"What's Credit Got to Do With It?"

Legislator Information Packet:

The Benefits of Credit-Based Insurance Scoring

Prepared and Presented by a coalition of

Nevada's Insurance Companies, Consumer Data and Analytics Companies, and National Insurance Trade Associations

March 2011

Nevada Assembly Bill 162, if enacted, would make Nevada one of only three states in the nation to statutorily prohibit insurers' use of credit-based insurance scores to help determine what consumers pay for auto and homeowners insurance.

After more than 20 years of insurers' experience in the use of credit information, the data show that credit-based insurance scores work to benefit most insurance consumers. And new evidence suggests that prohibiting the use of this accurate and predictive tool can disrupt the personal insurance market and result in higher insurance costs for consumers.

This packet provides comprehensive information about credit-based insurance scoring, based on state and national studies and real-world examples from today's insurance marketplace. We hope it answers many of the most frequently-asked questions about credit-based insurance scoring.

PCI Property Casualty Insurers Association of America
Shaping the Future of American Insurance

NAMIC®

American Insurance Association

Q: Why do insurance companies use credit history to set rates?
A: Insurance scoring helps insurers predict risk, increase availability and accurately price home and auto policies.

Insurance scoring matches rates to the risk of loss

An insurance score is the result of an objective statistical analysis of credit report information identifying the relative likelihood of an insurance loss, based on the actual loss experience of individuals with similar financial patterns.

Insurance scoring's predictive properties help insurers identify more accurately the risk of loss each policyholder represents. So, insurance scoring helps consumers three ways:

- ✓ **Lower rates:** Insurance rates are **reduced** for most consumers.
- ✓ **Rates match risk:** Higher-risk policyholders may pay a higher rate that accurately reflects their higher risk of loss – so lower-risk policyholders don't have to subsidize the cost of insurance for higher-risk policyholders.
- ✓ **Improved availability:** A good or fair credit history may offset negative underwriting factors such as a poor driving record or number of miles driven, thereby improving the availability and affordability for more insurance consumers.

"…insurers are unique in the U.S. economy, as they do not know the ultimate cost of their product when they sell it. Having a tool to more effectively predict losses helps insurers price their products more fairly, benefiting all consumers."

Lawrence Powell
The Independent Institute
Report: Credit-Based Scoring in Insurance Markets
October 2009

Experts and Studies Confirm: Insurance Scoring Benefits Most Insurance Consumers

- **Nevada, July 2005:** The state Insurance Division's own study results *"corroborate the insurance industry's contention that the majority of policyholders benefit from the use of credit scoring."*
- **Oregon, Fall 2006:** Voters rejected credit-ban Measure 42, 65-35% after learning it could increase auto and property insurance rates by millions statewide – as much as $175 per family per year.
- **Wisconsin, Fall 2007:** a domestic insurer testified before a Senate committee that *"nearly 75 percent"* of their customers get a discount because of use of credit information.
- **Washington DC, July 2007:** The Federal Trade Commission released a comprehensive report on the use of insurance scores in automobile insurance, based on a review of 2 million policies. The report confirmed that scores have "little effect as a 'proxy'" for race or income and validated the correlation between insurance scores and risk of loss.
- **North Dakota, January 2009:** a domestic insurer testified before a Senate committee *"upwards of 80 percent"* of its auto and homeowners customers are now receiving a discount because of their credit information.
- **Arkansas, June 2010:** The state Insurance Department reported *"88% of consumers either received a discount for credit or it had no effect on their premium"* and *"[f]or those policies in which credit played some role in determining the final premium, those receiving a decrease outnumbered those who received an increase by 3.3 to 1."*

Q: What does a consumer's credit history have to do with the price we pay for auto or homeowners insurance?

A: Credit-based insurance scores are an accurate and fair predictor of risk of loss.

Insurance Scoring: Accurate, Fair and Predictive

Most policymakers and consumers agree: lower-risk policyholders should not have to pay the same rates as higher-risk policyholders for home and auto insurance, so it is important for insurers to accurately predict each policyholder's likelihood of filing claims and price their policies accordingly.

Numerous studies by federal and state regulators, universities, independent auditors and insurance companies have all shown that an individual's credit history is a proven, accurate indicator of how likely that person is to file a future claim and the potential cost of that claim.

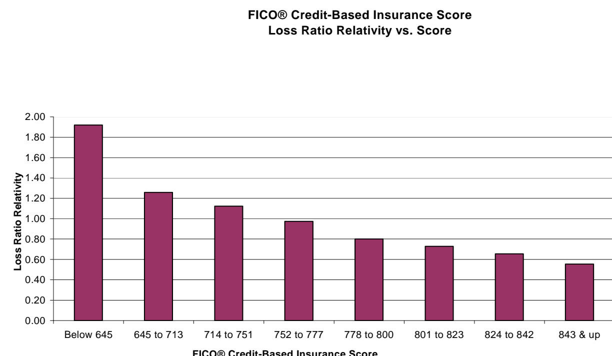
Credit reports & scores are accurate

It is a myth that credit reports, and therefore credit-based insurance scores, are often inaccurate.

According to the Consumer Data Industry Association, between 2004 and 2006, more than 52 million credit reports were provided to consumers free of charge, as provided for under federal law. Just 10% (520,000) of consumers had questions about their report or filed a dispute. Of the 10% who filed a dispute, just 1.98% (102,960) of disputes resulted in a deletion of data.

> ***"Credit-based insurance scores are effective predictors of risk under automobile policies. They are predictive of the number of claims consumers file and the total cost of those claims. The use of scores is therefore likely to make the price of insurance better match the risk of loss posed by the consumer."***
>
> ***"Credit-based Insurance Scores: Impacts on Consumers of Automobile Insurance"***
> **A Report to Congress by the Federal Trade Commission, July 2007**
> **(2 million policies examined by FTC)**

Insurance Scores and Risk of Loss are Related



FICO ® Credit-Based Insurance Scores for homeowners' insurance shows an inverse relationship between loss ratio and insurance score. The lower the score; the higher the loss ratio. Conversely, the higher the score; the lower the loss ratio.

Independent, university and government studies agree

Separate studies by the Federal Trade Commission, the Texas Department of Insurance (TDI), the University of Texas, Tillinghast Towers-Perrin, EPIC Consultants and others have all proven that credit-based history correlates with the risk of insurance loss. The recent TDI study showed that:

- The average loss per vehicle for people with the worst insurance scores is **double** that of people with the best credit-based insurance scores.
- Homeowners insurance loss ratios for people with the worst insurance scores are **triple** that of people with the best scores.
- Drivers with the best credit history are involved in about **40 percent fewer accidents** than those with the worst credit history.

Q: Does insurance scoring unfairly discriminate against minority or low-income consumers?
A: *No.* Insurance scores don't include race or income information.

Race, income, gender, address, ethnic group, religion, marital status or nationality are not considered

Insurance scores are objective and "blind" to race and income. Credit-based insurance scores do NOT consider a consumer's income, race, age, address, marital status or nationality because insurers and credit bureaus are legally prohibited from considering such data. An insurance score only measures the risk-relevant variables (payment history, public records, etc.) that are indicators of potential future risk.

While some studies have shown that individuals in some minority or income groups may have somewhat lower insurance scores than others, those same studies also confirm that the full range of scores, from highest to lowest, are present at all income levels and among all racial and ethnic groups.

U.S. anti-discrimination laws require businesses to avoid deliberate bias against minority groups. Through the use of insurance scoring, only individual consumers who represent potentially higher risk pay higher premiums, regardless of their race or income.

Credit scoring… is not unfairly discriminatory as defined in current law because credit scoring is not based on race, nor is it a precise indicator of one's race. Recall that not all minorities are in the worst credit score categories. Further, its use is justified actuarially and it adds value to the insurance transaction."

Jose Montemayor
Commissioner, Texas Department of Insurance
Report to the Governor and Legislature
January 2005

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

Federal Trade Commission (FTC)
July 2007

U.S. and State Regulators Confirm: Insurance Scoring is Objective

"Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance," Federal Trade Commission (FTC) Report, July 2007:

This comprehensive report included findings discounting the alleged "disparate impact" of credit-based insurance scores on low-income and minority consumers, concluding credit-based insurance scores, "appear to have little effect as a 'proxy' for membership in racial and ethnic groups in decisions related to insurance…"

The report continued, "Tests also showed that scores predict insurance risk within racial and ethnic minority groups…This within-group effect of scores is inconsistent with the theory that scores are solely a proxy for race and ethnicity."

"Use of Credit Information by Insurers in Texas: The Multivariate Analysis," Texas Department of Insurance, January 2005

An independent study by the Texas Department of Insurance confirmed that credit-based insurance scoring does not discriminate based on race or income. According to the study, a higher percentage of adults in low-income groups and certain minority groups (African-American and Hispanic) have somewhat lower scores compared with the rest of the adult population. However, the study also showed that each group studied receives the full range of insurance scores. This is only possible if insurance scoring is a color-blind, objective process.

Q: What has the use of credit information done to insurance rates?
A: Credit-based insurance scores *reduce* premiums for most consumers.

Credit-based insurance scores are fair & accurate.

Studies by the University of Texas and the Federal Trade Commission found credit-based insurance scores are highly predictive of whether an individual will file an insurance claim and for how much, while simultaneously finding no evidence they are proxies for ethnicity or income. Most insurance companies in the United States use insurance scoring to one degree or another to price auto and homeowner coverage because it allows them to better match the rates consumers pay with the level of risk they represent. It makes sense that people with a lower risk of filing a claim should pay less for their insurance.

While insurers are able to calculate scores for most consumers, about 4% of the population does not have sufficient enough credit history to generate a score. Washington state law (RCW 48.19.035) protects these consumers by prohibiting an insurer from charging someone more simply because they lack credit history.

Consumers could see rates go up if insurance scoring is prohibited.

Because most people manage their credit responsibly, the use of credit-based insurance scores benefits a majority of consumers and saves them money. Banning such use would mean that responsible consumers would pay more – and subsidize the cost of insurance for less responsible consumers.

Without the use of insurance scores:

- ✓ **Policyholders with a history of responsible credit management could pay more for their home and auto insurance.**
- ✓ **Policyholders with a *low risk* of filing a claim could subsidize the cost of insurance for those who are at *higher risk* of filing a claim.**

Study results "…corroborate the insurance industry's contention that the majority of policyholders benefit from the use of credit scoring."

Nevada Division of Insurance study, 2005

"88% of consumers either received a discount for credit or it had no effect on their premium."

Report to the Arkansas Legislature by the State Insurance Department, 2010

The numbers prove it…

Credit is only part of the score…

Insurance scores use *some* information from credit reports – but not all. And insurers also use other, non-credit information, such as driving record or marital status, to determine a policyholder's risk of loss. All these factors taken together help establish premium.

Most consumers earn favorable credit scores

According to FICO® (the data analytics company formerly known as Fair Isaac Corp.), **76%** of consumers exhibit good or fair credit management behavior, which result in higher credit scores. While credit scores and credit-based insurance scores are not identical, good credit scores correlate to good insurance scores – and result in lower insurance costs for consumers.

Most consumers pay less for insurance because of insurance scoring

A 2006 study conducted by the respected Oregon-based economic research firm ECONorthwest revealed:

58% of auto policyholders and 53% of homeowners policyholders in Oregon **paid lower premiums** due to the use of credit information by their insurer.

Policyholders with favorable insurance scores paid as much as **48% less** than they would have paid without the use of credit information.

Annual premium reductions for credit-based insurance scores averaged $115 on auto insurance and $60 for homeowners insurance. That means credit-based insurance scoring saved an average family $175 per year – savings that would be threatened by a law to prohibit credit-based insurance scoring.

Q: Aren't states moving to ban insurers' use of credit history?
A: *No.* Citizens and legislators nationwide have rejected laws to ban insurance scoring - *again and again, over 22 years.*

States regulate – *but nearly all allow* – credit-based insurance scoring

Nearly every state – including Washington – has laws to ensure the fair and accurate use of credit information by insurance companies. Only two ban its use entirely. Two others have enacted bans on credit-based insurance scores in specific lines of insurance: Hawaii (auto insurance) and Maryland (homeowners).

Legislators and regulatory agencies in 48 states have studied and debated insurers' use of credit information and have determined insurers should be allowed to use credit information in underwriting and/or rating decisions. Recent developments include:

- **In 2009, 16 states** considered legislation banning the use of credit-based insurance scoring. Not one of those bills passed either chamber of a single state legislature.
- **In 2008, 18 states** considered legislation banning the use of credit-based insurance scoring. Only two of those bills passed either chamber of a state legislature. Neither bill came to a vote in the opposite chamber.
- **In 2007, 14 states** considered legislation banning the use of credit-based insurance scoring. Not one of those bills passed either chamber of a state legislature. Not one of those bills passed out of its committee of origin.

> *"This is the classic case of an initiative that sounds worth a look at first glance, but would cause disruption, uncertainty and ultimately higher rates for everyone."*
> **The Daily Astorian (Oregon)**
> *October 20, 2006*

2006: Oregon Voters Say No to Higher Insurance Rates by 2-1

In the fall of 2006, Oregon voters resoundingly defeated a state ballot measure that proposed a ban on insurance companies' use of credit information to help them set rates for insurance.

In the nation's only public vote on an issue which has generated widespread debate in legislatures and regulators' offices across the country, consumers themselves strongly endorsed insurers' use of credit information, defeating Oregon Measure 42 by a nearly two-to-one margin – 65%-35% statewide.

Voters in one of the nation's most pro-consumer states overwhelmingly rejected attempts to ban insurance scoring because they came to see it as a practice that benefits most consumers and allows insurers to price policies more fairly.

Oregon voters responded to the experience insurers and consumers have seen across the nation over more than two decades:

Most consumers would end up paying more for their insurance. People with good credit would pay more for their insurance and people with bad credit would pay less.

A credit ban forces low risks to pay more; to subsidize high risks. Those with good credit histories would be forced to subsidize people with bad credit.

Current laws work – we don't need a ban. State consumer protection laws are already among the most restrictive in the nation, limiting how insurers may use credit information.

Alaska's cautionary tale...

In 2003, the Alaska Legislature passed a law allowing insurers to use credit-based insurance scores to rate home and auto insurance for new business, but required insurance companies to remove credit information when a policy renewed after two years. The result:*

- ✓ Nearly 40% of personal auto policies had premium increases between 11% and 25%.
- ✓ Almost 3 out of 10 homeowners' policies experienced premium increases between 11 and 20 percent.
- ✓ The most significant premium increases – greater than 20% - were given to roughly one-fourth of the personal auto policies and more than 4 out of 10 homeowners policies.

* Data call & analysis conducted by Property Casualty Insurers Association, 2/10

Q: Are credit scores declining for low-income consumers in the economic downturn?

A: Credit scores remain predictive across income levels and are steady – and in some cases, *rising* - for the majority of consumers.

As consumers reduce debt, scores remain steady for most; rise for some; decline for few.

Mortgage failures, recession and rising unemployment have led to assumptions that credit scores are declining, particularly for low-income consumers.

But the numbers tell a different story. Data provided by three leading credit reporting bureaus and FICO ® (formerly Fair Isaac Corp.) show that average credit scores remain steady – and are in some cases *rising*.

There have been real and tragic stories of consumers who have been directly impacted by the economic crisis - who have lost jobs or even their homes. For these consumers, there may be an impact on their *credit scores.* But it is important to note that *insurance scores,* which may include credit *and* non-credit factors, tend to weigh less heavily mortgage or credit default information than credit scores used for determining credit worthiness.

At the same time, data show a large number of consumers are seizing the opportunity to improve their financial management practices. They are paying bills on time, paying down balances and not seeking new credit lines. These prudent steps are helping to improve credit scores for many consumers.

INCLUDED in a consumer credit report	NOT INCLUDED in a consumer credit report
• Consumer accounts – credit cards, retail store cards, mortgages, auto loans; • Public information – bankruptcies, liens, judgments; • Consumer-initiated credit inquiries related to opening new credit accounts.	• Medical history and records; • Consumer buying habits; • Checking, savings, income, marital status, age, race, religion, family status, color, receipt of public assistance, disability, gender or national origin.

Insurance scores use *some* information from credit reports – but not all. And insurance scores may include other, non-credit information, such as driving record, to determine a policyholder's risk of loss. Importantly, insurance scores tend to place emphasis on a consumer's depth of credit history, reflected by the number and type of accounts maintained over time. This approach minimizes short-term impacts of reduced credit line capacity or increased delinquency.

> *"While credit card holders don't control their credit limits, in many cases, they do control their account balances. Recent data shows that a notable number of consumers have reduced their revolving credit usage, helping to minimize any effect from lenders reducing their account limits."*
>
> **Lamont Boyd**
> **Fair Isaac Corp. (FICO®) Report to the National Association of Insurance Commissioners**
> **April 2009**

Credit data show only minor fluctuations in insurance scores

At an April 2009 hearing before the nation's insurance regulators, credit bureau TransUnion's Global Chief Scientist, Chet Wiermanski, testified that between 2005 and 2008 the national average TransUnion Insurance Risk Score for each of the bureau's three proprietary insurance score models showed only minor fluctuations.

For example, the national average TransUnion Auto Insurance Risk Score, which ranges on a scale of 150 to 950, shifted from a low of 840.7 in the first quarter of 2006 to a high of 843.7 in the first quarter of 2008. The most recent national average TransUnion Auto Insurance Risk Score, as reflected of the fourth quarter of 2008, is 842.7. The national average scores for TransUnion's Property and combined Auto/Property Insurance Risk Scores showed similar fluctuations.

Current inventory of available studies, industry data & comment and recent news articles

Studies, 2001 - 2011

Virginia Bureau of Insurance, *Use of Credit Reports in Underwriting*, 1999

Conning Financial Intelligence and Solutions, *Insurance Scoring in Personal Automobile Insurance – Breaking the Silence*, 2001

EPIC Actuaries, LLC, *The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity*, 2001

Michigan Office of Financial and Insurance Services, *The Use of Insurance Credit Scoring in Automobile and Homeowners Insurance*, December 2002

Alaska Division of Insurance, *Insurance Credit Scoring in Alaska*, February 2003

University of Texas, *A Statistical Analysis of the Relationship Between Credit History and Insurance Losses*, 2003

Washington Office of Insurance Commissioner, *A Report to the Legislature, Effect of Credit Scoring on Auto Insurance Underwriting and Pricing*, January 2003

National Association of Mutual Insurance Companies (NAMIC), *The Legal Theory of Disparate Impact Does Not Apply to the Regulation of Credit-Based Insurance Scoring,* 2004

Texas Department of Insurance, *Use of Credit Information by Insurers in Texas*, December 2004

Maryland Insurance Administration, *Report on the Credit Scoring Data of Insurers in Maryland*, February 2004

Nevada Division of Insurance, *Report on the Use of Consumer Credit and Loss Underwriting Systems*, 2005

Texas Department of Insurance, *Use of Credit Information by Insurers in Texas: The Multivariate Analysis*, January 2005

Arkansas Insurance Department, *Use of Impact of Credit in Personal Lines Insurance Premiums Pursuant to Ark. Code Ann. § 23-67-415*, published annually since 2005

EcoNorthwest Oregon Insurance Scoring Economic Impact Study, 2006

Brockett, Patrick and Linda Golden, *Biological and Psychobehavioral Correlates of Credit Scores and Automobile Insurance Losses: Toward an Explication of Why Credit Scoring Works*, Journal of Risk and Insurance, 2007, Vol. 74, No. 1, 23-63

Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance*, July 2007

Report: Credit-Based Scoring in Insurance Markets – Lawrence Powell, Independent Institute, October 2009

St. Ambrose University, *Use of Credit Scores by the Insurance Industry: Iowa Consumers' Perspective*, December 2009.

Colorado Division of Insurance, *Credit-Based Insurance Scoring Study - Final Report*, January 7, 2010.

Industry data & comment, 1999 - 2011

Fair Isaac (now FICO), *Predictiveness of Credit History for Insurance Loss Ratio Relativities*, October 1999

Oregon Measure 42 (Oregonians Against Higher Insurance Rates), November 2006

ChoicePoint, *Understanding the Use of Credit and Scores for Insurance Underwriting*, 2006

ChoicePoint, *Understanding the use of Credit and Scores for Insurance Underwriting*, December 2007

CDIA Accuracy Report, 2009

CDIA Briefing Paper, The Use of Credit for Insurance Purposes, April 2008

PCIAA, The Predictive Values of Credit-Based Insurance Scores, January 2009

FICO® Credit-Based Insurance Score Trends in Dynamic Times, June 2009

FICO® Report: Scores in a Down Economy, July 2009

PCIAA, Banning Credit-Based Insurance Scores Would Hurt Main Street USA, April 2009

PCIAA, *Analysis of Removing Credit-Based Insurance Scores on Insurance Rates in Alaska*, February 2010

News reports and articles

Credit Scoring Explained, Readers Digest, October 2009

Insurance Scoring Shows Strength in Face of Economic Weakness, Auto Insurance Report, 5/18/09

What You Don’t Know About Auto Insurance, Wall Street Journal, 10/07/09