The Center For Economic Justice
1701 A South Second St.
Austin, TX 78704
(512) 448-3096
(fax) 448-3096

Extended Comments of Birny Birnbaum for the Florida Insurance Commissioner's Task Force on Credit Scoring

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The presence of four recommendations in the Task Force report directed at limiting the impact on consumers of insurers' use of consumer credit information reveals the Task Force's great concern about the impact on consumers of insurers' use of consumer credit information for underwriting and rating personal lines insurance. There is a strong case for a more comprehensive limitation and/or prohibition on insurers' use of consumer credit information because the practice:

- Is inherently unfair to large numbers of consumers;
- Violates important principles of risk classification; and
- Effectively deregulates insurance rates

These comments address the following issues:

- Why there are serious questions about the alleged correlation between consumer credit information and risk of loss;
- How consumer credit characteristics are related to consumer income and age
- Why insurers are so committed to using credit scoring;
- Why simple correlation is not sufficient to justify the use of credit scoring for underwriting or rating;
- Why credit scoring violates principles of risk classification;
- Why insurers' use of credit scoring is inherently unfair to many consumers;
- Why the failure of insurance regulators and/or state legislatures to limit insurers' use of credit scoring for underwriting and rating is effectively deregulation of private passenger automobile and residential property insurance rates;
- A warning to regulators and state legislators to be prepared for insurers' tactics in their fight to prevent restrictions on their use of credit scoring; and

Consumer credit history is not just another rating factor. Insurers' use of credit history and credit scoring for underwriting and rating should be getting major scrutiny by insurance regulators, state legislatures and consumers because it's role has grown to the point that, for some insurers, credit history has the greatest impact on determining the consumer's premium. Further, a growing number of insurers are using credit history and these insurers are using credit history more intensively.

In addition, insurers' use of credit history represents a radical departure from traditional risk classification and pricing practices. It is the epitome of moving from traditional groupings of consumers in rating groups based upon historical risk classifications to a continuum of pricing based upon non-insurance related factors.

There Are Serious Questions About The Alleged Correlation Between Consumer Credit Information And Risk Of Loss

Credit is unlike other rating factors in terms of the regulator's evaluation of the relationship between credit information and risk of loss. There has been no independent analysis of the alleged correlation because the only entities who have access to both the insurance data and the consumer credit information are the scoring vendors and insurers. This is a radical departure from regulatory practice. With any other rating factor, the information necessary for a regulator to evaluate an alleged relationship to risk of loss is available through statistical reporting. Thus the regulator can collect the insurance information and do an independent analysis – this is not possible with credit scoring and regulators have taken the word of the industry when they claim there is a correlation.

The "evidence" supporting the correlation claim comes almost exclusively from insurers, insurer trade associations and credit scoring vendors who refuse to divulge the methodology of their studies, details of the study results and/or the underlying data for independent verification. For those studies about which some information is known, the industry claims become more suspicious. For example, Fair, Isaac continues to bring out the Tillinghast "study" as support for the correlation – even though the NAIC Credit Reports subgroup dismissed the "study" as "counterproductive and misleading."

The industry cites a study by the Virginia Bureau of Insurance to support both the correlation claim and the claim that credit scores are not correlated with race or income. This study consisted of Fair Isaac providing the Virginia Bureau with average credit scores for a number of ZIP Codes and then the Department analyzed the average credit scores versus race and other demographic factors. The shortcoming of this study is that there is no verification of the credit scores and Fair Isaac was in a position to create the desired outcome with the data it provided to the Department. The industry, however, fails to mention this caution in the report:

> The Bureau has concerns about the long-term effect that the use of credit scores may have on Virginia consumers. As the number of insurers that use credit history as an underwriting tool increases, there may be an increase in the number of consumers that will be refused coverage, cancelled, non-renewed, or charged higher premiums due to their adverse credit history.

The industry studies are also suspect because they generally rely upon a univariate analysis with loss ratios as the dependent variable. Stated differently, the studies simply relate one variable – credit score – to loss ratio. This type of analysis is insufficient to determine if credit history is actually related to loss ratio or really just related to other rating factors which have a demonstrated relationship to risk of loss. The univariate loss ratio analysis of credit history is insufficient because such an analysis is predicated on the assumption that all other relevant rating factors are reflected in the premium (e.g. denominator of the loss ratio) and that these factors are accurately priced. This is simply not the case. Rather, a multivariate analysis focusing on exposures and claims is necessary. Multivariate means that other rating factors are included, so the unique contribution of credit history (if any) to explaining risk of loss is identified.

There is a growing body of information casting doubt on the insurers' correlation claim. For example, if consumers who have filed for bankruptcy in the past five years are far more likely to have claims that consumers who have not filed for bankruptcies, then we would expect an increase in loss ratios if the number of bankruptcies increases dramatically. Personal bankruptcies did increase dramatically during the 1990's, yet private passenger auto insurance loss ratios *declined.* The following data show a *negative* correlation – just the opposite of the positive correlation claimed by the insurance industry.

Year	Private Passenger Auto Countrywide Incurred Losses to Earned Premium	Countrywide Non-Business Bankruptcies	Private Passenger Auto Florida Incurred Losses to Earned Premium	Florida Bankruptcy Cases Filed
1985	75.9%	297,885		
1986	73.8%			
1987	71.1%	473,000		
1988	72.0%	526,066		
1989	73.8%	580,459		
1990	73.6%	660,796	68.0%	
1991	68.6%	812,685	66.8%	43,400
1992	66.8%	899,840	76.4%	52,400
1993	67.1%	852,306	72.1%	46,600
1994	67.6%	788,509	70.1%	41,900
1995	66.8%	806,816	69.6%	43,400
1996	66.7%	989,172	64.3%	51,900
1997	62.7%	1,263,006	60.6%	67,400
1998	62.4%	1,379,249	61.4%	76,400
1999	65.2%	1,352,030	69.7%	79,200

Another blow to the correlation claim comes from a recent study by the nation's largest mortgage insurers, MGIC Investment Corp, which evaluated thousands of home loans during the 1989 to 1991 recession. The study found that some borrowers with the best Fair, Isaac (FICO) scores faced more serious risk of delinquency and foreclosure than borrowers with the poorest FICO scores because local economic conditions are the most important factor in determining likelihood of delinquency and foreclosure. Consumers with high credit scores in a region with weak economic conditions were more likely to encounter problems than are consumers with lower scores in a region with stronger economic conditions.[1]

The revelations from this study are a major blow to the correlation claim because the credit scoring models are developed on a national basis. But, economic conditions vary greatly by geographic region. For example, surveys of mortgage delinquencies by the Mortgage Bankers Association of America show major differences across the country. In the fourth quarter of 2000, for example, delinquencies in the South were almost 60% higher than in the West.[2]

How Consumer Credit Characteristics Are Related To Consumer Income and Age

In addition to claiming a correlation between credit scores and risk of loss, the insurance industry also claims that credit scores are <u>not</u> correlated to income or race. Here, the industry relies up a "study" by the American Insurance Association that concludes that credit scores are relatively constant over different income classes. Again, the industry will not provide the information necessary for an independent researcher to replicate the results of the study. But the reliability of the insurers' studies must be strongly questioned because of the large amount of evidence – and common sense – contradicting the insurer studies' conclusions.

On the issue of credit scoring versus income and race, the Executive Vice President Peter McCorkell of Fair, Isaac admitted that credit scoring has a disparate impact on by race and income:

> *Doesn't scoring result in higher reject rates for certain minorities than for whites?*
> Again, the short answer is, "Yes," but it is the wrong question. The question ought to be: "Does credit scoring produce an accurate assessment of credit risk regardless of race, national origin, etc.?" Studies conducted by Fair, Isaac, and Company, Inc. (discussed in more detail below) strongly suggest that scoring is both fair and effective in assessing the credit risk of lower-income and/or minority applicants. Unfortunately, income, property, education, and employment are not equally distributed by race/national origin in the United States. Since all of these factors

1 "Study Produces Surprises on Credit Risks," by Kenneth R. Harney, November 10, 2001, *The Washington Post*, page H1.
2 "Mortgage Delinquencies Up, Foreclosures Down," March 15, 2001, Mortgage Bankers Association of America.

> influence a borrower's ability to meet financial obligations, it is unreasonable to expect an objective assessment of credit risk to result in equal acceptance and rejection rates across socioeconomic or race/national origin lines. By definition, low-income borrowers are economically disadvantaged, so one would not expect their score distributions to mirror those of higher-income borrowers.[3]

It is, therefore, unclear how mortgage credit scoring has a disparate impact by race and income but insurance credit scoring does not.

In its 1999 National Consumer Credit Survey, Freddie Mac found:

> Having a poor credit record is a relatively common problem in today's society. Using the combined results from the CCS (i.e., African-Americans, Hispanics and Whites) we estimate that:
>
> 30% of these groups have "bad" credit records
> 13% of these groups have "indeterminate" credit records
> 57% of these groups have "good" credit records
>
> Credit problems persist across income groups. We estimate that:
>
> 36 % of consumers with incomes under $25,000 had "bad" credit records
> 33 % of consumers with incomes of $25,000 to $44,999 had "bad" credit records
> 25 % of consumers with incomes of $45,000 to $64,999 had "bad" credit records
> 22 % of consumers with incomes of $65,000 and $75,000 had "bad" credit records
>
> Minority borrowers are more likely than white borrowers to experience credit problems. For African-Americans we estimate that:
>
> 48% of African Americans have "bad" credit records
> 16% of African Americans have "indeterminate" credit records
> 36% of African Americans have "good" credit records
>
> For Hispanics we estimate that:
>
> 34% of Hispanics have "bad" credit records
> 15% of Hispanics have "indeterminate" credit records
> 51% of Hispanics have "good" credit records
>
> For Whites, in contrast, we estimate that:

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3 Found in "Profitwise", Volume 10, Issue 3, Fall 2000, Published by the Consumer and Community Affairs Division of the Federal Reserve Bank of Chicago. http://www.chicagofed.org/publications/profitwise/2000/pwaug00.pdf

27% of Whites have "bad" credit records
12% of Whites have "indeterminate" credit records
61% of Whites have "good" credit records

It is unclear how the quality of credit histories can vary by income and race, but insurance credit scoring has no disparate impact by income and race.

Statistics from the 2000 Statistical Abstract of the United States reveal that credit characteristics vary not only by age and income but vary over time within age and income segments. Table 792 – *Financial Assets Held by Families by Type of Asset: 1992 to 1998* shows the ownership of any financial assets varies dramatically by age and income. The ownership of financial assets is related to the ability of a family to withstand an economic or medical catastrophe.

Table 796 – *Ratios of Debt Payments to Family Incomes: 1992 to 1998* shows higher ratios of debt payments to family income and higher ratios of families with payments 60 or more days due for younger and lower income families. The table also shows how these ratios – both of which figure prominently in insurance credit scores – vary over time.

Table 817 – Usage of General Purpose Credit Cards by Families: 1992 to 1998 shows that younger and poorer families are much less likely to pay off credit card balances each month and far more likely to hardly ever pay off the balance than older or more affluent families. Again, these characteristics – which vary by age and income – figure prominently in insurance credit scores

Why Insurers Are So Committed To Using Credit Scoring

There are two main reasons why credit scoring has become such a major part of the way many insurers underwrite and rate personal lines insurance. First, credit scoring is correlated with profitability. Second, credit scoring allows insurers to utilize a much more refined and detailed rating system.

As shown above, important consumer credit characteristics are related to the income level of the consumer. Thus, credit scoring is, for insurers, an easy and quick method of underwriting and rating by consumer income. And insurers have apparently determined than underwriting and rating by income is the key to greater profitability.

Progressive stated that the four most important factors it uses to determine the premium for a consumer are the consumer's prior bodily injury limits, whether the consumer had prior insurance, the credit score and driving record. Three of the four factors are strongly related to the consumer's income.

The Georgia Insurance Consumer's Advocate described the problem with rating based on income in a letter commenting on a recent Allstate filing to the Georgia Insurance Commissioner. The Advocate wrote the following about a surcharge Allstate wanted to charge consumers who only purchased minimum limits liability private passenger auto insurance coverage.

> This is another rating factor we believe has no potential for loss prevention or encouraging consumers towards less risky behavior. Further, we believe it is counter to the public policy declaration by the General Assembly that effective January 2001, $25,000 is sufficient to meet the state financial responsibility requirements. It doesn't make sense that the legislature should set the minimum requirements and then an insurance company can penalize consumers for complying. Clearly, a consumer's decision to purchase higher coverage is based on individual motivations and has little behavioral impact on risky activity.
>
> Finally, it appears the proposed rating factor could have a disproportionate impact on less-affluent consumers by shifting greater premium responsibility to lower limit consumers and away from the more-affluent, higher-limit consumers. Less affluent folks who purchase lower limit insurance may do so in order to be financially responsible with their other debts and obligations.[4]

The fact is that, while profitability and risk of loss are related, they are not the same. Two consumers may pose the same risk of loss, but present different profitability to the agent and insurer. The consumer who only wants to insure one vehicle at the minimum limits will be less profitable than the consumer who wants to insurer multiple vehicles at high limits and who wants property and life insurance. Many insurers simply do not want to write insurance for the poorest consumers.

The emphasis on rating factors that are largely income-related should be quite troubling to policymakers and consumers. But the problem is exacerbated with credit scoring because credit scoring enables insurers to move away from pricing based upon risk to pricing based upon what the market will bear. Instead of three rating tiers (or price levels) – preferred, standard and non-standard, insurers utilize credit scoring to create literally dozens of rating tiers. This proliferation of rating tiers is possible only because of credit scoring's numerical scale. As credit scoring becomes more widely used, consumers will be identified for higher rates because of their place on the credit scoring scale.

Writing in *American Agent and Broker*, New York agent Charles Wells writes that, "Over the past couple of years, we have seen more people put into nonstandard auto not only because of their driving records, but also for lack of financial prowess."[5] We used to think about nonstandard auto markets as the home for bad drivers. But with the advent

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4 Letter from Cathey Steinberg to John Oxendine, September 8, 2000.

5 "Credit Scoring Increases the Need for Nonstandard Auto Insurance." *America Agent and Broker,* July 2001.

of credit scoring, there are now more nonstandard drivers – an increase unrelated to the overall number of accidents.

Finally, some insurers are moving to credit scoring as a defensive measure. Insurers often act with a herd mentality and that appears to be the case with credit scoring also. Some insurers fear that failure to use credit scoring will result in adverse selection against their companies.

Why Simple Correlation Is Not Sufficient To Justify The Use Of Credit Scoring For Underwriting Or Rating

Insurers argue that a simple correlation is sufficient justification for the use of any characteristic of the consumer, vehicle or property as an underwriting or rating factor. But the existence of a correlation between a rating factor and risk of loss does not mean that insurers should be always permitted to use that characteristic underwriting or rating. We don't permit race as a rating factor, but there is a correlation between race and risk of loss for life insurance. There must be more to a rating factor than simple correlation to justify its use – particularly when it is something as enormous as consumer credit information.

The decisions about what factors, what characteristics of the consumer, to use for purposes of assigning premium is probably the most important insurance decision. And there is no natural of God-given set of rating factors and risk classifications. There are many ways to cut up the pie – to group consumers for purposes of assigning premium – that would meet industry standards.

As a society, we have decided, at least for private passenger automobile and residential property insurance, that we do not want everyone paying the same rate – an average premium for every driver – nor do we want the other extreme of consumers completely paying for their accidents out of pocket – the pay-as-you-go system. Rather, as a society, we have decided that some risk classification is desirable.

We believe these should be the guiding principles for insurance risk classification:

1. To roughly assign premium to consumers in relation to expected costs of that consumer on the system.
2. To promote loss prevention.
3. To promote beneficial competition and limit selection competition. Selection competition as a market failure.
4. To promote fairness and availability, which often means broader risk classifications than desired by the industry.
5. To be understandable to the public. We think that consumers are more likely to treat insurance companies fairly when it comes to claims if they feel that the insurance company has treated them fairly when it comes to charging premiums. It seems logical that folks who are the victims of redlining or who have been

charged higher prices because of credit history or things that are unrelated to their driving are more likely to inflate claims.

The ability of a rating factor to promote loss prevention is essential. One of the goals – perhaps the most important goal – of a risk classification system is provide incentives to consumers to pursue less risky behavior and avoid more risky behavior. By providing such incentives – such as surcharges for speeding or discounts for installing anti-theft devices or wind resistant construction – individual consumers benefit through lower rates and society benefits through lower loss of life and property.

Credit scoring fails this essential test of a rating factor because it provides no incentive to the consumer for loss prevention. Insurers use of credit scoring simply redistributes premium from one group of customers to another. In fact, insurers' use of credit scoring adds cost to the overall system because insurers must pay for obtaining consumer credit reports and for licensing credit scoring models.

Why Credit Scoring Violates Principles Of Risk Classification

Actuaries obtain guidance about risk classification from the American Academy of Actuaries Risk Classification Statement of Principles. Although this document is quite self-serving to the industry – it essentially provides an actuarial justification for what the industry does – these principles show that credit history conflicts with even industry standards for risk classification.

The Statement of Principles offers three reasons for risk classification:

1. Protect insurance system financial soundness by preventing adverse selection
2. Be fair, meaning that a statistical correlation exists and that prices reflect costs
3. Permit economic incentives to operate, meaning incentives for insurers to sell insurance at a profit.

The document notes that competition for the lower risks will be the most intense. When the document refers to availability of coverage, it is only from the perspective of insurers and means insurers' ability to charge differently for whatever risk classes are created.

The document discusses a number of operational considerations including:

- Absence of ambiguity – definition of classes should be clear and objective, no ambiguity should exist concerning the class to which the risk belongs and the classes should be collectively exhaustive and mutually exclusive.
- Manipulation – system should minimize the ability to manipulate or misrepresent a risk's characteristics so as to affect the class to which it is assigned.
- Measurabilty – variables used for classification should be susceptible to convenient and reliable measurement

The document also notes that hazard reduction incentives are desirable but not necessary that a causal relationship between the rating factor and losses is not necessary. Finally the document discusses public acceptability of risk classification schemes and offers the following. Risk classification systems should

- Not differentiate unfairly among risks
- Be based upon clearly relevant data
- Should respect personal privacy
- Should be structured so that risks tend to identify naturally with their classification.

Insurers' use of credit history as a rating factor does not meet any of the public acceptability guidelines. Moreover, insurers' use of credit history also fails even the industry standards for a rating factor because the use of credit history is ambiguous, subject to manipulation and not susceptible to reliable measurement.

One of the reasons that credit history should not be permitted because its use – particularly through credit scores – is not understandable or explainable to consumers. And if it was, it is information that is easily manipulated – through activities like rapid rescoring or credit repair. Thus, if insurers explain how they are using credit, then consumers will be able to manipulate their credit histories and distort its value as a rating factor – hence, insurers' secrecy about what they are doing in the guise of "trade secret."

Why Insurers' Use of Credit Scoring Is Inherently Unfair To Many Consumers

Unfortunately, there are many examples of why insurers' use of credit scoring is unfair to consumers.

After the September 11 attacks, tens of thousands of people working for airlines or travel support industries lost their jobs – throughout the country. Many of these people lost their health insurance in addition to their paycheck. Clearly, many of the newly unemployed started charging more on their credit cards, encountered more financial strain. Many will likely be delinquent on some credit cards or loans or file bankruptcy because they lost their jobs. And these people – indirect victims of a terrorist attack – will also face higher auto and homeowners insurance premiums. Did these people become worse drivers because they lost their jobs? The answer is clearly no. But this kind of unfair treatment of consumers at the hands of credit scoring repeats itself again and again.

When asked to explain why credit scoring predicts losses, insurers argue that a consumer's credit history describes the consumers management of financial resources and someone who manages his or her financial resources well is less likely to have insurance claims. This is a classic case of blaming the victim.
Studies have shown that the major reason why consumers file for bankruptcy is because of a major economic or medical event – such as losing a job or a family member getting a

dread disease. For example, *The Washington Post* has reported a recent study concluding a majority of consumers experience financial problems as a result of a catastrophic economic event. In a study by Harvard law professor Elizabeth Warren, about 600,000 personal bankruptcies in 1999 were estimated to be caused by illness or injury to a family member coupled with insufficient or no health insurance coverage.[6]

A December 2001 article in *insurer.com* reported that more than 725,000 laid-off workers had lost their health insurance since March 21, 2001. Again, these victims of an economic recession will face financial stress not only because they have lost their income, but because they lost their most important safety net – health insurance. Yet, these victims of economic conditions will be further penalized with higher auto and homeowners premiums.

Consumers who are the victims of identity theft suffer higher insurance premiums because of credit scoring. Typically, identity thieves use the stolen information to commit financial crimes, such as check or credit card fraud.[7] In over half of the reported cases of identify theft, the victim did not notice the theft for at least a month after theft occurred. This means that victims of identify theft will suffer higher insurance premiums before they can repair the damage to their credit reports.

The credit scores can vary dramatically depending upon which credit reporting agency provided the credit information. It is important to note that consumers can suffer not only from the presence of inaccurate information in their credit files, but also from the *absence* of accurate information in the credit files. The best credit scores depend not only on the absence of negative information – bankruptcies and delinquencies – but also on the presence of positive information – certain types of credit and payment history. Thus, the validity of credit scores relies upon complete, as well as accurate information. This is a significant issue because the three major credit reporting agencies do not have identical information for all consumers. Consequently, a consumer's credit score can vary significantly depending upon which credit reporting agency provided the credit information. At a hearing before the Georgia Insurance Commission on insurers' use of consumer credit information, a representative of the credit scoring model vendor ChoicePoint stated that, "Our score ranges from 300 to almost a thousand, so it's almost a 700-point range, but you could have a hundred, a hundred-and-fifty point change from bureau to bureau depending on variances in the data."

The problem with incomplete data was highlighted in 1999 when the Federal Trade Commission and federal banking regulators discovered that some consumer lenders were not reporting account information to the credit reporting agencies because they did not

[6] Crenshaw, Albert B. "Study Cites Medical Bills for Many Bankruptcies," *The Washington Post*, April 25, 2000, Page E1.

[7] "Identify Theft: One of the Fastest Growing Crimes in the U.S." by John Connery in the Summer 2001 issue of *Profitwise*, published by the Federal Reserve Bank of Chicago.

want competitors to market to their customers.[8] The practice of withholding data skews credit scores. Lenders withholding data accounted for 50% of the credit card market.

The reliance on credit reports by insurers is also unfair to lower-income consumers because many low-income consumers utilize non-traditional financial institutions that do not report to credit reporting agencies – such as rent-to-own and payday loans. Thus, lower-income consumers are penalized because their credit activity does not show up in the credit reports used by insurers.

Credit scores can be manipulated by people familiar with the scoring models. In a two-part series, Kenneth R. Harney described a service called "rapid rescoring" that, for a fee, helps consumers improve their credit scores by simply gaming the system. The articles cite an example of a woman who improved her credit score from 580 to 780 – from bad to "A-plus" – without any change in her behavior. The article cited one rapid rescorer who helped consumers raise their scores simply by shifting credit card debt from one card to many cards, "That may mean transferring the $900 balance on a $1,000 limit credit line to another with a $10,000 limit. The $900 on the $1,000 limit account is treated as a negative by the FICO score model. But the same $900 on a $10,000 limit card looks like a responsible management of credit."

The bottom line is that credit scores can be manipulated without any change in the consumer's behavior. This is exactly what an insurance rating factor should NOT be. The rating factor should provide an incentive for the consumer to pursue less risky behavior, not an incentive to manipulate the rating factor.[9]

Another example of the unfairness of credit scoring to insurance consumers comes from California where the state legislature passed a law in 2001 prevent banks from inducing college students into unsupportable credit card debt. The sponsor of the bill applauded passage for "recognizing that something must be done to stop the credit card industry from preying upon young people in college." The legislation prohibits the distribution of free gifts to college students who apply for a credit card and will require debt education in college and university orientation.[10]

As the California law points out, consumers should not be punished for the business decisions of banks. In 1990, banks sent out one billion credit card offers. By 1997, the number of offers had grown to 3.7 billion. Clearly, lenders were encouraging consumers to take on credit cards and credit card debt. In fact, most credit card offers are accompanied by notes telling consumers that "It's a good idea to carry more than one Master Card®" or "Do not hesitate to accept this card just because you already carry a

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[8] "Lenders Hiding Credit Data and Regulators Object," by Lisa Fickenscher in the July 7, 1999 edition of *American Banker*.

[9] "Bad FICO Mark? Rescore Your Credit" and "Credit Rescoring: How to Know if It's for You," by Kenneth R. Harney in the July 14 and July 21, 2001 editions, respectively of *The Washington Post*.

[10] "California Governor Signs Bill to Help Prevent College Student Credit Debt," from U-Wire on September 25, 2001.

credit card from another bank. . . . it costs you nothing to accept." We now know that it does cost you something to accept because your credit score – and your auto and homeowners insurance premium – may go up because you have more credit cards than the credit scoring models view as ideal.

The bottom line is that insurers' use of credit scoring is inherently unfair to consumers. Credit information is gathered primarily for purpose of evaluating credit worthiness, not insurance issues.

Credit info generated by consumers for purposes other than insurance:

- decision to seek another credit card
- decision to use one or more credit cards
- decision to pay in cash or get a loan
- decision to get a gas station card
- decision to pay in cash or use charge cards
- decision to rent or buy

Credit info impacted by things beyond control of consumer:

- Bank decisions to lower or tighten credit standards
- Terrorist attacks
- Recession/Inflation/Overall Economic Conditions

Why The Failure Of Insurance Regulators and/or State Legislatures To Limit Insurers' Use Of Credit Scoring For Underwriting And Rating Is Effectively Deregulation Of Private Passenger Automobile And Residential Property Insurance Rates

Insurers' use of credit history represents a sea change in how consumers are underwritten and rating – instead of a few rating tiers based on expected claim costs, we now have dozens of rating tiers based essentially upon credit scores. Fair Isaac's credit scores have redefined what types of consumers are desirable and undesirable for a consumer and Fair Isaac is revolutionizing how insurers classify risks.

By introducing dozens of new rating tiers, insurers can charge consumers higher premiums simply by placing them in a higher-priced rating tier. No rate increase is necessary to increase the rates for many consumers.

State regulators' failure to take substantial action on insurers' use of credit information for underwriting and rating is tantamount to deregulation of personal lines insurance without any change in state law.

A Warning to Insurance Regulators and State Legislators to Be Prepared For Insurers' Tactics in Their Fight to Prevent Restrictions on Their Use of Credit Scoring

Insurers will fight hard to keep state insurance regulators and state legislators from limiting insurers' use of credit scoring. A few years ago, after the Arizona state Senate had passed a bill prohibiting insurers' use of credit scoring, the National Association of Independent Insurers (an industry trade association) and Progressive sent out hundreds of thousands of letters to consumers telling them that their insurance rates would go up if the state House of Representatives concurred with the Senate. The bill did not pass.

Insurers claim that any prohibition or limitation of their use of credit scoring will cause insurers to write less business. These claims should be viewed with great skepticism. The logic of the insurer argument is that any restrictions on their underwriting or rating practices will limit insurance availability. Yet, in 1994, after being sued by the National Fair Housing Alliance for their use of age and value of the home in underwriting property insurance, State Farm and Allstate agreed to stop using these guidelines – and admitted that they would write more business in poor and minority communities as a result.

The insurer claims that credit scoring benefits more consumers than it harms is also suspect. First, the insurers provided no substantial evidence to indicate whether most consumers get a rate increase or a rate decrease from insurers' use of credit scoring. Second, and more important, what happens today is not necessarily what will happen tomorrow. Insurers are in a position, when they introduce credit scoring, to cause the majority of consumers to get a lower rate. In fact, insurers have a strong interest in limiting the initial impact of credit scoring on their policyholders. However, there is nothing to prevent future iterations of rate plans and credit scoring to cause most consumers to pay higher premiums that in the absence of credit scoring.

The bottom line is that there is no answer to the question of whether a majority of consumers benefit or lose from the use of credit scoring because the use of credit scoring simply redistributes premium among consumers and that redistribution can change over time. In contrast, we can say that the introduction of a rating factor that provides a discount for engaging in some loss prevention activity (theft prevention device, wind resistant construction, etc.) lowers premiums for some consumers without raising them for others so that consumers as a whole benefit and claim costs drop.

Finally, the insurers will engage in the scare tactic of claiming that any prohibition or limitation on credit scoring will cause good drivers to subsidize bad drivers. This is a red herring argument that seek to obfuscate the fact that credit scoring simply redistributes premium from some consumers to others and does so in a manner that seems arbitrary and penalizes the poorest members of society -- for being poor.