THE CONSUMER BENEFITS OF CREDIT- BASED INSURANCE SCORING AND RELATED REGULATORY ISSUES

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PERSONAL AUTO INSURANCE

- Personal auto insurance is generally very competitive, and comparatively affordable and available. Premiums have been relatively stable over-all, even as consumers have many choices of coverage, provider and distribution system.

- The HHI, a commonly used measure of competition in anti-trust jurisprudence, when applied to auto insurance demonstrates a very competitive market. Auto insurance countrywide is 671.4, when a market that scores under 1000 is “not concentrated”. 333 companies are writing the coverage.

- Auto insurance is also comparatively affordable. For example, as a percentage of median family income, it is 1.16%, having dropped 13.54% since 1995. Increases in the cost of auto insurance over the last 15 years have been far below energy, medical care, professional services and are only slightly more than food and beverages and the CPI over-all.

- Residual markets are at historic lows. The most recent available data show that auto residual markets have shrunk to about 1% of the over-all market, a 72.28% decrease from 1994 to 2006. Residual market premiums have decreased 55.97% from 1995 to 2007.

HOMEOWNERS INSURANCE

- This line, too, is generally performing well, but its vulnerability to catastrophe losses has prevented even a better picture. Like auto insurance, homeowners is highly competitive in most places, with an HHI score of 743.2, and 386 companies writing it.

- Homeowners insurance has also remained relatively affordable. The increase in expenditures has roughly tracked the increase in median home values, from 1995 through 2006. Average annual price increases in recent years have been less than 3%. From 1998-2008 household insurance expenditures have increased only 14.76% compared to the 122% increase in energy, and the 45.28% increase in medical care.

- Homeowners residual market shares are also quite low, with many states at 1% or less. Of course, there are exceptions, including Florida (51.4%), Texas (12%), Massachusetts (7.8%), California (6.3%) and Louisiana (5.5%).

CREDIT-BASED INSURANCE SCORING (CBIS)

- Insurers' use of credit information is specifically authorized by Federal law and regulated by state insurance laws, both general insurance laws ("rates shall not be excessive, inadequate or unfairly discriminatory") and specific laws relating to credit, such as NCOIL model law adopted by more than one half of the states.
- **Use of credit-based insurance scoring (CBIS) helped to produce the good results for personal lines.**
- Only four states ban its use and one of these is only in one type of insurance.
- One of the four, California, has a unique and intrusive rate regulatory system. Research has shown that insurance costs would have been much lower without that regulatory system.

CHANGES IN ECONOMIC CONDITIONS HAVE NOT GENERALLY WORSEND CBIS

- FICO, a major provider of CBIS to insurers, in a September 17, 2009 letter to the NAIC stated that: "In spite of the current economic climate,...average CBIS scores have remained virtually the same over time for the general population. …Interestingly, while general population average scores have remained stable during the current economic downturn, the average FICO CBIS scores for the lowest scoring quadrant show a very slight increase in score. …FICO CBIS score stability is important in helping insurers make objective, consistent and accurate underwriting and pricing decisions."
- Complaints to state regulators relating to CBIS remain very few in number, despite federal and state laws requiring consumer disclosures and notices.
- In the summer of 2009, NCOIL provided for extraordinary life circumstances (ELC) exceptions, where desired, as part of its model law. Some companies on their own are providing such exceptions.

THE 2007 FEDERAL TRADE COMMISSION (FTC) STUDY OF 1.7 MILLION AUTO INSURANCE FILES

- The FTC auto insurance study issued in 2007, was one of several credit scoring studies requested by Congress, and was not an investigation or enforcement proceeding. Other financial services were studied, as well.
- Insurers voluntarily provided 1.7 million files and followed up with significant actuarial expertise to assist the FTC, at no cost to the government.

- The FTC study stated that: “A consistent finding of prior research and the FTC’s analysis is that credit information, specifically credit based insurance scores, is predictive of the claims made under automobile policies.” And, “…risk prediction is an important method of competition among insurance firms.” Page 20 of the FTC report.

- The benefits of CBIS to the market are many and were validated by the FTC report:
  - More accurate risk assessment and pricing result.
  - Availability of insurance improves because insurers can confidently write virtually every risk because they have reliable, objective information, a significant improvement over older practices.
  - A majority of customers pay less as a result of credit based insurance scoring. The FTC estimates that 59% would pay less if credit based insurance scores are used. Page 38 of the FTC report. Even higher percentages have been reported for some companies.

- Insurers do not collect or use information on the race, ethnicity or religion of applicants or policyholders. Page 75 of the FTC report.

- Scoring does not serve as a proxy for race, ethnicity or income. As the FTC report stated: “If scores did not predict claims within racial, ethnic and income groups, the relationship between scores and clams must come from scores acting as a proxy for race, ethnicity, and income. On the other hand, if scores do predict risk within groups, then they do not serve solely as a proxy if used to assess risk for all customers.” Page 62 of the FTC report.

- “In short, because scores do predict risk within racial, ethnic and income groups, they do not act solely as a proxy for these characteristics.” Page 64 of the FTC report.
- “…scores do not predict risk primarily by acting as a proxy for these characteristics [race, ethnicity and income].” Page 68 of the FTC report.

- The FTC was also not able to find a substitute. “Finally, the FTC was not able to develop an alternative credit-based insurance scoring model that would continue to predict risk effectively, yet decrease the differences in scores on average among racial and ethnic groups.” Page 83 of the FTC report.

- The effect of banning CBIS was also considered. The FTC concluded that: “Banning the use of factors that are known to be correlated with risk could have negative effects on insurance markets.” Page 47 of the FTC report.

- Upon issuance, the report was viciously attacked by critics who were unhappy with the results. One FTC commissioner dissented from the report’s findings, but was answered by the FTC chairman in a 10 page statement in which she concluded: “In short, we have confidence in the quality of the process used and the results obtained in the study…”

- In our view, the vast majority of the report is sound, but the “small proxy effect” finding is disputed. As Professor Powell has written: “The econometric test used to support the existence of a proxy effect is flawed such that it would not withstand the scrutiny of a legitimate academic peer-review process. Clearly, the lack of objective confidence in the result suggests that public policy should not be altered to address this weak finding.”

- Despite the hopes of many critics, the many benefits of CBIS with regard to auto insurance were fundamentally affirmed by the FTC Report as they have been by prior government and private sector reports. That is perhaps why they have been so determined to discredit its findings. No discrimination was found and the twice removed concept of proxy effect, even if it is accepted as a valid concept, was not supported by the data.
- With full cooperation by insurers, the FTC is now conducting a large scale study of CBIS in homeowners insurance.

- Many other public and private studies have substantiated the risk predictiveness and/or market value of CBIS, including Arkansas (2010 and before), Nevada (2005) and EPIC Actuaries (2003).
- These studies are validated by the very small number of complaints typically recorded by regulators despite the huge volume of insurance transactions and specific “adverse action” consumer notice requirements.
- This history tends to support the view that consumer protection is best assured by allowing CBIS to play its role in maintaining good market conditions while engaging in complaint monitoring, on-going compliance activities with regard to existing laws and regulations and cooperative action by regulators, legislators and insurers to address any problems that might emerge, as warranted. ELC provisions are an example of recent cooperative and beneficial action.

- In July 2010, the Michigan Supreme Court struck down the Governor's efforts to ban CBIS with this language: '….we vacate the judgment of the Court of Appeals and reinstate the trial court's order declaring the OFIS rules invalid and permanently enjoining their enforcement." In doing so, the Court found that CBIS provides more accurate rates, benefits many consumers and helps with availability.

Insurance Institute of Michigan v. Commissioner, 486 Mich. 370, __N.W..2d__, 2010 Mich.LEXIS 1445 (2010)

Conclusion

- As proven by repeated governmental and private studies and real world experience, consumers have been well served by the use of CBIS as generally regulated, in terms of competition, availability and affordability.
- Banning and over-regulating CBIS are not supported by the facts, good public policy or the law. Doing so would likely harm the majority of policyholders and otherwise negatively affect well-functioning markets.