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Insurance Credit Scoring
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Since 1997, an increasing number of insurance companies in Michigan have used credit histories as a factor in setting rates on automobile and homeowners' coverage. The companies cite studies purporting to demonstrate that credit histories are accurate predictors of loss, and their use reduces financial risk. Many policyholders, meanwhile, assert that "credit scoring" is discriminatory and illogical, and has not resulted in lower rates.

After media reports on credit scoring escalated complaints to the Office of Financial and Insurance Services (OFIS), Frank Fitzgerald, the Commissioner of OFIS at the time, declared that he would study the use of insurance credit scoring to gage its effect on Michigan insureds. In June and July 2002, Commissioner Fitzgerald and members of his staff held six public hearings at different locations in the State, and solicited and compiled written and e-mailed comments and testimony. In addition, OFIS surveyed insurance companies writing private passenger automobile and homeowner insurance for the year 2000 about their use of credit scoring. In September 2002, then-Attorney General Jennifer Granholm petitioned Commissioner Fitzgerald to hold a formal examination into the legality of using credit scoring. In December, the Commissioner released a report that presented arguments on both sides of the issue, discussed his findings, and included administrative and legislative recommendations. More recently, he issued a set of directives for insurers' use of credit scoring. (Subsequently, Mr. Fitzgerald resigned from the position of Commissioner of OFIS.)

This article discusses the legislation that made credit scoring possible, summarizes former Commissioner Fitzgerald's report, including his recommendations for the Legislature, describes the recent directives, and briefly discusses legislation enacted in other states and introduced in Michigan. For more information from OFIS on insurance credit scoring, click here.

Background

Michigan statute specifies that insurance rates "shall not be excessive, inadequate, or unfairly discriminatory" (MCL 500.2109, 500.2403, 500.2601, and 500.2704). This language has been the subject of debate for years. In 1978, the Michigan Supreme Court determined that these provisions were too vague, and did not assure that mandated coverages were available at fair and equitable rates (*Shavers* v *Attorney General*). The Court's finding underscored the concerns of former Governor Milliken and former Insurance Commissioner Thomas C. Jones that, in 1977, auto and homeowners' insurance rates were inflated and in danger of being out of control.

In response, the Legislature passed Public Act (PA) 145 of 1979, a series of insurance reform measures that became known as the Essential Insurance Act (EIA). The emphasis of the Act, according to Commissioner Fitzgerald's recent report, was to "guarantee consumers the ability to meaningfully shop for the best coverage at the lowest price". The Act granted consumers access to the standards the companies use to sell insurance in order for them to get the best price.

Additionally, the EIA prescribed factors that an insurance company may use to develop its automobile and homeowners' rates. For auto insurance, the factors include the age of the driver, the length of time the insured has been driving, vehicle characteristics, and other factors related to use of the vehicle. Insurers may calculate homeowners' insurance rates using components such as the construction of the house, the fire protection class, and the loss experience of the insured. In 1996, these factors were expanded by Public Act 514 of 1996, which created Section 2110a in the Insurance Code (MCL

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500.2110a) to permit insurers to offer "premium discounts" to auto and homeowner policyholders. Under PA 514, the discounts may be based on any factor, as long as they comply with the Code, are applied uniformly, and are associated with factors that reduce risk to the insurers. At the time, supporters of the legislation argued that making available a range of discounts would foster greater competition among insurers and thus lower premiums for policyholders. Insurers are citing Section 2110a as authority to use credit scoring to offer discounts on premiums.

How Credit Scoring Works

Insurance companies subject to the Code are prohibited from denying or canceling auto or home insurance coverage based on credit history, and may use credit scores only to apply discounts. The Code contains a number of exemptions, however, that give insurers latitude. First, companies *not* subject to the provisions of the EIA may use credit scoring as they see fit. (Section 2129 of the Code (MCL 500.2129) permitted those companies with a surplus of less than $4 million to file a request for exemption from Chapter 21 of the Code, which contains most of the EIA, by January 1, 1981.) In addition, insurers may deny or cancel coverage based on credit history for other personal lines of insurance, such as coverage for boats, motorcycles, rental properties, and recreational vehicles. Most significantly, home or auto policies written on a group basis (usually coverage provided through an employer) may use credit scores not only to offer discounts, but also to set base rates or apply a surcharge. Of all the auto insurance sold in Michigan, 35% is written on a group basis, and 23% of all homeowners' insurance is written on a group basis. Therefore, credit scoring is used to make underwriting decisions (i.e., to deny or cancel insurance) and to apply additional charges on a great deal of the insurance sold in Michigan.

Insurance companies using credit scoring must first obtain an applicant's or policyholder's credit report, which reveals the person's open credit lines, filings for bankruptcy, and history of late or delinquent payments, among other information about how that person manages his or her credit and debt. Sometimes an insurance company uses an outside credit scoring company, such as Choice Point or Fair Issac, to obtain a credit history from a credit reporting agency. The credit scoring company applies a formula to certain credit factors to come up with a credit score, which it then reports to the insurance company. Insurers are on their own to determine how that score translates into a possible discount. Those policy-holders with a "good" score, as determined by the insurer, are offered discounts from a few dollars to up to 70% of the base premium.

OFIS Hearings

The Office of Financial and Insurance Services held public hearings in Cadillac, Portage, Port Huron, Lansing, Grand Rapids, and Detroit. Consumers, insurance agents, insurance industry representatives, and representatives from the insurance scoring companies Choice Point and Fair Issac, as well as two credit reporting agency representatives, attended the hearings. In addition, OFIS received 69 e-mailed or written submissions from individuals, seven submissions by agents, and "a number of" written comments from insurers and trade associations. According to former Commissioner Fitzgerald's report, almost all of the consumer testimony was against the use of credit scoring; agents were mixed in their opinions; and all insurance company testimony was in favor of the practice.

Opposition to Credit Scoring

Consumers at the hearings argued that credit scoring is unrelated to insurance risk. Rates, many people contended, should be based on factors that are more directly related to the type of insurance purchased, such as driving record or claims filed. For example, some complained that credit scoring unfairly penalizes them for making what insurers call "inquiries", which means applying for new lines of credit. Although it is easy to see why a high number of inquiries may come from those with poor credit, many were troubled by the use of inquiries in credit scoring, because applying for credit is not, in itself, doing anything wrong. Some agents testified that they were unable to give a clear explanation about how a person's credit history affected his or her premiums or why the person's credit rating was related to his or her premium.

Others complained that credit scoring negatively affects the young and those who pay their bills in full each month. These groups more than others tend to have no credit history or a history that does not reveal all the credit factors used by a company's formula, both of which may result in a lower credit score.

Consumers also contended that the use of credit scoring penalizes those who can least afford high insurance rates. Some agents testified that the people who are getting the worst rates are the poor. Other consumers claimed that they often fell into financial difficulty because of situations beyond their control, such as prolonged illness, job loss, and divorce.

Perhaps the complaint heard most frequently at the hearings was that the credit scoring process is shrouded in secrecy. Many people testified that they were never informed that their credit history would be used to price their premiums. When consumers did inquire about how their credit affected their rates, they were told that the information was not available or was confidential, or they were referred to the credit scoring company, which could not help them with insurance matters. Consumers complained that this secrecy does not allow a policyholder to contest the score, which can be problematic because credit reports can contain inaccuracies. According to written testimony submitted by the Public Interest Research Group in Michigan (PIRGIM), 29% of credit reports surveyed contained errors serious enough to cause the denial of credit, insurance, employment or other benefits.

A person's credit history can change, but the credit reports may not reflect this. Individuals testified that, upon application, the insurance companies rarely offered them an opportunity to review or dispute their insurance credit score, nor did they offer an appropriate resolution process if the score was incorrect. Additionally, consumers testified that a wide range of insurance credit scores was generated for the same applicant, because each insurance company may choose to use a different model, credit scoring company, and credit reporting agency.

Some people contended that their premiums increased even if they received a discount based on a credit score. Insurance agents speculated that this was due to credit scoring; i.e., companies' inflating their base rates for everyone and then offering a credit discount to a few. According to some agents, rates have doubled and tripled since credit scoring went into effect.

Support of Credit Scoring

Representatives of the insurance industry testified that there is a strong correlation between credit history and insurance risk: Studies have shown that people who manage their financial affairs responsibly are responsible with other assets, such as vehicles and homes. This conclusion is drawn from a *predictive* link, not a *causal* link, as a representative from the Alliance of American Insurers pointed out, and insurance companies bank on predictive links. For example, the representative said, it is common knowledge that a person with a number of speeding tickets is more likely than someone without speeding tickets to get into an accident. The speeding tickets only *predict* a higher likelihood of an accident; they don't *cause* the accident, just as a poor credit history can predict, not cause, the likelihood of insurance losses. To summarize written testimony supplied by Allstate, *why* credit scores predict loss is not as important as the fact that they *do* predict loss. Allstate cited a study showing that people within the bottom 10% of credit insurance scores are about 60% more likely to file an auto insurance claim than others. Arguably, to ignore such studies would be irresponsible, and force insureds with a low risk potential to pay for the losses of those with a high risk potential.

Additionally, insurers contended that only a very small percentage of credit reports contain errors that customers complain about, and only a fraction of that percentage contain errors that affect a consumer's credit score enough to influence insurance rates. A study commissioned by the Fair Issac company looked at the issue this way: "If credit reports were widely inaccurate, scores also would be inaccurate. The fact that insurance scores are so predictive of insurance loss performance testifies to the overall accuracy of credit information." The report of that study also claimed that credit reports had lower error rates than motor vehicle reports, which are routinely used to rate auto insurance premiums. Another insurer pointed out that insurers depend upon the accuracy of credit reports, as do lending institutions. In this competitive economy, the insurers testified, neither industry can afford to turn away a customer who represents low risk.

The industry argued that credit scores allow for consistent, accurate, and impartial pricing. Studies, including one from the State of Virginia, evidently show that low income people are *not* more likely to have poor credit history. Insurers claimed that credit scoring offers a nondiscriminatory, scientifically proven way of predicting future losses within a group. When consumers at the hearings testified that the use of credit scoring felt like an invasion of privacy, insurers responded that they maintained strict confidentiality procedures. In addition, reducing a person's credit history to a number limits the details agents know about their policyholders.

Many insurers testified that most of their policyholders receive a discount based on their credit score. The use of these discounts allows the insurers to give better rates to customers less likely to suffer a loss, hence encouraging more competition in the marketplace, as was argued in favor of passing Public Act 514 of 1996. In fact, they claimed, it is the nature of selling insurance to offer lower rates to some and not to others.

Not all companies keep their customers in the dark about their use of credit scoring. Allstate reported it is their policy to inform consumers of Allstate's intent to order a credit report, before ordering it, for any new insurance application or quote. The insurer also makes available a consumer brochure, accessible on the Internet, that explains the company's use of credit history. Allstate's agents reportedly are encouraged and taught how to answer consumers' questions about credit scoring.

Further, insurers pointed out that the law offers consumers a number of protections. First, under Michigan law, insurers are prohibited from using factors such as age, income, race, address, religion, gender, ethnic group, disability, or marital status when calculating rates. Second, the Federal Fair Credit Reporting Act provides consumer protections, including the right to obtain a free copy of a credit history if an insured is adversely affected by credit information, and the right to dispute incorrect or incomplete information. Last, Michigan is said to have one of the nation's most restrictive insurance credit scoring laws. Insurance companies operating in Michigan may not use insurance credit scoring to deny or cancel coverage, but most other states permit that practice.

Commissioner's Findings

At the close of the hearings and after analyzing the data from the surveys sent to insurance companies, former Commissioner Fitzgerald issued his report in December 2002. In the report, he made the general conclusions described below.

- Using credit histories to offer discounts on premiums is legal under Section 2110a of the Insurance Code, the section that was added in 1996. However, insurers are not meeting their obligations under that section when they fail to review credit history data at each renewal or within some reasonable period of time.

- A correlation does exist between a person's credit score and the likelihood that he or she will file an insurance claim, although it is not clear why. Additionally, there is no evidence that credit scoring discriminates against the poor or members of any race or region. While some evidence did indicate that people with low socio-economic standing had *better* insurance credit scores than those with high socio-economic standing, no study was definitive.

- Data from the survey sent to insurance companies revealed that most companies using credit scoring do penalize those policyholders who have not used credit and therefore do not have a credit history. These primarily include the young, senior citizens, low income individuals, or those who pay all their bills in full and on time each month. Many people who conduct their financial affairs responsibly are therefore losing out on a discount that is meant to reward responsible behavior.

- The lack of openness about how the companies use credit scoring and how they communicate its use to their policyholders was the area of greatest legal concern. Under the Insurance Code, insurers must provide policyholders with all information pertinent to the rate charged, and file with OFIS their manuals containing this information. Referring a consumer to a credit scoring bureau, whose employees do not have access to insurers' rating formulas, does not meet this obligation, and failure to provide OFIS with the formulas used in credit scoring is a further violation of the Code. Also, under the Federal Fair Credit Reporting Act, institutions must notify consumers when an adverse action has been taken against them because of their credit. Failure to offer the lowest insurance credit scoring discount is an adverse action, yet many companies are not notifying their policyholders when they do not qualify for this discount.

- Finally, survey data indicated that credit scoring does have an adverse effect on premium base rates. According to the Commissioner's report, "...insurers have greatly increased their base rates to compensate, at least in part, for the discounts being given to their policyholders."

In general, then, the Commissioner expressed concern about "the variety of ways that credit scoring is being used; the wide range of discounts that may be attributed to credit scoring; and the lack of adequate, detailed information that is made readily available to consumers that allows them to determine if their insurance credit score and resulting insurance premium is accurate."

Administrative Recommendations & Directives

In his December 2002 report, former Commissioner Fitzgerald included a number of administrative recommendations based on the findings described above. On February 14, 2003, he issued Bulletin No. 2003-01-INS, which ordered the OFIS staff to monitor and enforce insurers' compliance with the following directives:

- Companies using insurance credit scoring to apply discounts must annually file with OFIS their credit scoring formulas and the specific factors used to calculate a credit score. The formulas and factors will be available for public inspection under the Freedom of Information Act.

- At least once annually, companies using credit scoring discounts must inform policyholders of their insurance credit scores and levels of discounts. Additionally, insurers must recalculate and then apply a policyholder's credit score at least once annually, and at any time a consumer has successfully disputed his or her credit history information.

- Companies using credit scoring must file with OFIS an actuarial certification justifying discount levels and tiers, including discounts granted to policyholders with no credit history, or whose credit histories do not reveal all the credit factors used by the company's formula to determine the insurance credit score.

- Companies using credit scoring for personal lines of insurance other than auto or homeowners must file their formulas with OFIS. The credit classification factors must be refiled whenever the company adds, modifies, or deletes a factor used to calculate the score.

Legislative Recommendations

The former Commissioner made the following nine recommendations for the Michigan Legislature to consider:

- Prohibit the practice of denying, canceling, or limiting coverage, or surcharging insureds or applicants for personal lines of insurance other than auto or homeowners based on an insurance credit score.

- Prohibit a surcharge based on an insurance credit score for group automobile and homeowners insurance.

- Require insurers to review the credit history of all adults covered under one auto or homeowner policy, and then apply a credit discount based on the best credit score.

- Direct insurance companies on how to apply credit scoring discounts when there is a lack of credit history, or when credit histories reveal fewer than all the factors used by a company to determine its insurance credit score.

- Require notification to consumers that an insurance credit scoring discount is being applied at the time of either application for coverage or renewal of coverage.

- Require companies to inform insureds specifically why an adverse insurance credit scoring action is occurring. (Although the Federal Fair Credit Reporting Act requires this, placing the requirement in Michigan law would empower the Commissioner to penalize violators.)

- Prohibit certain types of credit inquiries from negatively affecting a person's insurance credit score. Inquiries to consider banning include those related to insurance coverage; collection accounts with a medical industry code; and multiple lender inquiries from the automobile lending industry made within 45 days of one another.

- Fund a comprehensive study under the direction of the Commissioner of outstanding issues pertaining to credit scoring. Such issues could include why there exists a predictive link between an insurance credit score and the likelihood of loss, and whether insurance credit scoring impermissibly affects people based on socio-economic or other factors.

- Consider repealing MCL 500.2129, which allows some insurance companies to be exempt from the Essential Insurance Act requirements.

Recent Legislation

Michigan is not the only state to grapple with insurance credit scoring. According to the National Conference of State Legislatures, 30 states introduced legislation in 2002 to address its use. Maryland is the only state to prohibit credit scoring entirely in homeowners' insurance, and Hawaii has long barred its use in rating plans for both auto and homeowners' insurance. Rather than enacting outright bans, however, most states have targeted legislation to address specific concerns with the practice. Last year, lawmakers in Arizona, Colorado, Idaho, Illinois, Maryland (for auto insurance), Minnesota, Missouri, and Washington enacted legislation that restricted the use of credit scoring.

In Michigan, four bills introduced at the end of the 2001-2002 session would have amended Section 2110a of the Insurance Code, the section that permits the use of premium discount plans in home and auto insurance. None of the bills was taken up in committee. This year, Senator Burton Leland introduced Senate Bill 191, which also would amend Section 2110a by prohibiting insurers from using credit histories to offer discounts. Further, the bill would prohibit companies writing home or auto insurance on a group basis to base their rates on the credit history of the group as a whole.

Conclusion

Former Commissioner Fitzgerald's directives to OFIS largely address concerns relating to the consistency and secrecy of credit scoring. Under these directives, consumers should be subject to more consistent, updated discounting and be better informed about when an insurer uses credit scoring to set its homeowners' or auto insurance rates. It will take statutory amendments, however, to ban credit scoring outright, to cast a wider regulatory net over currently exempt insurers, or to offer consumers further protections against a practice most of them oppose.