Testimony of Birny Birnbaum

Before the Alaska House State Affairs Committee

HB 5 and HB 47: Prohibition on Insurers' Use of Consumer Credit Information For Underwriting and Rating Personal Lines Insurance

March 29, 2003

Thank you for the opportunity to speak about insurance credit scoring. My recommendation to you is to prohibit the use of insurance credit scoring for underwriting and rating personal lines insurance and I will discuss why this is reasonable and necessary.

I ask that whatever your views on insurance credit scoring – whether you like or dislike, agree or disagree with, my testimony – that you aggressively challenge my arguments and facts. I am confident that I can not only respond to your challenges, but can also provide you facts and data for you and your staff to review. I ask you to do the same to proponents of credit scoring and to demand that they, too, provide the data and information to allow an analyst not allied with the industry to review their claims. I am providing you with the following documents:

- A report I recently submitted to the Ohio Civil Rights Commission, which contains an extensive bibliography of resources on insurance credit scoring;
- Tables from the *2000 Statistical Abstract of the United States*, which show a vivid correlation between income and the credit characteristics most heavily weighted in insurance credit scoring models.
- Comments on the problems with the National Conference of Insurance Legislators model law on credit scoring;
- Preliminary comments on a recent study by the Bureau of Business Research at the University of Texas.

I would like to cover the following points in my testimony today:

1. **Background and Experience on Insurance Credit Scoring**

2. Why It Is Reasonable and Necessary to Ban Insurers' Use of Consumer Credit Information for Personal Lines Insurance Underwriting, Rating and Payment Plan Eligibility

a. Inherently Unfair
   i. WTC Attack – charge someone injured in WTC attack higher health insurance premiums because of that injury? Then why allow it for homeowners and auto insurance?
   ii. Bankruptcy Caused by Economic, Medical Catastrophes – Loss of Job, Dread Disease, Divorce
   iii. Score Manipulation
   iv. Variances by Credit Bureau
   v. Variances by Region
   vi. Illogical Factors
   vii. ID Theft
   viii. Data Quality
   ix. Use of Data Collected for One Purpose for Unrelated Purpose
   x. Punishing Consumers Lenders' Business Decisions
   xi. Agent Groups, NAR, Consumer Groups Positions

b. Discriminatory
   i. Nature of Models – Absence of Positive Attributes
   ii. Nature of Models – Limited Information, What's Missing
   iii. Good Credit History Does Not Equal Good Credit Score

c. Undermines Regulatory Oversight of Insurers
   i. Use Underwriting and Multiple Tiers to Avoid Rate Oversight
   ii. Growing Use of Third Party Black Boxes

d. Undermines the Fundamental Insurance Mechanism
   i. Risk Classification – More Than Correlation Needed
   ii. Risk Classification – No Loss Prevention
   iii. Risk Classification – Individual Rating Tiers vs. Groupings of Risk

e. Arbitrary and Violates Actuarial Principles for Risk Classification
   i. Insurers' "Diversity" of Credit Use Methods is Definition of Arbitrary
   ii. Risk Classification Principles Violated

3. Industry Arguments – False and Unsupported

a. Rewards Financially Responsible Consumers
   i. Blaming the Victim
   ii. Not a Measure of Financial Responsibility

b. Patterns of Financial Management
   i. Single Incidents Can Have a Huge Impact – Buying a Home
   ii. Doesn't Capture Many Items That Are Part of Financial Management

c. Most Consumers Benefit
   i. Unsupported and Demonstrably False – **There is NO FREE LUNCH!**
   ii. Profoundly Un-American Argument
   iii. Why Are Agents Against Credit Scoring?

d. Use of Credit Promotes Competition
   i. Just the Opposite – Larger Insurers Much Better Able to Use Credit
   ii. Unsubstantiated Claim
   iii. Prohibition on Credit Creates Level Playing Field – No Insurer Put at Disadvantage vis a vis Another Insurer

e. We Only Offer Discounts Based on Credit
   i. Credit is Zero Sum Game with No Loss Prevention.
   ii. Can't Offer Discounts Only Without Raising Base Rate – Equivalent to Surcharge for Some Customers

f. Prohibition Will Raise Rates
   i. In Aggregate, Prohibition Will Lower Rates Because Expenses Associated with Obtain Credit History, Running/Licensing Score, Complying with FCRA Disappear
   ii. Where Were the Rate Decreases When Insurers Started Using Credit Scoring?

g. More Education Needed for Consumers, Legislators to Understand Benefits and Fairness of Credit Scoring
   i. Industry Refusal to Explain Models to Public
   ii. Bogus Trade Secret Claim – Consumers Only Ones in the Dark, Not Competitors
   iii. FCRA Adverse Action Notice Failure – No Notice to New Applicants

h. Consumers Think It Is Fair
    i. Biased Single Survey
    ii. Recent Texas Poll Survey
    iii. Why Are Agents Against Credit Scoring?
    iv. Why are Insurers Firing Agents Who Speak Out Against Credit Scoring?

i. Cost-Based Pricing – Subsidies without Credit Scoring
    i. Insurers Practice CBP When Convenient
    ii. No God-Given Risk Classifications -- Public Policy Decisions Necessary

j. No Impact by ZIP Code, Income or Race
    i. Secret Studies by Parties with Financial Interest in Outcome
    ii. Actual, Available Data Show Strong Relationship Between Income and Most Heavily Weighted Credit Characteristics – See OCRC Report and Charts from Statistical Abstract

k. Irresponsible to Ignore A Characteristic Predictive of Risk, Leads to Subsidies of Bad Drivers by Good Drivers
    i. Logical Extension of This Argument is Pay As You Go and the End of Insurance
    ii. Criteria for Good Rating Factor Must Be More Than Simple Correlation and Credit Fails Any Other Criteria

The Big Lie

The industry attempts to justify the use of credit scoring by blaming the victim. The industry argument goes something like this:

> In a sense, a credit score is a report card on how the individual has managed credit risk. It is reasonable to assume that one who is responsible in managing these credit risks will be responsible in managing his or her pure risks.

This explanation is a big lie. The logic is that, first, your credit report is a measure of your financial responsibility and, second, that good credit histories result in good credit scores. First, your credit report does not measure your "financial responsibility." It contains information about a limited set of credit transactions. It does not contain information about the other aspects of financial responsibility – assets, insurance, other. And it does not contain many transactions that demonstrate regular payment – such as utility, phone and cell phone bills. And it does not contain information on credit transactions from certain types of lenders – payday loans, check cashing, rent to own. In short, the very structure of the credit scoring is biased against certain groups of consumers and certain communities.

Probably the most important thing to remember is that a good credit history does not mean you will get a good credit score. You can have a perfect payment record and still get a bad score because you have more credit cards than the model likes, because you use only one credit card, because you borrow money from a consumer finance company rather than a bank, because you shop around for insurance and loans and the list goes on. The number of consumes with bankruptcies is a small percentage of all consumers, yet, based upon my research, about 50% of consumers pay more because of insurers' use of credit. Your credit score is **as much a function of the presence of positive attributes, as determined by the insurers and scoring model vendors** as the presence of negative attributes.

Comments on Alaska Division of Insurance Study

The Division of Insurance report fairly sets out a number of issues of concern with insurers' use of consumer credit information. The report also fairly sets out the limitations of the study, most of which are a result of insurers' controlling access to data necessary for an independent analysis.

> The test of whether the use of credit history in insurance underwriting and rating complies with Alaska's insurance laws lies only partially in the theoretical support for how credit history correlates with loss history provided in rate filings. After a rating plan is in use, the actual market results must also demonstrate that the rating plan performs generally as predicted. With Alaska's unique population characteristics, genuine questions and concerns exist about the impact of credit history on Alaska's insurance buying public. (page 5)

The report draws the important distinction between underwriting and rating in terms of regulatory authority while explaining the ability of insurers to use underwriting to evade rate regulatory oversight. **Any solution to the problems with credit scoring must be comprehensive and cover underwriting, tier placement, payment plans and rating. If you leave one of these out, you leave a loophole that insurers will simply move through.**

The report points out the need for independent analysis of the alleged correlation between credit and risk of loss and between credit and other consumer characteristics such as age, income or race.

> Based on the limited data received and evaluated so far, insurance credit scoring in Alaska appears to have different effects on different groups of Alaskan insurance consumers. In the aggregate, consumers that reside in higher income/high percentage Caucasian zip codes may be less impacted by the use of the consumer's credit history. It is premature to determine whether the policyholder distribution between preferred, standard and nonstandard markets is due primarily to credit history or to other underwriting and rating factors. However, the limited data does suggest that unequal effects exist on consumers with varying income and ethnic characteristics.

The industry has rabidly criticized the Division's report. The industry complains about the inadequacy of study because of limited data, yet the industry has for ten years hid the data necessary for an independent analysis of the issues associated with credit scoring.

Further, the industry criticisms should be discounted because they have no intellectual honesty. The industry savagely attacks any report that questions any aspect of credit scoring, while blindly praising and declaring as legitimate any study that supports the industry viewpoint. The intellectual hypocrisy is graphically illustrated by the response to the study by the Bureau of Business Research at the University of Texas in Austin. The so-called study is, in fact, simply an executive study. It reports some general conclusions, but provides no details on the nature of the analysis. Yet, within 24 hours of its release, the industry was praising this study as the second coming.

When it comes to making information available to regulators and the public about credit scoring and credit scoring models, the industry tries to justify their unwillingness to provide any information with a claim of "Trade Secret." The trade secret claim is silly. The only ones who don't know about the credit scoring models are consumers. By now, all insurers know what's in the models. Several insurers have developed their own models. Other insurers use third party models, but still know what goes into the models because of the reason codes and because of using the models over time. The notion that this is a trade secret is just silly.

The insurers' refusal to show the public what they are doing tells two things – one, they are afraid of the public reaction if the public knew what went into the models and two, consumers are not in a position to improve their premium by changing their behavior because they don't know what behavior is causing higher premiums

Qualifications of Birny Birnbaum

Birny Birnbaum is a consulting economist whose work focuses on community development, economic development and insurance issues. Birny has served as an expert witness on a variety of economic and actuarial insurance issues in California, New York, Texas and other states. Birny serves as an economic adviser to and Executive Director for the Center for Economic Justice, a Texas non-profit organization, whose mission is to advocate on behalf on low-income consumers on issues of availability, affordability, accessibility of basic goods and services, such as utilities, credit and insurance. Birny has authored reports on insurance markets, insurance credit scoring, insurance redlining and credit insurance abuses for CEJ and other organizations. Birny serves on the National Association of Insurance Commissioners Consumer Board of Trustees.

Birny has worked on insurance credit scoring issues for over 11 years as both an insurance regulator and consumer advocate. Birny has recently authored a report on insurance credit scoring for the Ohio Civil Rights Commission and served on the Florida Insurance Commissioner's Task Force on Credit Scoring.

Birny served for three years as Associate Commissioner for Policy and Research and the Chief Economist at the Texas Department of Insurance. At the Department, Birny provided technical and policy advice to the Commissioner of Insurance and performed policy research and analysis for the Department on a variety of topics. His particular areas of insurance expertise include:

- Homeowners and Automobile Insurance Availability and Affordability
- Evaluation of Underwriting and Rating Factors
- Data Strategy, Collection and Analysis
- Analysis of Insurance Markets and Availability
- Review of Rate Filings and Rate Analysis
- Loss Prevention/Cost Drivers
- Regulatory Policy and Implementation

Prior to coming to the Department, Birny was the Chief Economist at the Office of Public Insurance Counsel (OPIC), working on a variety of insurance issue. OPIC is a Texas state agency whose mission is to advocate on behalf of insurance consumers. Prior to OPIC, Birny was a consulting economist working on community and economic development projects. Birny also worked as business and financial analyst for the Port Authority of New York and New Jersey. Birny was educated at Bowdoin College and the Massachusetts Institute of Technology.

Resolution Unanimously Adopted by the Board of Directors of the National Association of State Farm Agents, Inc.

The National Association of State Farm Agents, Inc (NASFA) hereby resolves that we are opposed to any insurance company using credit scoring for the purpose of property and casualty underwriting and rating. We believe credit scoring is part of a marketing scheme designed to curtail market share, avoid rate regulation and it improperly emphasizes credit as an underwriting characteristic without sufficient demonstration of its reliability for underwriting purposes. There is tremendous opportunity to mischaracterize potential insureds and inadvertently or intentionally illegally discriminate. We further support legislation to prohibit credit scoring for the purpose of property and casualty underwriting and rating.

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There is another thing that NAPAA (National Association of Professional Allstate Agents) very leery of credit scoring: Insurance credit scores have proven to be a moving target. We have seen scores on the same risk change almost weekly. How can a score that changes that frequently be an accurate indicator of future risk?

Regardless of whether insurance credit scoring is truly predictive, is it good public policy to apply one set of unrelated data to another? Will lenders include claim/ticket history in their credit history matrix? Will employers and landlords demand to see the applicant's insurance credit scores before hiring or renting? If insurance companies can use seemingly unrelated data, why can't others?

So, what is the truth about credit scoring? NAPAA believes the use of credit has a disparate impact upon several segments of the American public. Therefore, we find it discriminatory and totally unacceptable at this time.

Press Release of the National Association of Realtors

Insurance Issues Create Barriers to Homeownership, Says NAR President

(February 27, 2003) -- WASHINGTON–Soaring homeowners insurance premiums and the lack of availability of insurance coverage have become significant new barriers to homeownership, especially for new homebuyers who may have no credit history and existing homeowners who may have filed as few as one or two legitimate water-related claims, the president of the NATIONAL ASSOCIATION OF REALTORS told reporters yesterday at a media briefing at the National Press Club
.

NAR President Cathy Whatley, owner of Buck & Buck Inc. in Jacksonville, Fla., questioned the use by insurers of credit scores and the CLUE (Comprehensive Loss Underwriting Exchange) database, which contains claim histories of both individuals and properties for a five-year period. Many borrowers who can qualify for mortgages are being turned down for homeowners insurance, and others are finding that phone calls to their insurance agent are recorded on their CLUE file and can jeopardize their coverage. "The crisis in insurance is putting homeownership beyond the reach of many young families, minorities and other Americans who have yet to achieve the American Dream. Many factors are contributing to the crisis, but the use of credit scores to deny coverage raises questions about fairness and equality, despite the insurance industry's acknowledgment that there has been no research which has proven a causal relationship between credit history and the likelihood that one will file an insurance claim," said Whatley.

Factors Involved in Credit Score and the Correlation to Income

From Fair, Isaac, as reported in the December 4, 2001 article "How Your Credit History Affects Your Auto and Home Insurance Premiums," posted on Insure.com

Past payment history (approx. 35%)
How you've paid your credit bills in the past, if your bills have been paid on time, items in collection, the number of "adverse public records" (bankruptcy, wage attachments, liens), and the number and length of delinquencies or items in collection.

Table 796: If your income is under $10,000, you are 10 times more likely to have a debt payment 60 or more days overdue than if your income is $100,000 or greater.

Amount of credit owed (approx. 30%)
How many accounts, what kind of accounts, and how close you are to your credit limits.

Table 796: If your income is $10,000 or less, you are 16 times more likely to have debt exceeding 40% of family income than if your income is $100,000 or greater.

Table 817: 46.4% of families with incomes under $10,000 almost always pay off their credit card balances compared to 72.0% of families with income greater than $100,000.

Table 817: 33.8% of families with incomes under $10,000 hardly ever pay off their credit card balances compared to 14.1% of families with income greater than $100,000.

Length of time credit established (approx. 15%)
How long you have had credit accounts and how long you have had specific accounts.

New credit (approx. 10%)
Number and proportion of recently opened accounts, the number of credit inquiries, and the reestablishment of positive credit history after payment problems.

Types of credit established (approx. 10%)
The number and activity of various types of credit accounts including credit cards, retail store accounts, installment loans, and mortgages.

Table 794: If your income is $100,000 or more, you are 9 times more likely to have a real-estate secured loan than if your income is under $10,000.