Comments of Birny Birnbaum of the Center for Economic Justice

NAIC Auto Study Group Hearing

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My name is Birny Birnbaum and I serve as Director of the Center for Economic Justice, a non-profit consumer organization that advocates on behalf of consumers for fair access and fair treatment of consumers for financial services with an emphasis on affordability and availability of insurance products. I have worked on auto insurance affordability and availability issues for over 20 years as a consumer advocate, insurance regulator and consultant to public agencies. I am one of the NAIC consumer representatives and I serve on the Federal Advisory Committee on Insurance, chairing the Affordability and Availability Subcommittee.

My colleagues Norma Garcia and Bob Hunter have laid out the issues of concern with auto insurance pricing practices of insurers and the implications for affordability of low- and moderate-income consumers. My comments will respond to industry comments.

I note that the hearing materials include a recent article by Dan Schwarcz and two colleagues ("Schwarcz article") regarding the relationship between insurance credit scores and income. I'll start by commenting on the paper. First, studies by two departments of insurance based on more comprehensive data than the Schwarcz article – Texas and Missouri – have concluded that average income levels in a geographic area are associated with average insurance scores. Consequently, it is unclear what the new article brings to the debate.

The Schwarcz article adds nothing to the debate about credit scoring. It is yet another review of data hand-selected by insurers – data with clear biases. It doesn't matter how sophisticated the analysis might be – any analysis of bad, woefully incomplete or biased data cannot yield a robust conclusion and certainly not the mammoth conclusions claimed by the authors.

The authors rely heavily on the FTC study of 2007, calling it "by far the most important and influential." That is demonstrably untrue. The Schwarcz article makes no mention of the massive critiques of the study, such as the fact that the study relied upon data selected by insurers and not data selected by researchers. The critiques of the auto study led to a major revision in approach by the FTC for the homeowner's credit scoring study.

The Schwarcz article promises a new contribution to the debate and new analysis. Yet that is clearly incorrect. The study simply uses more granular measures of income and a second proxy for income. The study not only fails to utilize a comprehensive data set specified by researchers, the study utilizes an incredibly tiny set of experience. The second of ***four*** caveats to the conclusions states:

> "It comes from a single insurer operating in a single state. Consequently, it may not be representative of other insurers in other states."

In fact, the data may not even be representative of other insurers in the same state. But the authors breeze by this with,

> "We have no reason to believe that the insurer is not representative of other insurers in other states. But it is possible."

Given that the authors describe no efforts to test whether the single insurer's experience is representative of other insurers in the state or of other states, there is no basis to believe anything about how representative the data are. Questioning whether the data are representative of other insurers and other states would however require tempering the bold conclusions of the article. Similarly the third and fourth caveats are individually, and certainly collectively, sufficient to temper conclusions, but that is not the case for the authors.

This brings me to the next issue – the strongly biased nature of the data set used. The data set consisted of some 66,000 policies issued from 1998 to 2006 that had full auto – liability plus comp plus collision and associated property insurance. One data set was full auto with homeowners policies and the other data set of some 8,000 policies was auto with renters or condo or coop insurance.

It is glaringly obvious that this data set is biased to exclude lower-income consumers who buy only auto insurance or who buy only auto liability insurance

There is mention in the paper of whether some or all of the policies were underwritten for credit which would have produced a data set limiting consumers with bad credit scores.
There is no discussion in the paper of whether the policies were distributed evenly across low, middle and upper-income census tracts or if one group overrepresented?
There is no discussion in the paper that only working with policies issued excludes consumers who failed to purchase insurance because their credit scores produced unaffordable premiums. As with all other studies, there is no information on quotes not accepted because of high premiums due to credit. Eliminating these quotes means eliminating the issue you are trying to evaluate.

There is no discussion in the paper of any efforts by the authors to verify the accuracy and completeness of the data in any way.

The paper sets up a straw man argument – there are two and only two explanations why credit scores might be correlated to claims. Credit is either a proxy for income or credit is a measure if financial irresponsibility and such irresponsible customers have more claims. They conclude that since they found no proxy effect, credit must be a measure "financial responsibility."

It is ridiculous to suggest there are only two explanations for the correlation of credit to claims. The authors provides zero empirical support for the financial responsibility argument, but simply default to it by virtue of their one other option being eliminated.

Second, the financial responsibility argument fails for any number of reasons. CEJ and the NCLC produced a report a couple of years ago examining credit histories showing that credit histories and credit scores reflect and perpetuate historical discrimination in financial services. The fiscal irresponsibility argument is a blaming the victim strategy.
The authors apparently find no difference in the predictiveness of credit scores between collision and comprehensive. If financial responsibility was a cause, then why is there a relationship between credit and comprehensive – a coverage dominated by natural disasters and not-at-fault events?

The authors' data set stops at 2006, the year before the financial crisis began. If credit history is a measure of "financial responsibility" then many millions of consumers became "financial irresponsible" between 2007 and 2010.

At the beginning of the financial crisis, there were about 50 million outstanding mortgages, the majority of which were owned or insured by Fannie Mae or Freddie Mac. In January 2007, about 0.5% of Fannie and Freddie mortgages were seriously delinquent (90+ days) or in foreclosure. Three years later, the percentage of seriously delinquent or in foreclosure mortgages was over 4% for Freddie and over 5.5% for Fannie – an increase of millions of "financially-irresponsible borrowers."

According to data from the Federal Reserve Board, delinquency rates for residential mortgages increased from 2.03% at the end of the first quarter 2007 to 11.26% at the end of the first quarter 2010, representing an increase of about 4 million mortgages in delinquency. [1]

According the FRB data, credit card delinquencies increased from 4% to 6.8% from 2007Q1 to 2009Q4, reflecting several million additional consumers with delinquencies showing up in credit reports.

In 2007, there were a total of 827, 396 bankruptcy filings. The number increased each year through 2010 when bankruptcies peaked at 1,561,008.[2] The number one cause of personal bankruptcy, by far, is medical debt.[3] According to a study by *the Atlantic*:

> Americans pay three times more for medical debt than they do for bank and credit-card debt combined, the report found. Nearly a fifth of us will hear from medical-debt collectors this year, and they'll gather $21 billion from us, collectively.

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[1] http://www.federalreserve.gov/releases/chargeoff/delallsa.htm
[2] http://www.creditslips.org/creditslips/2015/01/bankruptcies-down-12-in-2014-forecast-predicts-the-same-for-2015.html
[3] http://www.creditslips.org/creditslips/2015/01/bankruptcies-down-12-in-2014-forecast-predicts-the-same-for-2015.html

Putting aside the fundamental unfairness of charging consumers higher auto and home insurance rates because of reckless and abusive lending practices and because of medical costs that outstrip health insurance, the data on financial stress during the financial crisis should have led to significant deterioration in credit scores as millions more consumers became "financially irresponsible."

But TransUnion, a consumer reporting agency selling insurance credit scoring models, tells us that insurance credit scores were stable and improved slightly over the course of the financial crisis. If this is true, then what are insurance scores actually measuring? It certainly is not "financial responsibility."

In summary, the study adds nothing to the debate about credit scoring. It is yet another review of data hand-selected by insurers – data with clear biases. It doesn't matter how sophisticated the analysis, any analysis of bad, woefully incomplete or biased data cannot yield a robust conclusion and certainly not the mammoth conclusions claimed by the authors.

This study points to the ongoing problem with the regulatory oversight of insurer pricing – regulators and the public simply do not have the data to monitor the market performance of insurers. In the lending realm, the data are robust and comprehensive, available to regulators, scholars and interested parties and utilized for a variety of analyzes to identify, among other things, that low-income and minority communities were the targets of predatory lending practices and have borne the disproportionate impact of the foreclosure crisis.

Competition and Affordability

Insurers typically argue that any limit on risk classification harms competition and, consequently, harms consumers. They argue that credit scoring has enabled insurers to offer insurance to more consumers and point to historical declines in the number of consumers in assigned risk plans.

I'm a firm believer in the power of markets to benefit consumers, but regulation is essential to ensure that such competition is fair. The fact is that insurers' use of credit scoring has resulted in far higher rates for some consumers and lower rates for other consumers. UM motorist rates have not declined as a result of insurers' use of credit scoring. The data show that UM rates remain persistently high, despite dramatic increases in monitoring and punitive measures against uninsured drivers. The data also show that UM rates fluctuate with economic conditions, particularly the unemployment rate, indicating that the overwhelming reason for uninsured motorists is affordability. There is a need for the states to improve the balance of efforts to penalize uninsured motorists and improve affordability of auto insurance.

Insurers' claim that they singularly focused on deriving the most accurate rates for the risk they insuring is belied by a recent story on MN public radio about price optimization. The industry spokesperson simply confirms what consumers have argued all along – that pricing considers far more than expect claims and includes factors unrelated to cost-based pricing.

MN Public Radio, 11/16/2015
Insurance Federation of Minnesota spokesman Mark Kulda acknowledges some insurers in Minnesota use price optimization.
"It's also a practice used by many other industries," he said. "This is not really anything new in the economy. All companies really try to see how much can they charge for their product and what is the most that consumers will bear to pay. And it's no different in the insurance industry."

I must also address the confidence fairy argument – that unlimited risk classification allows insurers to have more confidence in writing insurance and therefore makes insurance more available. Putting aside the lack of evidence to support the claim, as discussed above, insurers routinely ignore the fact that the introduction of ever new rating factors – particularly those based on socio-economic characteristics and opaque to the consumer – lead to ever widening spread of rates with ever greater prices for those consumers viewed unfavorably by insurers. There is simply no empirical or public policy basis for unlimited risk classification and broad public policy support for limits on risk classification that promote affordability and empowerment of consumers for behavioral changes to reduce accidents and claims.

Finally, I also want to address the industry response to auto insurance affordability issues with “let’s focus on auto safety and reducing accidents.” Auto safety efforts are without a doubt important and should be a priority, but they are not a response to auto insurance affordability issues. These issues address a certain percentage of the population and their affordability issues will not be addressed by lowering overall rates by 5% when they are facing rates that are 200%, 300% of average rates because of socio-economic characteristics outside of their control.

Further, if the industry were truly concerned about reducing claims, the industry would embrace the rating issues raised by consumers because our proposals to modernize insurance rating rules are based on giving consumers better feedback and economic incentives to modify their behavior to reduce claims. The consumer proposals are consistent with the industry’s professed goals of reducing claims. In fact, reforming rating practices is necessary so that the practices reinforce other types of loss prevention activities. Instead, the frequent introduction of new opaque rating factors causing major changes in prices undermines rate stability and prompts insurers and states to introduce transition pricing rules.

Existing risk class regulation based on old old school big data, where regulators have oversight of all factors going into pricing and the data underlying the risk class analysis of rating factors and relativities.

Today, regulators simply do not have the resources to monitor all the databases and scoring models used by insurers nor access to the data underlying these new models.

If it is unrealistic to expect regulators to provide the type of historical review of advisory loss costs to new pricing tools, what is the way forward?

Recommendation 1: Each state should require personal lines insurers to report all types of data used for sales, marketing, underwriting, pricing, conditioning payment plan use and claims settlement; the sources of the data; and the uses of the data. The NAIC should develop a template to promote uniformity across the states. The NAIC should also serve as the data collection and compilation agent for those states needing assistance to carry out this request for information. This will provide states with basic information about the types of data used for pricing so regulators have a comprehensive view of market activities.

Recommendation 2: Each state should have access to all the underlying data supporting an insurer's rate filing in order to independently verify the calculations and modeling presented in that rate filing. Each state should have the authority to retain, at insurer expense, consultants with necessary expertise if the state does not have the necessary expertise in-house for the review of the filing or other big data application. The NAIC should serve as the data collection agent and provide technical assistance to states needing such assistance to verify the results presented by insurers in rate filings and other big data applications. Currently states are forced in the position of relying on insurer assertions instead of independent verification of model outputs and results. Consequently, if an insurer makes a significant error in its pricing model, there is no way for a regulator to find out, let alone find out if the insurer is misrepresenting its analytics.

Recommendation 3: Each state should monitor the outcomes in personal lines markets by collecting and analyzing transaction data on sales and claims. The NAIC should serve as the data collection and compilation agent for those states needing assistance to carry out this request for information. The only meaningful way to evaluate the impact of new pricing factors on the market is to collect the granular data to see what consumers are being offered what rates in what locations. There is a massive need to move beyond unsubstantiated claims to data-based conclusions

Thank you for your consideration.