Colorado Division of Insurance
Credit-Based Insurance Scoring Study
Final Report
January 7, 2010

I. Introduction

Credit-based insurance scores are one of many rating tools used by insurance companies. Credit-based insurance scores are used in both homeowner and personal auto lines of insurance and results in some consumers receiving premium discounts and others premium increases. The use of credit-based insurance scores as a rating factor has been, and continues to be, a controversial subject. The insurance companies have shown that, statistically, individuals with lower than average scores are more likely to file claims. Many consumers do not understand how their credit history relates to insurance, particularly if they are paying their insurance premiums on time. Since the Division of Insurance (”Division”) receives complaints from these consumers, it is important that the staff understand both the industry and consumer perspective of credit-based insurance scores.

In an effort to become more educated on this issue, the Division formed an internal work group to study the many facets of credit-based insurance scores and how they are used in today’s regulatory environment. This report summarizes the information the Division has received over the past few months.

II. Statutory Basis

Federal law specifically allows credit scoring models in the rating and/or underwriting of insurance policies. This law is referred to as the Fair Credit Reporting Act (“FCRA”) and is found in U.S.C. § 1681.

State law also specifically allows credit scoring models in the rating and/or underwriting of insurance policies. This law is the Colorado Consumer Credit Reporting Act and is found in § 12-14.3-103, C.R.S.

Section 10-4-116 C.R.S., Use of Credit Information, is modeled after the National Council of Insurance Legislators ("NCOIL") model law. This statute sets parameters around what types of information an insurer may use in its scoring model as well as sets forth the required disclosures. Section 10-4-616, C.R.S., Disclosure of Credit Reports, sets forth additional disclosure requirements.

III. Consumer and Credit Reporting Agencies

Choicepoint

On June 30, 2009 Division staff met with Choicepoint, a consumer reporting agency. As a consumer reporting agency, Choicepoint is contracted by insurers to provide credit-based insurance scores, as well as other reports such as Comprehensive Loss Underwriting Exchange ("CLUE") reports and motor vehicle records.

Choicepoint does not collect raw credit information from creditors; instead, Choicepoint requests the raw credit data from credit reporting agencies such as TransUnion, Experian and Equifax. Choicepoint provides a system for insurers to order and obtain consumer reports, including credit-based insurance scores. Choicepoint also tests and validates the credit characteristics on a continuing basis to ensure the characteristics used continue to be an indicator of insurance risk.

TransUnion

On June 30, 2009 Division staff met with a representative of TransUnion, a credit reporting agency. As a credit reporting agency, TransUnion collects data from, among others, creditors, such as lenders and collection agencies, and public records (i.e. bankruptcies) and generates a financial credit score. This credit score is the score commonly used by banks and mortgage companies to determine if an individual is credit-worthy.

Similarly, TransUnion contracts with insurers to provide credit-based insurance scores which are based on similar characteristics as those contemplated in a financial credit score, but have been statistically indicative of future losses. Insurance companies do not obtain an actual financial credit score; they only obtain the data applicable to insurance rating. Inaccurate information on a credit report may be disputed through this agency and any other credit reporting agency, such as Experian and Equifax.

Conclusion

Financial credit scores and credit-based insurance scores are not the same. While some of the same factors or characteristics are used to develop a credit-based insurance score; not all of the credit information is used. According to the credit reporting agencies, approximately 20 to 30 factors are used to develop a credit-based insurance score and over a hundred are used to develop a financial credit score. The 30 or so factors used are those that have been statistically proven to be an indicator of future losses. Both Choicepoint and TransUnion have indicated that, although the current economy may be

adversely affecting a financial credit score, the insurance scores have remained constant and, in some cases, improved. Improvement of insurance scores may be attributed to consumers paying down their debt and saving more.

IV. Insurer Information

Division staff met with four insurance companies accounting for over 50% of the private passenger automobile market share in Colorado. Each company utilizes a proprietary model which incorporates specific factors from a credit database to formulate a credit-based insurance score. They obtain the data from a reporting agency as described earlier. The credit-based insurance score is then incorporated with other rating factors, such as garaging location, type and use of vehicle, age of driver, at-fault accidents and/or moving violation convictions, to determine an appropriate premium charge for providing the insurance protection.

The credit-based insurance score causes one of three actions to occur, 1) the consumer receives a discount from the base premium due to a better-than-average score, 2) the consumer receives a surcharge on the base premium due to a lower-than-average score, or 3) the consumer neither benefits from nor is penalized due to the score. Although there are differences between individual company experiences within these groups, generally, about 60% of the company's business benefit from lower premiums, 35% receive higher premiums, and 5% receive no insurance cost change due to the use of the credit-based insurance scores.

The use of credit-based insurance scores varies widely among insurers. Some use it only to rate new customers or those who are adding new vehicles, while others utilize the rating tool in virtually all aspects of the business including new business, renewal, policy modification and tri-annual review pursuant to § 10-4-116(1)(g), C.R.S. Some insurers will adjust the premium up or down after the credit-based insurance score is reordered, while others will only adjust the premium if it benefits the insured.

Insurers assert the use of credit-based insurance scores allows the insurer to write policies for consumers they would otherwise not insure. Overall, they believe these scores continue to be highly predictive of future insurance losses, which allow them to more accurately price each individual consumer based upon the consumer's potential for a claim. Therefore, consumers benefit from the use of the credit-based insurance scores since they receive a more accurate premium charge based on their individual risk characteristics. Generally, insurers believe current statutes and regulations adequately protect Colorado insurance consumers.

V. Consumer Information

A. Complaints received

Section 10-4-116, C.R.S. sets forth the parameters for the use of credit-based insurance scores in Colorado. This section of law requires insurers that use credit-based insurance scores to order a new score at least every three years. This section of law went into effect on January 1, 2005; therefore, insurers began reordering the scores in 2008, which has resulted in an increase in the number of automobile protests[1] received by the Division that involve an increase in premium due to the use of a credit-based insurance score.

The Division receives automobile protests and consumer complaints through two different processes. The first, as noted above, is the statutory right to protest a private passenger automobile premium increase; these are coded in the Division's internal database as protests. The Division received 989 automobile protests between January 1, 2009 and July 31, 2009. Of the protests received, 308 involved an increase in premium due to the use of credit-based insurance scores. Please see Appendix A for a sample of the types of comments the Division receives from consumers on automobile protests that are the result of an increase in premium due to the use of a credit-based insurance scores.

All other consumer complaints are received through letters, emails or faxes. The Division opened 1,980 complaints between January 1, 2009 and July 31, 2009. Of the complaints received 11 involved credit-based insurance scores.

B. Consumer Advocates' Position

On September 24, 2009, the Division of Insurance participated in a conference call with Robert Hunter, FCAS, MAAA. Mr. Hunter is a former Commissioner with the Texas Department of Insurance. He currently serves as Director of the Consumer Federation of America, a consumer advocacy organization.

Mr. Hunter believes the use of credit-based insurance scores should be banned, and he presented several arguments in support of his position.

The American Academy of Actuaries promulgates Actuarial Standards of Practice (ASOP) that its members are required to follow. These standards provide guidance to actuaries in several areas, such as rating or reserving issues. Mr. Hunter believes that the use of credit-based insurance scores violates ASOP[2] because "a plausible relationship between the characteristics of a class and the hazard insured against" is required. Further,

[1] For additional information on the automobile protest process see § 10-4-629, C.R.S.
[2] Current ASOP 12 (adopted Dec. 2005) states, "while the actuary should select risk characteristics that are related to expected outcomes, it is not necessary for the actuary to establish a cause and effect relationship between the risk characteristic and expected outcome to use a specific risk characteristic." which does not support this opinion.

he asserts that any correlation that may exist between credit scores and losses lacks this plausible relationship.

Mr. Hunter also stated that the use of credit-based insurance scores is unfair because credit scores may be affected by factors that cannot be controlled by the consumer. For example, people whose credit score has been negatively affected by medical expenses would pay more for insurance than someone who had not had their credit affected by such expenses. Bank decisions, such as lowering an individual's credit limit, could have a negative impact on credit scores, and therefore insurance premiums. Both of these examples are entirely out of the control of the consumer, and could result in increased insurance premiums.

His final point in support of banning the use of credit-based insurance scores is that the use of credit scores is a proxy to rating based on race and/or income. One argument Mr. Hunter uses to support this position is the FTC report discussed below in the actuarial section.

On September 30, 2009 Mr. Birny Birnbaum met with the study group and presented the reasons why he believes credit-based insurance scores should be banned. Mr. Birnbaum was a former regulator for the Texas Department of Insurance and is now the Executive Director of the Center for Economic Justice, another consumer advocacy organization. Mr. Birnbaum's presentation was similar to Mr. Hunter's in that he is opposed to credit-based insurance scores. He believes the use of credit-based insurance scoring is a proxy to using race and/or income level as rating factors. Mr. Birnbaum cited the Missouri Department of Insurance Study. Specifically, "***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."[3]

Mr. Birnbaum questioned the industry's position that credit-based insurance scores are predictive of future loss. He believes the industry is using credit-based insurance scores because it improves retention and profitability; and is not truly predictive of future losses.

Mr. Birnbaum agrees with Mr. Hunter's opinion that credit-based insurance scores can be manipulated and therefore are arbitrary. One of Mr. Birnbaum's arguments is there are three different credit rating bureaus with which companies may contract to obtain credit data. Businesses, lenders and/or debt collection companies do not report to all three companies; therefore, the credit-based insurance scores could differ depending on which credit rating bureau the company chooses. Additionally, a lender's business decision to

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[3] Birny Birnbaum, Center for Economic Justice *NAIC Hearing on Insurance Credit Scoring*, April 30, 2009, Actuarial Considerations

lower a credit limit or cease lending would result in a lower credit score and affect the consumer whether or not the consumer is financially responsible for the change.

VI. Actuarial Justification

Insurance companies use a number of different rating factors to provide lower rates to risks that are better than average (fewer paid claims), and to increase rates to risks that are worse than average (more paid claims). With the appropriate actuarial or statistical justification demonstrating a difference in expected losses or expected expenses, these rate differentials are permitted under § 10-4-403, (1), (c), C.R.S. In addition to the use of credit-based insurance scores, some other examples of rating factors are the age of the driver, number of driver violations and number of miles driven.

Companies use various rating factors to stratify their book of business, and are continually looking for new rating factors that are predictive of future losses. A rating factor cannot be used without adequate justification that it is predictive of future losses. All rating factors are calculated so that the amount of premium decreases (in terms of dollars) equals the amount of premium increases (in terms of dollars). This ensures that the rating factor is revenue neutral and its use does not generate more premiums for the insurer, but rather provides rate differentials to those who pose a greater or lesser risk to the insurer than average.

The use of various rating factors that have been demonstrated to have a high level of predictability permits insurers to evaluate their risks more accurately, and, therefore, quote a price for insurance that more closely matches the insured's true risk to the insurer. Any insurer that wishes to use credit-based insurance scores must provide actuarial or statistical justification to the Division demonstrating its use is predictive of future losses.

Pure premium is an actuarial term that reflects the portion of the premium that is used to pay for only the insurer's losses, not the insurer's expenses (such as commissions, taxes, licenses and fees, and their general overhead expenses). The pure premium is calculated from independent analysis of claim frequency and claim severity. The lower the pure premium for a group of people, the lower the true risk this group represents to an insurer, and therefore the lower the premium charged to an individual policyholder.

The federal "Fair Credit Reporting Act" charged the FTC with determining if the use of credit-based insurance scores was a proxy for a rating factor based on protected classes of individuals, such as race, ethnicity, and income. The FTC found that when controls for race, ethnicity and income were placed on the analysis, the correlation between credit-based insurance scores and losses remained high.

The FTC Report shows that 59% of individuals receive a decrease in premium as a result of the use of credit-based insurance scores, while 41% receive an increase in premium. The average change in premium over all policyholders is 0%. This indicates that the use

of credit-based insurance scores is not intended to increase premiums across the board throughout the industry, but rather to provide rate differentials to individuals who are statistically expected to have differentials in expected losses. This is permitted under Colorado statutes.

In light of today's economic conditions, many policyholders are concerned that potential decreases in their financial credit scores and credit-based insurance scores will have an adverse affect on their insurance premiums. This is a valid concern because if the credit-based insurance scores worsen the premiums will increase. However, Colorado insurance laws require insurance companies to justify at least annually to the Division that their rates are compliant with all Colorado statutes and regulations. This includes the rating factors used to price a policy. If a significant portion of the population were to experience premium increases resulting from decreases in credit-based insurance scores that are not proportionate with the increase in risk they represent to the insurance company, the Division would require the company modify its rating factor to ensure it remains revenue neutral.

Finally, actuarial standards of practice and Colorado statutes do not require an actuary to explain *why* a rating factor is predictive of future losses, only that its use *does* correlate with future losses. Why a rating factor correlates with future losses is not something that can be quantified or determined in the actuary's statistical analysis.

VII. Other State Activity

In the 1990's, interest in insurance companies' use of credit information began to grow. States passed consumer protection laws and regulations to restrict the use of credit information in determining insurance premiums. The National Conference of Insurance Legislators (NCOIL) created a model law in 2002 to encourage more states to take action in this policy area. According to the National Association of Mutual Insurance Companies ("NAMIC"), 47 states currently have laws or regulations that address the use of credit-based insurance scores in setting insurance rates, and at least 22 states have adopted a substantial portion or the entire NCOIL model act.

For most states, the NCOIL Model Act remains the core statutory structure, but variations are emerging across the country. Like Colorado, some states have studied the topic and issued reports including Alaska, Indiana, Michigan, Texas, Virginia, Washington and, most recently, Wisconsin. These reports are available on the individual states' insurance department websites.

A few states have banned the use of credit-based insurance scores. Massachusetts and California ban the use in auto insurance while Hawaii bans it for both home and auto. Michigan currently bans the use of credit-based insurance scores, but the law was challenged and is currently in the state Supreme Court.

In Colorado, much of the debate about the use of credit-based insurance scores has focused on the two extreme public policy options – either allow its use or ban it. After studying the issue more thoroughly, the Division has discovered many policy options that fall between the two extremes, and states have enacted policies to match their unique political and regulatory structures. The following state profiles provide a review of some of these policy options:

- Illinois: In 2006, the Legislature passed a new section that allows certain extraordinary life events to be exempt from the credit based insurance score. This includes catastrophic illness, death of a spouse, loss of employment, etc… The language allows the companies to "review and consider an exception," rather than mandating the exemptions.

- Indiana: In 2009, Indiana removed the requirement that insurers reorder a credit-based insurance score and re-rate a policy every three years. Indiana's legislation also banned the use of late medical payments as a factor in determining credit-based insurance scores. Previously, only medical payments in collections were off limits.

- Oregon: In 2003, Senate Bill 260 passed, limiting the use of credit-based insurance scoring to new business only and, like Indiana, moved Oregon away from the common requirement to review an insured's credit-based insurance score every three years. Like other states, Oregon also wanted to address the occurrence and destructive effects of catastrophic events. In 2005, the law was amended to prohibit the reevaluation of credit-based insurance scores if an insured experiences a death or divorce of a spouse. In 2009, the law was further modified to prohibit an insurer from increasing the premium if an insured's score deteriorates. Therefore, if an insured requests a reevaluation of the credit-based insurance score, the effect can only be positive and premiums can only be decreased.

- Minnesota: Minnesota Revised Statute 72A.20 Subdivision 36 prohibits rejection, cancellation or non-renewal of a private passenger automobile or homeowner policy. If no credit-based insurance score is available the insurer must exclude the use of credit in the rating of a policy. Like Oregon and other states, Minnesota's statute addresses catastrophic events. Now, the insurer *must* provide a reasonable underwriting exception for catastrophic injury/illness, temporary loss of employment or death of an immediate family member.

- Wyoming: Wyoming Revised Statute § 26-2-134 empowers the insurance commissioner to promulgate rules with respect to personal automobile and homeowner policies and the use of credit scoring. While some rules to adjust the use of credit-based insurance scores have been proposed, changes in the Administration have delayed final changes.

- Wisconsin: Following a public hearing on September 14, 2009 the Wisconsin commissioner issued a report that highlighted practices that could be considered during the legislative session. Those practices include but are not limited to the impact of catastrophic events, use of scores on renewals only, and review of certain types of information.

In March 2009, the National Association of Insurance Commissioners held hearings related to credit-based insurance scores. No policy recommendations have been released to date.

VIII. Other Resources

The Division has identified a number of resources that discuss the use of credit-based insurance scores. Several of those resources are listed below for your reference. Additional information may be provided upon request.

National Association of Mutual Insurance Companies, http://www.namic.org/default.asp

Prepared Statement of the Federal Trade Commission, May 21, 2008, http://www.ftc.gov/os/2008/05/080521creditbasedtest.pdf

Center for Economic Justice, http://www.cej-online.org/

IX. Conclusion

The Credit-Based Insurance Scoring Study Group met with several representatives from the insurance industry, credit reporting agencies and consumer advocacy groups. This group was formed to expand the Division's knowledge about how credit based insurance scores are formulated and used, and explore possible opportunities for the Division to better protect consumers affected by the use of credit-based insurance scores.

Clearly, the industry has developed very sophisticated rating models using credit-based insurance scores. It is difficult to decipher whether the use of these scores is inherently wrong without extensive research and analysis that digs deep into these issues. Both the opponents and proponents have long-standing opinions that polarize the debate, and leave the consumer wondering why credit is even part of the rating system.

The Division has determined there is a middle ground. Rather than banning the use of credit-based insurance scoring entirely, there are several policy modifications that may benefit Colorado consumers. Exempting catastrophic events such as a death of a spouse, an illness or an involuntary loss of employment, or allowing credit-based insurance scores on new business only, both have potential to protect consumers when they need it most. Industry and consumers would benefit from small, but significant, changes rather than a complete ban across various lines of insurance.