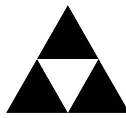

Purpose

The Federal Trade Commission (FTC) has requested comment on a Draft Model Order to File a Special Report to obtain data to study the effect of credit-based insurance scores on consumers of homeowners' insurance. This document focuses on two specific areas: 1) comments on the specifications for the Order to File a Special Report; and 2) recommendations on potential steps that may be considered in order to facilitate the study being considered by the FTC, including additional, previously conducted studies that could be reviewed as part of any new study by the FTC.

The Property and All Other Lines Subcommittee of the American Academy of Actuaries[1], part of the Property/Casualty Products, Pricing and Market Committee, provides actuarial support, advice, and communications on issues related to property and liability products, excluding auto insurance, medical malpractice, and workers' compensation liability products. The Subcommittee's work addresses issues that are financial and solvency-based and engages in the development of public policy at the state, federal, and international levels.

The Subcommittee is composed of the following members:

Jeffrey L. Kucera, FCAS, MAAA, Chair
Mark Allaben, FCAS, MAAA
Edward Baum, FCAS, MAAA
John Rollins, FCAS, MAAA
Alfred Weller, FCA, FCAS, MAAA
Anton Zalesky, ACAS, MAAA

[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces, and work groups regularly prepare testimony and provide information to Congress and senior federal policymakers; comment on proposed federal and state regulations; and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions, and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure that high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

Comments on the Specifications for the Order to File a Special Report

After reviewing the document and specifications regarding the Order to File a Special Report, the Subcommittee offers the following comments:

- The order is asking for three years of data: 2004, 2005, and 2006. Considering the volume of risks, the Subcommittee suggests that two years is sufficient to provide reasonable results.
- Companies do not typically maintain the detailed statistics of credit reports in their records. Instead, they maintain only the actual score as computed by an outside vendor or by a company-specific algorithm. As such, the Subcommittee suggests asking only for that actual score, so as to provide consistent data.
- The credit scoring algorithms vary from state to state due to differences in state law and variances in state filing requirements. As an example, some states may have restrictions on the type of information that can be used from medical payments or may require that any algorithm used in the state for the purpose of underwriting homeowners' insurance be filed with the state and available as public records. Consequently, those states will have different versions of credit-scoring mechanisms in place, frequently referred to as "credit-lite" scores. The Subcommittee recommends that only those scores that are most often used be required to be submitted.
- Because scores may be computed in several different ways, the same numeric score can mean something different for each company. These differences can be significant; for some companies, score increases are indicative of improving credit, while for other companies, score increases are indicative of less favorable credit. Because of these differences, the Subcommittee recommends that companies be required to simply rank their risks based on credit scores and report these based on percentile, i.e. with 1 being the 1 percent of customers with the best credit, 2 the next 1 percent of customers, etc.
- When writing a homeowners' policy, companies should not ask for identifying information or status records regarding the prospective policyholder's driver's license. While a company may have this information if it happens to also write the private passenger auto policy, it would require extensive programming to match the homeowners' policy to the auto policy and then obtain the driver's license number.
- Many companies do not maintain reasons for cancellation or non-renewal. Those companies that do maintain this information may not use consistent coding or reasoning. As a consequence, the Subcommittee recommends that this not be required.
- Dwellings and their contents are insured based on replacement value and may not have the market value of the home or land. The Subcommittee recommends that this information not be required.

- It is not apparent to the Subcommittee's members what correlation exists between flood insurance and this study. This is particularly true as acceptability of a risk for flood insurance and flood insurance rates may be established by the federal government. Furthermore, unless companies specifically write the flood insurance, they will not know whether a risk has flood insurance.

Additional Recommendations

There are several steps that the FTC should consider that will facilitate the gathering of data from individual companies and ultimately help with the final study to be conducted by the FTC. We suggest that the FTC consider the following:

- Before beginning its study, the FTC should decide and design how it will define and/or measure items like disparate impact or racial proxy, and it should test this qualification or standard against rating variables other than credit. Based on the definitions frequently cited, many rating variables could be found to have disparate impact, although not necessarily in the same direction as credit. Such examples are likely to include fundamental rating items like amount of insurance and construction type.
- There have been several studies already conducted with respect to the use of credit for rating and underwriting for both homeowners' and private passenger auto insurance. It would be beneficial to review some of these earlier studies. In particular, the Subcommittee recommends that the following studies (not presented in any particular order) be reviewed:
    - *The Impact of Personal Insurance Credit History on Loss Performance in Personal Lines* by James D. Monaghan (2000).
    - *Insurance Scoring in Personal Automobile Insurance – Breaking the Silence* by Conning & Company (2001).
    - *Predictiveness of Credit History for Insurance Loss Ratio Relativities* by Fair, Isaac (1999).
    - *Use of Credit Reports in Underwriting* by the Commonwealth of Virginia, State Corporation Commission, Bureau of Insurance (1999).
    - *Use of Credit Information by Insurers in Texas* by the Texas Department of Insurance (December 2004).
    - *Use of Credit Information by Insurers in Texas – The Multivariate Analysis* by the Texas Department of Insurance (January 2005).
    - The Federal Reserve also studied the use of credit scoring to quantify risk that is posed by a borrower rather than an applicant for insurance or a policyholder. In a report issued at the end of August 2007, the Federal Reserve said that credit scores were predictive of credit risk and were not proxies or substitutes for race, ethnicity, or gender, underscoring the FTC study.

CONCLUSION

The Subcommittee is pleased to have had this opportunity to provide comments and hope that the FTC will find them of value. Seeking comments on data issues is a positive step, and the Subcommittee suggests that, when the FTC develops the actual methodology to be used for its evaluation of credit, it again consider soliciting comments from interested parties.

While the use of credit by insurance companies may be considered controversial by many, two critical factors should be recognized. First, the use or absence of credit does not affect overall actuarially sound premium levels for a rating plan. That is, since a given total premium is required to support a risk portfolio, removal of credit from the rating plan will raise premiums for many low-risk insureds who have demonstrated good credit history even as it lowers premiums for the subset of risks who have demonstrated poor credit history. Further, these low-risk insureds will be paying higher premiums to subsidize those risks that produce higher losses. Second, the use of credit or insurance scores has generally allowed companies to broaden their markets and write more total risks over time.

Finally, the Subcommittee stands ready to offer any assistance that the FTC deems appropriate as the study develops. As experts on insurance data and rating, members of the Subcommittee are well-positioned and eager to assist the FTC in understanding insurance rating and underwriting issues.

For additional information, or if you have any questions, please contact Lauren G. Pachman, Esq., Casualty Policy Analyst at 202-223-8196 or pachman@actuary.org.