insurers do not use race, a prohibited factor, in underwriting and rating, intentional (“overt”) discrimination is not relevant to the CBIS discussion.

Proxy

Definition

A “proxy” is typically understood as one factor substituting for another. In the context of this discussion, the relevant questions would be does credit or CBIS stand in the place of a prohibited factor like race or is one able to determine a person’s race by seeing her insurance score? The FTC framed this by providing that whether CBIS is a proxy for race, ethnicity or income hinges on whether the scores are predictive within those groups. Here is the FTC’s conclusion on the issue: “In short, because scores do predict risk within racial, ethnic, and income groups, they do not act solely as a proxy for those characteristics.”

“Proxy” has been part of the landscape of this discussion since the term was used in Section 215 of the Fair and Accurate Credit Transactions Act of 2003 (FACTA),¹ requiring a study of the effects of credit scores and credit-based insurance scores on availability and affordability of financial products.

Discussion

The FTC found that the “relationship between scores and claims risk remains strong when controls for race, ethnicity, and neighborhood income are included in the statistical models of risk.”

Disproportionate Impact / Statistical Difference / Differential Effect

Definition

¹ Section 215 is included as an Exhibit to these comments. Specifically, (a)(3) provides in part for a study of “the extent to which, if any, the use of credit scoring models, credit scores, and credit-based insurance impact on the availability and affordability of credit and insurance to the extent information is currently available or is available through *proxies*, by geography, income, ethnicity, race, color, religion, national origin, age, sex, marital status, and creed, including the extent to which the consideration or lack of consideration of certain factors by credit scoring systems could result in negative or differential treatment of protected classes under the Equal Credit Opportunity Act...” (Emphasis added.)

“Disproportionate impact” refers to the pure statistical impact differences. Some may also refer to this as “disparate impact,” but a full disparate impact analysis goes further and it may simplify the discussion to refer to the statistical-only difference as “disproportionate impact.” The Federal Reserve study refers to this concept as “differential effect.”²

Discussion

This is not a legal or actuarial concept. Indeed, it governs the sale of no product or service in our economy.

Proxy Effect

Definition

The term “proxy effect” differs from “proxy.” It is not in FACTA nor is it commonly used in statistical, legal, or actuarial fields. However, it does appear in the FTC’s auto study. It seems to mean that even if there is no “proxy” – because a factor is risk related – there may be a “proxy effect” if there are score differences that cannot be explained by a factor other than race. This concept was not discussed in the parallel Federal Reserve study.

Discussion

In order to model correctly, the FTC needed some way of capturing the geographic risk. The insurers that provided the data for the FTC Study each used different territorial schemes. So the territory used for rating the policies would not work. While all the insurers could provide zip code, zip codes would be almost impossible for the FTC to use as is because there are too many to model. FTC needed to use one single scheme across all states to capture the geographic risk. In other words the FTC needed a means to group the zip codes into a reasonable number of groups with similar loss propensities. The solution required the insurers to report additional property damage data and that property damage data would be used to group the zip codes. This solution assumed that all the coverages behaved geographically very similar to property damage. It appears that assumption was incorrect.

Unfortunately, the FTC attempted to measure a “proxy effect” with more precision than its database would allow. Such a precise measurement would require the ability to precisely control the study for all non-racial factors such as age, gender, marital status, tenure, mileage, and geographical location of the insured. The FTC’s controls for these factors were less than ideal, and as such the FTC cannot say with any degree of certainty that it did in fact find even a small proxy effect.

For the property damage liability coverage where the FTC had the best controls for geographic risk, the FTC found no proxy effect. If the FTC had been able to control for geographic risk as accurately for all coverages as it did for the property damage liability coverage, all hints of a proxy effect would likely have disappeared.

Unfair Discrimination

Definition

The definition of “unfairly discriminatory” is tied to accurately measuring risk, meaning that rates must be cost-based and treat policyholders with equal risks equally. The standard of not being “unfairly discriminatory” is the very foundation for insurance regulation. It consumes the field in areas where a

² See page 54 of the Federal Reserve Board August 2007 Report to the Congress on Credit Scoring and Its effects on the Availability and Affordability of Credit.

State legislature does not otherwise deem a particular factor to be “unfairly discriminatory” via a public policy mandate.

Discussion

Every study of CBIS has found a correlation between credit-based insurance score and risk. Each of these studies has substantiated that there is actuarial justification.

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

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

Disparate Impact Analysis

Definition

The legal theory of disparate impact is applied on a case-by-case basis. It allows a plaintiff with no evidence of intentional discrimination to sue under certain civil rights laws³ by alleging that a business practice, such as an employment policy, disproportionately disadvantages the members of a protected group.

But because business practices that produce disparate effects occur all the time in the workplace and throughout society in the complete absence of any unlawful discrimination, Congress and the courts have taken care to carve out an important and express exception to liability – the “business necessity” rule, which recognizes that even when a policy results in a disparate / disproportionate impact, that policy **is permissible if it is reasonably related to a legitimate business objective and the plaintiff cannot prove that an equally effective alternative exists to achieve that objective.** The business necessity rule ensures that businesses are not unfairly punished for adopting a policy that serves a legitimate business purpose, but may happen to result in a disproportionate impact.

Discussion

There is disagreement over whether the disparate impact legal theory would be applicable to cases involving certain personal lines coverages. Regardless, even assuming the theory can be applied and that a valid and statistically relevant disproportionate impact is found, legitimate business needs are served by CBIS and no ready and equally accurate alternative is available.

³ Disparate impact theory was originally developed in the context of employment discrimination claims brought under Title VII of the Civil Rights Act of 1964. See *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971). The “business necessity” rule was codified by Congress twenty years later in the Civil Rights Act of 1991, 42 U.S.C. Sec. 2000e-2(k)(1)(A). The rule is also applicable for claims arising under the Fair Housing Act.

A comprehensive actuarial analysis of 2.7 million auto insurance policies across the United States conclusively demonstrated that credit-based insurance scores are linked to the propensity for loss. The massive multivariate study showed that insurance-based credit scores consistently ranked among the top two or three most important risk factors for all components of auto insurance coverage: bodily injury liability, personal injury protection, medical payments, property damage liability, collision and comprehensive.⁴

Improving the accuracy of risk assessment and pricing plainly qualifies as a legitimate business objective. Consideration of a consumer's credit history allows insurers to estimate a consumer's risk of loss with greater accuracy, with in turn allows the underwriter to set premiums at a level that more appropriately reflects that risk. Credit scoring is reasonably necessary to achieve an important business objective and is therefore consistent with business necessity. Broadening the availability of insurance coverage is an additional, and unquestionably legitimate, business purpose served by CBIS. The use of CBIS increases competition by allowing a low-cost but effective underwriting or rating tool. The FTC has agreed with this conclusion in its own study:

"After trying a variety of approaches, the FTC was not able to develop an alternative credit-based insurance scoring model that would continue to predict risk effectively, yet decrease the differences in scores on average among racial and ethnic groups."⁵

⁴ See EPIC Actuaries 2003 study.

⁵ FTC July 2007 Report, page 4.

EXHIBIT 1

FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003

SEC. 215. STUDY OF EFFECTS OF CREDIT SCORES AND CREDIT-BASED INSURANCE SCORES ON AVAILABILITY AND AFFORDABILITY OF FINANCIAL PRODUCTS.

(a) **STUDY REQUIRED.**—The Commission and the Board, in consultation with the Office of Fair Housing and Equal Opportunity of the Department of Housing and Urban Development, shall conduct a study of—

(1) the effects of the use of credit scores and credit-based insurance scores on the availability and affordability of financial products and services, including credit cards, mortgages, auto loans and property and casualty insurance;

(2) the statistical relationship, utilizing multivariate analysis that controls for prohibited factors under the Equal Credit Opportunity Act and other known factors, between credit scores and credit-based insurance scores and the quantifiable risks and the actual losses experienced by businesses;

(3) the extent to which, if any, the use of credit scoring models, credit scores, and credit-based insurance impact on the availability and affordability of credit and insurance to the extent information is currently available or is available through proxies, by geography, income, ethnicity, race, color, religion, national origin, age, sex, marital status, and creed, including the extent to which the consideration or lack of consideration of certain factors by credit scoring systems could result in negative or differential treatment of protected classes under the Equal Credit Opportunity Act, and the extent to which, if any, the use of underwriting systems relying on these models could achieve comparable results through the use of factors with less negative impact; and

(4) the extent to which credit scoring systems are used by businesses, the factors considered by such systems, and the effects of variables which are not considered by such systems.

(b) **PUBIC PARTICIPATION.**—The Commission shall seek public input about the prescribed methodology and research design of the study described in subsection (a), including from relevant Federal regulators, State insurance regulators, community, civil rights, consumer, and housing groups.

(c) **REPORT REQUIRED.**--

(1) **IN GENERAL.**—Before the end of the 24-month period beginning on the date of enactment of this Act, the Commission shall submit a detailed report on the study conducted pursuant to subsection (a) to the Committee on Financial Services of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate.

(2) **CONTENTS OF REPORT.**—The report submitted under paragraph (1) shall include the findings and conclusions of the Commission, recommendations to address specific areas of concerns addressed in the study, and recommendations for legislative or administrative action that the Commission may determine to be necessary to ensure that credit and credit-based insurance scores are used appropriately and fairly to avoid negative effects.



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October 24, 2008

Commissioner John Morrison, Chair
National Association of Insurance Commissioners
Market Regulation and Consumer Affairs (D) Committee
2301 McGee Street
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Re: **“Review of the Use of Credit-Based Insurance Scoring By Insurers” -
AIA Review of August 26, 2008 Draft**

Dear Commissioner Morrison:

The American Insurance Association (AIA) appreciates the opportunity to comment on the National Association of Insurance Commissioner’s August 26 draft report “Review of the Use of Credit-Based Insurance Scoring By Insurers.” Although relatively thorough in the number of reports analyzed, in tone and in content the report often takes a one-sided approach to credit-based insurance scoring (CBIS). An NAIC report on CBIS should take care to offer a balanced and unbiased approach, even when presenting a comprehensive consumer perspective. This would include describing the various viewpoints – consumers, insurers, academics, regulators - in the ongoing debate. Moving forward, any NAIC report should be accurate, objective, grounded in the law, recognize progress in the debate and be void of faulty presumptions.

Real consumers, policyholders and voters had the opportunity to comment directly on credit-based insurance scoring in Oregon via their vote and turned down a proposed ban by a margin of 2-1 (2006 election). For a consumer perspective, the report should dig deeper than critiques made by some special interest consumer advocacy groups. Most of the consumer viewpoints and footnotes in the report are attributed to one source (from the Center for Economic Justice). That is a disservice to the NAIC, its staff, the consumers they aim to serve and the insurers that they regulate (those same insurers that ultimately fund NAIC activities). The NAIC should consider other resources, such as complaint numbers from their own departments, insurers who operate each day on product, price and service using CBIS, vendors who create CBIS, agencies that supply data to create CBIS and the countless others in this arena.

The NAIC and individual state insurance departments have access to more complete and objective information sources, such as the number and nature of consumer policyholder complaints received about CBIS, trends over time, the ratio of complaints to numbers of auto and homeowners policies, and comparisons to complaints and inquiries received on other matters. The NAIC report on CBIS should include an inventory and analysis of data on CBIS-related policyholder complaints.

In the states in which AIA has recently testified on CBIS legislative proposals, the commissioners have provided the number of CBIS related consumer complaints, and they are in the few dozen annually, an impressive performance considering the millions of personal lines transactions in those states. This lack of real complaints is especially significant because under federal law a specific notice is sent to each consumer that has experienced an adverse action as a result of the use of CBIS.

The NAIC report also gives scant attention to one salient fact: the auto and homeowners markets (outside of catastrophe prone areas) are functioning quite well with generally stable prices and good availability. A major reason for this is wide use of CBIS, which allows more accurate pricing, reducing premiums for many, if not most, policyholders. In addition, availability, as demonstrated by historically low residual market populations, has improved because insurers now can insure virtually all risks because they can, with CBIS, reliably price them.

Importantly, to be credible the overarching review which comprises the first half of the report must achieve greater balance by a broader analysis of consumer attitudes, insurance department data and consumer feedback, insurer viewpoints and testimony on the efficacy of credit scoring, and studies conducted by academics.

Specific concerns with and suggestions for the report follow, with the draft language on the left and AIA's comments presented on the right:

<p>I. Introduction</p> <p>... This paper will: provide a background on how insurers use credit-based insurance scores; detail concerns over the use of these scores; and provide a summary of what studies concerning credit-based insurance scores have discovered. It is hopeful that this report will be useful to state regulators as they decide what regulatory framework should be implemented with respect to credit-based insurance scores.</p>	<p>The vast majority of states have acted on this issue. Indeed, most legislatures have enacted laws and regulators have issued regulations in many states. Most states have already “decide[d] what regulatory framework should be implemented with respect to” CBIS and are quite capable of using existing tools to determine what additional action is needed, if any. Therefore, we see little value for this report, except as background information and except to the extent it is an accurate and unbiased summary of prior studies.</p>
<p>II. Background on Use of CBIS by Insurance Companies</p> <p>What Credit-Based Insurance Scores Are</p> <p>In the past twenty years, one of the most important developments to automobile and homeowner insurance underwriting and rating has been the increased use of credit-based insurance scores. During this time, many consumer groups and regulators have questioned the predictability of these scores as well as their possible disproportionate or disparate impact on minority or low-income populations. ...</p>	<p>If this section is intended to be just the facts, the questions and the debates from later sections need not be incorporated here. The second sentence of the first paragraph is gratuitous.</p>
<p>Emergence of CBIS in Underwriting and Rating Mechanisms</p> <p>... Some insurance companies are not allowed by state law to use credit-based insurance scores for existing customers. Some insurers also choose not to use credit-based insurance scores in renewals. However, all insurance companies that use credit-based insurance scores do so in making decisions concerning potential customers.</p>	<p>This paragraph makes it sound like the prohibitions are on certain insurance companies. What does this mean? This is not the case.</p> <p>Many states have taken balanced approaches to addressing CBIS, indicating when they can be used and when they may not be the basis, or sole basis of actions, such as nonrenewal.</p>
<p>According to the National Association of Mutual Insurance Companies (NAMIC), 48 states have taken some legislative or regulatory action concerning the use of consumer credit information for underwriting and rating purposes. NAMIC identified 42 states that have prohibited certain uses of credit history information or banned the use of certain negative credit factors in the formulation of insurance scores....</p>	<p>This citation to the NAMIC summary seems to put its findings in the negative. This is creative. The fact is that less than a hand-full of states disallow CBIS, although some provide limitations on how it is to be used. Use of CBIS is also subject to federal law and state insurance laws of general applicability, such as those governing rating, underwriting and discrimination.</p>
<p>III. Benefits to Insurers in Using Credit-Based Insurance Scores</p>	<p>As you will see, the benefits are not only to insurers. They are also beneficial to many consumers and to the overall market. The reference to insurers should be removed from the section title as it gives the impression that insurers are in one camp and that all consumers are in another.</p>

<p>The main reasons insurers use credit-based insurance scores include: more refined risk classifications; customer valuation to drive target marketing; pricing and underwriting proficiency; and increased retention of customers. Insurers argue that the use of credit based insurance scores is necessary to properly evaluate risk and charge individual policyholders rates that most closely align with their true risk. They go on to say that not using credit-based insurance scores could result in subsidies from lower-risk individuals to higher-risk individuals.</p> <p>Insurers use credit-based insurance scores primarily in underwriting and rating of consumers. Underwriting is the process by which the insurer determines whether a consumer is eligible for coverage and rating is the process that determines how much premium to charge a consumer. The credit-based insurance score models used by insurers are designed to predict the risk of loss. Insurers use credit-based insurance scores for underwriting to assign consumers to a pool based on risk and then for rating by deciding how to adjust the premium up or down.</p> <p>...</p>	<p>Please expand this section. Omitted from the benefits section is data relating to the competitiveness of the personal lines market, except perhaps for homeowners insurance in some catastrophe prone areas. Auto insurance, for example, is available everywhere at prices which are stable or lower in recent years. And, most telling, auto residual markets are at historic lows, and in some states have virtually disappeared because of the availability and affordability of insurance, based on risk assessment made possible through CBIS.</p> <p>Please expand this section. Additional benefits include:</p> <ul style="list-style-type: none"> • CBIS provide consumers more accurate, and for a majority of people – upwards of 75% as some insurers have testified – more favorable, pricing terms. • CBIS fall not only under standard insurance rating law and anti-discrimination laws, but also additional state and federal protections via laws such as the NCOIL Model Act on Credit and the federal FCRA. • CBIS remove subjectivity from some of the insurance process and rate each individual applicant so that the price more closely matches the risk.
<p>Many experts believe that credit-based insurance scoring has come to be one of the most important factors insurers used in determining a consumer's automobile or homeowners insurance premium.</p>	<p>Please expand this section. Also:</p> <ul style="list-style-type: none"> • CBIS are one of many factors insurers use, not a sole factor and therefore a poor credit rating alone does not often have a great impact on a final premium, if it factors in at all (per the AR study showing 60% of consumers premiums were unaffected by CBIS). • CBIS are the most objective and accurate rating variables (as compared to DMV reports; self-reporting by insureds of miles driven; hidden traffic violations per “probation” and forgiveness laws; etc.).
<p>IV. Consumer Concerns over Credit-Based Insurance Scores</p>	<p>The title should remove reference to consumers. Also, the section more broadly addresses concerns from various sources. There are many consumers that benefit from CBIS. To set the paper up as an insurer versus consumer issue over simplifies and mischaracterizes the issue.</p>
<p>As the use of credit-based insurance scoring has increased among insurers, it is not surprising that consumers and regulators have</p>	<p>There have been consumers and regulators on both sides of the issue. This makes it sound like they are all solidly in the “concerns”</p>

<p>expressed numerous concerns over its use and possible effects.</p> <p>The most basic concern has been that most consumers do not understand the concept of credit-based insurance scoring or how or why it works. Most consumers are not even aware that their credit characteristics are being used to create a score that will then affect their purchase of an insurance policy. Even if they have the knowledge of the existence of credit-based insurance scores, it is not intuitive for consumers to understand how credit-based insurance scores work or why they work.</p>	<p>camp. The qualifier “some” should be added.</p> <p>There have been many educational efforts. Please get in touch with AIA if you would like to learn more.</p> <p>This comment is outdated. Many state notice requirements have changed over the past 5 years. Today, most states require a disclosure that credit information will be used. Additionally, the federal and state laws require an adverse action notice be sent. Most states (and the NCOIL Model) require disclosure of the top 4 items which negatively impacted a consumer’s CBIS.</p>
<p>Consumers intuitively can understand why they may have higher rates due to prior driving history or the location of their home, but it makes no sense to most consumers why their rates would be higher because of a score whose formula is unknown. In addition, while consumers can change many of their other behaviors in order to affect a rate, it is not readily known how to improve a credit-based insurance score.</p>	<p>The statement about changing behaviors is inaccurate for two reasons. First, a credit-based insurance score is easier to change than many other auto rating variables such as age, gender, marital status, and geography. Second, insurers, agent advice and brochures, insurance departments, newspapers, magazines, banks, insurance and financial trade associations and other sources have provided substantial educational information over the past decade on the importance of credit scores and CBIS, and how to improve scores.</p> <p>AIA agrees that more can still be done to educate consumers. Further and continuing education is important and the NAIC, individual insurance departments, insurers and consumer advocates can all play a critical role. However, CBIS and credit scores are dynamic and consumers have the ability and generally more power to change this rating factor in a favorable way than with others.</p> <p>Additionally, since the reauthorization of the FCRA (FACT Act) consumers are entitled to one free credit report a year from each of the three major credit reporting agencies, and that coupled with any adverse action notice that allows for a free report, has extended consumers’ knowledge of the credit report, the factors that make up a credit-based score and “how to improve” it exponentially.</p>
<p>As of yet, no research, quantitative or otherwise, has been produced that shows why there is a correlation between credit-based insurance scores and insurance losses. Though there are several studies claiming the predictive effects of credit-based insurance scores on insurance losses</p>	<p>This claim is not entirely true in that a compilation and brief analysis of previous research studies going back several decades by University of Texas Professors Patrick Brockett and Linda L. Golden seems to indicate that credit scores may be correlated with risk-taking</p>

<p>propensity, individual driver behavior, and insurance claiming behaviors and patterns. The NAIC report later mentions and reviews the Brockett and Golden study, thus the draft report is internally inconsistent.</p> <p>More importantly and germane to the question of how and why CBIS works, there is no legal requirement or actuarial principal that states that rating factors demonstrating a strong correlation and that are risk-based must be explained in terms of causation. A basic underpinning of the NAIC and state regulator review of any rating factor must be anchored in a traditional legal and actuarial framework. Actuarial Standard of Practice No. 12 addresses “Risk Classification.” The relationship between the risk characteristics and the expected outcomes (correlation) should be considered. However, “it is not necessary for the actuary to establish a cause and effect relationship between the risk characteristic and expected outcome in order to use a specific risk characteristic.” (See ASOP No. 12, Sec. 3.2.2.)</p> <p>Other rating variables illustrating a strong risk-based utility such as gender, age, and marital status are more easily understood in public and regulator perceptions as relating to behavior, experience and maturity that impacts insurance risk. However, demonstrating exact causation might not be any easier to precisely quantify than is credit scoring. Mention of the need to find precise causation for why CBIS are so closely related to insurance risk is a red herring.</p>	<p>and numerous insurance industry representatives have touted the effects of credit-based insurance scores, none have articulated why credit-based insurance scores are related to insurance claims.</p>
<p>Many states have the authority to review models and are specifically granted that right under the NCOIL model law. Regulators should have the expertise to review them for compliance with law and the ability to maintain them confidential for legitimate trade secret and competitive reasons.</p> <p>Rate filings utilizing CBIS have been submitted and approved for more than a decade to the very same regulators that comprise the NAIC. Clearly each and every one of those millions of rate approvals by regulators and their staff reflect not only a real risk prediction value and a lack of discrimination, but an inherent a benefit to consumers.</p> <p>This paragraph is slanted. Instead of recounting the much larger percentages of people that receive discounts or are unaffected due to</p>	<p>This lack of an explanation is troubling to consumers as they struggle to understand why their rates may be affected by personal, financial characteristics seemingly having nothing to do with risk or insurance. Because the actual credit-based insurance score models are proprietary to individual insurers, it is difficult to know precisely what weight is given to credit-based insurance scores during the underwriting and rating process.</p>
<p>Insurers say credit-based insurance scores allow them to improve the speed and consistency of underwriting as well as being able to offer</p>	<p>Insurers say credit-based insurance scores allow them to improve the speed and consistency of underwriting as well as being able to offer</p>

<p>policies to more consumers. This, too, seems counter-intuitive to some consumers as they learn they may not be offered insurance or may receive a higher rate due to some unknown credit characteristics.</p>	<p>CBIS, the paper chooses to emphasize the few who pay more. In addition, federal and state laws require reasons to be given for adverse actions, so the reference to “unknown credit characteristics” is factually wrong.</p>
<p>Many critics believe that credit-based insurance scores may actually be double counting other risk factors, meaning that the score is not directly a predictor of loss ratios, but instead the score is correlated with other data such as age and location that are already incorporated in insurers’ underwriting and pricing models. In addition, credit-based insurance scores may not be measuring how responsible or careful a person is, but instead may be a proxy for identifying individuals who are unemployed, single, divorced or disabled.</p>	<p>This statement should be revised. It misrepresents the current debate. In this section and in several other places, the draft is misleading and inaccurate when it implies that many believe credit scoring is a surrogate for other rating or demographic factors. It gives short shrift to findings which indicate otherwise.</p> <p>The assertion of “many critics” here is vague, most likely outdated and probably cannot be supported, and likely refers to the same few critics. Four key studies from diverse sources (insurance actuaries, state insurance department, federal government) including the 1999 Monaghan study, EPIC actuarial study of 2003, the Texas Insurance Department studies of 2003-2005, and the FTC report of 2007 have strongly illustrated and concluded that CBIS does not materially double count other risk factors, and that it contributes an additional accuracy, efficacy, fairness, and risk-relatedness to the rating process. This is borne out by the other multivariate studies, including EPIC Actuaries.</p>
<p>In addition to consumer and regulator concerns, insurance agents have expressed frustrations with the use of credit-based insurance scores. Producers often cannot even provide a premium quote to a potential customer because of either the customer’s low credit-based insurance score or lack of sufficient credit history. A producer may also be required to ask customer’s for social security numbers in order for the insurer to obtain credit information. This can affect the relationship between agent and consumer when the agent is not able to explain why credit information is being used or how exactly it will affect the consumer’s potential purchase. Some agents have also expressed frustrations over the way the use of credit-based insurance scores has seemed to prohibit agents from writing much business in a particular geographic area.</p>	<p>Like the “many critics” who believe CBIS double counts other risk factors, this assertion is outdated. When first introduced on a widespread scale 8-10 years ago many agents did express frustration with CBIS, but as they became more familiar with procedures, providing information to consumers, and gained knowledge about the contribution to accuracy in rating, frustration and opposition to CBIS has greatly diminished.</p> <p>Look to recent evidence. In a May 2008 letter to House Financial Services Committee Chairman Watt and Ranking Member Miller, several trade associations – including the Independent Insurance Agents and Brokers of America – strongly opposed a ban of scoring. They state: “CBIS are a regulated, effective, objectively verified and fair risk measurement tool. Banning or prohibiting their use would restrict consumer choice and eliminate the mechanism by which insurers provide discounts to the majority of consumers.”</p>

<p>Even ignoring the issue of not knowing for sure why credit-based insurance scoring might help measure risk, one of the basic fundamental questions that regulators and consumer groups are concerned with is whether it is fair for insurers to charge higher rates to people whose financial situation may have been caused by a catastrophic event. Using credit-based insurance scores may just contribute to creating greater disparity between socioeconomic groups.</p> <p>Individuals experiencing unfortunate economic situations, often outside their own control, are unfairly penalized by the use of credit-based insurance scores. Those who have been affected by natural disaster, terrorism, identity theft, or medical crises may see their current situation exacerbated through no fault of their own.</p> <p>Given the recent state of the U.S. economy and financial difficulties facing individual consumers, the use of credit-based insurance scores may further unfairly treat those who are struggling to make ends meet. As the housing market falls rapidly in some U.S. cities and mortgage defaults rise, negative credit characteristics will likely increase for many individuals. As consumers face difficulties paying current bills in a climate of low job growth and rising health care costs, some individuals may be forced to make credit-related decisions that are not viewed favorably. If this then leads to a decline in credit-based insurance scores and rising insurance rates, some consumers may be headed for a never-ending declining spiral. Policymakers may find this to be unacceptable in today's economic environment.</p>	<p>This portion should be removed or modified. It argues and implies that many regulators and consumer groups struggle with CBIS because they are concerned whether it is fair for consumers to charge higher rates to people whose financial situation has been caused by a catastrophic event. This section does not make any effort to explain or take into account the NCOIL model (via drafting note) and other individual state laws/regulations, and insurer and industry practices that allow adjustments for "extraordinary life circumstances."</p> <p>The last sentence of the first paragraph, regarding "socioeconomic disparity" is pure fiction. Nowhere is proof for this provided and indeed, because rates are lower for many insureds and coverage more available, CBIS may have no impact at all on socioeconomic disparities. In any event, an allegation of this importance should not simply be repeated in an NAIC document, without substantial evidence. In the absence of that, such statements disserve regulators, the public and consumers.</p> <p>However difficult the current economic condition, there is no proof that it is resulting in increased problems for insureds through the use of CBIS. Legislation, regulation and company practices are able to respond to these circumstances and prevent widespread problems. Unless and until real complaints show a dramatic increase, there is no basis in fact for these dire predictions.</p> <p>There is simply no evidence that these dire predications are in reality occurring. Indeed, the evidence is to the contrary. The NCOIL Model, adopted in more than one half of the States, other state regulatory actions and insurer practices are preventing the kinds of unfair outcomes that are of concern in this paragraph. Proof to the contrary is non-existent and these allegations should therefore be deleted. To repeat unsupported accusations, as this portion of the draft deliberately misleads both regulators and the public.</p>
<p>This report focuses on credit-based insurance scores and not credit scores in general, but it is worth noting that a Freddie Mac Consumer Credit survey from 1999 concluded that African-Americans and Hispanics were significantly more likely to have negative items on their</p>	<p>This study is irrelevant to CBIS. There is no proof of CBIS being unlawfully discriminatory. And it is the obligation of regulators to enforce the law, not create new standards to fit the peculiar political agendas of advocacy groups. CBIS is race blind and good risks of all</p>

<p>credit history than whites were. If certain socioeconomic groups have worse credit scores in general or worse credit-based insurance scores in particular, it seems that charging higher rates to these groups leads to greater societal disparities in contrast to what is desired by society in general.</p>	<p>credit history than whites were. If certain socioeconomic groups have worse credit scores in general or worse credit-based insurance scores in particular, it seems that charging higher rates to these groups leads to greater societal disparities in contrast to what is desired by society in general.</p>
<p>No legitimate study has found any direct proxy. This must be revised. Review the FTC study closely for differences between “proxy” and “proxy effect”. This is an important distinction.</p> <p>CBIS were found to be predictive within racial, ethnic and income groups in the FTC and Texas studies. —It would be impossible for an insurer to guess race or target and rate groups based on CBIS. The NAIC report should strive to report and accurately interpret findings from the Texas, FTC and other studies, rather than make the inferences contained in this section.</p>	<p>Credit-based insurance scores may also serve as a proxy for other factors that are typically not allowed by state insurance regulators. It was mentioned above that correlations between credit-based insurance scores and insurance losses may actually be due to other characteristics that are already accounted for in underwriting and rating. It may also be the case that the correlation is due to characteristics such as income or race that are typically barred by states from being used.</p>
<p>There is no evidence that the use of CBIS violates state or federal anti-discrimination laws. Despite all of the studies, legislative and regulatory activity and the availability of the courts, there has never been a finding of intentional discrimination. The paper uses the term “disproportionate impact” which has no legal meaning or significance. It should not, therefore, be used in the paper. Where applicable, the accepted legal standard for discrimination is “disparate impact” which is significantly different than “disproportionate impact.” CBIS, based upon virtually all of the studies cited in this paper, clearly meets that test as a risk assessment tool.</p>	<p>If race or income is predictive of credit-based insurance scores, then insurers could use the legally-allowed credit-based insurance scores to avoid writing policies to people of a specified income level or race. If credit-based insurance scores are found to have a disproportionate or even disparate impact on low-income consumers or minorities, these consumers may be unfairly treated when it comes to the availability or affordability of insurance.</p>
<p>It is clear how missing and thin files are handled. The report should not imply that large numbers of consumers are being penalized. Specifically, the NCOIL Model (adopted in large part by most states) provides the insurer with three options for handling no hits and thin files: (1) treat the consumer as otherwise approved by the Insurance Commissioner/ Supervisor/Director, if the insurer presents information that such an absence or inability relates to the risk for the insurer; (2) treat the consumer as if the applicant or insured had neutral credit information, as defined by the insurer; or (3) exclude the use of credit information as a factor and use only other underwriting criteria.</p>	<p>It also is not clear what is done with consumers who either do not have a credit score or have a “thin” file. There are estimates that as many as 50 million Americans are “unscorable” using traditional credit information because of “thin” files. By definition, insurers will have trouble providing a credit-based insurance score for these customers leading to the question of how insurers will handle underwriting and rating. If the lack of credit history causes these individuals to not have an appropriate credit-based insurance score, this could be detrimental to a large proportion of society. These individuals might be unfairly treated for not having enough credit history to develop a score.</p>
<p>Many insurers have reported and testified that CBIS gives them the</p>	<p>There have been accusations that credit-based insurance scores,</p>

<p>ability to reach out to a much wider, even a full range of customers that may not have been offered or written for homeowner auto insurers in the past due to uncertainties on risk. This is because CBIS allows for more accurate risk assessment and pricing, and consumers in all areas have been beneficiaries. Some insurers have reported that due to CBIS, up to 80-90% of applicants fall into underwriting guidelines and can be offered insurance, compared to less than 50% prior to the advent of CBIS.</p> <p>The FTC study mentions several insurers by name that specifically cited that CBIS “enabled them to offer policies to higher-risk consumers than they had previously.” (See pages 46-47.)</p> <p>Coinciding with the rise of CBIS is a major and ongoing decline in the number of risks written through residual markets, particularly urban auto insurance market. Although property residual markets have been impacted by catastrophe risk, in general numbers of homeowners insurance risks written in urban residual property markets have declined precipitously as well for non catastrophe prone states.</p> <p>The FTC study references a marked drop in the number of state residual market policies from the mid-1990s to 2000, just a CBIS was coming into common usage. In addition, there is well-documented evidence of auto residual market declines in the AIPSO annual reports spanning 1990-2006.</p>	<p>instead of predicting insurance losses, may actually be predicting the profitability of potential customers. Some allege that insurers mainly use credit-based insurance scores to locate “better” customers – those who are wealthier and may tend to be more loyal to one company. Companies have attempted to refine predictive modeling in general and one of the reasons for this is to target the right audience by marketing to “profitable risks.”</p> <p>The insurance industry has acknowledged that predictive modeling in general can play a useful part “in increasing hit and retention ratios.” 11 Insurers are able to market ads to “profitable risks.” Insurers are focusing resources on not only creating models to measure risk of accidents, driver behavior, climate change and other risks, but also to model the chance that a consumer will be a loyal customer or purchase additional financial products such as life insurance or retirement products. In 2005 while speaking to investment analysts, the CEO of Allstate, Ed Liddy, stated this concept with respect to tiered pricing:</p> <p style="padding-left: 40px;">Tiered pricing helps us attract higher lifetime value customers who buy more products and stay with us for a longer period of time.</p> <p>The focus on identifying consumers based on their future profitability due to loyalty or ability to buy additional financial products rather than the focus on risk and loss prevention is troubling to many consumer advocates.</p>
<p>Similar to the first half of this report providing an overview on scoring, AIA fears that the analysis suffers from a singular focus on critiques by a very limited number of consumer advocates with negative perceptions of scoring highlighted with “many consumers feel” or “consumers believe” language, while ignoring broader assessments of consumer views and other viewpoints including insurers and academics. AIA suggests ways the discussion and review of each of the research studies can be made more balanced.</p>	<p>V. Prior Research Concerning the Effect of CBIS</p>
<p>The literature is not sparse. Contrary to the NAIC opinion expressed</p>	<p>Types of Studies</p> <p>...</p> <p>...</p> <p>This section of the report will go through the reports chronologically, with</p>

<p>special emphasis on methodology and the findings of each report. Although there are at least 18 reports of relevance, the literature remains somewhat sparse and more work, as described in Section V of this report, could and should be done. ...</p> <p>Due to the importance of predicting risk, insurance companies have likely completed enormous amounts of internal research concerning the effect of credit-based insurance scores on loss performance and insurance risk. However, that data and the results are proprietary and, for the most part, unknown to the public. It is worth mentioning that access to these models and the corresponding data could provide tremendous additional information to the overall topic.</p>	<p>in the draft report, there have been three major studies using multivariate analysis—FTC 2007, Texas 2004-2005, and EPIC Actuaries 2003.</p> <p>Under general insurance regulatory law and the NCOIL model, regulators are given full access to credit scoring models and methodologies.</p>
<p>Nature of Studies</p> <p>... The NAIC, in its 1996 report described below, has criticized the studies that use loss ratio as the dependent variable and credit history as the predictor. The NAIC report pointed out that credibility of this method rests on underlying assumptions. If the rating variables within the existing premium are not completely accurate then the analysis of new variables is not valid. There are hundreds of rating factors such as geographic rating territory, driving experience, age of driver, age of home, various discounts and surcharges. Small errors in pricing a number of these factors could add up to significant overall pricing errors. In addition, a company may deviate its pricing away from true target loss ratios for marketing reasons, making the loss ratios inaccurate and inappropriate as measures for these studies.</p> <p>These deficiencies with using loss ratios as a dependent variable have led some, including the NAIC in its 1996 report, to call for a multivariate analysis in order to measure the correlation between credit-based insurance scores and risk of loss. Some regulators suggest that an unbiased and multivariate analysis is necessary to determine the effect of credit-based insurance scores on loss costs after accounting for all other factors</p>	<p>The introduction to this section on the reports in general and the NAIC report from 1996 leaves the impression that there still have not been any multivariate studies done on CBIS and indicates that this is a problem in assessing whether CBIS merely duplicates other variables or demographic factors.</p> <p>Indeed, several studies of CBIS have used multivariate analysis and have established that scoring does not merely duplicate other variables. In particular, the 2004-2005 Texas studies, the 2003 EPIC Actuaries study and the 2007 FTC study took this approach.</p>
<p>Listing of Reports</p> <p><u>National Association of Insurance Commissioners, “Credit Reports and Insurance Underwriting,” 1996</u></p>	

<p>In 1996, the NAIC's Market Conduct and Consumer Affairs (EX3) Subcommittee requested that the NAIC prepare a white paper concerning credit as an underwriting tool. The report recognized that even in 1996 there was considerable controversy about the correlation between credit history and risk of loss. The report also expressed concern for the way that insurers might use credit reports or credit information as the sole underwriting tool to determine insurability, ignoring factors that are more traditional. There were also concerns over the accuracy of credit characteristics that went into forming the credit-based insurance scores.</p> <p>... The NAIC report called for a multivariate analysis in order to determine the effect of credit-based insurance scores while factoring for all other risk factors.</p> <p><u>Commonwealth of Virginia, State Corporation Commission, Bureau of Insurance, "Use of Credit Reports in Underwriting," 1999 ...</u></p> <p><u>Fair Isaac, "Predictiveness of Credit History for Insurance Loss Ratio Relativities," October 1999 ...</u></p> <p><u>Monaghan, James E., "The Impact of Personal Insurance Credit History on Loss Performance in Personal Lines," 2000, <i>Casualty Actuary Society Forum-Winter: 79-19-05</i>. ...</u></p> <p><u>Conning & Company, "Insurance Scoring in Personal Automobile Insurance - Breaking the Silence," 2001 ...</u></p> <p><u>American Academy of Actuaries and Risk Classification Subcommittee of the Property/Casualty Products, Pricing, and Market Committee, "The Use of Credit History for Personal Lines of Insurance: Report to the National Association of Insurance Commissioners," 2002 ...</u></p> <p>The AAA paper summarized four prior studies that are also all included in this report. The paper provided recommendations regarding a future study including the recommendation that a study consider both credit history and insurance claims experience as manifestations of other personal characteristics. The paper also recommended that a future study looking at the effect of credit-based insurance scores on protected classes should define what is meant by "disproportionate impact" and define what magnitude of "disproportionate impact" would cause regulatory concern.</p>	<p>Concerns about sole use are addressed under the NCOIL Model.</p> <p>See comments above. The paper seems to recognize that research has advanced on correlation since 1996. It should indicate that the NAIC's call for multivariate analysis has since been addressed.</p>
	<p>"Disproportionate impact" is not a standard that exists in the law of discrimination. The standard is "disparate impact", which is very different. Nor does "disproportionate impact" exist in state rating and insurance regulatory laws. Since regulators are required to apply the law, this document's setting forth an unrecognized statistical standard and then suggesting that insurers should be measured against it, is not an appropriate action by regulators. The mere fact that AAA provided a definition does not mean it is recognized by the actuarial profession or rises to the level of industry practice and usage.</p>

<p><u>“The Use of Insurance Credit Scoring In Automobile and Homeowners Insurance.” A Report to the Governor, the Legislature and the People of Michigan, Frank M. Fitzgerald, Commissioner of Financial and Insurance Services, December 2002</u></p> <p>...</p> <p>The report, contrary to most other research, found that individuals with “relatively lower socio-economic standing had better insurance credit scores, on average, than those of higher socio-economic standing.” The Michigan study was not able to find evidence of bias or illegal impact with respect to race or ethnicity.</p>	<p>The draft report does not seem to support the “contrary to most other research” finding. Regardless, such description is gratuitous.</p>
<p><u>Kellison, Bruce, Patrick Brockett, Seon-Hi Shin, and Shihong Li, “A Statistical Analysis of the Relationship Between Credit History and Insurance Losses,” Bureau of Business Research, University of Texas at Austin, 2003. ...</u></p> <p><u>Miller, Michael J. and Richard A. Smith, “The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity An Actuarial Study” by EPIC Actuaries, LLC, 2003</u></p> <p>... The random sample of policies was taken from policies in effect during 2000 and 2001. ...</p>	<p>The NAIC may want to indicate that 2.5 million policies were used.</p>
<p><u>Wu, Cheng-Sheng Peter and James C. Guszczka, “Does Credit Score Really Explain Insurance Losses? Multivariate Analysis from a Data Mining Point of View,” 2003, Proceedings of the Casualty Actuarial Society 113-138. ...</u></p> <p><u>“A Report to the Legislature, Effect of Credit Scoring on Auto Insurance Underwriting and Pricing,” Washington Office of Insurance Commissioner, Prepared by: Washington State University, Social & Economic Sciences, Research Center, Dave Pavelchek, PRR Inc. Bruce Brown, January 2003</u></p> <p>The State of Washington prepared a report in 2003 whose purpose was to examine whether credit-based insurance scoring had unequal impacts on certain demographic groups. The study did not attempt to measure whether credit-based insurance scores were correlated with loss ratios. The state obtained data on several thousand consumers from three</p>	<p>The stated purpose of the study was “to find out whether credit scoring has unequal impacts on specific demographic groups.” The study did not address the issue of whether the use of CBIS correlates with higher loss ratios. Researchers contacted about 3,000 policyholders from three larger insurers in Washington by telephone to gather demographic information such as ethnic status, income, and other factors. This scope and methodology must be recognized to put this study into context.</p> <p>The authors of the Washington study were also cautious in qualifying limited findings relating to credit scoring and its impacts on various demographic groups.</p>

automobile insurance companies. Data obtained included, age, gender, ZIP code, credit scores and rate classifications. The consumers were then contacted by phone in order to obtain additional information regarding ethnicity, marital status and income level.

The study found that age was the most significant factor, meaning that older drivers had, on average, higher credit-related insurance scores, lower credit-based rate assignments, and less likelihood of lacking a valid credit score than younger drivers. Income was also a factor in that people in the lowest income categories had higher premiums and lower credit-related insurance scores. More of the low income individuals also lacked the credit history to have a credit-related insurance score. Ethnicity was not able to be sufficiently measured due to the small number of minorities in the sampling. Overall, the study found that the impact of credit-based insurance scores is probably not equally distributed among demographic groups.

With respect to age, the study found a reasonably strong relationship between credit scores and the age of policyholders. Credit scores tended to rise with age. The relationship between age, particularly young drivers, and auto insurance risk is well-established in insurance data and numerous studies by industry and federal highway safety agencies. There was a minor relationship between income and credit scores that researchers indicated might result in a plus or minus four percent variation in premiums. Results were inconclusive on any relationship between credit scores and ethnicity. The study found no discernable tie to credit scores and other demographic and rating variables such as marital status, gender, and geographical location.

With respect to income, the researchers noted that results varied from one company to another, with policyholders in one of the three companies indicating “no general correlation between incomes and credit score rate adjustments across all income levels.” The study uses several examples to show that score variations associated with income might result in premium variations of the order of plus or minus four percent. This is a very small range, and with so many other factors involved in the interaction of credit scoring, income and premiums that are not accounted for in the statistical model, it is difficult to attach much significance to the finding. For example, the 2000 average auto insurance expenditure in Washington was \$722. Four percent of the average expenditure is \$28.

With respect to ethnicity, the study did not provide information on the number of minority respondents, but estimates based on available information would indicate that fewer than 100 persons out of 3,000 respondents identified themselves as African-American, and fewer still identified themselves as Hispanic or Native-American. There were varied results regarding whether the different ethnic groups were more likely to have lower insurance scores. The Washington report notes that “relatively small numbers of ethnic minorities and the number of refusals and unclassifiable survey responses” made it difficult to pin down any statistical significance between minority status and CBIS.

There is a real danger that those with a strong bias against credit scoring will draw conclusions and interpretations that are unwarranted

<p><u>State of Alaska. Department of Community and Economic Development, Division of Insurance, "Insurance Credit Scoring in Alaska," February 21, 2003 ...</u></p>	<p>by the statistical significance of findings in the study.</p>
<p><u>Maryland Insurance Administration, "Report on the Credit Scoring Data of Insurers in Maryland," 2004 ...</u></p>	
<p><u>Kabler, Brent, "Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri," 2004</u></p> <p>The Missouri Department of Insurance has conducted the most comprehensive state study concerning credit-based insurance scores and their potential effects on various socioeconomic groups. The Department's 2004 study used ZIP-code level data on credit-based insurance scores and race, income, and other demographic variables. The report used credit-based insurance scores from twelve large insurance companies used for automobile or homeowners policies.</p> <p>Credit score data was aggregated at the ZIP code level. The data contained mean credit scores and the number of exposures for each of five equal credit score intervals. The study examined the bivariate relationship between credit score deciles and minority populations and per capita income in a ZIP code. A multivariate analysis was also completed that factored for race/ethnicity, income, and additional socioeconomic variables.</p> <p>The Missouri study found that credit-based insurance scores were correlated with the racial, ethnic, and income characteristics of ZIP codes. The report found that the use of credit-based insurance scores leads to significantly worse scores for residents of high minority ZIP Codes and for residents of low-income ZIP Codes. The correlations remained after controlling for education, income and marital status. The impact on pricing and availability of insurance was not studied in depth in the Missouri report.</p> <p>Criticisms of the Missouri study were that the study "ignores the fact that the variation of scores between individuals will dwarf any differences</p>	<p>This was <u>not</u> a comprehensive study. Indeed, the Missouri study did <u>not</u> match <u>actual</u> policyholders, credit scores, and demographic characteristics. Rather conclusions were inferred at a zip code level. Much of the analysis was done and conclusions reached using statistical modeling techniques, some of which have been critiqued in professional journals. The Missouri study was very limited with respect to the analysis of credit scoring. It also did not take into account positive marketplace indicators for CBIS in urban areas. During the period of time credit scoring had been used in Missouri, auto residual market policies, which historically were concentrated in urban areas, dwindled from over 14,000 to several hundred.</p> <p>Also, AIA offers the following observations of the MO study:</p> <ul style="list-style-type: none"> • The report is basically an analysis of average credit scores compared against aggregate demographic data by zip code, ignoring the strong correlation between insurance scores and insurance losses. The report does not address the very real and significant fact that consumers with good insurance scores benefit from insurer use of credit history. • The report disregards the interaction of credit information with traditional underwriting and rating variables, such as gender, age, territory, driving record, and vehicle type. Such multivariate analyses have shown that the use of credit-based insurance scores makes the actuarial process fairer and more accurate than methods based on other traditional variables alone. • The report declares that the aggregate level of analysis used "does not purport to make inferences about minority or lower-income individuals <i>per se</i>" but then proceeds to employ statistical techniques in an attempt to <u>claim</u> that the aggregate-level analysis is likely to apply to individuals.

<p>among average scores by race, income, or ZIP code. We expect that an analysis which accounted for the variation of scores among individuals would show virtually no relationship between insurance scores and race or income.”</p> <p>The study also assumed that most differences in average credit-based insurance scores between ZIP codes were from race, income and geography. The study did not attempt to determine the impact of credit-based income on loss propensity.</p>	<ul style="list-style-type: none"> • The report examines factors that insurers by law cannot use and that credit scoring models do not use – such as race and income. • The report alleges that territorial rating is restricted or prohibited for use in personal lines insurance. It is AIA’s understanding that all states permit the use of geographic area (territory), including California, where territorial differences in loss costs are a part of rating. <p>For additional, third party perspective on this study, please see a informative review by EPIC Consulting.</p>
<p><u>Texas Department of Insurance, “Use of Credit Information by Insurers in Texas: The Multivariate Analysis” (Jan. 31, 2005) and Texas Department of Insurance, “Use of Credit Information by Insurers in Texas” (Dec. 30, 2004)</u></p> <p>In 2004 and 2005, the Texas Department of Insurance conducted studies concerning the relationship between credit-based insurance scores and risk propensity for automobile and homeowner policies. The Department obtained data from six large insurance firms operating in Texas, using each company’s credit scoring model.</p> <p>The Department obtained race data for each consumer from the Texas Department of Public Safety and ethnicity data from a Hispanic surname match. The study used median income for the ZIP code in which policyholders lived.</p> <p>For automobile policies, the study found that credit-based insurance scores were negatively correlated with the total amount of claims. The report stated that insurers paid out less on automobile policies for customers with higher scores because they filed fewer claims than customers with lower scores. For homeowners insurance, the Texas study found that credit-based insurance scores were negatively correlated with the size of the claims and loss ratios.</p> <p>The multivariate analysis found that credit-based insurance scores were correlated with claims experience even after factoring for other variables.</p>	<p>The Texas analysis considered over two million Texas auto and homeowners insurance policies, credit scores and loss histories the findings on correlation to loss. Following are some additional highlights from the Texas:</p> <ul style="list-style-type: none"> • <u>Scoring Increases Accuracy and Allows For Better Classification and Rating of Risks Based on Claim Experience:</u> Credit scoring contributes additional predictive power and accuracy to the insurance rating process. Moreover, it is not merely duplicated by other important variables such as geography, age, marital status, and driving record, according to the TDI. • <u>Strongly Related to the Probability of Filing A Claim:</u> Consistent with other studies, the TDI Phase 2 report found that credit scoring is most predictive in the area of claim frequency. • <u>Auto Insurance:</u> The TDI study found that for personal auto liability, credit scoring is generally just as important as territory and driving record in terms of predicting future losses. • <u>Homeowners Insurance:</u> TDI found that credit scoring was one of several important rating variables, including territory, construction, and level of fire/theft protection for predicting future losses but was unable to draw conclusions on the relative ranking among the variables. • <u>Claims Experience Varies Significantly By Credit Score:</u> For both auto liability and homeowners, difference in claims

<p>The report found that losses for the 10 percent of policyholders with the worst credit-based insurance scores were 1.5 to 2 times higher than that of the 10 percent of policyholders with the best credit-based insurance scores. The study concluded that “By using credit score, insurers can better classify and rate risks based on differences in claim experience.”</p> <p>The study found that African Americans and Hispanics tended to have lower credit-based insurance scores than Asians and whites. African Americans and Hispanics combined to make up over 60% of consumers having the worst credit scores but only around 10% of the best scores. It did not find consistent results in terms of income.</p>	<p>experience by credit score in the Texas study was substantial. Typically, the claim experience for the 10 percent of policyholders with the worst credit scores was 1.5 to 2 times greater than that of the 10 percent of policyholders with the best credit scores.</p> <ul style="list-style-type: none"> • <u>Impact on Availability and Affordability:</u> In his summary letter transmitting the study to Texas Governor Perry and the legislature, Commissioner of Insurance Jose Montemayor noted “that banning credit scoring overnight, by rule or law, creates pricing and availability disruptions in a market that has just stabilized and begun to rebound. The same effect would occur if a narrow rate limits, or collar, due to credit scoring were adopted with immediate effect. Premiums would go up for a very large number of policyholders if the collar on credit scoring (or any other risk variable for that matter) is set too narrow, because it would force an immediate price shock unrelated to a change in risk.”
<p><u>Arkansas Insurance Department, “Use and Impact of Credit in Personal Lines Insurance Premiums Pursuant to Ark. Code Ann. § 23-67-415,” July 2007</u></p> <p>The Arkansas Insurance Department submitted a report to the state Legislature in July 2007. The state requires each insurance company to annually report the number of personal policies that received a premium increase and decrease due to credit scoring. The report found that a strong majority of insurers used credit in determining premium. The companies using credit history made up 94% of Arkansas’ market in 2006.</p> <p>Unlike most of the other state reports, the Arkansas report sought to discover how many consumers were helped and hurt by the use of credit-based insurance scores. During 2006, 30% of all policies received a premium reduction due to credit scoring and 9% received a premium</p>	<p>The most recent Arkansas study, dated July 2008, affirmed what the previous three years of studies showed and that is the vast majority of consumers either receive discounts and better rates from scoring or there is no effect at all. Fewer than one in ten Arkansas policyholders received rate increases because of their scores. It stated:</p> <p>...91% of consumers whose premium involved a credit component either received a lower premium or their premium was unaffected and “for those policies in which credit played some role in determining the final premium, those receiving a decrease outnumbered those who received an increase by 3.44 to 1.¹</p> <p>This finding contradicts frequent statements by consumer advocates that CBIS penalizes and increases rates for a large number of policyholders. The fact that CBIS has a neutral effect on the largest</p>

¹ “Use and Impact of Credit in Personal Lines Insurance Premiums Pursuant to Ark. Code Ann. §23-67-415”; A report to the Legislative Council and the Senate and House Committees on Insurance & Commerce of the Arkansas General Assembly by the Arkansas Insurance Dept. July 2007. The Arkansas Insurance Dept. examined approximately 1.8 million auto and nearly 500,000 homeowners policies. Arkansas enacted the National Conference of Insurance Legislators Model Act on Credit in 2003.

<p>increase due to credit scoring. The percentages were similar when broken out by individual lines of business. Although most consumers were either not affected or positively affected by the use of credit, the Arkansas Insurance Department was not able to report on whether those negatively impacted were disproportionately minority or low-income.</p>	<p>number of policyholders is an indication that although it increases accuracy and fairness, CBIS is one of many important rating factors utilized in auto and homeowners insurance rating, not a sledge hammer, or a sole determinant. The report should also note that for Arkansas policyholders where credit scoring did make a difference, those receiving discounts outnumbered those receiving increases by 3.33 to 1.</p>
<p><u>Federal Trade Commission, “Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance.” 2007</u></p> <p>The FTC, as required by Congress, studied whether credit-based insurance scores affect the availability and affordability of automobile and homeowners insurance. In July of 2007, the FTC released its report regarding automobile insurance. A study regarding homeowners insurance is currently being conducted by the FTC with a forthcoming release.</p> <p>The FTC used data from five insurers that had previously provided automobile data for the EPIC study. The information included data related to the policy and the driver, claims and a ChoicePoint Attract Standard Auto credit-based insurance score for the first named insured on the policy. The data related to automobile insurance policies in place between July 1, 2000, and June 30, 2001. The FTC combined the data from the five insurance companies with data on race and income data based on ZIP code.</p> <p>The FTC divided credit-based insurance scores into deciles and found that the average number of claims and average size of claims fell as scores rose. The FTC study attempted to control for other risk factors such as age and driving history and found that credit-based insurance scores continued to be correlated with loss ratios although the relationship lost some of its strength.</p> <p>The FTC report found that credit-based insurance scores are “effective predictors” of the number of automobile claims and the total cost of those claims. The report was not able to address the question of why credit-based insurance scores are an effective predictor of risk.</p> <p>The FTC report found that African Americans and Hispanics were</p>	<p>Contrary to the criticism leveled by some interest groups, the majority of the FTC (4 to 1) strongly supported the study and authorized it issuance. Indeed in Congressional hearings, the FTC continues to stand behind the report, its data and its findings.</p> <p>The FTC study was mainly criticized by consumer advocates in terms of the sample. In fact, insurers and the FTC worked carefully together on legal assurances regarding the quality and veracity of the data/sample. There was no “hand-picking” by the insurance industry. Samples were drawn according to research, actuarial and statistical standards.</p> <p>Other Benefits of CBIS acknowledged in the FTC Study but ignored in the description of this study by the NAIC. (See direct quotes below.)</p> <ul style="list-style-type: none"> • Score may reduce the extent of adverse selection and make insurance markets more efficient. • Innovation in risk prediction techniques like credit-based insurance scores may affect the availability of insurance and some of the costs association with selling insurance. • Consumers may have a broader range of options to choose from when purchasing insurance. • Because credit-based insurance scores predict risk more accurately for consumers, insurance companies may be willing to offer coverage to some higher-risk consumers. • In addition, credit-based insurance scores may make the process of underwriting and rating quicker and cheaper, and competition between insurance companies may cause cost

strongly overrepresented in the lowest credit-based insurance score deciles and under-represented in the highest credit-based insurance score deciles. Nonetheless the FTC found that credit-based insurance scores have only “a small effect as a proxy” for membership in racial groups. The FTC found that the relationship between credit-based insurance scores and claims risk remained strong even when controlling for race, ethnicity and income.

In models without controls for race, the FTC found average predicted risks for African Americans and Hispanics to be 10% and 4.2% higher than if scores were not used. In models with controls for race, these groups had average predicted risk 8.9% and 3.5% higher than if scores were not used. The FTC acknowledges that “The difference between these two predictions for African Americans and Hispanics (1.1% and 0.7%, respectively) is a measure of the effect of scores on these groups that is attributable to scores serving as a statistical proxy for race and ethnicity.” So the FTC study does find a proxy effect for race but it believes the effect is a small one.

The FTC was not able to develop its own model using credit-based insurance scores to effectively predict risk while decreasing differences in scores among racial groups.

The FTC report claims that credit-based insurance scores may have benefits to consumers. Through the use of these scores, companies are able to measure risk more accurately, which may lead insurers to offer insurance to higher-risk consumers. Insurers may also be able to offer coverage more efficiently and more cheaply, passing along savings to consumers. The FTC was not able to quantify these benefits.

The FTC study was criticized for failing to obtain a comprehensive and independent data set of claims related data. Some critics argued that the data was “hand-picked by the insurance industry.”¹⁵ Also, the FTC report did not address the question of insurance availability and affordability. The FTC was not able to create a model to show alternatives to credit-based insurance scores that are predictive of claims but do not use credit information and do not have disproportionate impact on minorities or low income consumers. It is also important to note that though the FTC stated there was a “small” proxy

savings from these process improvements to be passed on to consumers in the form of lower premiums.

- Several firms, including the Hartford and MetLife Home and Auto, have stated that the use of credit-based risk scores enabled them to offer policies to higher-risk consumers than they had previously. This could lead to higher-risk consumers having more choices as they shop for insurance.
- Further, banning the use of factors that are known to be correlated with risk could have negative effects on insurance markets. If firms cannot adjust prices based on the risk associated with a characteristic, they will have an incentive to refuse to offer policies to people with the characteristics.
- This could cause firms to expend resources on finding ways to avoid higher-risk consumers, reducing the availability of insurance to higher-risk consumers....
- Figure 7 in the FTC shows that the state-run program (auto residual markets) fell during the second half of the 1990s, as scores were being introduced, and then leveled off after 2000.

	<p>effect, the data did show that certain minority groups could be adversely affected by the use of credit-based insurance scores.</p>
<p><u>Brockett, Patrick L. and Linda L. Golden, "Biological and Psychobehavioral Correlates of Credit Scores and Automobile Insurance Losses: Toward an Explication of Why Credit Scoring Works," The Journal of Risk and Ins., 2007, Vol. 74, No. 1, 23-63. ...</u></p>	
<p>VI. LITIGATION</p>	
<p><u>Willes v. State Farm Fire and Casualty Co., 512 F.3d 565 (Jan. 9, 2008) ...</u></p>	
<p><u>Alaska Dep't. of Commerce v. Progressive Cas. Ins. Co., 2007 WL 2333341 (Alaska August 17, 2007) ...</u></p>	
<p><u>Safeco Ins. Co. v. Burr, 127 S.Ct. 2201 (U.S. June 4, 2007) ...</u></p>	
<p><u>DeHoyos v. Allstate Corp., 240 F.R.D. 269 (W.D. Tex. Feb. 21, 2007)</u></p>	
<p>The Western District Court of Texas approved the settlement agreement entered into by the parties in late 2006. This settlement was brokered after plaintiffs sued Allstate, alleging that its credit scoring procedure resulted in discriminatory action against approximately 5 million African-American and Hispanic customers nationwide. Allstate denies any discrimination occurred and maintains that its use of information from credit reports is valid. The settlement provides for the following: a new algorithm for calculating premiums, an appeals process for those with resulting adverse credit information, funding for education, media and marketing, and monetary relief ranging from \$50 to \$150 per class member.</p>	<p>The description of the DeHoyos case should mention that CBIS may continue to be used. AIA suggests adding to the end of this paragraph: Allstate was permitted to continue to use CBIS, albeit with some modifications to its program.</p>
<p>VII. Conclusion</p>	<p>This section should be entirely deleted or re-written to eliminate the unsubstantiated allegations and to reflect the facts and the substance of the report. The fact is that there have been many public and private studies and they have all substantiated the risk relatedness of CBIS. Also as the report itself must admit, there has never been a finding by a court <u>under the law</u> that CBIS are discriminatory. No further study therefore is warranted. Continuing to repeat unsupported accusations for the purpose of justifying more regulatory activity not only is disingenuous but is destructive of public confidence in the regulatory system and worst of all, siphons off regulatory resources from where they are most needed, as documented by recent events--assuring</p>

<p>solvency.</p>	
<p>This section continues to imply in places that the numerous research reports still have not included a “true multivariate” analysis. The report should try either to explain why the EPIC, Texas, and FTC studies were not multivariate analyses or drop this assertion.</p>	<p>Valid criticisms exist questioning whether true multivariate analyses have been conducted to eliminate the possibility that credit-based insurance scores act as a proxy for variables that are already being measured or ones that should not be used, such as income or race. Until multivariate analyses have been conducted, the question of how much impact credit-based insurance scores have on loss experience will not be answered fully.</p>
<p>These statements are not supported. Not all studies looked at demographic information; some went to the correlation issue alone. None of the studies found actual discrimination. In fact, the objectivity and accuracy of CBIS has been documented by each and every one of the studies. Additionally, as the numerous Arkansas studies show, many consumers are not impacted by CBIS and most benefit. The entire population has benefitted from shrinking residual markets – evidence of greater availability and affordability.</p>	<p>In addition, most studies seem to acknowledge that credit-based insurance scores are correlated with race and income. Certain minority groups as well as low income populations tend to have lower credit-based insurance scores. This leads to low income and minority populations having availability and affordability issues when it comes to insurance.</p>
<p>The discussion of “proxy” is misleading, implying that it is a legally recognized basis on which regulators can and should act. Indeed, it is not. The mere statistical happenstance of the application of a race and income neutral factor does not prove anything at all. Further, even the so-called “proxy effect” has serious qualifications in the FTC report, not at all accurately reflected in these statements. See the Congressional testimony submitted by Lawrence S. Powell, Ph.D. Whitbeck-Beyer Chair of Insurance and Financial Services University of Arkansas-Little Rock from earlier this year to the Oversight and Investigations Subcommittee. While the NAIC has indicated that it is not generally looking to testimony and other non-studies in this paper. Dr. Powell’s insights are new and useful. They shed light on the weaknesses of the “proxy effect” discussion. In particular, he questions the possible finding of a small effect given that it is based off of</p>	<p>Several studies have found that credit-based insurance scores may serve to some extent as a proxy for race or income. Because insurers cannot use race or income as rating or underwriting factors, perhaps credit-based insurance scores are being used as a proxy for race or income. If this is the case, it may be that credit-based insurance scores should not be allowed by state regulators – just as race is no longer allowed in life insurance regardless of any actuarial validity.</p>

<p>A large concern of consumers and regulators is that credit-based insurance scores may be used primarily as a tool to predict profitability of customers. Even if credit-based insurance scores have some correlation with risk propensity, the larger issue might be how effective credit-based insurance scoring is in measuring loyal or high income consumers who are less likely to make an insurance claim. Such a measure is contrary to the typical risk variables that are used in risk prevention. For instance, charging drivers more based on past accidents is a way to influence future behavior, i.e., safer driving. Charging consumers more because they are less loyal or wealthy is contrary to the notion of risk prevention because a consumer can not change their behavior and aid in loss prevention. If credit-based insurance scores are merely used as a profitability measure regulators may wish to decide if this is truly best for the overall consumer good.</p>	<p>extrapolations from different coverages rather than the coverages at issue.</p> <p>The statements imply that there must be something wrong in a very competitive market such as auto and homeowners insurance with using tools, rating and underwriting in trying to maintain solvency, profitability, and avoiding losses that would make it difficult to continue writing insurance as broadly as possible.</p> <p>It also contradicts reports and testimony by insurers who have noted that scoring provides the ability to write and compete in a broader range of the marketplace, including policyholders that may have greater risk. This benefit increases insurance ability. Therefore the assertion that there is something wrong with one aspect of CBIS that may allow insurers to compete more effectively, profitably and broadly, while increasing efficiency and pricing more accurately is misplaced.</p>
<p>Possible Future Research</p> <p>Although there has been a fair amount of research related to credit-based insurance scoring and loss propensity and effects on consumers, more can be studied. The FTC thus far has been unable to create a model to recreate credit-based insurance scores without affecting race and income groups. The forthcoming FTC study may attempt to create a model. It is unknown for certain whether insurers can get the same results without using credit-based insurance scores. Unfortunately, it is difficult for regulators or others to truly test the effects of credit-based insurance scoring because insurers hold their models to be trade secrets and thus proprietary.</p> <p>Future studies could add valuable information to the existing literature and aid regulators in deciding what public policy stances to take with respect to the use of credit-based insurance scores. Two aspects could use additional research. The first is determining, through a multivariate analysis, the exact nature of credit-based insurance scores and how they work. Within this, additional study is needed into whether credit-based insurance scores are correlated with risk factors already taken into account by insurers. Analyzing actual models utilized by insurers would be the most accurate way to study the full effect of credit-based</p>	<p>There is no demonstrated need for further state or NAIC study. No issue that we know of has been studied more. Yet, the findings all bear out the risk assessment value. In addition, no study or court has found CBIS to violate the law. Further study of this issue may please particular special interest groups, but it would waste regulatory resources that should be focused on other issues, such as solvency regulation.</p>
<p>Future studies could add valuable information to the existing literature and aid regulators in deciding what public policy stances to take with respect to the use of credit-based insurance scores. Two aspects could use additional research. The first is determining, through a multivariate analysis, the exact nature of credit-based insurance scores and how they work. Within this, additional study is needed into whether credit-based insurance scores are correlated with risk factors already taken into account by insurers. Analyzing actual models utilized by insurers would be the most accurate way to study the full effect of credit-based</p>	<p>No additional state or NAIC studies are needed. Regulators have the power and the tools to identify and deal with any problems, should they emerge, under existing law and regulation.</p>

<p>insurance scoring.</p> <p>When conducting an analysis of the predictive powers of credit-based insurance scores it is important that the researchers also consider whether credit-based insurance scores are primarily being used for profitability reasons. On its face, credit-based insurance scoring may seem to be predictive of loss ratios but it may be that the underlying effect of using credit-based insurance scores is to find more profitable customers. These customers may be more profitable not due to consumers having fewer or less severe losses but because those consumers report losses less frequently or are more “loyal” to their insurance company. This reason is in contrast with the role of loss prevention for insurance. In this case insurers are no longer pricing risk but pricing profitability. Such a situation, if discovered, would need to be considered fully by regulators as they likely would look on credit-based insurance scores differently.</p>	<p>See discussion elsewhere on profitability.</p>
<p>The importance of credit-based insurance scoring on minority populations remains an important and timely issue. A bill introduced in Congress (HR 5633) would amend the Fair Credit Report Act (FCRA) to prohibit the use of credit information in underwriting or rating personal lines of insurance if the FTC finds that the use of credit information results in “racial or ethnic discrimination” or “represents a proxy or proxy effect for race or ethnicity.” The bill goes on to define the term “proxy for race or ethnicity” as “a substitute or stand-in for race or ethnicity, either by design or in effect, without regard to the extent of the effect.”</p>	<p>No study or judicial decision has found that CBIS constitute unlawful discrimination. In fact, just the opposite, as most recently reiterated in the FTC auto study and as forcefully pointed out by Texas Commissioner Montemayor. The so-called “proxy effect” is a complicated statistical construct that has not been shown to be material or relevant except in the rhetorical sense, and even if relevant, the evidence for its existence is anything but strong. In any event, a “proxy effect” does not make a case of discrimination, as the law defines it. To repeat inflammatory and contested accusations of questionable relevance is to mislead the readers of this report on issues of critical concern to all of us.</p>
<p>Additional research could be done on how the use of credit-based insurance scores by insurers affects minority groups and lower income groups. Most of the research shows that these groups do experience some negative impact due to the use of credit-based insurance scores. In order to do this, a study would likely need to analyze actual models used by insurers. In 2002, the Risk Classification Subcommittee of the American Academy of Actuaries (AAA), at the request of the NAIC’s Credit Scoring Working Group, defined objectives for a possible study concerning credit-based insurance scores. The subcommittee stressed that a future study would need to decide how to measure</p>	<p>These paragraphs should be deleted in their entirety. As currently written, they are inconsistent with the facts and even with much of this report.</p> <p>Such research would be useless, because this is not the legal test.</p>

<p>disproportionate impact and what magnitude of impact would cause concern.</p> <p>The AAA Report defined “disproportionate” impact as a rating tool that “results in higher or lower rates, on average, for a protected class, controlling for other distributional differences.” The report defined “disparate” impact as resulting in “substantial disproportionate impact” with no business necessity for the practice.¹⁶ The term disparate impact has also been used in recent proposed legislation, although an exact definition has not been defined in that legislation.</p>	<p>An informal AAA definition does not rise to the level of an actuarial standard of practice or other peer reviewed and tested concept</p>
<p>If a disproportionate impact is found due to credit-based insurance scores it may be sufficient for regulators to give further consideration to the practice of using credit-based insurance scores. Even if there are actuarial sound reasons for using credit-based insurance scores, public policy concerns may provide enough reason to restrict or eliminate the use of credit-based insurance scores.</p>	<p>“Disproportionate impact” is not a legal standard and it should not be the basis for any regulatory action. The legal standard is “disparate impact”, where applicable. Public policy and the laws are legislative functions, not regulatory. If CBIS complies with the law, that is the end of the matter.</p>
<p>Additional multivariate analyses, possibly utilizing actual models from insurers, could provide regulators and the public with additional information explaining 1) whether credit-based insurance scores alone truly influence loss experiences and 2) whether the use of credit-based insurance scores has a disproportionate impact on certain minority or low-income populations. This additional research will allow regulators to make more informed decisions concerning the use of credit-based insurance scores.</p>	<p>Multivariate studies have already been done. Further state or NAIC research wastes public and private resources. Again, the paper repeats a special interest advocacy term “disproportionate impact” that has no legal significance and cannot be the basis of action by regulators.</p>

Appendix / Chart Outlining Study/Report Major Findings

Study / Draft Report	Comment
<p>...</p> <p>“A Report to the Legislature, Effect of Credit Scoring on Auto Insurance Underwriting and Pricing,” Washington Office of Insurance Commissioner, Prepared by: Washington State University, Social & Economic Sciences, Research Center, Dave Pavelchek, PRR Inc. Bruce Brown, January 2003</p> <p>“In almost every analysis, older drivers have, on average, higher credit</p>	<p>Quotes are not the best approach – they may not put the size, scope, caveats and findings of the previous research into perspective.</p> <p>This quote does not put the paper in context. Please re-read the report with an eye toward the stated limitations. AIA is happy to discuss.</p> <p>The report indicated that there is “no general correlation between incomes and credit score rate adjustments across all income levels.”</p> <p>The Washington report notes that “relatively small numbers of ethnic minorities and the number of refusals and unclassifiable survey</p>

<p>scores, lower credit-based rate assignments, and less likelihood of lacking a valid credit score. Income is also a significant factor. Credit scores and premium costs improve as income rises. People in the lowest income categories – less than \$20,000 per year and between \$20,000 and \$35,000 per year – often experienced higher premiums and lower credit scores. More people in lower income categories also lacked sufficient credit history to have a credit score.”</p> <p>...</p>	<p>responses” made it difficult to pin down any statistical significance between minority status and CBIS.</p>
<p>Kabler, Brent, “Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri,” 2004</p> <p>“Credit scores are significantly correlated with minority status and income, as well as a host of other socio-economic characteristics, the most prominent of which are age, marital status and educational attainment.”</p>	<p>The Missouri study cannot actually make any conclusions on correlations of scores with race, income, and other socio economic characteristics, because it does not match actual scores with real people and policyholders. Statistical inferences are made at the broad zip code level. The study ignores a dramatic decline in auto residual market policies in Missouri during the period of time that CBIS was introduced in the state. This decline indicates that availability increased in urban areas of Missouri.</p>
<p>Texas Department of Insurance, “Use of Credit Information by Insurers in Texas: The Multivariate Analysis” (Jan. 31, 2005) and Texas Department of Insurance, “Use of Credit Information by Insurers in Texas” (Dec. 30, 2004)</p> <p>“The average credit scores for Whites and Asians are better than those for Blacks and Hispanics. In addition, Blacks and Hispanics tend to be overrepresented in the worse credit score categories and underrepresented in the better credit score categories.”</p>	<p>The Texas analysis considered over two million Texas auto and homeowners insurance policies, credit scores and loss histories the findings on correlation to loss. Following are some additional highlights from the Texas :</p> <ul style="list-style-type: none"> • Scoring Increases Accuracy and Allows For Better Classification and Rating of Risks Based on Claim Experience: Credit scoring contributes additional predictive power and accuracy to the insurance rating process. Moreover, it is not merely duplicated by other important variables such as geography, age, marital status, and driving record, according to the TDI. • The Texas commissioner concluded that banning or greatly restricting the use of credit would greatly damage a market that showed increasing competition and consumer benefits, and had recovered from earlier problems. A ban would raise auto and homeowners insurance costs for a sizable number of Texans.
<p>...</p> <p>Federal Trade Commission, “Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance,” 2007</p>	<p>We suggest adding the following clarification’s in the NAIC’s descriptions of the FTC’s findings on race, ethnicity and proxy. See also the Congressional testimony of Arkansas Professor Lars Powell on</p>

"Credit-based insurance scores appear to have little effect as a 'proxy' for membership in racial and ethnic groups in decisions related to insurance."

"Credit-based insurance scores are distributed differently among racial and ethnic groups, and this difference is likely to have an effect on the insurance premiums that these groups pay, on average."

proxy issues in the FTC study.

Scores as a Proxy for Race and Ethnicity, pages 61-72

"On the other hand, if scores do predict risk within groups, then they do not serve as a proxy if used to assess risk for all consumers.... (With reference to Table 14)... Because they show that scores predict risk within groups, these results show that credit-based insurance scores do not predict risk solely by acting as a proxy for membership in racial and ethnic groups."

"The large differences in average risk on comprehensive coverage for Hispanics and African Americans should be treated with some caution, as the geographic risk variable in the FTC database is not a very effective control for geographic variation in risk on comprehensive coverage."

Test for... Existence of a Proxy Effect, page 67-68

"The only statistically significant difference was that the estimate relative risk for the lowest score decile was larger when protected class controls were included in the model. This is opposite of the change that would occur if scores were acting as a proxy."

"The FTC's analysis revealed that including these controls (for race, ethnicity, and income) did reduce somewhat the effect of scores on predicted risk for three coverages. The results show, however, that scores do continue to predict claims strongly if controls for race, ethnicity, and income are included in the risk models, which means that scores do not predict risk primarily by acting as a proxy for these characteristics." --p 68

* * * * *

In closing, if it is going to be issued, the paper should be significantly revised. As currently drafted, it is not only internally inconsistent, but in some places, it lacks objectivity. In addition, it includes rhetoric containing novel concepts and theories that have little or no relationship to the law that regulators must implement. The vast majority of state legislatures and/or regulators have already enacted balanced CBIS requirements. Not only is no further state or NAIC research needed, but today regulators already have all the tools they need to address any concerns.

Sincerely,

Jeffrey Junkas,
Director of Public Affairs
Midwest Region

David Snyder,
Vice President &
Assistant General Counsel

David Unnewehr,
Assistant Vice President
Policy Development & Research

Enclosure