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Joel Ario, Mike Kreidler
Co-Chairs, Credit Scoring Working Group

Re: MAWG Activities

Dear Administrator Ario and Commissioner Kreidler:

I write regarding the proposal for the NAIC to develop and implement an independent study regarding the relationship of consumer credit information to risk of loss and to other consumer characteristics, including race and income.

Let me preface my remarks with the need for such a study, particularly one that focuses on the relationship of insurers' use of consumer credit information to factors other than risk of loss, such as race and income. It is my understanding that the working group has decided that such a study is relevant and necessary. I agree. Even assuming that credit scoring (as used by insurers) is related to risk of loss, there is a public policy debate in the vast majority of states regarding the impact of insurance credit scoring on various classes of consumers. I have personally testified before state legislatures or insurance commissioners in many states and the issue of whether credit scoring has a disproportionate impact on poor consumers, on seniors and on other classes of consumers has arisen in each state. Representatives of the insurance industry, including the trade associations NAII and AIA, and individual insurance companies, including State Farm, have testified that credit scores do <u>not</u> vary by income or race. The insurers and their trade associations routinely point to the AIA study of credit scoring impact by income and to the Virginia Bureau of Insurance study to support their contention.

In contrast to the industry argument, attached, please find a report I recently prepared for the Ohio Civil Rights Commission in which I conclude that insurance credit scoring very likely has a disproportionate impact by race and income. Also attached are pages from the *2000 Statistical Abstract of the United States* showing a significant correlation between those credit characteristics most heavily weighted in insurance scoring and income.

The bottom line is that the proposed study is a reasonable and necessary contribution by the NAIC to the public policy debate on insurance credit scoring.

The industry argues that such a study is not necessary and the only issue is whether the use of credit scoring complies with current rating laws. Consequently, from the insurers' view, the only issue worth studying is whether a correlation exists between insurance scoring and risk of loss. The industry argues that a study, such as one proposed by the working group, will be used for "political purposes."

It seems clear to me that the working group does not agree with the industry position. The working group has decided that a simple correlation to risk of loss is not sufficient to inform the public policy debate on credit scoring – particularly since the industry has produced its own study regarding disparate impact on protected classes and income. Further, the working group should admonish the industry to offer factual arguments instead of denigrating perceived intentions of those who disagree with the industry.

My request to the working group is to acknowledge the industry position – that the proposed study should not be undertaken – and to state the working group's disagreement with that position. I think the working group has done this, but my hope is that the working group's effort to seek out comments on the structure and content of the study not be abused by the industry to delay the development of the important study.

Regarding the study itself and issues related to studies in the future, I offer the following suggestions. First, the working group should ask the Statistical Information Task Force to modify the *Statistical Handbook* to provide instructions to statistical agents and regulators for the on-going collection of credit scoring information in statistical reports. The specific changes should be the addition of two data fields to reports submitted by insurers. The first data field is for the raw insurance score, whatever that is and whatever scoring methodology the insurer uses. The second field is for the rating or underwriting category assigned to the consumer based on the raw score. The addition of credit scoring fields to statistical reports is reasonable, necessary and long overdue. I take responsibility for not recommending these additions earlier. But, just as statistical agents (and regulators) collect data on driving record, method of construction and other rating and underwriting factors, information on credit scoring should now be incorporated into these statistical reports.

Of course, once these data are available, in a few years, regulators will be in a position to independently analyze insurance credit scoring in a number of ways.

Second, there are several methods that the NAIC could use to study the impact of credit scoring on selected consumer characteristics, such as race, income, age and others. One approach is use available information about the credit characteristics of consumers by age, income and race from the Survey of Consumer Finances (the attached Statistical Abstract charts are derived from this survey) to establish typical credit reports and histories for different groups of consumers and run those credit profiles through the scoring models.

Another approach is to get average scores by ZIP Code and analyze those results. This would be an amplification of the study performed by the Maryland Insurance Administration. The industry has argued that a ZIP-Code based analysis is invalid. I disagree. First, the industry argument contradicts their embrace of the Virginia Bureau of Insurance study, which as based on average scores by ZIP Code. The difference between the proposed study and that performed b the VBI is that the average scores would not be supplied by Fair, Isaac or some other entity with a financial interest in the outcome of the study. The ZIP Code approach would require the impendent acquisition of scores or the verification that scores provided by an insurer reflected a random, and not a biased or altered, sample of consumers in an area.

Further, the fact that a ZIP Code analysis relies upon ZIP Code averages is addressed by the fact that many ZIP Codes would be used in the analysis. I recognize the issues raised by Brent Kabler – ecological fallacy and modifiable areal unit area – but do not believe these are fatal problems for a ZIP Code analysis. First, with a large number of ZIP codes and the associated average socio-economic characteristics of those ZIP Codes, a statistically valid analysis can be performed that identifies the relationship between insurance scoring and various socio-economic characteristics. Second, ZIP Codes <u>are</u> an arbitrary unit of aggregation. But that does not make the resulting analysis invalid. ZIP Codes are used because both insurance and socio-economic data by ZIP area readily available. The issue is whether there are a sufficient number of ZIP Codes in the analysis to draw statistically significant inferences about various independent variables. And with a sufficient number of ZIP Codes, the answer is yes.

A third idea for a study is the review the changes in insurers writings by rate tier and ZIP Code over time. If the industry argument of no disproportionate impact by income, race or geographic location is valid, there should be a different pattern of writings by geographic location and rating tier than if there is a disproportionate impact by income, race or geographic location. This study would require commissioners to issue a call to insurers to provide a report of policies written, policies cancelled, policies nonrenewed and policies lapsed by ZIP Code (census tract is better), product (policy form), rating tier and calendar quarter for the most five years.

I know that we are in the initial stages of designing an independent study of credit scoring issues to be conducted or coordinated by the NAIC, but I think there a number of approaches that will shed light on the important questions and which can be accomplished in a matter of months instead of a matter of years.

Sincerely,

Birny Birnbaum
Executive Director