Statement of the Alliance of American Insurers

on the

Value of Credit Scoring in Personal Lines Insurance

Delivered to Commissioner Fitzgerald

July 9, 2002

Good afternoon Commissioner. I am representing the Alliance of American Insurers. The Alliance is a national property casualty trade association, based in Downers Grove, Illinois, with over 300 member companies. The Alliance commends you and your staff for conducting public hearings on the issue of insurer use of credit, and we appreciate the opportunity to provide our views on the issue.

The Alliance believes that insurers should maintain the right to consider credit information in their rating decisions. We believe that credit history and credit scores (also called credit-based insurance scores) are fair and accurate tools that allow insurers rate risks with greater certainty. Further, we maintain that consumers directly benefit from insurer use of more sophisticated rating tools. Since the Essential Insurance Act already precludes insurers from considering credit in their underwriting decisions in Michigan, it's critical for healthy competition to preserve the right of insurers to consider credit information in their pricing decisions; and it's critical to allow consumers the right to seek out insurers who may offer actuarially-justified discounted rates based on their favorable credit history.

The Alliance has been actively involved in the credit scoring issue as it has evolved across the country this year – so I would like to offer a quick "national perspective." I want to dispel the myth that "every state is banning credit" and that Michigan is somehow behind the curve on this issue. The use of credit scoring has been around for many years – but its use has virtually "exploded" over the past two years as more and more insurers have begun to use credit scoring as an accurate and objective rating (and in many states, underwriting) tool. The relative "newness" then of credit scoring, compounded, unfortunately, with our slow response to adequately explain credit scoring to our agents and policyholders, has led to credit scoring becoming a controversial issue in many states. Legislation to address insurer use of credit scoring did, in fact, surface in at least 31 states this year. However, contrary to what many people believe, insurer use of credit scoring has not been banned in any of those states. Out of 31 states, only 8 states have passed laws to further regulate (above and beyond regulation already in place in every state) insurer use of credit scoring. Two states do have partial bans: the state of Hawaii bans the use of credit scoring in rating and the state of Maryland bans the use of credit in Homeowners lines and auto underwriting, but not rating.

It is important to understand how insurers use credit information. Unlike lending institutions that consider credit histories and credit scores to determine one's ability to repay a loan, insurers consider credit information credit scores to measure one's ability to *manage* credit. Credit scores actually represent an objective and fair way of measuring subjective factors – factors of responsibility and stability.

The relationship between credit and insurance risk may appear strange until one looks at the broader picture – that both are measurements of how one manages risk. And there are numerous studies and actuarial reports available to illustrate the clear correlation between credit score and insurance loss. (We would be happy to provide copies of published research on this issue to the Insurance Bureau.) This correlation is sometimes hard to understand or accept. Credit habits are *predictive,* but may not directly *cause* one to have insurance losses. But correlation is not a new concept in insurance. For example, we would all agree that a person with a history of speeding tickets is far more likely to have an accident. But those past speeding tickets don't *cause* the accident. Instead the past driving history *correlates* with the likelihood of accidents.

Credit scores are primarily affected by credit habit *patterns.* So a person with a rare late payment or someone who has prudently initiated several credit inquiries while shopping for the "best deal" will not likely have a poor credit score. Further, credit scores used by insurers do not discriminate against lower-income individuals. In actuality people of all economic levels have good and bad credit records. Income is NOT a factor considered in an insurance credit score.

In addition to income level, one's address, ethnicity, religion, gender, familial status, nationality, age, and marital status are also NOT considered within a credit score calculation.

Some opponents of insurer use of credit information have charged that insurers use credit information for the purpose of charging higher premiums. We disagree with this charge. Insurers are in the business to write and retain policies. Any insurer who would attempt to unfairly rate or tier their policies, would not remain in business very long. On the contrary, credit information has proven to be an effective tool for insurers, allowing them to rate (and, in many states, underwrite) business with a greater degree of certainty and accuracy. Further, our member companies repeatedly tell us that the vast majority of applicants and policyholders have *good* insurance scores, and that the *majority* of risks receive a discount based on these favorable scores. For example, one of our member companies has told us that 90% of their policyholders receive a discount based on their credit score. This means that if insurers are prohibited from establishing a discount plan based on credit information, that same majority of policyholders would likely see a premium "increase" as those policyholders would be required to subsidize others.

Privacy is another issue that has been raised in opposition to the use of credit information. Today, more than ever, consumers are concerned with privacy and confidentiality of personal records. We don't believe that the use of credit reports, either directly, or indirectly through scoring mechanisms, is intrusive. Insurers must employ strict confidentiality procedures in their use of credit histories. And the use of scoring allows the underwriter to objectively consider credit information and credit management habits without having to scrutinize all the details of one's credit history. Likewise, an applicant or policyholder will not have to fear that every detail of his private credit information will become known to his agent – who may be a family friend or neighbor. Consumers need not feel that their insurer's use of a credit history or score will jeopardize their privacy.

Some people have also voiced concern over possible inaccuracies or errors in their credit records. While errors obviously occur, their impact on insurance underwriting has been negligible. Often errors found on credit reports are not relevant to the information that goes into a score for consideration by insurers. In fact, insurance scores are based on information far more accurate than motor vehicle records. However, if credit information is found to be in error, the Federal Fair Credit Reporting Act (FCRA) already clearly protects consumers by prohibiting insurers from considering information known to be in error. The FCRA, which gave insurers the right to consider credit information nearly thirty years ago, also requires insurers to disclose the source of adverse information to policyholders and to advise policyholders how incorrect information may be disputed and corrected. By federal law, once a consumer files a dispute with the credit-reporting agency, the agency has only thirty days to resolve the dispute. If information cannot be verified during that time, the disputed information must be removed from the consumer's record.

Finally, if an applicant or policyholder objects to an insurer's practice of reviewing a credit report or credit-based insurance score, or believes that their company has unreasonably changed a rate based only on credit, that person is free to shop for another insurance company. Insurance is a highly competitive business and there remains a lot of consumer choice out there.

And just as not all insurers will choose to use credit information in their rating process, those that do will not all use them in the same manner. Nor would we want them to all use it in the same manner. That would take away much of the competition necessary for a healthy insurance market. A perfect example of this "difference" is how companies consider consumers who do not have credit records.

We also want to caution consumers that there may be many factors behind a premium increase. Sometimes we see seemingly large increases in the bill, but credit (or the loss of a credit-based discount) may actually account for only a small portion of that increase. For example, positive factors such as increased coverage amounts (or "inflation guards") on a homeowners policy to assure adequate replacement cost coverage may be included on a renewal, along with the loss or reduction of a credit discount. But since the Fair

Credit Reporting Act requires insurers to notify policyholders of an adjustment based in whole or in part on credit – the notice may, unfortunately, imply that a credit score was the sole factor behind a premium increase.

The Alliance believes that the use of credit reports and insurance scores has positive overall effects on consumers. For some applicants and policyholders it can become an emotional issue. Sometimes people fall on hard times and good people end up with bad credit records. But again, a *score* allows an underwriter to look at a trend – not just a few incidents. Further, older items will carry less weight – so our mistakes don't haunt us forever.

It is true that some policyholders will not be eligible for discounts based upon their insurance score or based upon information in a credit report. But then, some applicants will also be subject to higher premiums due to an unfortunate traffic accident – maybe their first in years. So while some say that it is not "fair" for insurers to consider credit information, we believe that just the opposite is true. All consumers deserve to be rated as accurately as possible, and given the most favorable rate applicable for their exposure.

Credit-based insurance scoring is an effective tool for insurers - and a fair one for consumers. To protect competition and consumer choice, it is imperative that insurers be permitted to fully price risks using nondiscriminatory and statistically valid tools available to them.

I mentioned earlier that some insurers made the mistake of not communicating with agents or policyholders earlier on this issue. I believe that the vase majority of insurers are now making a great effort to explain to their agents and policyholders how credit scoring works, and the advantages of credit scoring. The national trade associations, including the Alliance, have produced publications for use by member companies and numerous companies have now produced educational materials in an effort to more openly communicate with their customers.

The Alliance of American Insurers appreciates the opportunity to provide our comments. Thank you for your time.

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