Fast Facts

Michigan's Office of Financial and Insurance Regulation has recently challenged insurers' use of credit scores in personal lines of insurance.

The use of credit scores is a subject of frequent legislative debate across the country.

Supporters and opponents of the use of credit scores have both made persuasive arguments for their positions.

The Use of Credit Scoring in Rating and Underwriting Personal Insurance

By Richard W. Paige, Robert A. Kaatz, and Jonathan R. Schulz

Introduction

The highly charged political and legal dispute regarding the use of credit score information by insurance companies in determining rates for personal lines of insurance could be making its way to the Michigan Supreme Court. Supporters of the practice argue that it is a highly effective method of evaluating risk, and it reduces the extent to which lower-risk consumers subsidize higher-risk consumers. Their opponents counter that the method is discriminatory, highly susceptible to error, and unnecessary. Both sides may soon have their day in Michigan's highest court to resolve the issue.

The Status of Credit Scoring by Insurers in Michigan

Before July 1, 2005, insurance companies doing business in Michigan used credit score information as a factor in determining rates for personal lines of insurance, such as automobile and homeowners policies. The insurers determined that policyholders with poor credit scores were more likely to file claims, and therefore charged higher insurance premiums to cover those individuals.

In 2004, Governor Jennifer Granholm and the commissioner of the State of Michigan Office of Financial and Insurance Services (now known as the Office of Financial and Insurance Regulation or OFIR) proposed a rule prohibiting the use of credit scoring in determining the rates for personal lines of insurance.[1] Governor Granholm and others believe that credit scoring is unfair and violates Chapters 21, 24, and 26 of the Insurance Code,[2] which prohibits insurers from charging "excessive, inadequate, or unfairly discriminatory" rates.[3] On March 25, 2005, the State of Michigan Office of Regulatory Reform filed new administrative rules with the Secretary of State,[4] effectively banning the use of credit scoring in the underwriting of personal lines of insurance as of July 1, 2005.

On March 29, 2005, the Insurance Institute of Michigan and the Michigan Insurance Coalition filed a lawsuit in Barry County Circuit Court, challenging the validity of the rules and seeking an injunction barring their enforcement.[5] On April 25, 2005, Circuit Judge James H. Fisher issued a permanent injunction against enforcing OFIR's rules, finding that the OFIR commissioner exceeded her rulemaking authority under the Insurance Code.[6] Judge Fisher ruled that:

> Implementation of the [OFIR] rules would cause irreparable loss to Plaintiffs because Plaintiffs would incur the expenditure of millions of dollars in unrecoverable implementation costs and also because they would cause disruption of the entire casualty insurance market in the State of Michigan.[7]

The OFIR commissioner appealed Judge Fisher's ruling to the Michigan Court of Appeals. On August 21, 2008, the Court of Appeals issued a split decision and three separate opinions.[8] The decision vacated Judge Fisher's April 25, 2005 order and lifted the permanent injunction.

In October 2008, the plaintiffs and the defendant OFIR commissioner both filed applications for leave to appeal with the Michigan Supreme Court. The plaintiffs requested that the Supreme Court reverse the Court of Appeals' opinion and reinstate Judge Fisher's injunction. The OFIR commissioner requested that the Supreme Court validate OFIR's credit scoring rules. The Supreme Court has yet to take any action on the pending applications.

In the interim, OFIR started denying insurers' rate filings if they used credit scores in determining their rates. On April 10, 2009, however, Judge Fischer precluded OFIR from challenging or denying insurers' rate filings on the basis that they used credit scores.[9]

The Use of Credit Scoring in Other States

Only four other states have, by means of statute or regulation, effectively banned the use of credit scoring for certain types of personal insurance policies: California (personal auto),[10] Hawaii (personal auto),[11] Maryland (homeowners),[12] and Massachusetts (personal auto).[13] Michigan's new OFIR rules are the most restrictive in the country because they seek to ban the use of credit scoring for all types of personal insurance policies.

Most states currently allow credit scoring in underwriting and rating personal insurance subject to certain limitations. Approximately half of all states have adopted the National Conference of Insurance Legislators' (NCOIL's) Model Act Regarding Use of Credit Information in Personal Insurance.[14] Among other things, the NCOIL's Model Act prohibits insurers from denying, cancelling, or not renewing a policy of personal insurance, such as automobile or homeowners, solely on the basis of a person's credit information.[15] The NCOIL's Model Act also prohibits insurers from basing renewal rates solely on credit history.

The dispute over the use of credit scoring has more frequently taken place in legislatures rather than in court. According to one survey, 44 bills concerning credit scoring have been introduced in 20 states in the beginning of 2009.[16] Based on the past history of similar bills, the vast majority of these bills will likely never be enacted. Bills have also occasionally been proposed in Congress. Two bills, titled Nondiscriminatory Use of Consumer Reports and Consumer Information Act of 2008 and Personal Lines of Insurance Fairness Act of 2008, were introduced in the United States House of Representatives last year to amend the Fair Credit Reporting Act and prohibit the use of credit information for personal lines of insurance. These bills, HB 5633 and HB 6062, never became law.

In 2007, the Supreme Court of Alaska decided a dispute between several insurers and the Alaska Division of Insurance regarding the use of credit scores in personal lines of insurance. In *State v Progressive Casualty Ins Co,*[17] three insurers requested permission from the Alaska Division of Insurance to "freeze" their insureds' credit scores when the policy was first written and then use those credit scores in subsequent policy renewals. The Alaska Division of Insurance denied the request because an Alaskan statute stated that an insurer may not "fail to renew or, at renewal, again underwrite or rate a personal insurance policy based in whole or in part on a consumer's credit history[.]"[18] The Supreme Court of Alaska held that this statute prohibited insurers from considering a consumer's credit score as a factor in their renewal decisions.

Policy Reasons Supporting the Use of Credit Scoring

Supporters of credit scoring have made several arguments in favor of its use. The goal of every insurance company is to use the best methodologies available to accurately predict the likelihood that a policyholder will file a claim. Studies have consistently shown that there is a strong relationship between credit scores and loss ratio (the cost of claims filed compared to the policy premiums collected).

In response to the growing controversy regarding the use of credit scoring in the underwriting of insurance policies, Congress issued a mandate requiring the Federal Trade Commission (FTC) to conduct a study examining, among other

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things, the statistical relationship between credit information and insurance risk.[19] The July 2007 FTC study reached the following conclusions:

- Credit-based insurance scores are effective predictors of risk under automobile policies.
- The use of credit scoring is likely to make the price of insurance better match the risk of loss posed by the consumer.
- The use of credit scoring may result in benefits for consumers.
- Credit-based insurance scores appear to have little effect as a "proxy" for membership in racial and ethnic groups in decisions related to insurance.[20]

Other studies have also shown a strong correlation between credit history and insurance risk. In 1996, the actuarial consulting firm Tillinghast Towers-Perrin conducted a study that analyzed the relationship between loss ratios and credit insurance scores.[21] The Tillinghast study reviewed nine samples of data from eight different insurance companies. In eight of the nine samples, the study found the probability that a statistically significant correlation exists between loss ratios and credit insurance scores was over 99 percent (in the other sample, the probability was approximately 92 percent).[22]

A 2000 study published by the Casualty Actuarial Society also demonstrated the strong correlation between credit history and loss ratios.[23] The study found that the loss ratio for the policyholders with the worst credit scores was 33 percent higher than the loss ratio for all policyholders. Conversely, the loss ratio for the policyholders with the best credit scores was 25 percent lower than the loss ratio for all policyholders.[24]

In March 2003, the Bureau of Business Research at the University of Texas published its own study comparing loss ratios to credit history.[25] The study found that policyholders with the worst credit scores had an average claim loss of $918, which was 32 percent higher than the average claim loss of $695. In contrast, the policyholders with the best credit scores had an average claim loss of $558, which was 20 percent lower than the average claim loss of all policyholders.[26]

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Supporters of the use of credit scoring also argue that the practice provides a financial benefit to those consumers with good credit scores. This impact was addressed in the July 2007 FTC study:

> Better risk prediction techniques allow insurance companies to more effectively separate higher-risk consumers from lower-risk consumers. This information assists insurance companies in charging consumers prices that correspond more closely to the true risk they pose, on average. This, in turn, *decreases the premiums of lower-risk consumers* and increases the premiums of higher-risk consumers, on average. Improved risk prediction techniques therefore reduce the extent to which lower-risk consumers subsidize higher-risk consumers.[27]

Further illustrating this point, Allstate Insurance Company provided written testimony to OFIR, which stated that "[m]ore than half of Allstate's customers in Michigan are paying less for insurance because of discounts based on insurance score."[28] Supporters of credit scoring argue that the overwhelming evidence confirming the strong correlation between credit scores and loss ratios combined with the financial benefits to those policyholders with good credit histories provides ample justification for the use of credit scoring by insurance companies in the underwriting of personal lines of insurance.

Policy Reasons to Prohibit the Use of Credit Scoring

There are many arguments that opponents of credit scoring have used in proposals to ban its use in underwriting and rating personal insurance. First, no studies have shown a correlation between a loss and a person's credit score. Opponents of credit scoring have argued that the risk of loss—and not the likelihood that the insured will file a claim—should be the primary consideration in rating or underwriting insurance. As Linda Watters, former Michigan OFIR commissioner, explained: "You can have a low credit score because you made your mortgage payment late, but that does not increase the likelihood that your house will be struck by lightning."[29] Or as Representative Maxine Waters stated in support of HB 6062: "Credit scores have little if no bearing on how likely a person is to have a car accident, to break speed limits, or to otherwise engage in risky driving behavior that could result in an insurance claim."[30]

Second, opponents of the use of credit scoring have argued that there are various discriminatory impacts on many who are otherwise a low insurance risk. More people with poor credit scores tend to reside in low-income and certain minority communities.[31] Individuals without established credit histories, such as recent immigrants, the elderly, and younger individuals, are more likely to be unfairly impacted. In addition, people who are experiencing temporary hardship, such as a recent divorce or loss of employment, will likely be disproportionately affected.

Third, many have argued that a high percentage of credit reports contain serious errors and that it is therefore unfair for insurers to use them.[32] These errors can result from mis-merged file information, identify theft, coding or reporting errors, or errors intentionally caused by a creditor to keep the customer captive.[33] Insurers do not have the ability to identify these errors. In

addition, credit scoring models cannot accurately account for individuals who manage their finances well but do not use credit.

Fourth, several opponents of the use of credit scoring have argued that the use of credit scoring does not result in lower prices for the large majority of consumers. Some studies have shown that, after credit scoring is taken into consideration, approximately half of the policyholders pay less and approximately half pay more.[34] Thus, there is no net benefit to consumers overall.

Lastly, many have argued that the use of credit scoring is unnecessary because insurers already have other means of information available that is sufficient to assess the risk of their insureds. For example, with respect to individuals who already have an insurance coverage history, an insurer can assess that person's claims history. Thus, in balancing the benefits and harm, opponents of the use of credit scoring argue that the harm of credit scoring to consumers far outweighs the benefits.

Conclusion

The ultimate resolution of the use of credit scoring in rating and underwriting personal lines of insurance in Michigan may soon be decided by the Michigan Supreme Court. Should the Supreme Court decide to hear the *Insurance Institute of Michigan* case, it must decide whether the use of credit scoring results in "excessive, inadequate, or unfairly" discriminatory rates. Both opponents and supporters of this practice have made strong arguments supporting their respective positions. No matter how the Michigan Supreme Court rules on the *Insurance Institute of Michigan* case, it is likely that the issue will continue to be debated both in Michigan and other states for many years to come. ■

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FOOTNOTES

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