Insurance Credit Scoring: An Unfair Practice

A Report by the Center for Economic Justice[1]

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Insurance credit scoring is the practice by insurers of using consumers' credit information for underwriting, tier placement, rating and/or payment plan eligibility. The problems with insurance scoring are so great that the practice should be prohibited. Insurance scoring should be prohibited because it:

- is inherently unfair;
- has a disproportionate impact on consumers in poor and minority communities;
- penalizes consumers for rational behavior and sound financial management practices;
- penalizes consumers for lenders' business decisions unrelated to payment history;
- is an arbitrary practice; and
- undermines the basic insurance mechanism and public policy goals for insurance.

There is widespread opposition to insurance credit scoring among consumers and insurance agents. There are hundreds of agents who want to come forward and tell why they are opposed to credit scoring, why credit scoring has worsened insurance availability and how credit scoring has a disproportionate impact on poor and minority consumers. But they can't tell their stories because of their fear of reprisal by the insurance companies they represent. To hear from these agents, the agents must be given protection against these reprisals. To give you a sense of who these agents are, the following agent organizations have come out against credit scoring – National Association of State Farm Agents, National Association of Professional Allstate Agents and the United Farmers Agents Association.

This report covers the following topics:

- Problems with insurance scoring
- Evidence that insurance scoring discriminates against minority consumers
- Response to insurance industry claims about insurance scoring

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1 CEJ is a Texas 501(c)3 non profit organization that advocates on behalf of low income consumers on insurance, credit and utility matters. Web Site: www.cej-online.org. Birny Birnbaum, CEJ's Executive Director and the author of the report, has 13 years experience with credit scoring as an insurance regulator and consulting economist to consumer organizations and public agencies.

1. Problems with Insurance Credit Scoring Warrant a Prohibition

You've just been laid off from your job. Or your daughter has a major medical problem that your health insurance (if you have any) doesn't fully cover. Or you've just gotten a divorce. These three life events account for 87% of family bankruptcies.[2] To "help" you out in this stressful time, your insurance company will raise your homeowners and auto insurance rates because of credit scoring.

The disagreements about insurance credit scoring really boil down to what "fair" means. For insurers, "fair" means that an insurer can produce some kind of data showing a statistical relationship between credit scores and insurance losses. For consumer groups, such a statistical relationship is a necessary, but not sufficient, definition of fair insurance practices. Fair rating factors must also not penalize consumers for rational behavior, for factors outside of their control and for arbitrary practices of insurers and lenders. Fair means that consumers who are the victims of some economic or medical catastrophe are not penalized because they were unlucky enough to lose their jobs, have a family member get sick or get divorced.

When it comes to the real world understanding of fair, insurance credit scoring is terribly unfair.

- Because your credit score depends on having the "right" kind of information in your credit report, you can have a perfect credit history and still get a bad credit score. Contrary to insurer credit scoring myths, your credit score has nothing to do with your "financial responsibility."

- Because your credit report can vary dramatically among the three major credit bureaus, your credit score can vary from good to bad depending upon which bureau provided your insurer with information.

- Because your credit score is based on many things other than how timely you pay your loans, you score can vary dramatically depending on what time in the month your credit report was ordered.

- Because your credit score depends on what type of credit you have, you can get a low score even if you have a perfect payment record. If you have a credit card with a tire company, a loan from a consumer finance company like Household or Beneficial, or have an installment sales contract from a used car dealer, you get a lower score regardless of whether you pay on time. But if you have a gas station credit card, you score is higher!

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[2] 2001 Consumer Bankruptcy Project, cited on page 81 of *The Two Income Trap*, Elizabeth Warren and Amelia Tyagi.

- Because your credit score depends on the presence of loan information, you get a lower score if you pay in cash or don't borrow much or if you use lenders that don't report to credit bureaus. Many younger consumers were penalized with higher rates due to so-called "thin" credit files because the Sallie Mae – the student loan lender to millions – decided it would only report payment history to one of the three major credit bureaus.

- Because your credit score depends on the ratio of your debt to your credit card limit, a consumer who uses one credit card to maximize frequent flier miles gets a lower score than another consumer who charges the same amount but does it on three or four cards.

1.1 Insurance Scoring Penalizes Victims or Economic or Medical Catastrophes

Credit scoring is inherently unfair because it penalizes consumers who are the victims of economic or medical catastrophes, such as job loss, divorce, dread disease or terrorist attack. For example, in the aftermath of the September 11 attack, hundreds of thousands of people working in the travel-related industry lost their jobs. Out of this group, thousands had to increase borrowing to offset loss of income or loss of health insurance. Many filed for bankruptcy. It is unfair for insurance companies to further penalize these victims by raising their homeowners and auto insurance rates.

One of the myths perpetrated by insurers to rationalize the use of insurance credit scoring to legislators is the myth of the immoral debtor. Insurers argue that good credit scores reflect the financial responsibility of consumers. And they ask why should financially responsible consumers subsidize the rates of consumers who are not financially responsible? As explained further below, this argument fails because a good credit history does not equate to a good credit score. Stated differently, an insurance score is simply not a measure of financial responsibility.

Regarding the "immoral debtor," data on the causes of bankruptcies reveal that the overwhelming majority of bankruptcies result from job loss, medical problems and divorce. Fully 87% of bankruptcies for families with children arise from these three reasons. And the remaining 13% includes reasons such as natural disaster or crime victim.[3]

In their recent book, *The Two Income Trap*, Elizabeth Warren and Amelia Tyagi study the growth, composition and causes of bankruptcy. They were astonished to find that the number of women filing for bankruptcy grew from 69,000 in 1981 to nearly 500,000 by 1999. As they researched the causes of this phenomenon, they documented the fact that financial strain on families – particularly families with children – resulted from dramatic increases in the cost of housing, health care and schooling combined with deregulation of

[3] 2001 Consumer Bankruptcy Project, cited on page 81 of *The Two Income Trap*, Elizabeth Warren and Amelia Tyagi.

interest rates for loans and business decisions made by lenders for easy credit. They found that married couples with children are more than twice as likely to file for divorce than couples without children and that a divorced woman raising a child is nearly three times more likely to file for divorce than a single woman without a child. They concluded that "having a child is the single best predictor that a woman will end up in financial collapse." Their research shows that the insurer rationalization for credit scoring – "financial responsibility" – is indeed a myth refuted by the facts.

1.2 A Good Credit History Does NOT Equal a Good Credit Score

Credit scoring is inherently unfair because a good credit history does not equal a good credit score or favorable insurance treatment. This occurs because insurance credit scores are based not just on bankruptcies and delinquencies, but also on other factors unrelated to credit management. For example, credit scores are often based on the type of credit (consumer finance loans are less favorable than bank loans), the number of credit cards (there is a magic number that is optimal, even if the consumer only uses the retail store cards once to get the first time 10% purchase discount), length of time credit has been established (which is another way of charging younger people more), length of time since last account opened (which penalizes families that have just moved or refinanced their mortgage) and the number of inquiries (which penalizes consumers who shop around for the best rate – behavior that should be rewarded and not punished with higher insurance rates.) While the insurance industry offers a rationale for each of these factors, the fact is that credit scoring casts too wide a net and penalizes people engaged in behavior we would all consider good financial management.

1.3 Credit Scoring Produces Arbitrary Results

Credit scoring is unfairly discriminatory and violates actuarial standards for risk classification because it is an arbitrary process. For example, your score can vary from very bad ("high risk") to very good ("low risk") depending on which credit reporting agency provides the credit information to the insurer because a consumer's information varies among the big three bureaus. A representative from ChoicePoint admitted this in a hearing before the Georgia Insurance Commissioner in 2001. The author recently ordered my three-bureau credit report and found different inquiries in each of the three bureaus – not one single inquiry was reported by more than one bureau.

Credit scoring is arbitrary because a score can change dramatically over a short time frame for no apparent reason. The author' auto credit score in November 2002 (obtained from www.choicetrust.com) was very low – around the 17th percentile. In May 2003, the author's score was in the 82nd percentile. In six months (or perhaps a shorter period), the author's score went from very high risk to very low risk. No other insurance risk factor is so arbitrary.

1.4 Consumers Penalized for Lenders' Business Decisions

Over the course of the 1990's consumer debt grew dramatically as lenders made credit more easily available to many consumers. The number of credit card solicitations grew from 1 billion to 5 billion annually. Lenders moved to low- or no-down payment mortgages. Although lenders are certainly free to make business decisions about loaning money, consumers should not be penalized with higher homeowners or auto insurance premiums because of those decisions.

To illustrate the problem, Fannie Mae recently began requiring a 10% down payment for 30 year mortgages on manufactured homes. Previously, consumers could get a loan with no money down. In defending the proposal, Deborah Tretler, vice president of single family homes for Fannie Mae, stated, "We don't serve borrowers well when it is easy for a borrower to get into a home under very flexible terms, only to have them lose their home, their credit ruined and their homeownership dreams turned into a nightmare."[4]

Warren and Tyagi, in *The Two-Income Trap*, explain how lenders make lots of money off of problem borrowers through higher interest rates and substantial penalty fees.

It is not only lenders' <u>lending</u> decisions that make insurance scoring unfair, it is also lenders' <u>reporting</u> decisions to credit bureaus. In some cases, lenders report only partial information about loans to credit bureaus. For example, some major credit card vendors do not report card limits, to prevent competitors from learning about their customers. But by failing to report credit limits, the credit scoring models often use the current balance as the limit – with the result that the consumer appears to be maxing out his or her credit line. Which, in turn, lowers the insurance score.

In another example, Sallie Mae, the nation's largest lender for student loans with millions and millions of borrowers, has decided to report loan information to only one of the three major credit bureaus – again, to protect its customer list. If a consumer who has a good student loan payment history seeks auto insurance and the insurer happens to use a credit bureau that Sallie Mae has <u>not</u> reported to, the consumer gets a lower score than he or she should because a lack of information penalizes a consumer in an insurance score.

In yet another example, journalist Ken Harney explains how some lenders refuse to report the credit limits on credit cards and other loans to credit bureaus. Absent this information, the credit bureaus report the current debt balance as the credit limit. This harms consumers because a factor in credit scores is the ratio of current debt to credit limits. Harney cites a consumer who was charged a much higher rate than she would have been had the lenders reported her credit limits:

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[4] "Mortgage regulations could stop some would-be homeowners," by Genaro C. Armas of the Associated Press in the September 12, 2003 issue of the *Austin American-Statesman.*

> *That extra expense would not have been caused by anything she did wrong, but rather by what the card company did without her knowledge: keep her good credit behavior a secret from potential competitors by withholding her credit limit and highest balance, thereby decreasing her credit score. Credit card companies sometimes try to hide their best customers' identities from other lenders trolling the credit bureaus' vast databases to prescreen targets for card offers. Typically the trollers ask the bureaus for lists of cardholders with higher scores, and avoid those with marginal or lower scores.*[5]

These examples of how lenders' business decisions can dramatically affect an insurance consumer's insurance score further illustrate the arbitrary and unfair nature of insurance credit scoring.

1.5 Credit Scoring Penalizes Consumers in Poor and Minority Communities

In addition to being arbitrary, credit scoring also has a systematic bias against consumers in poor and minority communities, described further below. ***It is important to state clearly that the claim that credit scoring has a disproportionate impact on consumers in poor and minority communities is NOT an argument that poor people are poor financial managers. The two arguments are unrelated because good financial management / good credit history does NOT equate to a good insurance credit score. It is the structure of insurance credit scoring models – and not the financial management habits of low-income consumers – that creates the bias against consumers in poor and minority communities.*** Further, it is unclear how anyone who has actually examined the factors and structure of credit scoring models could legitimately assert that the claim of systematic bias against consumers in poor and minority communities is a critique of the financial management habits of low-income consumers.

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

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.

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[5] Ken Harney, "2 Missing Numbers Can Doom a Loan," *Washington Post,* 1/1/05, page F1. See also Kenneth Harney, "Credit Card Limits Often Unreported," *Washington Post*, 12/25/05, page F1.

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.

Insurance credit scoring undermines these public policy goals in at least two ways.

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 credit scoring 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 for 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 and credit scoring adds costs to the system.

2. The Impact of Credit Scoring on Poor and Minority Consumers

Despite insurers' claims to the contrary, it is clear that insurer underwriting and rating practices now emphasize a consumer's economic status rather than their driving record.

2.1 Prior Bodily Injury Limits

For example, several insurers now charge higher rates to consumers because of their prior liability limits. If your previous policy was a basic limits policy, you will be charged more than if your previous policy was, say, 50,000/100,000 limits. The use of prior liability limits by insurers to determine assignment to a rating tier clearly penalizes low income consumers because of their income. Given that insurers are completely willing to use underwriting and rating factors that penalize consumers because of economic status, it should be no surprise that credit scoring has a disproportionate impact on consumers in low-income and minority communities.

2.2 Insurance Credit Scoring Penalizes Consumers in Low-Income and Minority Communities

Despite insurer protests, there is no ample evidence that insurance credit scoring penalizes consumers in low-income and minority communities.

2.2.1 Fair Isaac Admission

On the issue of credit scoring versus income and race, the Executive Vice President of Fair, Isaac and Company, Peter McCorkell, admitted that credit scoring has a disparate impact based upon 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 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.[6]

[6] Page 15, Fall 2000 Issue of *Profitwise*, a publication of the Federal Reserve Bank of Chicago.

2.2.2 Freddie Mac Study

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:
>
> 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 the insurance industry still maintains insurance credit scoring has no disparate impact based upon income and race.

2.2.3 Data from the Survey of Consumer Finances

Statistics the Survey of Consumer Finances, reported in the 2000 Statistical Abstract of the United States reveal that credit characteristics vary not only by age and income, but also 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 much 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.

2.2.4 The University of Texas Study

Further evidence of the disproportionate impact of insurance credit scoring on poor and minority consumers comes from the report prepared by the University of Texas Bureau of Business Research on the relationship between insurance credit scoring and insurance losses. The authors' analysis of the correlation between credit scoring and insurance losses is unreliable – it relies upon a simple loss ratio methodology that the NAIC credit scoring working group rejected in 1996 as "misleading and counterproductive." However, the report does reveal other important findings.

The authors found that average and median credit scores were much higher in the standard market than in the nonstandard (so-called "high risk") market. But the scores were taken from policies issued in 1998 – before the insurers were using credit history to underwrite consumers in the standard and nonstandard markets. Consequently, if credit history was unrelated to underwriting risk factors used by insurers, we would expect average scores to be similar in the standard and nonstandard markets. The fact that the scores were so different between the two markets means that insurers were already using some underwriting factor or factors to distinguish risk of consumers that is correlated to credit.

In addition to showing that credit scores are a proxy for other risk factors used by insurers, the difference in credit scores between the standard and nonstandard markets also indicates that credit scores are correlated to race and income of consumers. Just as low credit scores are more prevalent in the nonstandard market, the likelihood of being denied coverage in the standard market and ending up in a high-cost county mutual grows dramatically as the neighborhood becomes less affluent and less white.

Standard Auto Insurance Market Rejection Rates in Texas versus Race and Income

Automobile Rejection Rate	1996 Average of Non-Anglo Population Percentage	1996 Average of Median Household Income	1996 Number of ZIP Codes
0.0% to 5.2%	4.7%	$22,414	1
5.3% to 10.4%	12.1%	$44,042	74
10.5% to 15.6%	13.6%	$30,565	317
15.7% to 20.8%	20.7%	$24,871	413
20.9% to 26.0%	29.4%	$24,523	280
26.1% to 31.1%	43.0%	$23,456	142
31.2% to 36.3%	54.6%	$21,549	79
36.4% to 41.5%	68.5%	$19,954	65
41.6% to 46.7%	82.7%	$17,682	45
46.8% to 51.9%	83.7%	$16,441	38
Over 51.9%	92.3%	$14,015	26

2.2.5 Factors Used in Credit Scoring Models are Biased Against Consumers in Low-Income and Minority Communities

A review of the factors contained in insurance scoring models – and the information missing from consumer credit reports and scoring models – further documents the disproportionate impact of credit scoring against poor and minority consumers.

Reason codes for insurance models from ChoicePoint include factors that systematically discriminate against consumers in poor and minority communities. In the ChoicePoint models, a consumer's score is affected by the type of credit and/or the type of lender -- regardless of whether the consumer is current on the payments. A consumer who gets a loan from a consumer finance company gets a lower score than a consumer who gets a loan from a bank – even if the consumer has a perfect payment record. A consumer who has a credit card from a tire store -- such as Goodyear -- gets a lower score just for having that account. A consumer who buys a car through an installment sales contract gets a lower score -- even if the payment record is perfect. Clearly, consumers in less affluent neighborhoods are far more likely to use these types of credit mechanisms than consumers in more affluent communities.

The fact is that the financial institutions in poor and minority communities are different from those in more affluent white communities. And this difference results in a systematic bias in insurance credit scoring models. As a further example, consider payday lenders, check cashing lenders and rent-to-own businesses – which target poor consumers. Even if a consumer was able to pay the extraordinarily high interest rates from these businesses, it would not help the consumer's insurance score – because these institutions do not report to credit bureaus. And the absence of information in a credit report is a credit score negative. Consequently, consumers who pay in cash or who use financial institutions that do not report to a credit reporting agency are penalized with lower scores. Finally, consider a consumer who demonstrates financial responsibility by paying all her utility bills on time for decades. This actual financial responsibility is not rewarded in insurance credit scoring models because these payments do not appear in credit reports.

2.2.6 The Missouri Department of Insurance Study

A few weeks ago, the Missouri Department of Insurance released a study that specifically examined the impact of insurance credit scoring on the availability of insurance coverage in poor and minority communities. This is the first independent study based on detailed credit scoring data using rigorous statistical analysis. The Department collected credit score data aggregated at the ZIP Code level from 12 insurers for the study period of 1999 to 2001. For each Missouri ZIP Code, the Department obtained:

- Mean credit score
- The number of exposures for each of five equal credit score intervals

The Department then utilized a variety of multi-variate statistical techniques to isolate the relationship of income and race to credit scoring, independent of other factors. The study found:

- ***The insurance credit-scoring system produces significantly worse scores for residents of high-minority ZIP Codes.*** The average credit score rank in "all minority" areas stood at 18.4 (of a possible 100) compared to 57.3 in "no minority" neighborhoods – a gap of 38.9 points. This study also examined the percentage of minority and white policyholders in the lower three quintiles of credit score ranges; minorities were overrepresented in this worst credit score group by 26.2 percentage points.

- ***The insurance credit-scoring systems produces*** [sic] ***significantly worse scores for residents of low-income ZIP Code.*** The gap in average credit scores between communities with $10,953 and $25,924 in *per capita* income (representing the poorest and wealthiest 5 percent of communities) was 12.8 percentiles. Policyholders in low-income communities were overrepresented in the worst credit score group by 7.4 percentage points compared to higher income neighborhoods.

- ***The relationship between minority concentration in a ZIP Code and credit scores remained after eliminating a broad array of socioeconomic variables, such as income, educational attainment, marital status and unemployment rates, as possible causes.*** Indeed, minority concentration proved to be the single most reliable predictor of credit scores.

- ***Minority and low-income individuals were significantly more likely to have worse credit scores than wealthier individuals and non-minorities.*** The average gap between minorities and non-minorities with poor scores was 28.9 percentage points. The gap between individuals whose family income was below the statewide median versus those with family incomes above the median was 29.2 percentage points.

Based upon the results of this study, the former Governor of Missouri has called for a ban on insurance credit scoring.

2.2.7 The Texas Department of Insurance Preliminary Report

The Texas Department of Insurance (TDI) reviewed over 2 million policyholder records and obtained policyholder-specific information on race. The TDI report, issued in the beginning of January 2005, states unequivocally that insurance credit scoring discriminates against minority consumers:

> The individual policyholder data shows a consistent pattern of differences in credit scores among the different racial/ethnic groups. The average credit scores for Whites and Asians are better than those for Blacks and Hispanics. In addition, Blacks and Hispanics tend to be over-represented in the worse credit score categories and under-represented in the better credit score categories.[7]

The TDI study confirms and validates the Missouri Department of Insurance (MDI) study. Insurers complained about the Missouri study because it inferred socio-economic characteristics from ZIP Codes to average credit scores. But the MDI methodology is well accepted in the field of fair lending analysis. The TDI study not only confirms the MDI study results – it validates the MDI methodology.

[7] Texas Department of Insurance, "Report to the 79th Legislature: Use of Credit Information in Texas," December 30, 2004, page 3.

2.3 Conclusion

In conclusion, the problems with credit scoring are apparent and even acknowledged by the industry, as evidenced by their "compromise" proposal (the NCOIL model) with a variety of purported restrictions and regulatory oversight. But what are the great benefits to consumers that warrant the use of this problematic factor and intense regulatory resources? Ultimately, there are none. Moreover, all the benefits alleged by the insurance industry come down to one claim – the purported statistical relationship between credit scores and loss ratios. And while a definitive statistical relationship is a necessary justification for the use of certain information as an underwriting or rating factor, such a statistical relationship can not be sufficient justification. If it were, then race would be a legitimate rating factor. But lawmakers across the country have decided that race is not a legitimate basis for underwriting for rating insurance. If race can not be used directly by insurers, then insurers should not be permitted to use race indirectly through credit scoring.

3. Insurer Misinformation about Credit Scoring

Insurers have provided a tremendous amount of misinformation in the credit scoring debate.

"***The Texas Department of Insurance study confirms the strong relationship between credit scores and insurance losses."***

The TDI study did no such thing. The study states:

> *There appears to be a strong relationship between credit scores and claims experience on an aggregate basis. However, credit scores, to some extent, may be reflective of other risk characteristics associated with claims. It is necessary to evaluate if, and to what extent, credit scoring enables an insurer to more accurately predict losses. Thoroughly analyzing this issue requires simultaneous analysis of the variables affecting likely claims experience. The Department is in the process of conducting a multivariate analysis using the individual policyholder data and will report the results by January 31, 2005.*[8]

The TDI study specifically did NOT draw any conclusions about the relationship between credit scores and insurance losses. Instead, the study stated that further analysis was needed.

[8] Texas Department of Insurance, "Report to the 79th Legislature: Use of Credit Information in Texas," December 30, 2004, page 3-4.

"The majority of consumers benefit from credit scoring. A ban on credit scoring would raise rates for most consumers."

This is perhaps the most insidious argument because it contains an implied threat to regulators and legislators – don't mess with credit scoring or insurers will raise rates and blame regulators and legislators. However, the facts show that the majority of consumers do not benefit and that all consumers lose. First, our own research shows that 50% or fewer consumers actually get a discount. Attached please find a good example of how one insurer – Farmers had to double the base rates to pay for credit scoring discounts and that even consumers who got a 40% "discount" paid more after credit scoring than before. Because credit scoring has no ability to reduce claim costs, there is no free lunch. Beware of proposals to allow insurers to offer only discounts – consumers are not protected from credit-based rate increases.

Second, since not all insurers use credit scoring in the same way, a ban on credit scoring does not mean that any consumer must get a rate increase. By shopping around, consumers will be able to find an insurer providing a rate the same or lower than their current rate. The insurer threats about rate increases assume a static, non-competitive market – a complete contradiction to the insurer claims about a vibrant, competitive market they use in other situations. The bottom line is that, by banning credit scoring, the Legislature is not forcing any insurer to raise the rates for a single consumer. If rates go up for some consumers, it is because of decisions made by insurers.

Third, there is no guarantee that today's beneficiaries will be tomorrow's beneficiaries. An insurer can change the cutoff score for a discount and change the percentages of who benefits.

Fourth, why is this argument relevant? The issue is whether credit scoring is an unfair practice and counter to insurance public policy goals. It is profoundly un-American to justify an unfair practice because the (alleged) majority benefits.

Fifth, insurance credit scoring raises the costs for everyone. There is no reduction in insurance claims, but there is an increase in insurance administrative costs to pay for developing or licensing the scoring model, for obtaining the credit history and for complying with the Fair Credit Reporting Act adverse action notice requirements. Further, because credit scoring has such major rate impacts, particularly on poor consumers, the number of uninsured grows with credit scoring. Consumers pay more with greater numbers of uninsured drivers – higher uninsured motorist rates and higher taxes to pay for emergency room services for uninsured drivers.

"We can write more business with credit scoring."

If this were the case, why are major agents groups opposed to credit scoring? Groups like the National Association of State Farm Agents, the National Association of Professional Allstate Agents and, the United Farmers Agents Association have called for a prohibition on credit scoring. Our research has shown an increase in auto insurance residual markets in the past few years.

"There is a statistical correlation between credit scores and loss ratios."

Since at least 1995, when the National Association of Insurance Commissioners (NAIC) started examining credit scoring, the key issue has not been whether there is a simple correlation between credit scores and loss ratios, but whether credit scores are a proxy for other factors already used by insurers or a proxy for prohibited factors such as race and income.

Interestingly, the industry has started to cite a study by the University of Texas Bureau of Business Research as providing "definitive" evidence on the correlation of credit to loss. CEJ is well acquainted with this UT report and can provide the following facts. First, the study failed to effectively address the question of correlation to loss because the authors relied upon a methodology that the NAIC working group dismissed in 1996 as being "counterproductive and misleading." Second, the study did show that credit is a proxy for other factors already used by insurers. This study looked at policies issued before insurers started using credit and found that the average score in the standard and preferred (low risk) market were much higher than the average score in the nonstandard (high risk market). Because the policies examined were from a period before insurers used credit, the difference in average scores shows that credit replicates other underwriting factors already used by insurers. Third, my own research shows that the likelihood of being placed in the nonstandard market is very highly correlated with race and income, indicating that credit scores are, in turn, biased against poor and minority consumers.

Beyond the technical problems with the correlation argument is the bigger policy issue – why should a simple correlation be sufficient justification for the use of a consumer characteristic as a rating factor? From the insurers' perspective, anything that allows them to further segment the market is good. But from a public policy perspective, why would we want insurers to use your check writing habits as the basis for pricing your insurance? If insurers found a correlation between eye color and risk of loss, should that be allowed?