Testimony of Birny Birnbaum

Before the Kansas House Insurance Committee

March 13, 2003

Thank you for the opportunity to speak about insurance credit scoring generally and about SB 144 in particular. 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. In the event you decide to allow insures to continue to use consumer credit information for underwriting and rating personal lines insurance, I will offer a few suggestions to strengthen the consumer protections in SB 144. As it currently stands, SB 144 is quite weak at protecting consumers from unfair practices involving consumer credit information.

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 a report I recently submitted to the Ohio Civil Rights Commission, which contains an extensive bibliography of resources on insurance credit scoring and 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.

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

4. Suggestions to Strengthen SB 144

First, it is worth noting how many restrictions and prescriptions are necessary for the use of credit as an underwriting or rating factor. Given the tremendous regulatory resources necessary to enforce SB 144 and, given the many concerns with credit scoring reflected in SB144, one would think that there are some powerful reasons for allowing insurers to use insurance credit scoring. But, in fact, there are no such powerful reasons. All the industry has is an alleged correlation. Surely that cannot be enough to justify the use of insurance scoring.

Second SB 144 will not benefit consumers because of lack of enforcement. Some of the provisions are simply unenforceable, while others would require a commitment of regulatory resources that you will be unable to provide.

Third, the definition of adverse action needs improvement. It must be crystal clear than any consumer who fails to receive the most favorable treatment because of information in his or her credit or other consumer report must be given adverse action notice. Incredibly, many insurers have failed to give adverse action notices to all new business applicants who got some quote no matter how high that quote was – all based on a terrible misreading of the FCRA.

SB 144 does not adequately address this problem. The definition of adverse action is slightly lacking because it seems to revolve around <u>change</u> from a current situation instead of an offer from the insurer of something other than most favorable provisions because of credit information. We suggest the following definition.

> Any action by the insurer to offer a consumer other than the most favorable underwriting action, price, terms of coverage, rating tier, or other feature of the personal lines insurance policy upon initial application or renewal by the consumer.

And this definition of adverse action must be accompanied by the requirement that insurers must provide notice of adverse action whenever an adverse action is taken in whole or in part because of information in a consumer credit report or other consumer report, as that term is defined in the FCRA.

We did not include payment plan in the definition of adverse action. In fact, the law should state a clear prohibition against the use of any consumer credit information or information in any consumer report to condition the eligibility of a payment plan. An insurer is never in a position to provide coverage without payment. And the purpose of the payment plans is to make insurance – including insurance required by the state – available and affordable. Insurers' use of credit scoring is intended to identify the most profitable business. While this is a rational act on their part, the consequences conflict with the public policy goals of making insurance available and affordable to the entire population.

Fourth, any prohibitions or limitations on insurance credit scoring or factors included in insurance scoring should include underwriting, tier placement, terms and conditions of the policy and price of coverage. If you don't cover all aspects of the insurance transaction, then you invite insurers to game the system by shifting activities from rating to underwriting.

Fifth, several sections of the bill prohibit the sole use of credit scoring for certain actions by the insurer. Unfortunately, this is meaningless. Actually, it is worse than meaningless because it appears to promise a consumer protection when, in fact, none are created. Insurers can get around the "sole" limitation every easily and in ways that do not accomplish the consumer protections you seek. For example, one section prohibits an insurer from taking an adverse action solely because a consumer does not have a credit card account. Since insurers use credit scores that consider various credit factors, insurers are already in compliance with this provision, even if the absence of a credit card is 99.9% of the reason for the adverse action.

Sixth, the use of inquiries in credit scoring models should be prohibited. Connecticut has already done this. Trying to micro-manage the use of inquiries in the scoring models continues to leave big holes, but, more important, it is unenforceable. It is unrealistic to expect the insurance department, which already has scarce resources, to be doing anything other than a cursory review of the models and will be unable to intensively investigate the models to see if the limitations are in place.

Seventh, several key consumer protections are missing. First, insurers should be required to obtain credit information from all three credit reporting agencies to ensure full and complete information. Second, insurers should be required to update their models every 24 months to ensure the models reflect the most recent economic conditions. Third, the public disclosures must be much more explicit. Insurers should be required to provide identify the top 5 credit characteristics / factors that prevented the consumer from getting a better score. The disclosure should also include the optimal value for the credit characteristic in the score, the value assigned to the consumer and point impact of the difference on the consumer's score. It is only in this way that a consumer will be in a position to exercise his or her rights under the FCRA.

Eighth, Section 8 provides for the filing of certain information with the insurance commissioner and declares most of that information to be exempt from public disclosure. This is both unreasonable and unnecessary. First, it is imperative that the public has information about how insurers use credit so they can be part of the enforcement process. It is unreasonable to expect the insurance department alone capable of the extensive enforcement associated with this bill. Second, there is no trade secret. The essence of a trade secret claim is that disclosure will provide a competitor with some advantage. In fact, all insurers using credit scoring know what is in the models and how the various credit characteristics affect scores. Many insurers have created their own models, but all the models use basically the same information and credit characteristics. The only folks who don't know about the models are members of the public. Insurers will not be at a competitive disadvantage if details about the model are revealed, but consumers will be empowered. We suspect that insurers want to keep this stuff secret because of the uproar that will occur from consumers as they learn more about the models.

Ninth, we want to restate the importance of applying all the requirements and prohibitions regarding credit scoring to underwriting and tier placement as well as to rating and coverage denial and cancellation. We have seen how insurers have evaded regulatory oversight of rates by changing underwriting guidelines dealing with credit scores. There is no solution to the problems of credit scoring unless the solution is comprehensive.

Tenths, the protection for agents is necessary and important. I would add that agents should also be protected from company retribution for providing you and the department with information about credit scoring that insurers do not like. We have seen agents fired for testifying about credit scoring and this is not only unfair, but deprives you and the public of a critical source of information about the impact of credit scoring on consumers.

Eleventh, and finally, the legislation should not only require the commissioner to perform studies on insurers' use of credit scoring and the impact of credit scoring on various groups, but should require the commissioner to include the perspectives of all stakeholders, including consumers. The industry has vast resources to provide studies and assistance to the department; consumer views are typically not included unless the regulator aggressively seeks out those views. We urge you to require the commissioner to do so. In addition, the commissioner should be required to collect data as follows;

> Data Collection and Independent Regulatory Analysis. The Commissioner shall direct statistical agents to collect insurer-specific premium, exposure and loss data broken out by raw credit score and credit score category assigned to consumer in addition to other data categories required in approved statistical plans. As soon as such data are available to perform an actuarially credible and/or statistically significant analysis, the Commissioner shall perform an analysis of the correlation of credit information to frequency and severity of claims and to other underwriting and rating factors both permitted and prohibited.

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.

Spring 2003 Issue of *Exclusive Focus*, the Official Publication of the National Association of Professional Allstate Agents, Inc.

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) -- 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.

SAMPLE REPORT

Personal insurance credit inquiry for John Doe

With your permission, Progressive reviews selected information from your credit history when you request a quote for insurance. Your rate is based on many factors: the car you drive, where you live, the amount and type of coverage you select, your driving and claims history, and your payment and credit history.

	You	Average
Experience you have with managing credit		
Months you have managed credit	48 Months	96 Months
Age at which you first established credit	16	21
Number of times a payment was past due more than 30 days	4	1
Current payment status of installment loans and revolving accounts		
Number of loans and accounts with a satisfactory current payment record	2	5
Number of credit card accounts currently past due more than 30 days	0	0
Use of available credit		
Percent of available credit limit currently being used on revolving accounts	88%	35%
Percent of available credit limit currently being used on all open accounts	70%	56%
Months since your most recent auto loan was made	12 Months	4 Months
Credit inquiries you initiated in the past 25 months	5	4
Insurance Credit Score	116	100

Your payment and credit history information was obtained from Experian. More detailed information can only be obtained by you by calling Experian at 1-888-397-3742. You may order a copy of your credit report free of charge.

Definitions

Installment loans have fixed terms with regular payments, such as a car loan, home loan, student loan, or personal loan. Revolving accounts have varying payments depending on the balance of the account. This includes all major credit cards and cards from department stores.

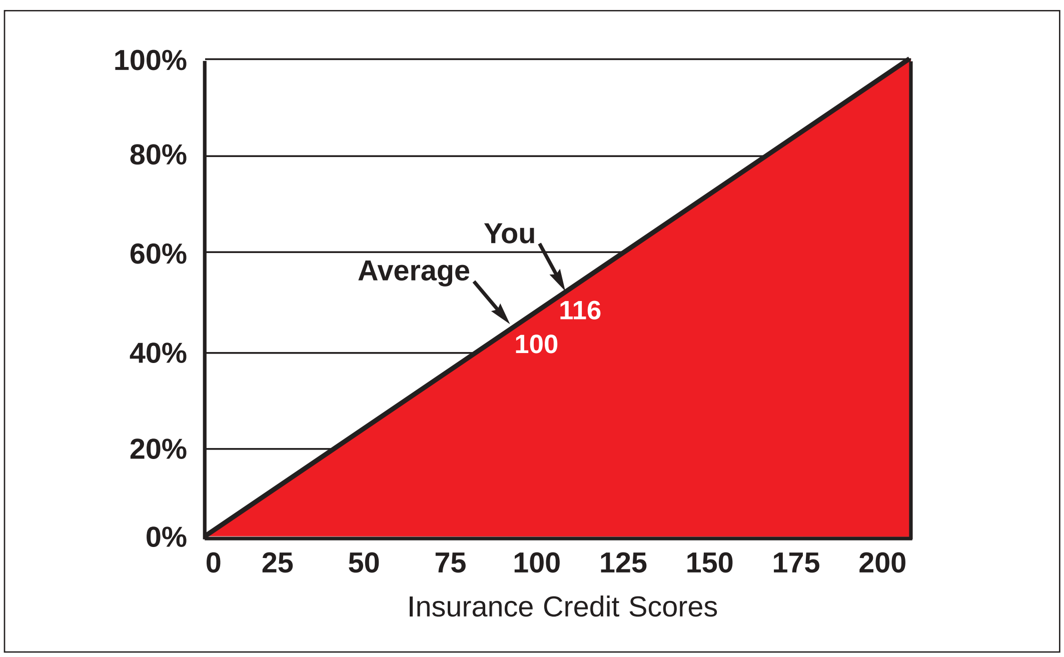
SAMPLE REPORT

Personal insurance credit inquiry for John Doe

How your insurance credit score is determined

A lower score is better, as it indicates that you have carefully and consistently managed credit over many years. Consumers who use credit responsibly are statistically less likely to be involved in auto accidents and may be eligible for lower rates. To determine your insurance credit score, we subtract points for items that are better than average and add points for items that are worse than average.

Every consumer starts with the same number of points		**100**
Items better than average:		
First established credit at age 16	-10	
12 months since last auto loan was made	-7	
Total of all better than average items		**-17**
Items worse than average:		
Managed credit for 48 months	18	
2 loans and accounts that are current	8	
88% of available credit in use	4	
5 credit inquiries in the past 25 months	3	
Total of all worse than average items		**33**
Your insurance credit score =		**116**



Consumers who received a quote from Progressive in the past 6 months had an average insurance credit score of 100.

Your insurance credit score is 116 and is lower than 44% of consumers who received a quote from Progressive in the past 6 months, but is higher than the average.

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Code	*Positive Characteristics*	*Code*	*Negative Characteristics*
1	Favorable amount owed on accounts (+)	**51**	Excessive or unknown amount owed on accounts (-)
2	No recent delinquency (+)	**52**	Recent delinquency (-)
3	Presence of revolving credit accounts (+)	**53**	Absence of revolving credit accounts (-)
4	Favorable number of accounts with outstanding balances (+)	**54**	Too many accounts with balances (-)
5	Favorable number of finance accounts (+)	**55**	Too many finance company accounts (-)
6	Favorable number of recent credit checks (+)	**56**	Too many recent credit checks (-)
7	Favorable number of new accounts (+)	**57**	Too many new accounts (-)
8	Proportion of revolving balances to revolving credit limits is favorable (+)	**58**	Proportion of revolving balances to revolving credit limits is too high, or no revolving credit accounts (-)
9	Favorable amount owed on revolving accounts (+)	**59**	Unfavorable or unknown amount owed on revolving accounts (-)
10	Favorable length of revolving credit history (+)	**60**	Insufficient length of revolving credit history (-)
11	No past delinquency or favorable length of time since last delinquency (+)	**61**	Delinquency date too recent (or date unknown) (-)
12	Favorable length of credit history (+)	**62**	Insufficient length of credit history (-)
13	No current or past delinquencies (+)	**63**	Delinquency (-)
14	Favorable time since last derogatory public record or collection (+)	**64**	Recent derogatory public record or collection (-)
15	Minimal or no past due balances (+)	**65**	Past due on balances (-)
16	Favorable payment history (+)	**66**	Delinquency, derogatory public record or collection (-)
17	Absence of collection accounts (+)	**67**	Presence of collection accounts (-)
18	Favorable number of revolving accounts with balances (+)	**68**	Too many revolving accounts with balances (-)
19	Favorable time since last credit check (+)	**69**	Date of last credit check too recent or unknown (-)

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REASON CODE LISTING

Code	Positive Characteristics	Code	Negative Characteristics
20	Favorable time since most recent account established (+)	**70**	Insufficient time since most recent account established (-)
21	Favorable number of installment loan accounts (+)	**71**	Unfavorable number of installment loan accounts (-)
22	Favorable number of installment loan accounts with outstanding balances (+)	**72**	Too many installment loan accounts with outstanding balances (-)
23	Favorable time since most recent installment loan established (+)	**73**	Insufficient time since most recent installment loan established (-)
24	Favorable number of accounts with large high credit amounts (+)	**74**	Too many accounts with high credit amounts (-)
25	Proportion of loan balances to installment loan amounts is favorable (+)	**75**	Proportion of loan balances to installment loan amount is too high (-)
26	Favorable number of real estate accounts (+)	**76**	Unfavorable number of real estate accounts (-)
27	Favorable number of new finance company accounts (+)	**77**	Too many new finance company accounts (-)
28	No delinquency ever on installment loans (+)	**78**	Poor installment loan delinquency(-)
29	Favorable percentage of open revolving accounts to all other accounts (+)	**79**	Unfavorable percentage of open revolving accounts to all other accounts (-)
30	Favorable number of accounts (+)	**80**	Presence of delinquency, public record or collection (-)
31	No delinquency on open revolving accounts (+)	**81**	Delinquency on open revolving accounts (-)
32	Favorable length of time since most recent finance company account opened (+)	**82**	Finance company account opened recently (-)
33	Favorable number of accounts (+)	**83**	Unfavorable number of accounts (-)
34	Favorable length of time since most recent retail account opened or no retail accounts present (+)	**84**	Unfavorable length of time since most recent retail account opened (-)
35	No finance company accounts or no recently active finance company accounts (+)	**85**	Unfavorable number of recently active finance company accounts (-)
36	Favorable number of recently active accounts (+)	**86**	Unfavorable number of recently active accounts (-)
37	Favorable number of revolving or open accounts (+)	**87**	Unfavorable number of revolving or open accounts (-)

38	Number of adverse public records (+)	*88*	Number of adverse public records (-)