PREPARED STATEMENT OF

THE FEDERAL TRADE COMMISSION

on

"Credit-based Insurance Scores: Are They Fair?"

Before the

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
HOUSE COMMITTEE ON FINANCIAL SERVICES

Washington, D.C.
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I. Introduction

Chairman Watt, Ranking Member Miller, and members of the Subcommittee, I am Commissioner J. Thomas Rosch of the Federal Trade Commission ("Commission" or "FTC ").[1] I appreciate the opportunity to appear before you today to discuss the Commission's recent study of the impact of credit-based insurance scores on consumers of automobile insurance, and the effect of scores on members of racial and ethnic minority groups. I also am grateful for this chance to describe how the Commission intends to conduct a similar study of the impact of credit-based insurance scores on consumers of homeowners insurance.

II. Background of Credit-Based Insurance Scores and Studies

Over the past decade, insurance companies have increasingly used information about credit history in the form of credit-based insurance scores to decide whether to offer insurance, and, if so, at what price. Credit-based insurance scores are numerical summaries of a consumer's credit history. These scores typically are calculated using information about past delinquencies and information on the public record (*e.g.*, bankruptcy); debt ratios (*i.e.*, how close a consumer is to his or her credit limits); evidence of seeking new credit (*e.g.*, inquiries and new accounts); the length and age of the credit history; and the use of certain types of credit (*e.g.,* automobile loans). Insurance companies use scores as a factor when estimating the number or total cost of insurance claims that prospective customers (or customers renewing their policies) are likely to file. Insurance companies then use this information to assign consumers to risk pools and to determine the premiums that consumers pay.

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[1] While the views expressed in this statement represent the views of the Commission, my oral presentation and responses to questions are my own and do not necessarily reflect the views of the Commission or any individual Commissioner.

Insurance companies and other proponents of credit-based insurance scores contend that they assist in predicting risk of loss more accurately, thereby allowing insurance companies to charge consumers premiums that conform more closely to their individual risk of loss. However, consumer advocates, civil rights groups, and other opponents of credit-based insurance scores raise the concern that their use results in members of racial and ethnic minority groups and members of other protected classes paying higher insurance premiums than other consumers.

To assist policymakers in evaluating these arguments, Congress directed federal agencies to conduct empirical studies of the impact of credit-based insurance scores on the availability and affordability of insurance. Pursuant to Section 215 of the Fair and Accurate Credit Transactions Act ("FACTA"),[2] the FTC, in consultation with the Office of Fair Housing and Equal Opportunity at the Department of Housing and Urban Development ("HUD"), is required to study whether credit-based insurance scores affect the availability and affordability of insurance. Among other things, Congress specifically directed the Commission to focus its empirical analysis on the effects of scores on members of racial and ethnic minority groups.

III. FTC Automobile Insurance Study

The FTC recently submitted to Congress a report with its assessment of the effects of credit-based insurance scores on consumers of automobile insurance.[3] The FTC is submitting a complete copy of its automobile insurance report, as well as statements of Commissioner views regarding the report, for the record of this hearing. I will describe briefly the methodology the FTC staff used to conduct the automobile insurance study, and present an overview of the

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[2] 15 U.S.C. § 1681 note.

[3] *See* Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* (July 2007) ("FTC Automobile Insurance Report"), available at http://www.ftc.gov/opa/2007/07/facta.shtm.

report's findings and conclusions.

A. FTC Automobile Insurance Study Methodology

Section 215 of the FACTA specified some of the process used in the FTC automobile insurance study. As directed by law, the Commission sought input from federal and state officials, industry members, consumer, civil rights, and housing organizations, as well as members of the public concerning methodology and research design. The FTC received nearly 200 public comments in response to requests for views on these issues, and learned more about these issues from numerous discussions with government officials, industry groups and private companies, as well as with community, civil rights, consumer, and housing groups. Following this process, the FTC's expert economic researchers determined the data that needed to be obtained and the methodology to be employed in analyzing the data.

At the heart of the methodology was the Commission staff's creation of its own extensive database with information from automobile insurance policies and other sources. Through a third party, the FTC staff obtained insurance policy information regarding the customers of five large automobile insurance companies, who represented 27% of the United States automobile insurance market. FTC staff supplemented this data with additional insurance claims information from an independent source. Because neither the automobile insurance companies nor the independent source have data concerning the race and ethnicity of their customers, race and ethnicity information from the Social Security Administration, the United States Bureau of the Census, and a Hispanic surname match was added to the insurance policy information. In addition, credit-based insurance score information was obtained from ChoicePoint and Fair Isaac Corporation and added to the insurance policy information.

The FTC staff used econometric and statistical techniques to analyze the information in its database. As a threshold matter, it determined to what extent credit-based insurance scores are predictive of claims on automobile policies. The results of that analysis were then used to calculate the effects of scores on predicted claims for all automobile insurance consumers, with these predicted claims serving as a measure of the likely effects of scores on the premiums all consumers pay. The Commission staff then compared the average scores of different racial and ethnic groups, and the likely impact of differences in average scores on the premiums different groups would pay. The FTC staff also determined whether, and to what extent, scores remained predictive of claims when controls were included for race, ethnicity, and income.

The FTC staff also attempted to construct an alternative scoring model that would predict risk accurately while decreasing the differences in scores, on average, among racial and ethnic groups. The agency staff created a baseline credit-based insurance scoring model that was as predictive as possible of automobile insurance claims. Several scoring models were then built that were intended to be predictive of claims, yet have smaller differences across racial and ethnic groups than the baseline scoring model.

As in many research studies, the Commission had to make a significant number of judgment calls requiring the application of significant technical expertise and experience in econometrics and statistics. Reasonable minds may differ on these judgment calls. There was robust debate about these issues among the Commissioners at the time that the report was submitted to the Congress. Commissioner Leibowitz supported the decision to issue the report, but wrote separately to emphasize that "while the analysis demonstrates that credit-based insurance scores are correlated with risk . . . differences in credit-based insurance scores across racial and ethnic groups are a disturbing reminder that our society is - still - not race blind, and that the vestiges of our history of discrimination remain ever-present." Commissioner Harbour dissented from the decision to issue the report because she "distrust[ed] the integrity of the underlying data," "disagree[d] with the methodology used," and "doubt[ed] the reliability of any conclusions the report might draw."

In addition, some consumer groups have raised concerns about the methodology used. FTC Chairman Majoras recently responded to these concerns in detail in letters she sent to Chairmen Frank, Watt, and Gutierrez. We would like to submit these letters for the record of this hearing.

The FTC has given careful and thorough consideration to the methodological concerns that have been raised about our automobile insurance study. Following this consideration, a majority of the Commission continues to believe that the methods used were sound and that the findings made and conclusions reached were well-supported.

B. FTC Automobile Insurance Study Results

The FTC's automobile insurance study compared risk predictions for the consumers in the FTC database with and without the use of credit-based insurance scores. Consistent with prior research,[4] the Commission found that using credit-based insurance scores led to more effective prediction of risk under automobile insurance policies. Scores predict both the number of claims that consumers are likely to file and the total cost of those claims to the insurance company.

The use of effective risk prediction techniques, including credit-based insurance scores, decreases premiums for less risky consumers and increases premiums for more risky consumers.

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[4] *See* Texas Department of Insurance, "Use of Credit Information by Insurers in Texas: The Multivariate Analysis" (Jan. 31, 2005) (supplemental report) ("2005 Texas Report"); Texas Department of Insurance, "Use of Credit Information by Insurers in Texas" (Dec. 30, 2004) ("2004 Texas Report"); Michael J. Miller and Richard A. Smith, *The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity: An Actuarial Study by EPIC Actuaries, LLC* (June 2003).

Specifically, the FTC study found that if credit-based insurance scores are used, 59% of consumers in the FTC's database would be predicted to have their premiums decrease and 41% of them would be predicted to have their premiums increase. The average amount of these premium decreases was smaller than the average amount of these premium increases.

Although the Commission study found that credit-based insurance scores are effective predictors of automobile insurance risk, it is not clear why. A variety of alternative explanations for the link between scores and risk have been suggested in the economics literature and elsewhere. But the FTC was not able to determine which of these possible explanations, if any, is correct.

The FTC study also revealed that credit-based insurance scores are distributed differently among racial and ethnic groups of consumers. African Americans and Hispanics tend to be over-represented among consumers with the lowest credit-based insurance scores and under-represented among consumers with the highest scores. This result is consistent with prior research.[5] With the use of scores, the average predicted risk for African Americans and Hispanics therefore increased by 10% and 4.2%, respectively, while the average predicted risk for non-Hispanic whites and Asians decreased by 1.6% and 4.9%, respectively. These changes in predicted risk would be expected to increase the insurance premiums that African Americans and Hispanics pay on average, while decreasing the premiums that non-Hispanic whites and Asians pay on average.

Averages, however, do not tell the complete story. The use of credit-based insurance scores increases and decreases the premiums of some consumers in each racial and ethnic group. The impact of the use of scores differs on average across racial and ethnic groups, because some

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[5] *See* 2005 Texas Report and 2004 Texas Report.

groups have a lower proportion of consumers with higher scores than other groups. For this reason, the use of credit-based insurance scores is likely to result in reductions in premiums for 62% of non-Hispanic whites and 66% of Asians, but only 47% of Hispanics and 36% of African Americans. Or, to put this another way, the use of scores is likely to lead to increased premiums for 64% of African Americans and 53% of Hispanics, but only 38% of non-Hispanic whites and 34% of Asians.

The FTC also evaluated whether credit-based insurance scores act as a "proxy" for membership in racial and ethnic groups in insurance decisions. Membership in racial and ethnic groups cannot be used directly to determine what premiums to charge. Some have suggested that, because race and ethnicity cannot be used directly to assess premiums, other factors might be used as a "proxy" for membership in racial and ethnic groups in determining what premiums to charge. The FTC conducted statistical tests to determine whether credit-based insurance scores act as such a proxy.

To test this hypothesis, the FTC added to its model controls for race and ethnicity. As discussed above, adding credit-based insurance scores to the model resulted in the average predicted risk of African-American and Hispanic consumers increasing by 10% and 4.2%, respectively. When the model included controls for race and ethnicity, adding the scores resulted in the average predicted risk of African-American and Hispanic consumers increasing by only 8.9% and 3.5%, respectively. Of the predicted increase in average risk of 10% and 4.2% for African Americans and Hispanics, 8.9% and 3.5%, respectively, of the increase therefore cannot be attributed to race or ethnicity because it appeared in a model that controlled for race. The difference between these two sets of predictions (1.1% for African Americans and 0.7% for Hispanics) shows the effect of scores as a statistical proxy for race and ethnicity. This proxy effect was proportional to the proxy effect that the FTC found for other tested factors, such as geographic risk, tenure of customer, and prior claims. In short, this FTC study did find that the credit-based insurance scores have a proxy effect, but it appears to be relatively small.

As part of its proxy analysis, the FTC also tested to determine whether credit-based insurance scores predict risk for a sample composed of members of only one racial or ethnic group. The FTC tests showed that scores predict risk for samples which include only members of a particular racial or ethnic group. For example, African Americans with higher credit-based insurance scores were found to have a lower risk of loss, while African Americans with lower scores were found to have a higher risk of loss. These findings suggest that credit-based insurance scores predict risk of loss apart from the role they play as a proxy for race or ethnicity.

Finally, the FTC automobile insurance study assessed whether the agency could develop a credit-based insurance score model that both predicted risk effectively and decreased the differences in scores among racial and ethnic groups. Despite substantial efforts, the FTC staff was not able to develop a model that effectively predicted risk and narrowed the differences in scores among racial and ethnic minority groups. This does not necessarily mean that such a model could not be constructed, but it does suggest that there is no readily available scoring model that would satisfy these criteria.

IV. FTC Homeowners Insurance Study

In addition to the completed FTC automobile insurance study, Section 215 of FACTA mandates that federal agencies, in consultation with HUD, conduct a study of the impact of credit-based insurance scores on the availability and affordability of homeowners insurance. The Commission therefore has commenced this study and has begun the process of obtaining the data necessary to do the requisite econometric and statistical analysis.

The methodology that the Commission staff will use in the FTC homeowners insurance study to obtain and analyze data generally will be the same as or similar to the methodology used in the FTC automobile insurance study. There is one important exception, however.

Some consumer, civil rights, and housing groups raised a number of methodological concerns related to the FTC automobile insurance study, primarily objecting to the fact that the information in the FTC database had its genesis in information that insurance companies voluntarily provided through a third party. To increase the level of public confidence in its homeowners insurance study, the FTC intends to use its authority under Section 6(b) of the FTC Act to obtain homeowners policy information from insurance companies. A description of the FTC's plan for the homeowners insurance study, including the use of Section 6(b) orders, is set forth in the recent letter from Chairman Majoras to Chairmen Frank, Watt, and Gutierrez.

The Commission notes that using Section 6(b) orders to increase the level of public confidence in its homeowners insurance study means that the study will take longer to complete. Although the time required to complete the homeowners insurance study will depend on a number of contingencies, the Commission estimates that the use of Section 6(b) orders will delay its completion from late spring of 2008 until sometime between the summer of 2009 and the winter of 2010.

V. Conclusion

The Commission's core mission is protecting consumers. In the context of credit-based insurance scores, the FTC plays two important roles in fulfilling that mission. One role is to conduct research and policy activities to inform the debate about scores and help policymakers make critical decisions related to the use of scores. The FTC's automobile insurance and homeowners insurance studies are intended to perform this function.

The Commission's other role regarding scores is just as important. To protect consumers, we provide them with critical information so that they can make decisions that are in their best interest. The use of credit-based insurance scores has an effect on the insurance premiums consumers are likely to pay. Some consumers, however, may not realize that their credit history may affect their premiums. The FTC therefore recently revised and reissued its consumer education materials, including its Spanish language materials, to give even greater emphasis to the link between credit history and insurance premiums. We hope that these materials, this hearing, and other efforts will alert consumers that having the best possible credit history is critical not only in decisions creditors will make about them, but in the decisions insurance companies will make about them too.

Thank you.