# Score Wars:

## Consumers Caught in the Crossfire
## The Case for Banning the Use of Credit Information in Insurance

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# Introduction

This report examines the use of credit information in the underwriting and pricing of insurance and its negative impact on consumers.[1] The impact of credit data on insurance decisions such as coverage and premiums varies from insurer to insurer and from state to state, depending upon insurer practices and varying laws and regulations. Nonetheless, the common thread is the use of consumer data that is credit-based and how this impacts consumers in any state that permits this use. This report discusses why using credit information is both unfair to consumers and unnecessary, examines trends in state laws over the last four years, discusses the flaws in the model law touted by the industry, offers a model state law to protect consumers, and provides additional suggestions for protecting consumers from the unfair use of credit information in insurance decisions.

Credit scores,[2] based upon information contained in an individual's consumer report (also commonly referred to as a "credit report"), were developed for use by lenders to predict how likely it is that a prospective borrower will default on a loan. This technology has allowed lenders to speed up the process of granting credit by using a credit score as an indicator of a borrower's creditworthiness, though there are still significant fairness issues for consumers with credit scores. Today, most consumers understand that creditors consider credit histories when deciding whether to grant credit to the consumer and on what terms.

But what happens when credit information is converted into an insurance score[3] or is used in some other way to make decisions about providing an essential consumer product, such as homeowners or automobile insurance, that is not related to granting credit? Credit-based underwriting and pricing in insurance is becoming increasingly commonplace, but at a high price to consumers. Consumers Union opposes both the practice and the sanctioning of this practice because using credit information as the basis to make decisions about insurance is both unnecessary and unfair to consumers. Using credit information in insurance decisions leads to a discriminatory impact which makes insurance more expensive for low-income consumers and for members of some minority groups who are otherwise good insurance risks. The practice is unnecessary because insurers have many other rating and underwriting factors at their disposal to properly rate a policy. There is no need to use a factor that has a discriminatory impact and

[1] This insurance industry practice can involve the use of a consumer's information taken directly from a consumer's credit file, consumer information reported to another through a credit report or in the form of a credit score, or through the calculation of an insurance score, which is based in part upon information derived from a consumer's credit file.

[2] The Fair Credit Reporting Act (FCRA) defines a "credit score" as: A numerical value or categorization derived from a statistical tool or modeling system used by a person who makes or arranges a loan to predict the likelihood of certain credit behaviors, including default (and the numerical value or the categorization derived from such analysis may also be referred to as a "risk predictor" or "risk score." 15 U.S.C.S. § 1681g (f)(2)

[3] According to the Insurance Information Institute, an "insurance score is a numerical ranking based on a person's credit history." *See* http://www.iii.org/media/hottopics/insurance/creditscoring/.

makes essential insurance products, such as homeowners and automobile insurance, less affordable thus less available for consumers.

Increasingly, credit scores and credit information are being used for purposes other than determining whether a consumer will default on a loan or make late payments. Many insurance companies use consumers' credit information to determine whether they will offer homeowners and automobile insurance to consumers, and at what price. Bankrate.com reported in 2003 that insurance industry consultants, Conning & Co. found that "ninety-two of the 100 largest personal auto insurance companies in the country use credit data in underwriting new business."[4] For existing policyholders, insurers also use credit information to make decisions about non-renewing policies or hiking premium rates.

In addition to considering an individual's credit score, many insurers use an "insurance score" which is derived, in part, from information contained in a consumer's credit history. Companies such as Fair, Isaac and Co., provide the credit bureaus with the formulas to develop insurance scores. Some insurance companies use their own models. The credit bureaus run the score using the formulas developed by an insurance company or another model provider. Then the credit reporting bureaus sell the consumers' insurance scores to the insurance companies. Insurers do not see an individual consumer's credit file, but information contained in the consumer's credit file affects the price of insurance.

Federal law and a few states give consumers the right to obtain their credit scores, but no similar law exists for insurance scores. Insurance scores thus remain the ultimate black-box. Insurance companies are not required to provide consumers with the score or how it was calculated. Insurers also are not required to follow uniform standards when calculating insurance scores, so individual scores and what data is used to calculate them can vary significantly from insurer to insurer. This leaves consumers largely in the dark about what they can do differently, as responsible drivers or homeowners, to improve an insurance score.

There are many serious underlying problems when insurance companies use consumer credit information to decide who gets insurance and how much it will cost. The most serious concerns (discussed more fully in this report) are:

- ♦ insurers cannot show a logical, causal link between credit scores and risk and without a causal link, this rating factor has the potential to be unfairly discriminatory;

- ♦ a high percentage of credit files contain serious errors which can artificially depress credit scores and consumers are concerned that inaccurate or even accurate information about them is being used to limit their opportunities;[5]

[4] Lucy Lazarone, *Auto Insurers Use Your Credit History to Determine Rates*, Bankrate.com, April, 21, 2003, (available at http://www.bankrate.com/brm/news/auto/20011107a.asp). Also, see *Guess Who's Looking at Your Credit Report*, (available at http://www.smartmoney.com/consumer/index.cfm?story=20010820).

[5] *Credit Score Accuracy and Implications for Consumers*, Consumer Federation of America, and National Credit Reporting Association, December 17, 2002, (available at http://www.consumerfed.org/pdfs/121702CFA_NCRA_Credit_Score_Report_Final.pdf); *Mistakes Do*

- credit scoring does not benefit most insurance consumers, in fact, many consumers getting so-called credit scoring discounts *pay more* for insurance than they did before credit scores were used,[6] and;

- using credit scores can result in unfair discrimination because certain score ranges can be associated with an individual's race or income. Low credit scores tend to be concentrated in low-income neighborhoods and in certain minority communities. Otherwise good drivers or responsible homeowners from low-income or minority communities are more likely to bear the burden of 20-50% surcharges,[7] simply because of lower credit scores.

The insurance industry defends the practice of using credit information in insurance decisions. They claim it provides speed and efficiency. They say that most consumers are benefited by using credit data and that using such information allows insurance companies to more accurately and quickly rate an individual's insurance risk. Insurers contend that speed and efficiency translate into cost savings to insurers which helps insurance companies gain a competitive edge in the marketplace.

A representative of Fair, Issac, Co., a prominent provider of insurance scoring models, noted that insurance scores can be very useful to insurers as a way to boost profitability. He described insurance scores as "an extremely powerful and useful tool"[8] noting that, "an insurer's ultimate goal is to do everything possible to retain profitable customers while working toward improving—or losing—unprofitable customers."[9] Other touted benefits of insurance scoring models are that they provide a means to "target prospects who will generate value . . . [and provide] an efficient means of matching appropriate offers to policyholder risk and of eliminating high-risk, low-profit prospects."[10] Finally, the representative asserts that insurance scores can help insurance companies decide, "should this person be reviewed more carefully during underwriting, or targeted for cross-selling, or fast-tracked for claims handling?"[11] In other words, insurance scoring models, which incorporate credit-based data, provide a way for insurance companies to decide which consumers to serve, and how to serve them, based upon the profitability that a consumer may return to the company.

In support of its position that using credit-based data in insurance is an appropriate business practice, the industry frequently points to a 2004-2005 Texas Department of Insurance study,[12]

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*Happen: A Look at Errors in Consumer Credit Reports*, National Association of State PIRGS, June 2004, (available at http://uspirg.org/reports/MistakesDoHappen2004.pdf).

[6] Birny Birnbaum, *Insurance Credit Scoring: An Unfair Practice*, April 2004.

[7] For information on the degree of surcharges on those who do not qualify for credit scoring discounts, see Lazarone, *supra* note 4.

[8] Lamont D. Boyd, *Expanded Use of Credit-Based Insurance Scores—Boosting P&C Profitability*, Today's Insurance Professionals, Winter 2003, at 1, (available at http://www.fairisaac.com/NR/rdonlyres/31E747C2-6777-4715-A7D5-95180E4A3046/0/ExpandedUseInsuranceAR.pdf

[9] *Id*.

[10] *Id*.

[11] *Id*.at 2.

[12] *Use of Credit Information in Texas*, Texas Department of Insurance, December 30, 2004, (available at

referred to hereafter as the Texas Study, that found a correlation between low credit scores and increased insurance claims filing. The same study also found that using credit scores had a disproportionate impact on certain minorities and low-income individuals. Nonetheless, Texas law permitted the use of credit scoring despite the opposition expressed by a diverse coalition of advocacy groups that felt that "regardless if a link was found, the legislature should end the unfair and discriminatory use of underwriting practices, including credit scoring."[13] Indeed, the findings of a correlation between claims filing and credit scores fails to resolve the serious underlying concerns noted above.

A chief economist for the Insurance Information Institute has described the use of factors such as credit information for setting rates as part of an insurance industry "technology arms race." The motivator, he said, is that insurers gain a competitive edge if they can "more accurately assess risk and price better" than rivals.[14] While insurers are preoccupied with gaining a competitive advantage over one another, consumers are getting caught in the crossfire.

We do not believe insurers should be allowed to use credit as a rating or underwriting factor simply because, at best, it is actuarially justifiable. Most states do not have laws that adequately protect consumers from the practice. The insurance industry supported National Conference of Insurance Legislators (NCOIL) model law, which has been adopted in various forms in 26 states, fails to protect consumers from the serious unresolved concerns with using credit data in insurance decisions. Legislators and regulators should prohibit the use of credit data as the basis for an underwriting or rating factor because there is a high probability that credit data will be inaccurate, using credit data results in an unfair discriminatory impact, the benefits are illusory, the practice is unnecessary, and its use interferes with the availability and fair pricing of essential insurance coverage.

**Consumers Union recommends:**

1. States should pass a ban against the use of credit information in insurance underwriting or rating for personal lines of insurance.
2. Legislatures with state laws based on the NCOIL model should repeal those laws.
3. In an effort to protect the victims of Hurricanes Katrina and Rita, the states of Texas, Louisiana, Alabama, Mississippi and Florida should pass an immediate moratorium on the use of credit information in insurance decisions.
4. All state laws that contain an NCOIL exceptional circumstances exemption should be modified to make the exception apply automatically to all individuals residing in a

http://www.tdi.state.tx.us/reports/pdf/creditall04.pdf); *Supplemental Report to the 79th Legislature—Use of Credit Information by Insurers in Texas*, Texas Department of Insurance, January 31, 2005, (available at http://www.tdi.state.tx.us/reports/pdf/credit05sup.pdf).

[13] *Advocacy Groups Call for End to Discriminatory Insurance Practices: TDI Report Shows Use of Credit Scoring is Discriminatory, Direct Link to Risk Unproven*, Texas Watch, January 10, 2005, (available at http://www.texaswatch.org/media/release011005.htm).

[14] Sheryl Jean, *Insurers Using Many New Factors to Set Prices*, Contra Costa Times, February 9, 2006, (available at http://www.charlotte.com/mld/cctimes/news/nation/13972124.htm?source=rss&channel=cctimes_nation).

declared disaster area, for a period of no less than 36 months, while retaining the right of individuals to request the exemption based on individual life circumstances.

5. Insurance Commissioners who have the authority to do so should adopt regulations banning the use of credit information in insurance underwriting and rating.

6. Insurance Commissioners should require insurers using credit information to file their models annually with the regulator's office and the commissioners must have these models tested by an independent actuary not affiliated with the insurance industry. As in Florida, insurers using credit or insurance scoring models should be required to show that the use of such models does not does not disproportionately affect persons of any race, color, religion, gender, age or place of residence. The results should be made public and released in a joint report to the National Association of Insurance Commissioners.

7. When applying for insurance, consumers should refuse to grant permission to their insurers to access consumer credit files to be used in making insurance related decisions. Consumers should refrain from giving their social security number to insurance companies to prevent it from being used to obtain credit information.

# I. Revisiting the Issue from the Consumer Perspective - Reasons for Banning Credit-Based Underwriting and Pricing in Homeowners and Automobile Insurance

While a significant majority of consumers do not know that their credit histories could impact their insurance rates, when consumers do become aware, they are often quite shocked to learn that their insurer is, or may be, using credit information to underwrite or rate an auto or homeowners' insurance policy. Consistent with what the insurance industry has known all along, consumers oppose the practice citing irrelevance, unfairness and invasion of privacy concerns.[15]

Section A. discusses in detail the many reasons why using credit information to provide or rate insurance coverage is fundamentally unfair to consumers and should be stopped: Its use makes auto and homeowners insurance less available or higher priced for many low-income or minority individuals who are good drivers and responsible homeowners; discounts aren't always genuine and those who don't qualify for them pay an even heftier price; underlying credit data on which the practice relies upon is notoriously inaccurate; insurance scoring models are secret, making it difficult for a consumer to alter behavior to increase a score; and policyholders who insurers believe might legitimately use the insurance policies they pay for are penalized unfairly through credit scoring.

Section B. discusses why the practice is unnecessary. Specifically, insurance companies can already charge you more if you make frequent claims, and insurers have many other options besides using credit scoring to protect their interests without unfairly impacting consumers.

## A. Using Credit-Based Information in Insurance Rating and Underwriting is Unfair to Consumers

### *1. Credit Scoring—evidence of the race and income connection and a disproportionate impact on minorities and the poor*

The insurance industry describes consumer credit files as a race and income neutral source for obtaining credit history.[16] It is true that consumer credit files do not contain direct information about an individual's race or income; however, using credit information can result in a discriminatory impact upon members of certain minority groups and low-income individuals. Even though credit information can be "race and income neutral" on its face, credit information

[15] Joseph J. Annotti, Fo*cus Group Research on the Use of Credit-based Insurance Scores*, Address at Midwestern Actuarial Forum Fall 2002 Meeting, (2002) (available at http://www.casact.org/affiliates/maf/0902/annotti1.ppt#1). At the time of the presentation, Mr. Annotti was the Assistant Vice President of Public Affairs/Grass Roots for the National Association of Independent Insurers (NAII).
[16] *See*, *Credit Scoring, The Topic*, Insurance Information Institute, June 2006, at 1, (available at http://www.iii.org/media/hottopics/insurance/creditscoring/).

can function as a proxy for race and income. Whether discrimination results from intentional conduct or is inadvertent, its impact must be carefully considered and addressed.[17]

A credit score can function as a proxy for race when it is likely that certain score ranges are associated with an individual's race. A recent study documented this connection. In an examination of quarterly sample of 25 million anonymous consumer credit reports and scores for every U.S. County between 1999 and 2004, The Brookings Institution recently found that "counties with relatively high proportions of racial and ethnic minorities are more likely to have lower average credit scores." The report notes that this association did not show that a bias exists or that there is a causal relationship between race and credit scores. The report explained:

> Instead, this association reflects the numerous, historical disparities between races in the access to the availability of high quality education, well-paying jobs, and access to loans, among other factors. But the presence of this relationship does raise important questions that should be explored through further research, particularly in instances where information in reports are being used in nontraditional, under-researched market application, like screening job applicants and pricing insurance.[18]

Others have examined the relationship between income and race and credit scores. In 2004, the Missouri Department of Insurance studied the impact of credit score use on predominantly low-income and minority communities in Missouri, in response to concerns expressed by regulators and consumer groups that the use of credit scores may restrict the availability of essential insurance products in these communities. The Missouri study was based upon information from the 20 largest homeowner and automobile insurers that used credit scoring as a significant part of their underwriting and rating criteria between 1991 and 2001. Among the key findings:

When looking at the data in the aggregate, based upon zip code characteristics that the author reports as producing "valid inferences about 'individuals that reside in poorer ZIP Codes,' or 'individuals that reside in areas with large minority concentrations,' but not about minority individuals or poor individuals per se;"[19]

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[17] A representative of the insurance industry disagrees that a disparate impact theory of discrimination is applicable to issue of credit scoring in insurance. *See*, Robert Detlefsen, "*Disparate Impact" Theory Provides No Support for Banning Credit Scoring in Insurance*, April 8, 2005, (available at http://www.namic.org/pdf//050408WLFCreditScoringDispImpact.pdf). This position is based in part on equating the use of credit-based data by insurers to the use by lenders and credit card issuers who use "race-neutral data" that may produce a disparate impact. The author ignores a major distinction between the two. Using an individual's debt repayment history for credit purposes is more easily defended as a legitimate business use of credit data. Using credit data to predict insurance loss is less compelling since it involves using credit data for a non-credit purpose. Insurers are not considering the information for debt repayment purposes since premiums are generally paid in advance. The remedy for an insurer if an insured does not pay premiums that are due is to discontinue coverage. A lender, on the other hand, places much greater reliance on credit information to protect against the risk of non-repayment inherent in a credit transaction.

[18] *Id*. at 10.

[19] Brent Kabler, *Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri*, Missouri Department of Insurance, 2004, at 16, (available at http://insurance.mo.gov/reports/credscore.pdf).

1. Mean credit scores are significantly correlated with the minority concentration in a Zip Code.
2. Mean credit scores are correlated with socioeconomic characteristics, particularly income, educational attainment, marital status, and age.
3. The correlation between minority concentration and credit scores remains even after controlling for numerous other socioeconomic characteristics that might be expected to account for any disproportionate impact of credit scores on minorities. Indeed, minority concentration proved to me a much more robust predictor of credit scores than any of the socioeconomic variables included in the analysis.[20]

As for "Individual-Level Analysis,"[21] the Missouri study concluded:
Credit scores appear to be significantly correlated with race/ethnicity and with family income.[22] In other words, insurance companies could discern with some certainty an individual's race or income based upon the individual's credit score.

Prior to embarking on the Missouri Department of Insurance study, that study's author, Brent Kabler, Ph.D. had previously considered existing studies on the relationship between income, race and credit scores. He concluded that previous studies on the issue were either flawed, inconclusive, or contained insufficient data upon which to assess a discriminatory impact. In particular, he noted that the much touted 1998 insurance industry study, produced by the American Insurance Association (AIA), finding that there was no relationship between income and credit scores, suffered "from methodological flaws so serious that no conclusions are warranted."[23]

Kabler also noted that the 1999 State of Virginia study, frequently cited by the insurance industry as supporting a conclusion that there is no connection between income or race and credit score, did not appear to be designed to measure disproportionate impact, only acts of intentional discrimination, and therefore was not relevant to prove the point insurers assert.[24] He noted that the Washington Department of Insurance study found a "statistically significant association between credit scores and income, [but the] findings regarding the racial impact of scoring were inconclusive, primarily because of the small number of minorities included in the survey sampled from the relatively homogenous population of the state of Washington."[25]

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[20] *Id*. at 17.
[21] *Id*. at 16. According to Kabler, the "individual analysis . . . is based on statistical procedures that model underlying individual-level distributions that could account for the observed ZIP Code level observations. The results of three different models for each company/ insurance line combination are presented. These results, *taken together*, provide credible and compelling, if not irrefutable, evidence for conclusions."
[22] *Id*. at 17.
[23] *Id*. at 15 (an analysis of the *American Insurance Association on the Impact on Insurance Availability, Affordability and Accessibility of Insurance Underwriting Use of Credit History and Credit Scoring*, American Insurance Association, (1998)).
[24] *Id*. (an analysis of the *Report of the State Corporation Commission's Bureau of Insurance on the Use of Credit Reports in Underwriting to the State Commerce and Labor Committee of the General Assembly of Virginia*, Commonwealth of Virginia, (1999)).
[25] *Id*. (an analysis of, Dave Pavelcheck and Bruce Brown, *A Report to the Legislature: Effect of Credit*

Kabler's findings contained in the Missouri study as well as his conclusions about the usefulness of earlier studies were discredited by the insurance industry.[26] In a rebuttal published in the Journal of Insurance Regulation, Kabler responded:

> The most recent rebuttal issued by EPIC Actuaries, funded by three insurance trade associations, is best received as a tendentious polemic rather than a sober, objective and thoughtful appraisal of the Missouri study. . . . Stated plainly and without a trace of hyperbole, the rebuttal is demonstrably wrong in both its generalizations and in *every single particular*.[27]

In December 2004 the Texas Department of Insurance found that "there are consistent patterns reflecting differences in credit scores, most notably, between different racial/ethnic classes."[28] Regarding credit score and race, the Department found:

> Whites and Asians, as a group, tend to have better credit scores than Blacks and Hispanics. In general, Blacks have an average credit score that is roughly 10% to 35% worse than the credit scores for Whites. Hispanics have an average credit score that is roughly 5% to 25% worse than those for Whites. Asians have average credit scores that are about the same or slightly worse than for Whites.[29]

Regarding the relationship between credit score and income, the Texas Department of Insurance "found that, in general, the average and median credit scores tend to get better as the income level rises."[30] The Department also found that drivers over than 70 years of age had the best average credit scores. Individuals in the age range of 21-30 were over-represented in the worst credit score range.[31]

A January 2005 Texas Department of Insurance Supplemental Report found that there is an actuarial correlation between credit scores and claims filing. In other words, notwithstanding the Department's earlier findings that certain groups are more impacted because lower credit scores are more prevalent in certain racial groups, income levels and age groups, the Texas Insurance Commissioner allowed insurers to continue using credit scoring because the Texas Department of Insurance found an actuarial connection between credit scores and claims filing. The outcome in Texas allowing the use of credit scoring was largely dependent upon how "unfair discrimination" is defined in Texas law. The Texas Insurance Commissioner concluded that he did "not have a legal basis to ban a practice that has a disproportionate impact if it produces an

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*Scoring on Auto Insurance Underwriting and Pricing,* State of Washington, Office of the Insurance Commissioner (2003)).

[26] Epic Consulting, LLC, *A Critique of: Insurance Based Credit Scores: Impact on Minority and Low-Income Populations in Missouri*, Insurance Information Institute, February 2004, (available at http://www.iii.org/media/lateststud/epic/).

[27] Brent Kabler, *A Reply to Criticism of the Missouri Department of Insurance Study 'Insurance-Based Credit Scores: Impact on Minority and Low-income Populations in Missouri*" 2 Journal of Insurance Regulation 4 (Summer, 2004).

[28] *Use of Credit Information in Texas, supra* note 12, at 11.

[29] *Id*, at 13.

[30] *Id*. at 16.

[31] *Id*. at 17.

actually supported result and is not unfairly or intentionally discriminatory."[32] In other words, in accordance with the Texas Insurance Code, the Insurance Commissioner cannot find "unfair discrimination" even where there is a disproportionate impact unless there is proof of intentional discrimination or if underwriting and rating classifications are not actuarially supported.[33]

Had Texas law defined unfair discrimination to include a disproportionate impact, given the data in Texas showing a disproportionate impact, the Insurance Commissioner could have found that using credit data in insurance resulted in "unfair discrimination." The outcome in Texas does not preclude Texas policymakers Texas from revisiting the issue if Texas broadens its definition of unfair discrimination. Also, contrary to insurance industry assertions, the Texas outcome does not dictate how the issue should be decided in other states that may look more broadly at what constitutes "unfair discrimination."

The State of Florida has grappled with the results of the various studies and the arguments made by all of the stakeholders on both sides of the credit score debate. In January 2002, a task force convened by the Florida Treasurer and Insurance Commissioner reviewed numerous studies and heard testimony from interested parties on the issue. The task force concluded, "none of the studies are particularly convincing and, by themselves, would probably have left the issue in a stalemate."[34] However, as part of their investigation, the task force received compelling testimony from several insurance agents. The task force wrote:

> What tipped the balance for the Task Force was the testimony of several insurance agents with offices located in lower income areas. They unanimously condemned the use of credit scores because of the negative impact on their lower income customers. They testified that credit scores negatively affected both availability and affordability, that is, credit scores made it more difficult for them to find carriers for their customers, and when they were able to find companies willing to write the business, the premiums were higher.[35]

The Texas, Missouri and Florida studies all support the conclusion that the disproportionate impact of the use of credit scores falls most heavily upon those who have the lowest credit scores. Consumers with the lowest scores are low-income or members of minority groups. The Missouri study stated the situation most succinctly: "the evidence appears to be credible, substantial, and compelling that credit scores have a significant disproportionate impact on minorities and the poor."[36]

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[32] *Id*. at 2.
[33] Letter from Jose Montemayor, Texas Insurance Commissioner, to the Honorable Rick Perry, Governor of Texas, et al., January 31, 2005, at 1, (available at http://www.tdi.state.tx.us/reports/pdf/credit05sup.pdf).
[34] *Task Force on the Use of Credit Reports in Underwriting Automobile and Homeowners Insurance*, Florida Department of Financial Services, January 23, 2002, at 10, (available at http://www.fldfs.com/Consumers/crtf/CRTF_Final_Report.pdf).
[35] *Id*.
[36] Kabler, *supra* note 19, at 39.

### 2. *Causation cannot be proven*

While trying to understand the connection between low credit scores and risk, consumers may rightly ask, "Does it make sense that a person's credit score would have anything to do with whether another individual causes an auto accident, or whether their house is devastated by a hurricane?" Consumers believe that there should be some logical, causal connection between the risk and the rating factor. Without the connection, the rating factor seems patently unfair, even if there is a statistical correlation.[37]

The January 2005 Texas Department of Insurance Supplemental Report found that there is an actuarial (statistical) correlation between credit scores and claims filing. The Texas Department of Insurance conceded that the study measured only statistical relationships between the variables but did not measure causal factors which it deemed beyond the scope of this study.[38] In other words, there is no showing that a lower credit score makes a consumer more likely to have an accident. Also, the study found that for automobile insurance, there was "very little or no statistical evidence that credit score was related to the amount of a claim, or claim severity."[39] In homeowners insurance, the study found some evidence that credit score related to the amount of a claim but was unable to draw a definite conclusion.[40]

Former Texas Insurance Commissioner, Jose Montemayor noted a nagging concern with the lack of causal connection. He noted, "Credit scoring allows for a finer level of observation, but measuring propensity for risk strictly by the numbers can seem callous. Unlike other risk related factors, credit scoring does not have a readily discernable, causal link to risk, such as driving record."[41] While the Commissioner ultimately allowed the use of credit scoring because of limitations in Texas law, he also noted, "if the presence of credit scoring in insurance will only feed suspicion and divide us as Texans, its continued use to any degree may simply not be worth it."[42]

Insurance commissioners and consumer advocates aren't the only ones to point out a lack of causal connection between credit scores and insurance risk. The Insurance Information Institute (III), a major insurance industry group, while noting that "the reasons behind the predictive value of credit scores appear to be behavioral" (relating to money management skills), concedes that "a low insurance score doesn't predict that a person will have an accident."[43]

The insurance industry disputes that finding a causal link between low credit scores and risk is important.[44] While defending this position, representatives of the insurance industry frequently

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[37] *See, Advocacy Group Calls for End to Discriminatory Practices, supra* note 13.
[38] *Supplemental Report to the 79th Legislature, supra* note 12, at 2.
[39] *Id.*
[40] *Id.*
[41] Letter from Jose Montemayor, Texas Insurance Commissioner, *supra* note 33, at 3.
[42] *Id.*
[43] *Credit Scoring, The Topic, supra* note 16, at 5.
[44] David F. Snyder, Catherine I. Paolino, *American Insurance Association Statement to the National Association of Insurance Commissioners*, presented before the Market Conduct & Consumer Affairs (D) Committee Hearing on Credit-Based Insurance Scores, December 8, 2001, at 2 (available at

point to a 2000 study written by James E. Monaghan, an insurance company actuary.[45] Reliance upon the conclusions reached in the Monaghan study is questionable, however. The non-partisan American Academy of Actuaries noted the following weaknesses with the Monaghan study:

> The database does not allow for the analysis of renewal business. The database is confined to the experience of one insurance company from 1993 through 1995. The study was intended for a wide audience, and therefore does not provide in-depth analytical detail. The multivariate analysis presented in the study is bivariate (two variables) and does not evaluate the importance of credit characteristics versus a combination of other rating variables. Many of the study conclusions are stated without providing the results of the underlying analysis."[46]

In conclusion, consumer concerns about the lack of a logical connection between low credit scores and risk are not relieved simply because the insurance industry dismisses them based upon a limited insurance industry study.

### *3. The benefits and burdens of the use of credit scores—discounts aren't always genuine and the impact on those who fund the discounts is hefty*

Although insurers claim that most consumers will get discounts, most don't, and the discounts can be illusory. The burden falls most heavily on those with the lowest credit scores.

Individuals with the lowest credit scores are harmed the most when credit data is used to determine insurance rates. In general, sizeable surcharges are the norm for those who least qualify for a credit scoring "discount." A representative from Conning & Co., which conducted a study for the insurance industry on the impact of credit scoring, underscored the potential surcharge to consumers with poor credit, "A consumer with bad credit is going to pay 20-to 50-percent more in auto insurance premiums than a person who has good credit."[47]

There is no such thing as a "discount only" scenario for determining rates that insurance policyholders will pay when using credit scores as a rating or underwriting factor. Insurers need to cover their costs. Therefore, they will not fund a discount by collecting fewer premium dollars. In fact, a reduction in premiums for some through a credit scoring discount necessarily means the insurer must collect more money from those who don't get the discount to make up the difference.

In order to more fully understand the degree of the disproportionate impact using credit scores has on individuals with lower credit scores, it's essential to examine the supposed benefits the

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http://www.aiadc.org/outbound/credit/CR_6781_2994.pdf).

[45] James E. Monaghan, *The Impact of Personal Credit History on Loss Performance in Personal Lines*, (2000), (available at http://www.casact.org/pubs/forum/00wforum/00wf079.pdf).

[46] American Academy of Actuaries, *The Use of Credit History for Personal Lines of Insurance: Report to the National Association of Insurance Commissioners*, American Academy of Actuaries Risk Classification Subcommittee of the Property/Casualty Products, Pricing, and Market Committee, November 15, 2002, at 9, 10 (available at http://www.actuary.org/pdf/casualty/credit_dec02.pdf).

[47] Lazarone, *supra* note 4.

insurance companies say they provide to those who have better scores. Ironically, when credit scoring is used, even those receiving so-called "discounts" can pay more and those who don't qualify for the discount are penalized, especially those who are disproportionately impacted by using credit scoring in insurance.

An example illustrating the fallacy of the "discount" was presented in an April 2004 report[48] authored by Birny Birnbaum, an economist for the Center for Economic Justice and former associate commissioner of the Texas Department of Insurance. Birnbaum analyzed data supplied by Farmers Insurance Company of Ohio that showed the overall impact on premiums to consumers when Farmers began using credit scoring to rate and underwrite policies in Ohio (see Appendix). Based upon this data, Birnbaum found that of 84,329 policyholders whose rates were adjusted to reflect the impact of a credit scoring discount, Farmers raised the overall rates for 49.2% (41,461). A nearly equal number of consumers 50.8% (42,868) experienced an overall rate decrease. According to Birnbaum, this result is fairly typical of what happens when insurers use credit scoring, and does not support the insurance industry argument that a large majority of consumers benefit in the form of discounts when credit scoring is used.

In the Ohio example, after the base rates were raised, policyholders receiving a 40% credit scoring "discount" were still paying 20.3% more in premiums after credit scoring was used. A policyholder had to qualify for a minimum of a 60% credit score discount before actually paying less than they did before the insurer began to use credit scoring. The result was that 50% or fewer of 84,329 policyholders actually got a real discount (premium savings) even though 94% (79,280) were listed as receiving a "discount."

Who actually paid less as a result of credit scoring in Ohio? In that state, 21.5% (18,137) consumers received a 19% decrease, and only 29.3% (24,731) received a significant 41.9% decrease from the rates they were charged before credit scoring was used.

The impact of using credit scores was much more significant when looking at the percentage of increases on those who did not qualify for a true discount. After Farmers raised the base rate in Ohio to provide a credit scoring "discount," 8.8% (7,421) of the policyholders experienced a 100.5% increase in their rates; 13.7% (11,548) of the policyholders had a 50.4% rate increase, and; 26.7% (22,500) policyholders had their rates rise by 20.3%. Ironically, this later group experienced a significant rate increase while receiving a 40% credit scoring so-called "discount."

### *4. Insurance is an essential product; redlining with credit scores hurts everyone*

All consumers are concerned about having access to fairly-priced insurance products. For those who are low-income, accessibility and affordability are critical concerns because an unfair increase in cost can make homeowners and auto insurance simply unaffordable, even if the consumer has no history of claims and has paid all of the premiums on time. Credit scoring has a stronger adverse impact for poor consumers when it is used to deny consumers insurance or to

[48] Birnbaum, *supra* note 6.

place consumers in higher-risk (higher-cost) product pools. Affordability and access to quality insurance products is not a luxury, but a practical necessity.

The consequences of not having adequate insurance are far reaching. While insurance is a business, the economic stability of our cities and our nation depends in part on access to fairly priced coverage.[49] Without insurance, banks and other financial institutions cannot make loans, and individuals who suffer a loss involving their personal property may struggle to recover. The devastation caused by Hurricanes Katrina and Rita clearly demonstrates that people without adequate insurance are likely to suffer significantly, not only as a result of the disaster, but also because they may not have the means to recover. Without adequate insurance, homes and important possessions cannot be replaced, and lives cannot be easily rebuilt.

Everyone loses when insurers are allowed to use credit scoring to erect an unfair and unnecessary barrier for those who can least afford to pay. Rising premiums for those with low credit scores can make auto insurance too expensive for them, causing an increase in everyone else's uninsured motorist rates. In addition, the increase in uninsured drivers because of credit scoring will raise the costs on taxpayers and on the health insurance system to pay for the injuries caused by these uninsured drivers. Homeowners going without sufficient insurance cause a high societal price when disaster strikes and taxpayers are asked to pick up the tab. Everyone wins when insurance is fairly priced and equally accessible to all.

### *5. Credit reports contain serious errors leading to erroneous credit scores*

In 2002, the Consumer Federation of America and the National Credit Reporting Association analyzed the credit scores of more than 500,000 consumers and reviewed the files of more than 1,700 individuals maintained by the three major credit repositories. According to their analysis, they concluded that "tens of millions of consumers are at risk of being penalized for incorrect information in their credit report, in the form of increased costs or decreased access to credit and vital services."[50]

In 2004, U.S. PIRG found that one in four credit reports contained errors serious enough to cause consumers to be denied credit, housing, or even a job, based upon its survey of over 200 adults living in 30 states who reviewed their credit reports for accuracy.[51] According to this report, "some of the mistakes on consumer reports are the result of mis-merged file information, when the bureau simply adds one consumer's account to another's file."[52] Other mistakes result from identity theft, or from "coding or reporting errors where a consumer's on-time payments are falsely listed as late."[53] U.S. PIRG reported that the credit bureaus, creditors and other furnishers of information can all be at fault for an error impacting on a consumer's credit score. Perhaps one of the most alarming findings of this report is that "some of the errors are

[49] *Meeting the Insurance Crisis of Our Cities; A Report by the President's National Advisory Panel on Insurance in Riot-Affected Areas,* at 17 (1968).
[50] *Credit Score Accuracy and Implications for Consumers, supra* note 5 at 37.
[51] *Mistakes Do Happen: A Look at Errors in Consumer Credit Reports, supra* note 5.
[52] *Id.* at 8.
[53] *Id.*

intentional, where a creditor seeks to deflate its own customers' credit scores—to maintain its customers as captive customers."[54]

Whether errors are intentional or inadvertent, consumers end up the losers. The high percentage of serious errors in credit reports undermines the assumption insurers make to justify the use of credit information, i.e., that good credit scores are evidence that an individual is a good money manager.

Insurers have no way of knowing which of their customer's credit files include inaccurate or erroneous information leading to a depressed credit score. Consumer credit files upon which insurance scores are calculated may contain a multitude of potential errors or omissions. For example:

- credit scoring models are not designed to include good money management traits and not all types of good money management behavior is reported to the credit bureaus;
- credit scoring models are also not designed to account for individuals who manage their finances well, but operate without credit;
- the credit score may be inaccurate, because of errors in a consumer's file, identity theft, or fraud against the consumer;
- a credit-card issuer's report is distorted because it fails to provide a consumer's credit limit in its report to the three national bureaus.[55]

There are many reasons why someone may have a low credit score but still be an excellent driver or a responsible homeowner. Yet under this system, these consumers will be penalized.

Artificially low credit scores reduce the credit options for these consumers by limiting their ability to shop around for the best credit product at the best price. In the context of insurance, because more insurers are using credit scores to make decisions about insurance, these same consumers will find their options for obtaining fairly priced insurance similarly limited.

While the availability of free annual credit reports may lead to greater consumer awareness of the contents of consumer credit reports and more corrections of erroneous information, it is too soon to tell if this has happened. It is particularly unwise to allow insurers to base insurance decisions affecting the consumer on information that has such a high error rate.

[54] *Id.*

[55] Kenneth R. Harney, *Your Credit Score Can Plummet When Issuers Withhold Credit Limit,* Seattle Times, January 1, 2005, (available at http://seattletimes.nwsource.com/html/homerealestate/2002136863_homeharn02.html). Harney reported that a consumer's credit score was reduced by 66 points solely because her credit-card issuer did not report her credit limits.

### 6. *Insurance scoring models are secret*

Insurance companies claim that there is a correlation between a consumer's score and the chance that he or she will file a future insurance claim. But they have kept their scoring formulas secret, preventing an independent, public review of the actuarial soundness of their assertions. There is no standard mathematical model for how insurers use credit information to influence insurance decisions or for how they derive insurance scores from credit information. It's hard for consumers to gauge what they can do differently to increase an insurance score, or to know what factors are viewed more favorably by different insurers.

Insurers want to continue using their models that allow them to use credit information in insurance decisions but they don't want to share them even with regulators. One industry group representing a large share of the insurance market, the National Association of Mutual Insurance Companies (NAMIC),[56] has actively opposed proposed requirements in the state of Alaska that would require insurance companies to file such models showing statistical validation that credit information models are predictive of future loss potential.[57]

Additionally, the insurance industry recently sued the Office of Insurance Regulation in Florida, a state which allows the use of credit scores in insurance, to block the implementation of proposed regulations that would require insurers to prove that using credit scoring "does not have an unfairly discriminatory impact on consumers of a certain race, gender or income level and various other classifications."[58] Notwithstanding the suit, on May 22, 2006 the Florida Financial Services Commissioner authorized the Insurance Commissioner to begin implementing the new rule, "citing continued delays due to litigation and ongoing potential harm to Floridians due to the use of credit information by insurers."[59] In ordering the implementation, Florida State Insurance Commissioner Kevin McCarty stated, "Florida's cultural and ethnic diversity is unparalleled, but unfortunately this is also an environment where credit scoring often victimizes innocent consumers."[60] The insurance industry is holding fast to its opposition to the

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[56] NAMIC provides the following information regarding its association, (available at http://www.namic.org/about/default.asp), "Founded in 1895, NAMIC is a full-service national trade association with more than 1,400 member companies that underwrite 43 percent ($196 billion) of the property/casualty insurance premium in the United States. NAMIC members account for 44 percent of the homeowners market, 38 percent of the automobile market, 39 percent of the workers' compensation market, and 31 percent of the commercial property and liability market."

[57] Letter from Christian John Rataj, Esq., NAMIC State Affairs Manager, to Commissioner Linda S. Hall, Division of Insurance, State of Alaska, September 7, 2005 (available at http://www.namic.org/pdf/050907AlaskaComments.pdf).

[58] Florida allows the use of credit information in insurance underwriting and rating. The Florida Office of Insurance Regulation instituted a new rule, as of January 31, 2006, requiring insurance companies to demonstrate how they use credit scores in rating and underwriting insurance coverage.

[59] *Insurance Commissioner to Implement Rule to Prevent Discrimination in Purchase of Insurance,* Florida Office of Insurance Regulation, May 23, 2006 (available at http://www.floir.com/PressReleases/ViewMediaRelease.asp?ID=2340. The informational Memorandum sent to all affected insurance companies can be viewed at http://www.floir.com/Memoranda/OIR-06-10M.pdf).

[60] *Insurance Commissioner to Implement Rule to Prevent Discrimination in Purchase of Insurance, supra* note 59.

implementation of the new rule. A representative from the insurance industry vowed, "We will do everything possible to prevent them [the Department of Financial Services] from enforcing this illegal rule."[61]

### *7. It is unfair to penalize any group of policyholders who enforce their contractual rights against an insurer*

Individuals who pay their insurance policy premiums shouldn't be penalized simply because they might use their policy if they suffer a legitimate loss. At best, insurers have been able to show that there is a correlation between low credit scores and filing a claim, not that those with low credit scores experience a greater frequency or severity of losses.[62] Yet, insurers use this as a reason to charge more. An increased possibility of filing a claim, a speculative event at best, may be only an indication that a consumer is more likely to use a policy in the event of suffering an insured loss. In such a case, the consumer is merely holding the insurer accountable to the policy agreement and requiring the insurer to honor its contractual obligation to cover insured losses, after the consumer has honored their half of the bargain, i.e., paid their premiums to the insurer.

## B. USING CREDIT-BASED INFORMATION IN INSURANCE AND UNDERWRITING IS UNNECESSARY

### *1. Claims frequency already an available rating factor*

Insurers already have the ability to screen consumers for claims frequency and severity and to use that information in their rating decisions. This is certainly the case for consumers who have some insurance coverage history. Insurers need only to scan their own claims records or an insurance claims database to determine if the particular consumer has a history of making claims. In cases where insurers are using both claims frequency and credit history as rating factors to screen for those who are likely to make claims against their policies, insurers are "double counting" potentially unfavorable rating factors against a consumer.

### *2. Credit score surcharge is unnecessary to protect insurers*

Insurers have a variety of remedies available to protect themselves against consumers who file too many claims. Insurers can raise premiums for those who file too many claims or even terminate claims-prone consumers. These measures don't lead to the same unfair results for consumers when credit information is used to rate or underwrite a policy. Unlike credit scoring, these actions can be based upon verifiable risk behavior, not on information with no causal relationship to the risk of loss.

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[61] *Florida Regulator Accused of Flaunting Law in Credit Rule*, Insurance Journal, May 23, 2006 (available at http://www.insurancejournal.com/news/southeast/2006/05/23/68771.htm).

[62] *Supplemental Report to the 79th Legislature—Use of Credit Information by Insurers in Texas, supra* note 12 at 2.

## C. Some States Have Laws and/or Regulations to Protect Consumers, but the Majority Do Not

Many states have enacted legislation or promulgated regulations regarding the use of credit-based data in insurance and a few of those have done so in a manner to protect consumers. In 1973, Hawaii passed a law banning the use of credit information in all automobile insurance policies. Maryland's homeowner insurance statue, passed in 2002, establishes prohibitions on particular payment plans, or refusal to underwrite, renew or cancel policies based in whole or in part on credit information. Maryland law is less protective for automobile insurance, allowing insurers to use credit information as a basis for rating new automobile insurance policies. Effective 2004, Oregon enacted a strong statute and corresponding regulations governing the use of insurance credit scores by prohibiting the cancellation or non-renewal of existing policies based in whole or in part on credit information. Washington has a similar provision.[63] California law has not permitted the use of credit information in underwriting or rating automobile insurance policies since the passage of Proposition 103 in 1988. Additionally, the California Department of Insurance has taken a strong stance in opposition to the use of credit scores, credit reports and other credit information in underwriting homeowners insurance. As stated in an August 2004 report examining underwriting guidelines and access to homeowners insurance in California:

> The Department does not allow use of credit or insurance scores in underwriting homeowners insurance. This is because the insurance companies have failed to demonstrate that credit scores are not discriminatory toward protected classes such as women, the elderly, the poor and racial/ethnic groups.[64] Because credit scoring has the potential to be discriminatory and unfair, the use of credit information in rating and underwriting homeowners insurance is a major concern.[65]

In June of 2005, the California Department of Insurance and Allstate entered into a $30 Million settlement to refund $30 million in policy credits and premium returns to eligible California policyholders who had been affected by several of Allstate's practices, including the "use of "Financial Stability" criteria, a form of credit scoring, to underwrite property coverage, resulting in the placement of some consumers in a program with higher rates."[66] The California Department of Insurance also announced, "as part of the settlement Allstate will pay a $4 million fine. The fine addresses issues that arose from a 2002 examination of Allstate's handling of its auto and homeowners policies, as well as its use of credit scoring." In recent years, the insurance

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[63] Haw. Rev. Stat. § 431:10C-207; Md. Code Ann. §27-501; Or. Rev. Stat. Ann. § 746.661to 746.663 and Or. Admin. R. 836-080-0425 (prohibits the cancellation or non-renewal on existing policies based in whole or in part on credit information), Wash. Rev. Code § 48.18.545.

[64] Don McNeill, *Underwriting Guidelines and Access to Homeowners Insurance*, California Department of Insurance, at 20 (August 2004) ((available at: http://www.insurance.ca.gov/0400-news/0200-studies-reports/0600-research-studies/upload/Underwriting-Guidelines-and-Access-to-Homeowners-Insurance.pdf).

[65] *Id.* at 29.

[66] *Insurance Commissioner John Garamendi Announces $30 Million Settlement with Allstate Insurance; As Many as 250,000 Policies Could Qualify for Return of Premiums or Credits on Future Premium Bills*, California Department of Insurance, June 27, 2005 (available at: http://www.insurance.ca.gov/0400-news/0100-press-releases/0080-2005/release063-05.cfm).

industry has repeatedly tried and failed to undo consumer protections in California by seeking passage of legislation that would permit the use of credit information in personal lines insurance.

The majority of states, however, have unfortunately elected to use variations of a model law proposed by the National Conference of Insurance Legislators ("NCOIL"), a historically industry-friendly organization.[67] According to NCOIL, since its November 22, 2002 adoption of its Model Act Regarding Use of Credit Information in Personal Insurance, 22 states have enacted proposals similar to the NCOIL model.[68] Additionally, NCOIL cites 4 other states that have enacted regulations that incorporate the NCOIL model to varying degrees.[69] As a result, many consumers remain unprotected.

### D. THE INDUSTRY NCOIL MODEL ACT DOESN'T PROTECT CONSUMERS

The NCOIL model does not in any way prevent the use of credit scores for insurance purposes; instead it allows their use. The NCOIL model law's primary loophole is that it allows the use of credit scoring provided that credit scoring is not the sole or only criterion used to underwrite or rate an insurance policy subject to its provisions.[70] Since credit scoring is never the sole factor used in underwriting or pricing insurance, the NCOIL model act offers consumers virtually no protection. The model act does not indicate what weights must be given to non-credit-based factors which means that insurers are free to use a credit-based factor almost exclusively, as long as some other factor is minimally considered. Requiring the minimal inclusion of another rating factor besides one that is credit- based does not eliminate the underlying problems with using credit-based data to rate or underwrite insurance policies. Under the NCOIL model act, insurers would continue to use credit scores, even though serious concerns have been raised about the whether credit history predicts consumer accident propensity, the inaccuracy of credit scores, and the disproportionate impact the practice has on low-income and minority consumers. While the NCOIL model legislation contains some purported protections for consumers, in practice, these provide little or no benefit to the consumer. For example:

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[67] According to the Consumer Federation of America , at least 40 percent of the leadership of the National Conference of Insurance Legislators (NCOIL) has worked for or with the insurance industry and most of these NCOIL members have current business ties to the insurance industry. *See,* Consumer Federation of America, *NCOIL's Policy Positions Have Anti-Consumer Tilt,* June 2003 (available at http://www.consumerfed.org/releases2.cfm?filename=0709insurance.txt).

[68] *National Conference of Insurance Legislators (NCOIL) 2005 Annual Meeting & Seminar Materials*, § 5 (VII)(A) (1), October 27, 2005. The 22 states that have passed legislation incorporating the NCOIL model include: Arkansas, Colorado, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Montana, Nebraska, Nevada, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Rhode Island, Tennessee, Texas, and Virginia.

[69] *Id*. States that have passed regulatory actions include Alabama, Delaware, Mississippi, and West Virginia.

[70]National Conference of Insurance Legislators, *Model Act Regarding Use of Credit Information in Personal Insurance*, § 5 (B) (Amended 2004). This model provides that insurers shall not: "Deny, cancel or nonrenew a policy of personal insurance solely on the basis of credit information, without consideration of any other applicable underwriting factor independent of credit information and not expressly prohibited by Section 5 (A)."

**Disclosing the use of credit information does not fix the problem.** The NCOIL model act requires an insurer or its agent to tell a consumer at the time of application that the company may obtain credit information in connection with the application. The company or its agent is not required to give the consumer a new disclosure statement upon renewal if the consumer received one at the time of application.[71] Though this provision purports to protect consumers, an NCOIL model act disclosure does not educate consumers about the serious underlying problems with using credit-based data to rate or underwrite auto or homeowners insurance policies. Further, a disclosure that credit scoring is being used can't fix the problems with the practice, such as credit inaccuracies caused by incomplete or erroneous information. Disclosures do not protect responsible drivers and homeowners with lower credit scores who experience increased premiums or other adverse actions simply because of low credit scores.[72]

**An exceptional circumstances exemption does not fix the problem.** According to NCOIL, seven states that have adopted or incorporated the NCOIL model act also include an "exceptional life event"[73] safe harbor. This gives consumers a limited opportunity to ask the insurance company to disregard credit information in rating or underwriting a policy. While the provisions vary from state to state, examples of potentially qualifying events can include a divorce, loss of employment, a death in the family, or the occurrence of a catastrophic event. The exceptional circumstances exemption was not part of the original NCOIL model law. In many cases, the exemption was inserted as a compromise to gain passage of a state law based on the NCOIL model law. In February 2006, NCOIL amended its model to include an exceptional life circumstances clause,[74] however, the model leaves it up to individual states to decide which exceptional life circumstances should qualify.

In order for a consumer to benefit from an exceptional life event exemption, it is up to the individual consumer to know that the exemption exists. The consumer must then request an individual exemption from the insurer, even if the individual is part of a larger group, such a group of hurricane victims. The insurer has the discretion to decide whether to grant the request for an individual exemption.

Given that the majority of consumers are unaware that insurers use credit information, as discussed later in this report, it is highly unlikely that consumers will know about the existence of

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[71] *Id*. at § 7.
[72] *Id*. at § 5(E)(1)-(3). This addresses how insurers should treat individuals who lack sufficient credit data upon which to rate or underwrite a policy. Insurers are required to exclude or treat as neutral an absence of credit data or an inability to calculate an insurance score unless the insurer presents information that such an absence or inability relates to the risk for the insurer and an Insurance Commissioner/Supervisor/Director has approved otherwise.
[73] Susan Nolan, *NCOIL Readopts Credit Scoring Model, Will Consider Extraordinary Life Circumstances*, NCOILetter, December 2005, at 4 (available at http://www.ncoil.org/news/2005_NewsLetters/December2005.pdf). *See also* Steve Tuckey, *NCOIL Puts Extraordinary Event in Credit Model*, National Underwriter, February 28, 2006. As reported in this source, according to NCOIL, seven states, Colorado, Florida, Louisiana, Montana, New Mexico, Texas and Virginia, added extraordinary life circumstances provisions when they originally adopted the NCOIL model (on file with author).
[74] Tuckey, *supra* note 73.

an exceptional life events exemption in the states that have adopted one. It is also not helpful that the exemption must be invoked on an individual basis, even when there is an identifiable group of individuals who have been impacted by a single event. These barriers mean that consumers who qualify for an exemption may not exercise the option when needed, making the benefit of an extraordinary life event exemption illusory.

Also, when an insurer grants an extraordinary circumstances exemption, the insurer is required to rate the policy using other rating factors, and to ignore credit information. This suggests that insurers can already rate a policy fairly without credit information and that insurers can do so with sufficient accuracy to protect both the insurer and the insured.

### E. The Use of Credit Scoring in Insurance Proliferates While Consumers are Largely in the Dark

A study published in March 2005 by the Government Accountability Office (GAO) found that while consumers understood the basics about credit reporting, about two-thirds of the over 1,500 consumers it surveyed nationwide were not aware that their credit histories could affect insurance availability and price.[75] The GAO study also found that race and ethnicity were associated with consumers' knowledge of credit reporting issues. According to the GAO survey, "African Americans and whites scored similarly . . . while Hispanics scored consistently lower."[76] Those with "relatively low household incomes—in particular, those in households making less than $25,000—generally were less aware of issues pertaining to credit reports, scores, and the dispute process compared with those in higher income groups."[77] According to the Consumer Federation of America, consumer understanding of and access to credit scores has improved somewhat during 2005, but is still insufficient.[78]

The 2005 GAO findings confirming the lack of consumer awareness are consistent with what influential segments of the insurance industry already knew when it began its campaign to legitimize the use of credit information in insurance decisions through the passage of the industry sanctioned model law developed by the National Conference of Insurance Legislators (NCOIL). Since 2002, the insurance industry was fully conscious that many consumers were unaware of the practice, and of those who were aware, the majority did not approve. That year, a spokesperson from the National Association of Independent Insurers, NAII,[79] speaking before

[75] *Credit Reporting Literacy Consumers Understood the Basics but Could Benefit from Targeted Educational Efforts*, United Sates Government Accountability Office, Report to Congressional Committees, March 2005, at 10-11, 13, 15, 44, 63 (available at http://www.gao.gov/new.items/d05223.pdf).
[76] *Id*. at 89.
[77] *Id*. at 87, 88.
[78] *Consumer Understanding of and Access to Credit Scores Improves Over Past Year But Still Insufficient, Annual Survey Finds*, Consumer Federation of America, September 20, 2005 (available at http://www.consumerfed.org/pdfs/Providian_Press_Release_9_05.pdf) .
[79] In 2004 the National Association of Independent Insurers (NAII) merged with the Alliance of American Insurers (Alliance) to form the Property Casualty Insurers Association of America (PCIAA), according to information available on the PCIAA website at http://www.pciaa.net/sitehome.nsf/main. PCIAA describes itself as "the nation's premier insurer trade association, representing over 1,000 companies that write 40.7

another industry group presented the findings of consumer focus groups the NAII convened in 4 U.S. cities, (Chicago, Austin, Portland and Baltimore) to gauge, among other factors, consumer reaction to the use of credit-based insurance scores.

Among the key findings of the focus groups:

- participants were not aware that credit-based insurance scores were used as a risk factor;
- a distinct majority of consumers are generally and intuitively uncomfortable with-- if not outright opposed to—the use of credit-based insurance scores as an underwriting and rating factor;
- [the participant consumers] don't believe [there is] a relationship or correlation between credit history and risk;
- [the participant consumers] objected [to the] use of credit [as] an invasion of privacy;
- even after the industry position on correlation was explained to the participants the consumer reaction was described as a "grudging acceptance;"
- the NAII concluded that "grudging acceptance is a victory for insurers" noting that "acceptance will not come easily" and that "insurers must address the consumer concerns in order to break the cycle of complaints directed at policymakers" noting that "legislative bans are triggered by consumer complaints."[80]

Knowledge of the negative consumer sentiments did not stop the insurance industry from capitalizing on the lack of consumer awareness while it pushed for the passage of the NCOIL model law as "pro-consumer."

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percent of the nation's automobile, homeowners, business, and workers compensation insurance. PCI is an advocate for sound public policy that fosters a healthy and competitive insurance marketplace. The association serves as the voice of the property/casualty insurance industry before state and federal policymakers; state and federal courts; key insurance industry, governmental, and business groups; the news media; and the public."

[80] Annotti, *supra* note 15.

# II. Legislators and Regulators Should Protect Consumers Through Legislation or Regulation

In order to protect consumers, states can and should ban insurance companies from using credit-based data in rating or underwriting personal lines of insurance, such as automobile and homeowners insurance policies. Although versions of the NCOIL model act have been adopted by legislation or regulation in 26 states, consumers remain unprotected because the fundamental consumer concerns about the use of credit information in insurance decisions are largely unaddressed.

Adopting greater consumer protections against the use of credit-based data in insurance will not jeopardize the insurance marketplace. The insurance marketplace remains vigorous in states that have passed bans or partial bans on the use of credit information. In Hawaii, a state which has banned the use of credit information in automobile insurance rating and underwriting since 1973, Insurance Commissioner Jeffrey Schmidt noted that he did not see that the credit information ban has not caused a problem. He stated, "The market is good; premiums have come down, while at the same time, companies have made reasonable profits."[81] Similarly, the marketplace in Maryland continues to thrive after it passed a law that prohibits the consideration of credit information in existing private passenger motor vehicle insurance and homeowner's insurance policies. A representative of the Maryland Department of Insurance indicated that overall, the market is robust and Maryland has one of the highest insured rates in the country even though premiums have increased since the law was passed.[82] After passage of the law in Oregon, the insurance market has remained healthy and experienced no disruption.[83] In California, the automobile insurance marketplace remains robust even though Proposition 103, passed by the voters in 1988, prohibits insurers from using credit information in rating and underwriting automobile insurance. Contrary to insurance industry threats, major players did not leave the marketplace, consumers continue to have plenty of insurance options, and insurance companies are able to adequately rate and underwrite personal lines insurance policies without using credit information as a factor where the use of such information has been banned or limited. All of these conditions support extending these consumer protections to additional states to stop the use of credit information in insurance in rating and underwriting of homeowners and automobile insurance.

[81] Telephone interview with Jeffrey P. Schmidt, Hawaii Insurance Commissioner (January 24, 2006).
[82] Telephone interview with Darlene Frank, Director of Public Affairs, Maryland Insurance Administration (May 25, 2006).
[83] Telephone interview with Michael Morter, Senior Policy Analyst, Oregon Insurance Division (February 17, 2006).

# III. Consumers Union and PIRG's Model State Law to Regulate the Use of Credit Information in Insurance Decisions

Consumers Union and U.S. PIRG have developed a model law. This model state law applies to all personal homeowner's and automobile insurance policies on existing and new business. The model law prohibits insurers from using information regarding a consumer's creditworthiness, credit standing, or credit capacity for the purpose of determining rates for insurance or eligibility for coverage.

This model law was adapted from the Maryland statute (Insurance Code § 27-501.) However, it differs from the Maryland statute in that it prohibits the use of credit information in underwriting new auto policies as well as in existing policies. While allowing the limited use of credit information, the Maryland statute places a 40% cap on discounts and surcharges in automobile insurance policies where credit information is considered. Since this model is more protective of consumer rights, it omits the provisions from the Maryland statute allowing for the use of credit information and any limiting discounts or surcharges.

**Model Law Language**

MODEL LAW REGULATING THE USE OF CREDIT-BASED
INFORMATION IN INSURANCE UNDERWRITING AND PRICING

(A) An insurer may not require a particular payment plan for an insured for coverage under a private passenger or homeowner's insurance policy based on the credit history of the insured.

(B) (1) In this subsection, "credit history" means any written, oral, or other communication of any information by a consumer reporting agency bearing on a consumer's creditworthiness, credit standing, or credit capacity that is used or expected to be used, or collected in whole or in part, for the purpose of determining personal lines insurance premiums or eligibility for coverage.

(2) With respect to private passenger, residential property, and other personal lines of insurance, an insurer may not:

(i) refuse to underwrite, cancel, refuse to renew a risk, or increase the renewal premium based, in whole or in part, on the credit history of an applicant or insured; or

(ii) rate a risk based, in whole or in part, on the credit history of an applicant or insured in any manner, including:

1. the provision or removal of a discount;
2. assigning the insured or applicant to a rating tier; or
3. placing an insured or applicant with an affiliated company; or

(iii) require a particular payment plan based, in whole or in part, on the credit history of the insured or applicant.

(iv) use, in whole or in part, insurance scores or consumer reports, as a basis to make a written or oral solicitation of insurance that is not initiated by the consumer.

# IV. Recommendations

1. States should pass a ban against the use of credit information in insurance underwriting or rating for personal lines of insurance.

2. Legislatures with state laws based on the NCOIL model should repeal those laws.

3. In an effort to protect the victims of Hurricanes Katrina and Rita, the states of Texas, Louisiana, Alabama, Mississippi and Florida should pass an immediate moratorium on the use of credit information in insurance decisions.

4. All state laws that contain an NCOIL exceptional circumstances exemption should be modified to make the exception apply automatically to all individuals residing in a declared disaster area, for a period of no less than 36 months, while retaining the right of individuals to request the exemption based on individual life circumstances.

5. Insurance Commissioners who have the authority to do so should adopt regulations banning the use of credit information in insurance underwriting and rating.

6. Insurance Commissioners should require insurers using credit information to file their models annually with the regulator's office and the commissioners must have these models tested by an independent actuary not affiliated with the insurance industry. As in Florida, insurers using credit or insurance scoring models should be required to show that the use of such models does not does not disproportionately affect persons of any race, color, religion, gender, age or place of residence. The results should be made public and released in a joint report to the National Association of Insurance Commissioners.

7. When applying for insurance, consumers should refuse to grant permission to their insurers to access consumer credit files to be used in making insurance related decisions. Consumers should refrain from giving their social security number to insurance companies to prevent it from being used to obtain credit information.

# V. Conclusion

Using credit-based data in insurance rating and underwriting should be banned because the practice is unfair to consumers and it's not necessary. The practice creates barriers to obtaining fairly priced insurance which is essential to protect personal assets and is vital to a functioning economy. These barriers hurt everyone. The poor have an even harder time affording the insurance they need. Even those who believe they benefit stand to lose when higher premiums drive others from the marketplace, and the discounts they expect to receive may not be genuine. Most state laws don't protect consumers in a meaningful way. These states should pass a new law to ban the practice of using credit-based data in insurance. While insurers say the practice of using credit-based data benefits consumers, we disagree. The downside for consumers is so much more compelling that the practice should be banned.

# Appendix

Birnbaum Analysis of Farmers Insurance in Ohio

**Actual Impact of Credit Scoring -- Farmers in Ohio**

| Code | Policies | Factor | Discount | Rate Before Credit Scoring | Rate After Credit Scoring | Rate Increase After Base Rate Change | | |
|---|---|---|---|---|---|---|---|---|
| E, N | 3,054 | 1 | 0% | $100 | $200.50 | Yes | | 100.5% |
| Z | 661 | 1 | 0% | $100 | $200.50 | Yes | | 100.5% |
| Y | 594 | 1 | 0% | $100 | $200.50 | Yes | | 100.5% |
| X | 740 | 1 | 0% | $100 | $200.50 | Yes | | 100.5% |
| W | 1,038 | 1 | 0% | $100 | $200.50 | Yes | | 100.5% |
| V | 1,326 | 1 | 0% | $100 | $200.50 | Yes | | 100.5% |
| U | 1,652 | 0.75 | 25% | $100 | $150.38 | Yes | | 50.4% |
| T | 1,992 | 0.75 | 25% | $100 | $150.38 | Yes | | 50.4% |
| S | 2,385 | 0.75 | 25% | $100 | $150.38 | Yes | | 50.4% |
| R | 2,635 | 0.75 | 25% | $100 | $150.38 | Yes | | 50.4% |
| Q | 2,884 | 0.75 | 25% | $100 | $150.38 | Yes | | 50.4% |
| P | 3,186 | 0.6 | 40% | $100 | $120.30 | Yes | | 20.3% |
| O | 3,852 | 0.6 | 40% | $100 | $120.30 | Yes | | 20.3% |
| L | 4,236 | 0.6 | 40% | $100 | $120.30 | Yes | | 20.3% |
| K | 5,196 | 0.6 | 40% | $100 | $120.30 | Yes | | 20.3% |
| J | 6,030 | 0.6 | 40% | $100 | $120.30 | Yes | 41,461 | 20.3% |
| I | 1,545 | 0.4 | 60% | $100 | $80.20 | | | -19.8% |
| H | 7,086 | 0.4 | 60% | $100 | $80.20 | 49.2% | Overall Rate Increase | -19.8% |
| G | 9,506 | 0.4 | 60% | $100 | $80.20 | | | -19.8% |
| F | 7,822 | 0.29 | 71% | $100 | $58.15 | 50.8% | Overall Rate Decrease | -41.9% |
| D | 8,221 | 0.29 | 71% | $100 | $58.15 | | | -41.9% |
| C | 6,063 | 0.29 | 71% | $100 | $58.15 | | | -41.9% |
| B | 2,617 | 0.29 | 71% | $100 | $58.15 | | | -41.9% |
| A | 8 | 0.29 | 71% | $100 | $58.15 | | | -41.9% |
| | | | | | | | | |
| Total | 84,329 | | | | | | | |

New Rate Calculated by Multiply $100 Old Rate time 2.005 (to reflect 100.5% increase

# Farmers Insurance Company of Columbus / Farmers Insurance Exchange

## Ohio Fire (Excluding Mobile Homes)

### Derivation of FPRA Code Discount Factors

| FPRA Score | FPRA Code | Current PIF | Total Premium | Total Loss | Loss Ratio | Loss Ratio Relativity | Rebased Loss Ratio Relativity | Proposed Discount Factor | Premium Spread by Group |
|---|---|---|---|---|---|---|---|---|---|
| NA | E & N | 3,054 | 4,544,004 | 1,996,307 | 43.9% | 0.724 | 0.264 | 1.000 | 0.040 |
| 226-375 | Z | 661 | 596,468 | 993,183 | 166.5% | 2.742 | 1.000 | 1.000 | 0.005 |
| 376-400 | Y | 594 | 533,863 | 860,884 | 161.3% | 2.656 | 0.968 | 1.000 | 0.005 |
| 401-425 | X | 740 | 734,950 | 902,181 | 122.8% | 2.022 | 0.737 | 1.000 | 0.006 |
| 426-450 | W | 1,038 | 1,029,330 | 1,332,899 | 129.5% | 2.133 | 0.778 | 1.000 | 0.009 |
| 451-475 | V | 1,326 | 1,321,730 | 1,568,696 | 118.7% | 1.955 | 0.713 | 1.000 | 0.012 |
| 476-500 | U | 1,652 | 1,723,258 | 1,631,864 | 94.7% | 1.560 | 0.569 | 0.750 | 0.015 |
| 501-525 | T | 1,992 | 2,108,336 | 2,392,179 | 113.5% | 1.869 | 0.681 | 0.750 | 0.019 |
| 526-550 | S | 2,385 | 2,490,593 | 2,393,096 | 96.1% | 1.583 | 0.577 | 0.750 | 0.022 |
| 551-575 | R | 2,635 | 2,908,825 | 2,792,033 | 96.0% | 1.581 | 0.576 | 0.750 | 0.026 |
| 576-600 | Q | 2,884 | 3,126,207 | 2,941,839 | 94.1% | 1.550 | 0.565 | 0.750 | 0.028 |
| 601-625 | P | 3,186 | 3,727,179 | 2,438,888 | 65.4% | 1.078 | 0.393 | 0.600 | 0.033 |
| 626-650 | O | 3,852 | 4,470,625 | 3,355,325 | 75.1% | 1.236 | 0.451 | 0.600 | 0.039 |
| 651-675 | L | 4,236 | 5,224,379 | 4,617,989 | 88.4% | 1.456 | 0.531 | 0.600 | 0.046 |
| 676-700 | K | 5,196 | 6,484,066 | 5,204,246 | 80.3% | 1.322 | 0.482 | 0.600 | 0.057 |
| 701-725 | J | 6,030 | 7,774,172 | 5,511,778 | 70.9% | 1.168 | 0.426 | 0.600 | 0.069 |
| NA | I | 1,545 | 1,795,786 | 943,923 | 52.6% | 0.866 | 0.316 | 0.400 | 0.016 |
| 726-750 | H | 7,086 | 9,638,670 | 5,531,973 | 57.4% | 0.945 | 0.345 | 0.400 | 0.085 |
| 751-775 | G | 9,506 | 13,675,321 | 6,775,538 | 49.5% | 0.816 | 0.298 | 0.400 | 0.121 |
| 776-800 | F | 7,822 | 12,074,421 | 5,002,925 | 41.4% | 0.682 | 0.249 | 0.290 | 0.107 |
| 801-825 | D | 8,221 | 13,112,538 | 4,898,344 | 37.4% | 0.615 | 0.224 | 0.290 | 0.116 |
| 826-850 | C | 6,063 | 9,986,690 | 3,447,613 | 34.5% | 0.569 | 0.207 | 0.290 | 0.088 |
| 851-875 | B | 2,617 | 4,259,923 | 1,293,453 | 30.4% | 0.500 | 0.182 | 0.290 | 0.038 |
| 876-900 | A | 8 | 17,775 | 1,617 | 9.1% | 0.150 | 0.055 | 0.290 | 0.000 |
| Total | Total | 84,325 | 113,359,109 | 68,828,774 | 60.7% | 1.000 | 0.365 | | 1.000 |

Notes: 1) Total Premium and Total Loss are from IMPACT 1996 to February 2001 YTD data.
2) Base rate will be increased uniformly by 100.5% to achieve revenue neutrality.

## Farmers Insurance Company of Columbus
## Ohio Homeowners and Landlords Protector
### Summary of Premium Effects -- Effective September 16, 2001

| Type of Change | Special/Protector Plus | Renters/Condos | HO Total |
|---|---|---|---|
| Base Rate Changes by Territory | 19.3% | 11.4% | 19.0% |
| FPRA Discount | -50.1% | -50.1% | -50.1% |
| Required FPRA Base Rate Offset | 100.5% | 100.5% | 100.5% |
| Crossover correction | 0.0% | 0.0% | 0.0% |
| Sewer & Drain Rate Change | 2.6% | 0.1% | 2.5% |
| Overall Rate Change Effect | 22.5% | 11.5% | 22.1% |
| Annual 2000 Premium | $ 25,108,816 | $ 940,929 | $26,049,745 |
| Annual Dollar Effect | $ 5,646,465 | $ 108,225 | $ 5,754,689 |
| Indicated Change | 21.7% | 11.4% | 20.2% |

# HOMEOWNERS PACKAGE
# FARMERS INSURANCE COMPANY
# FARMERS INSURANCE EXCHANGE

## RATING RULES (cont.)

### ★ FIRE REVISED PRICING MECHANISM DISCOUNT

Insureds may be eligible for a discount based on their **Farmers Property Risk Assessment (FPRA) code**. The FPRA code for the head of the household will apply to all Property policies in the household. The discount will apply to all policy types except Mobile Home.

| FPRA CODE | FACTOR |
|---|---|
| A | 0.29 |
| B | 0.29 |
| C | 0.29 |
| D | 0.29 |
| E | 1.00 |
| F | 0.29 |
| G | 0.40 |
| H | 0.40 |
| I | 0.40 |
| J | 0.60 |
| K | 0.60 |
| L | 0.60 |
| M | 1.00 |
| N | 1.00 |
| O | 0.60 |
| P | 0.60 |
| Q | 0.75 |
| R | 0.75 |
| S | 0.75 |
| T | 0.75 |
| U | 0.75 |
| V | 1.00 |
| W | 1.00 |
| X | 1.00 |
| Y | 1.00 |
| Z | 1.00 |