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Insurers' Use of Credit Scoring for Homeowners Insurance in Ohio

A Report to the Ohio Civil Rights Commission

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1. Executive Summary

Insurance companies in Ohio have increasingly used consumer credit information – in the form of insurance credit scoring – to determine if they will offer a consumer a residential property insurance policy and how much to charge for the policy offered. Insurance credit scoring is the use of mathematical formula to translate information in a consumer's credit report into a numerical value. Insurance credit scoring is now used by the majority of Ohio insurers for residential property insurance and is used in a variety of ways – for underwriting (including rating tier selection), rating (or premium development), coverage eligibility, marketing, and payment plan eligibility. Table 1 below lists the major writers of residential property insurance in Ohio and their use of consumer credit information as of November 2002.

Insurers typically file little information about their use of consumer credit information with the Ohio Department of Insurance. Consequently, there is little public information available about insurers' use of consumer credit information in Ohio. This occurs because most insurers use consumer credit information for underwriting. Underwriting is generally the insurers' process of determining whether or not to offer coverage to a consumer and, if offered, what type of coverage and what type of rate level or market tier to offer. Insurers' underwriting practices are codified in rules called underwriting guidelines. These guidelines are not typically filed with the Ohio Department of Insurance and the Department has historically not requested them from insurers.

In contrast to underwriting guidelines, insurers do submit rate filings to the ODOI. The rate filings contain base rates and rating rules. Rating is the process of developing a premium for a specific consumer based upon that consumer's personal or property characteristics using the base rate, rating factors and rating rules in the rate filing.

Historically, insurers had two or three rate levels or rating tiers. The preferred rates had the most restrictive underwriting guidelines and the lowest rates. The standard rates had slightly less restrictive underwriting guidelines and somewhat higher rates. The non-standard rates had the least restrictive underwriting guidelines and much higher rates. It was common for insurers to have a separate insurance company for each rate level. Stated differently, each insurance company had one set of rates and represented one tier.

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Use of Credit Information for Homeowners Insurance by Ohio Insurers

Insurer	Use	Notes
State Farm	None	Underwriting based primarily on claims history.
Nationwide	Eligibility	Agent sees only "eligible" or "ineligible" on rating screen.
Allstate	Rating	Per 4/30/01 filing, credit used for Financial Stability Rating Class. Discounts range from 0% to 47% -- nearly 2:1 potential spread. Different factors for tenants and condo policies. Tenant spread is 0% to 60%.
Cincinnati	Pay Plan	Full annual premium payment required based on credit
Westfield	Rating	Tier selection
Grange Mutual	Rating	Per 7/1/99 filing, discounts of 0%, 2%, 5%. Currently uses three tiers, which may vary from percentages in 99 filing.
Farmers	Rating	Per 2/16/02 filing, discounts range from 0% to 72% -- nearly 4:1 potential rate difference based on credit score.
Erie	None	Underwriting based primarily on claims history
Liberty Mutual	None	Underwriting based primarily on claims history and type of dog. Offers discounts for university- and employer-affiliation.
Motorist Mutual	Eligibility	
Central	Eligibility, Rating	Credit Score cutoff used to determine eligibility and/or tier selection.
Travelers	Rating	Tier selection.
State Auto	Eligibility	
Ohio Casualty	Rating	Nine tiers based on credit.
Encompass	Eligibility, Rating	Had four tiers based on credit. Agent now sees acceptable / unacceptable.

With the advent of insurance scoring, many insurers have increased the number of rate levels or rating tiers to 20 or more, with multiple rating tiers being written (or sold) in one insurance company. In some cases, the rules governing eligibility (or assignment of a consumer) for rating tiers are still contained in underwriting guidelines and, consequently, not filed with the ODOI and not available to the public. In other cases, the rules are part of the rating manual, where the insurance score is the last factor applied to the premium in the rate development and the insurance score (or the insurance score in combination with other factors, such as claim history) determines the rating tier factor applied to the premium. If the rating tier is applied as a rating factor, then the rate filing includes information about the rating tier eligibility and rate differential by rating tier.

Our review of filings at the Department revealed information about only three insurers' use of insurance credit scoring – Allstate, Farmers and Grange Mutual. Farmers' use of credit scoring has the greatest potential impact on consumers – nearly a 4:1 difference in rates between best and worst credit scores. Allstate's use of credit information also has a major impact – nearly a 2:1 impact between best and worst credit scores for homeowners and 2.5:1 for tenants insurance. We believe the Grange Mutual information, found in a 1999 filing, is out of date. Based upon our interviews, we also believe that Westfields' and Travelers' use of credit information has a large impact on Ohio consumers.

The insurance industry argues for use of the insurance credit scoring with claims of a correlation between consumer credit information and risk of claims. The "correlation" means that certain credit characteristics can "predict" which consumers are more likely to have an insurance claim. The industry relies upon a number of its own secret studies to support this claim. There has been no meaningful opportunity for independent review or analysis of these studies because the underlying data are never made available to independent reviewers (where independent is defined as someone not in the employ of the insurance industry). Other information that is available to the public contradicts and calls into question the alleged correlation.

In addition, consumer organizations have argued that credit scoring itself is correlated to certain underwriting or rating factors that are prohibited, such as race. The industry argues that use of credit scoring does not discriminate or have disparate impact on poor and minority populations. Again, the industry relies upon its own secret studies. Other data and information strongly suggest insurers' use of credit has a disparate impact on poor and minority populations. Finally, the industry argues that, since race is not a factor considered in the credit scoring models, that even if credit scoring has a disparate impact on protected classes, such a result is fair insurance discrimination and not unfair discrimination.

Based upon all the available information, it is our opinion that insurers' use of insurance credit scoring for underwriting, rating, marketing and/or payment plan eligibility very likely has a disparate impact on poor and minority populations in Ohio. Consequently, it is our opinion that insurers' use of insurance credit scoring makes insurance less available and/or more expensive for poor and minority populations in Ohio.

2. Introduction: Insurance Concepts

In this section, we discuss basic insurance terminology and concepts.

2.1 Types of Insurance

There are many types of insurance sold. The types of insurance are generally broken down into two major categories: life/health (L&H) and property/casualty (P&C). Life/health coverages include life, health and disability insurance. Property/casualty coverages are generally broken into personal and commercial lines. Personal lines are those coverages purchased by individuals, including private passenger automobile and homeowners insurance. Commercial lines are those coverages purchased by businesses and include commercial multi-peril (property and liability), medical malpractice, workers' compensation, and commercial automobile insurance. This report focuses on residential property (homeowners) insurance.

Residential property insurance is considered a "lines" of insurance. Within each line are a variety of coverages. For residential property insurance, the consumer typically selects one of the major coverages. An important characteristic of coverages is whether they provide first party or third party coverage. First party coverage pays for personal injury or property damage to the insured. Third party coverage pays for personal injury or property damage that the insured causes to a third party.

Residential property insurance is a broader term for insurance most people know as homeowners insurance. The coverages age:

Dwelling – This is first-party coverage. This coverage pays for damage to your house. An important factor for dwelling coverage is whether the coverage is for replacement value or actual cash value. The replacement value policy pays the replacement cost of the home, while the actual cash value policy only pays the actual market value of a home. If a $100,000 home is totally destroyed, for instance, but costs $125,000 to rebuild, the replacement value policy would pay $125,000 but the actual cash value policy would only pay $100,000.

Personal property – This is first-party coverage. This coverage pays either the actual cash value or replacement cost of your personal property (excluding autos) that are damaged, stolen, or destroyed.

Liability – This is third-party coverage. This coverage pays the other person (the third party) if you cause injury to the person or the person's property.

Medical Payments – This is third-party coverage. This coverage pays the other person (the third party) for medical expenses incurred from an injury on your property.

Loss of use – This is first-party coverage. This coverage pays for your living expenses, including rent, during the time your house is being repaired.

A *Homeowners policy* refers to a multi-peril policy that provides all five coverages. A *Dwelling, or Fire,* policy normally provides only the dwelling coverage. A *Renters* policy normally provides all coverages other than dwelling.

2.2 Types of Insurers

Insurance companies that sell private passenger automobile and homeowners insurance differ based on the type of *ownership* of the company and the method of *sales*.

The two main types of ownership are stock companies and mutual companies, but there are others. Stock companies are publicly owned companies whose stock generally trades in one of the stock markets. Stock companies are owned by their shareholders – the purchasers of the company's stock. Allstate is a stock company. Mutual companies are owned by their policyholders. State Farm Mutual Automobile Insurance Company is a mutual company.

Insurers also differ by how they sell their policies. *Direct writers* do not use agents to sell their policies. Two examples are USAA and GEICO. These companies sell insurance over the phone through sales representatives. Most insurers, however, sell their policies through agents. *Captive agent* insurers sell their policies through agents who only sell for that company. State Farm, Farmers, and most Allstate agents are captive agents. *Independent agent* insurers sell their policies through independent agents that represent more than one insurer. Progressive, SAFECO and Travelers are examples.

2.3 Market Segments

Most insurance markets consist of several submarkets: preferred, standard, nonstandard, residual, and surplus lines. *Preferred* companies have the lowest rates and sell to the consumers perceived to represent the lowest risk. *Standard* companies sell to consumers perceived to represent average risks. *Nonstandard* companies have the highest rates of these three types of companies and sell to consumers perceived to represent the highest risk. The preferred, standard and substandard markets are known collectively as the "voluntary market" or the "admitted market." Those consumers unable to obtain coverage in these three markets must turn either to a residual market mechanism or to surplus lines companies.

Residual market mechanisms were created to provide some type of insurance to those consumers who could not obtain it in the voluntary market. Most states have some residual market for private passenger automobile insurance. The automobile insurance residual markets are typically called "insurance plans" or "risk pools." For residential property insurance, some states have "FAIR" plans, which are similar in structure to automobile insurance risk pools. Most FAIR plans were created in the 1960's and 1970's following the incidence of urban riots and charges of insurance redlining. A number of

coastal states now have property insurance residual markets for catastrophe events, including hurricane and earthquake. These residual markets are relatively new, some having been created in the last few years.

Not all states have residual market mechanisms and many of those that do limit the types of coverages available. Residual market mechanisms operate in one of two ways. In some, consumers are insured through a pool with state-set rates and all insurers share the profits or losses from all such policies. Alternatively, these consumers are assigned to an insurance company that must accept the risk at a state-set rate and the profit or loss on the policy. Consumers normally pay higher rates in a residual market and receive limited benefits.

Surplus lines carriers, also known as "off shore" and "non-admitted" insurers, are not regulated by the state. These insurers are permitted to insure only those consumers who are unable to purchase coverage in the admitted market. These insurers present several disadvantages to the consumer. Rates are usually much higher than admitted companies, policy forms are not regulated, no state guaranty coverage is provided if the company goes broke, and the absence of solvency regulation increases the chances that the company will be unable to pay its claims.

Most insurance "companies" are really a group of insurance companies. Normally, an insurer group owns preferred, standard, and nonstandard companies with correspondingly higher rates. Each of the companies in the insurer's group has decreasingly restrictive underwriting guidelines. When a consumer goes into State Farm, for instance, he or she may be placed in State Farm's preferred company if the consumer meets the most restrictive underwriting guidelines. Otherwise, State Farm will insure the consumer in either its the standard company or substandard company, or deny coverage altogether.

For most consumers, auto and homeowners coverage is obtained in the standard and preferred markets. These two markets normally sell the large majority of insurance policies in a state. For consumers forced into the substandard, residual, or surplus lines markets, however, insurance is unavailable in the standard and preferred markets. The insurance availability problem includes both the inability to obtain insurance at all and the inability to purchase insurance in the standard and preferred markets.

2.4 Underwriting Guidelines

Underwriting is the process by which an insurer determines whether it will accept or reject an applicant and, if acceptable, at what price. *Underwriting guidelines* are the standards on which the insurer makes the underwriting decision. Insurers provide underwriting guidelines to insurance agents (or sales representatives for direct writers) for the agent to make the initial decision as to whether to offer coverage and at what price. An underwriter in the insurer's home office reviews applications to ensure they meet the underwriting guidelines. Insurers also use underwriting guidelines to determine whether the company will renew an existing policy.

Underwriting guidelines range from very detailed and objective written rules (*e.g.* limitations on insuring homes under a specified value) to broad and subjective forms of guidance for the agent or underwriter (e.g. limitations on insuring consumers with "bad morals"). Some of the more common underwriting guidelines for auto and homeowners insurance are listed in the following table:

**Top Underwriting Guidelines
For Auto and Homeowners Insurers**

Auto	Homeowners
Credit history	Credit history
Driving experience	Made previous homeowners claim
Cancelled/refused by another company	Minimum coverage / value of the home
No prior insurance	Age of home
Age	Location of the home
Occupation	Lifestyle
Residential stability	Marital status
Employment stability	Employment stability
Not-at-fault accidents and claims	
Marital status	
Purchase of other insurance	
Previous insurer was nonstandard	
Type of car	

Not all discrimination is wrong or illegal. Some discrimination is clearly proper, like refusing to sell homeowners insurance to the class of consumers who have been convicted of arson. Other discrimination is clearly *improper*, like refusing to sell to the class of African-American consumers. Those practices in the middle require a two-step analysis. First, does the underwriting guideline violate broad public policy? Is the guideline simply a surrogate for another prohibited characteristic? Second, does the underwriting guideline identify a characteristic of the consumer, vehicle or property that is demonstrably and uniquely related to risk of loss? The second test typically requires detailed insurance data upon which to perform statistical and actuarial analyses. The data must be sufficiently detailed to enable the analyst to identify the unique contribution of the underwriting guideline or rating factor in question. Identifying the unique contribution is necessary to ensure that the underwriting guideline is simply not correlated (i.e., a surrogate) for another known underwriting guideline or rating factor – including prohibited rating factors. Such an analysis enables the analyst to determine whether the practice *unfairly* discriminates against consumers who do not satisfy the underwriting guideline.

Finally, the *ways* insurers use underwriting guidelines to discriminate is not limited to the mere denial of coverage. Insurers use underwriting guidelines to discriminate against consumers in the following ways:

- Refusal to sell a policy at all.
- Charging a higher premium for the same coverage.
- Refusal to sell a replacement value policy.
- Requiring higher deductibles.
- Exclusion of specific coverages.
- Different benefits for the same price.
- Poorer service.
- Paying less for similar claims
- Conditioning payment plan eligibility

Underwriting guidelines are important because they determine both the availability and affordability of insurance to groups of consumers. Insurance data are critical in the review of underwriting guidelines because the data will show whether the underwriting guideline properly identifies a group of consumers for whom the expected costs of the transfer of risk are higher or lower.

2.5 Rating Factors and Premium Calculations

Calculating a premium for auto and homeowners insurance is a two-part process. First, the underwriting process determines the *base rate* for the coverage. The base rate for each company will differ, as will the base rate for the different insurers within the company group. Thus, the base rates between Allstate and State Farm will differ, but the base rates between State Farm's preferred and substandard companies will also differ.

Second, the premium calculation involves the application of a series of rating factors to the rate base. *Rating factors* are the factors that change the base rate because the insurer or state has determined that the factor represents a difference in risk. For instance, a brick home represents a lower risk for fire than a wood frame house, so a discount factor is applied to the base rate for brick homes. Rating factors can cause the rate to increase (*surcharges*) or decrease (*discounts*).

Rating factors differ by state and by insurer. Common rating factors for auto insurance include coverage amount, territory (usually county of residence), use of car (pleasure only, business use), age of drivers, type of car, amount of deductibles, surcharges, and various discounts. Common rating factors for homeowners insurance include coverage amount, territory (usually county), type (brick or frame), amount of deductibles, and various discounts.

2.6 Rate Standards

Rates are developed to meet both legal and *actuarial* standards. In some instances, the legal and actuarial standards differ. When that occurs, the legal standards take precedence.

The common legal standard is that rates must be just, reasonable, adequate, not excessive and not unfairly discriminatory for the risks to which they apply. Rates satisfy that standard if the rate is a sound estimate of future costs of coverage offered and if consumers of the same class and essentially the same hazard are offered the same rates.

Rates are generally developed by actuaries working for, or on behalf of, insurance companies. A certified actuary is a person who is a member of the Casualty Actuary Society, but membership is usually not mandatory. Membership in the CAS is based upon passing a series of tests. It is important to point out that membership in the CAS does not impart consistent or good judgment to actuaries. Two actuaries analyzing the same data can, and often do, come up with widely divergent rate results. While ratemaking is a complex subject and activity, a consumer advocate can often identify the key ratemaking assumptions and question those assumptions.

2.7 Rate and Risk Classifications

The ratemaking analysis first produces *average statewide rate change indications by coverage.* For example, the ratemaking analysis may initially produce a 5% average statewide increase for bodily injury liability. The insurer then selects the average statewide rate change by coverage it will use or proposes to use. It is common for insurance companies to select rate changes significantly different from the actuarially indicated rate changes. There is generally little or no explanation provided by insurance companies for their selection of rates significantly different from the actuarially indicated rates.

The statewide average rate change is then *distributed to the various risk classifications*, such as different driver classes, increased limits factors and rating territories. If some parts of the state (rating territories) have better than average loss experience for a particular coverage, these rating territories should get a lower rate change than the statewide average for that coverage. Of course, if one rating territory gets a lower than average rate change, another rating territory must get a higher-than-average rate change.

Failure to reflect differences in costs among risk classifications, as well as attempting to charge different rates based upon a rating factor that is unrelated to differences in costs, is *unfair discrimination*. However, it is important to point out that an actuarially sound rate must be legal. For example, insurance companies are prohibited from discriminating on the basis of race, religion or national origin. Thus, even if cost differences based upon these characteristics could be demonstrated, it would be illegal and actuarially improper to treat consumers differently based upon any of these prohibited characteristics. States legislatures routinely pass laws expressing public policy regarding the nature of insurance

risk classification. It is important to mention this because risk classifications are not natural or pre-ordained; rather, there are many ways of grouping consumers for the purposes of ratemaking that are fair.[1]

3. Insurers' Use of Consumer Credit Information and Credit Scoring

Credit reports are one type of "consumer report" whose use is covered by the Fair Credit Reporting Act. Other types of consumer reports used by insurers include motor vehicle reports and claims history reports. Although insurers have looked at consumer credit reports for many years, the use of credit reports to produce an insurance credit score is relatively new. According to one of the credit scoring model vendors, insurers used consumer credit reports as early as the 1970's to identify consumers who posed high likelihood of fraud or arson. The first insurance credit scoring models were developed in the early 1990's by Fair, Isaac and Company, the company that had developed credit scoring models for lenders. The original credit scoring models predicted the likelihood of a loan default. The original insurance credit scoring models predict likelihood of an insurance claim. Scoring models have since been developed by Fair, Isaac and ChoicePoint to predict frequency of claims, likelihood of a consumer renewing a policy and likelihood of a response to direct marketing.

Allstate was an early user of insurance credit scoring, utilizing a model for automobile insurance in 1994. Adopting of insurance credit scoring was slow through 1990's, but grew exponentially by the end of the century. Today, almost every insurer uses some form of credit scoring for private passenger automobile insurance and the vast majority of insurers use it for residential property insurance.

Insurers use insurance credit scoring for a variety of purposes, including underwriting for overall eligibility, underwriting for rating tier eligibility, as a rating factor, determining payment plan eligibility and pre-screening for direct marketing.

Under a provision of the FCRA, as amended effective in 1997, insurers can obtain a list of consumer based upon certain credit characteristics without the consumers' permission, as long as the insurers provide a firm offer of insurance to the consumers on the list. That firm offer is subject to other insurer underwriting guidelines. This activity is called pre-screening and has been subject to virtually no oversight by insurance regulators.

A consumer credit report contains a listing of information about some of a consumer's credit activity, including a list of accounts (or trade lines), payment history, amount owed on a particular date, account credit limit, late payments, delinquencies, defaults, bankruptcies, other so-called public records, liens and some personal information. An insurance credit score is a value generated by applying a mathematical model to the specific characteristics of a consumer's credit report. See Appendix 1 for a number of descriptions and examples of insurance credit scoring and for resources on the FCRA.

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[1] See Appendix 1 for a listing of documents and resources for each section of this report.