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'Overseeing' the Poor: Technology Privacy Invasions of Vulnerable Groups

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Credit Scoring: 21st Century Redlining and the End of Insurance

Why does the Center for Economic Justice work on insurance issues and why am I talking to you about insurance today? Insurance is not a pleasant topic for most people. State governments require you to buy auto insurance, lenders require you to buy homeowners insurance and it's generally tedious and unpleasant to buy and really unpleasant to use. But the amount of money consumers spend on insurance – auto, property, health, life, disability – is huge. Homeowners and auto insurance expenditures were about $200 billion in 2003. Life and disability insurance is in the hundreds of billions. And let's not talk about health insurance expenditures.

There are two main reasons CEJ works on insurance issues, particularly as they impact low income and minority consumers. First, insurance is the mechanism that consumers and businesses use to protect their assets in the aftermath of a catastrophic event – whether that's a fire, an auto accident, a natural disaster, theft. Insurance enables consumers and businesses to preserve and to build assets, wealth and financial security. Insurance is essential for individual and community economic development. And low income consumers should have the same access to these essential financial tools as more affluent consumers. The history of insurance redlining, however, is a story of less access, inferior products and higher prices for low income and minority consumers.

Second, insurance is the primary mechanism for loss prevention – insurance provides economic incentives for less risky behavior and economic disincentives for more risky behavior. Or at least, that is what insurance pricing should do. Insurance pricing should be based on factors that are under the control of the consumer and which make a difference in the likelihood of an auto accident or homeowners' claim. Insurance is the primary tool to encourage behavioral changes that actually reduce accidents, human suffering and property damage.

What we have seen over the past few years in auto and homeowners insurance – and what we will see more in life, disability and health insurance – is the nothing short of the end of insurance because of unfettered insurer access to personal information and unlimited risk pricing practices by insurers

Insurers compete on many dimensions – price and quality of service not being the most important. The dominant area of competition among insurers is risk selection – the insurer who can develop the most detailed and sophisticated segmentation of the consumer pool will be the most profitable. At one point in time, long ago, increased pricing segmentation was important and beneficial to consumers – we went from essentially one rate for everyone to a number of rates based, in part, on factors related to risk, and in part on demographic factors correlated to different likelihood of loss.

But since the mid 1990's, growing slowly at first but exponentially in the last few years, we see insurers using vast information databases, cheap computing power and weak privacy protections to create an ultra-refined risk classification system that focuses on the economic status of a consumer. The primary example of this is insurance credit scoring.

Insurance credit scoring is the use of a computer model to generate a score using your credit history as the raw material. And for many insurers – including the largest insurers – credit scoring has become the most important factor in determining whether an insurer will offer you coverage and on what terms and price. For some insurers, one consumer who differs from another consumer solely because of credit score can pay 4 to 5 times as much as the other consumer.

Now insurers claim that credit scores are great predictors of expected losses. They say they don't know why credit scores are such good predictors, but they offer a rationalization that goes something like this:

A consumer who manages his or her financial assets well is likely to be a good manager of other risks. Consequently, a good credit history equals a good credit score and lower expected losses.

This explanation represents, first, a big lie, and, second, a post hoc rationalization.

The big lie is that a good credit history yields a good insurance credit score. Simply not the case – my own personal credit history is over 25 years of on-time payments – no late payments, no public records – the definition of a clean credit history. Yet, my auto insurance score was in the 17th percentile. Of course six months later, it magically went up to the 70th percentile, but we'll save a discussion of the arbitrary nature of insurance credit scoring for another time. When we look at an actual insurance credit scoring model, you'll see why a good credit history does not equal a good insurance credit score.

Let's get to the "why it works" explanation. Insurers' use of credit scoring was not developed based on any hypothesis about credit behavior and driving behavior or credit behavior and home maintenance. Insurance credit scoring is the classic data mining exercise where, first, Fair Isaac, and then Choice Point and individual insurers evaluated each of the 450 odd data elements in a consumer's credit report. And they picked out the factors that were most predictive of profitable business – partly expected losses, partly who would stay with the company and not shop around and partly who would buy other

products from the insurer. Allstate, for example, seeks consumers who are the most likely not to shop around for a better price and the most likely to buy other products – particularly life insurance – from Allstate.

If you look at actual scoring models, you see that the models focus on a consumer's economic status and not on the history of payments – which is why a good credit history does not equal a good credit score.

With one exception the presence of any of the following leads to a worse insurance score, regardless of your payment record:

- Number of accounts opened in the last year or two
- Number of department store accounts
- Number of department store accounts with a balance of 50% or more of limit
- Number of consumer finance accounts
- Number of auto finance accounts
- Number of open retail store accounts
- Number of sales finance accounts
- Number of open automotive related accounts
- But having an oil company credit card improves your score!

Then there are a set of factors that reflect your age – and younger is worse – regardless of your payment record:

- Average number of months all accounts on file have been open
- Average number of months bank revolving accounts have been opened
- Age of oldest account in months

Then there are a set of factors with magic numbers. For these factors, there is an optimal number, regardless of your payment record. For example:

- Number of credit card accounts open

Then there are a set of factors that penalize consumers for rational behavior, such as using one credit card to rack up frequent flyer miles:

- Number of credit card accounts where balance is 75% or greater than limit

As you review the factors in these scoring models, two things become clear. First, your so-called "financial responsibility" has little weight in the scoring model. And second, the models are systematically biased against consumers in low income and minority communities. The bias arises for two reasons. First, the credit scoring models are systematically biased against the credit characteristics of low income and minority consumers, such as type of credit used. Second, consumers in low income and minority

communities are not served by the financial institutions that report to credit bureaus. Even if a consumer was able to pay the massive interest rates for a check cashing, payday loan or rent to own, it would not help because these institutions do not report to credit bureaus. And so-called thin files – little credit information – yield bad scores.

In short, insurance credit scoring is the 21st century tool for redlining. In the past, for example, insurers simply didn't write homeowners insurance for homes older than a certain age or under a certain value. These underwriting guidelines eliminated coverage in older and low-income neighborhoods. Fair housing groups challenged these practices and prevailed – these underwriting guidelines have largely been eliminated, although these characteristics are still used for determining premium. But today, insurers have a new tool – credit scoring – that accomplishes the same redlining as in the past. Insurers defend credit scoring as an "objective" tool that doesn't "consider" race or income. Sound familiar? As if bias could not be built into a computer model.

The use of data mining is not limited to premiums charged. The same data mining techniques are used for claim settlement – computer models to assist the insurer in settling claims that take into account, indirectly and among other things, the economic status of consumers. Some insurers recently started using the CLUE database to decline homeowners coverage to consumers who simply inquired about whether a particular event was covered under the policy. Insurers are compiling huge databases and working closely with law enforcement to use data mining to identify insurance fraud. And data mining by insurers is not limited to auto or homeowners – the issue of genetic testing and use of genetic information in life, disability and health insurance is of concern to many consumer and privacy advocates.

The title of this brief talk is credit scoring – the end of insurance. Here's why.

First, even if credit scoring did what it's purported to do – charge higher rates for consumers with a poor credit history – it is inherently unfair and undermines the basic purpose of insurance which is to protect consumers assets in catastrophic times. Consider that 87% of families who file for bankruptcy do so because of one of three reasons – job loss, divorce, catastrophic illness. So even if credit scoring is working as its proponents claim, the practice penalizes those consumers who are victims of an economic catastrophe with, at best, higher rates, and at worst, the elimination of coverage in the time of greatest need.

Second, the use of data mining products, such as credit scoring, also undermines the other core purpose of insurance by giving more and more weight in the rating process to factors outside of the consumer's control and which provide no economic incentive for loss prevention. Credit scoring undermines the loss prevention capacity of insurance because it is unrelated to behavioral changes that reduce the likelihood of an accident or damage from an event. When you know that insurance rates will go up by 25% if you get a speeding ticket or an at-fault accident, that knowledge affects your behavior. When you get a discount for putting on hail-resistant shingles on your home or installing an anti-

theft device in your vehicle, the consumer is in a position to take positive action to not only affect the likelihood of an accident or claim, but also in a position to lower his or her premium. And these types of discounts provide a benefit to some consumers without raising the rates for other consumers – you can give someone a 40% discount for a hail resistant roof and pay of that discount with lower expected losses – so a discount for one does not mean a rate increase for another. With credit scoring, it's less than a zero sum game – since is there no reduction in losses, any discounts for some consumers must be paid for by rate increases for other consumers.

Let me conclude by saying that the impact of credit scoring is not limited to low income and minority consumers – the end of insurance affects us all because the essence of insurance is spreading the risk over large numbers. As insurers systematically eliminate group after group of consumers with high tech redlining – the risk is spread over a smaller and smaller group. And who knows what the next demographic characteristic will be? It may be one of yours. Will you be denied life insurance because of a new genetic test? Will you avoid taking a genetic test because of your fear that insurers will use that information to eliminate your coverage?

What we need in the insurance field is what many of you have demanded in other fields – a limitation on the access to and use of certain consumer information by business and government.