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**The Use of
Insurance Credit Scoring
In Automobile and Homeowners Insurance**

**A Report to the Governor, the Legislature and
the People of Michigan**

**Frank M. Fitzgerald, Commissioner
Office of Financial and Insurance Services**

December 2002

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Introduction

On May 15, 2002, Commissioner Frank M. Fitzgerald of the Michigan Office of Financial and Insurance Services (OFIS) announced that he would undertake a study of the use of consumer credit history to set insurance rates and to gauge the effect of this practice on consumers in Michigan. The Commissioner is authorized to make determinations with respect to the use of insurance credit scoring in rating plans under Sections 2110a, 2403, and 2603 of the Insurance Code of 1956 (the Code), 1956 PA 218, MCL 500.2110a, 500.2403, and 500.2603.

The broad purpose of the study, which included six public hearings around the state, was to gather information on the use of insurance credit scoring in personal automobile and homeowners insurance policies and to take testimony concerning its effect on Michigan citizens. Insurance credit scores are derived from one or more formulas based on factors in a person's credit history. Formulas and scores are established by insurance companies and also by companies such as Fair Isaac or ChoicePoint.

In Michigan, most insurance companies cannot use insurance credit scoring to refuse to write a policy, cancel a policy or non-renew a policy based on a person's insurance credit score. However, many insurance companies have started to use insurance credit scoring in determining the premium a person will pay. For policies written on an individual basis, this is applied as a discount that a person may or may not be eligible for depending on the person's insurance credit score.

Because there is no intuitive connection between a person's credit history and the likelihood that he or she will incur a loss, this practice is controversial and raises numerous questions. Lack of knowledge as to how insurance credit scores are derived and what a person can do to improve an insurance credit score is raised as a concern, in addition to the overall fairness of the practice.

Subjects and issues that were addressed at the public hearings and during this study included: formulas used in insurance credit scoring; whether insurance credit scores can accurately predict the likelihood of filing an insurance claim; the range of credit history rate discounts being used; consumer awareness of the use of insurance credit scores for setting insurance rates; how the use of insurance credit scores for insurance rates is explained to consumers; and the role of insurance agents.

The public hearings were scheduled and held as follows with the information posted on the OFIS web site:

- **Tuesday, June 4 - Cadillac, Michigan**
Link to hearing information - http://www.michigan.gov/cis/0,1607,7-154-10555_12902_15784-39843--,00.html
- **Thursday, June 13 - Portage, Michigan**
Link to hearing information - http://www.michigan.gov/cis/0,1607,7-154-10555_12902_15784-39844--,00.html
- **Saturday, June 15 - Port Huron, Michigan**
Link to hearing information - http://www.michigan.gov/cis/0,1607,7-154-10555_12902_15784-39845--,00.html

- **Tuesday, July 9 - Lansing, Michigan**
Link to hearing information - http://www.michigan.gov/cis/0,1607,7-154-10555_12902_15784-39846--,00.html
- **Thursday, July 11 - Grand Rapids, Michigan**
Link to hearing information - http://www.michigan.gov/cis/0,1607,7-154-10555_12902_15784-39847--,00.html
- **Thursday, July 18 - Detroit, Michigan**
Link to hearing information - http://www.michigan.gov/cis/0,1607,7-154-10555_12902_15784-39848--,00.html

Written testimony regarding the use of insurance credit scoring for setting insurance rates also was solicited and was received at the hearings and at OFIS via U.S. mail and electronically via the OFIS web site. The OFIS insurance credit scoring web page, including some of these additional comments is at: http://www.michigan.gov/cis/1,1607,7-154-10555_12902_15784---,00.html

In addition to the hearings and written testimony, OFIS also surveyed companies writing automobile and homeowners insurance to obtain specific information about how or whether each company utilizes credit histories. The results of this survey will be discussed later in this report. A list of some of the largest insurers and their insurance credit scoring practices is also available on the OFIS web site at: http://www.michigan.gov/documents/cis_ofis_credscor_lst_26800_7.pdf

Due to the growing use nationally of insurance credit scores, OFIS also researched and studied other states and how or if they regulate this practice. OFIS also is participating with the National Association of Insurance Commissioners (NAIC) in its ongoing study of the issue.

Historical Perspective

Rate regulation in Michigan is based on laws passed by the Legislature. Statute mandates that rates shall not be excessive, inadequate, or unfairly discriminatory. With the increasing use of insurance credit scores to determine insurance rates, it is necessary to look at these mandates once again.

Insurance companies are always exploring methods of reducing their expenses by minimizing their exposure to risk. The current scheme of using credit scores in an attempt to more precisely categorize risk is an industry answer to reduction of risk. "Theoretically, each individual purchasing insurance has a greater or lesser likelihood of loss than does every other individual. But to assign a separate price to each individual would be scientifically inaccurate, hazardous, expensive, and would run counter to one of the purposes of insurance." (1)

Michigan has regulated property and casualty rates since the 1930s. It was recognized early that availability at affordable prices of essential personal insurance -- automobile and homeowners insurance -- was a challenge. Placement facilities were created in the 1940s for automobile and the 1960s for homeowner insurances to respond to the availability problems. During that time insurance agents could make field decisions on the insurability of an applicant. Applicants routinely were denied coverage based on an agent's judgment using the guidance of the company's unwritten underwriting rules. An applicant denied coverage had no recourse for a fair determination of insurability. Many insureds were forced to settle for high cost, inadequate coverage through high-risk insurance placement facilities.

On January 1, 1973 automobile insurance became compulsory for drivers in Michigan. By 1976 it was apparent that availability of affordable automobile insurance was diminishing, particularly in urban areas. It also became apparent that homeowner insurance was not available at affordable prices. Insurance rates were high at the time and many people were placed with the Michigan Automobile Insurance Placement Facility (MAIPF). Being placed in the MAIPF limited the scope of coverage, and eliminated the ability to shop between companies for the best price.

The homeowners insurance market was experiencing similar problems in the 1970s. People living in cities found it difficult to obtain coverage and the rates were very high. Often coverage could only be secured through the Michigan Basic Property Insurance Association (the FAIR plan). Coverage was limited to fire and burglary. Rates for this limited coverage were very high.

In a March 14, 1977 letter, Commissioner Thomas C. Jones quoted the Honorable William G. Milliken's 1977 State of the State Message:

[T]he citizens of Michigan are finding that some forms of insurance, particularly automobile and homeowners, are now essential investments. At the same time, many people discover that purchasing the insurance coverage they need at a reasonable price is becoming increasingly difficult, if not impossible.

Inflation, changing practices in the writing of automobile and homeowners insurance, and inconsistencies in regulating the industry have all combined to create a threatening situation in the cost and availability of these essential lines of insurance. We must act before the situation reaches crisis proportions. (2)

In the March 14, 1977 letter, the Commissioner concurred with the Governor's statements and called for an effective statutory scheme to respond to those issues. In response, the Legislature enacted amendments to the Michigan Insurance Code, which became known as the Essential Insurance Reform Act, (the EIA) in 1979 PA 145. The intent of the EIA was to guarantee access to automobile and homeowners insurance, call for rates to be competitive and fair, allow for more freedom of choice by the consumer, and create an improved regulatory atmosphere.

The 1977 Report to the Governor, titled "*Essential Insurance in Michigan - An Avoidable Crisis*", stated that the objective of fair and reasonable prices in insurance is met by prices which stand up to four specific standards:

1. Prices must provide the industry the opportunity to pay all losses and expenses and return a reasonable, but not an excessive profit.
2. Equal risks must pay equal prices and different risks must pay prices that differ solely according to their historic level of risk as represented by actual losses.
3. Classes must be created only on the basis of characteristics which have a causal relationship with loss propensity.
4. Certain characteristics are not acceptable public policy for purposes of risk classification. (3)

The Michigan Supreme Court determined in *Shavers v Attorney General*, 402 Mich 554, 267 NW2d 72 (1978), that no-fault automobile insurance did not violate the Michigan constitution but that insurance law and regulations did not assure that mandated coverages were available at

fair and equitable rates. The Court also held that Michigan motorists were entitled to know how their rates were calculated and to a procedure for appealing what they believed was unfair treatment by insurers.

The court gave the Legislature and the Commissioner 18 months to develop and enact legislation to address these problems. The court held that mechanisms controlling the rate setting procedures were constitutionally deficient in three respects:

1. The terms in the Insurance Code providing that "rates shall not be excessive, inadequate, or unfairly discriminatory" were not sufficiently explicit;
2. The statutory provisions enabling motorists to challenge the rates were inadequate; and
3. There were no statutory provisions that enabled motorists to challenge being denied coverage, having a policy canceled, or being assigned to the MAIPF. (4)

Again, the emphasis of the EIA was to ensure that price differentials determined by the use of classification plans were not based on factors or judgment not fully substantiated by objective data. The purpose was to guarantee consumers the ability to meaningfully shop for the best coverage at the lowest price. It also gave consumers access to the standards the companies used to make underwriting decisions.

The Legislature, through the EIA, prescribed factors an insurance company could use to develop its automobile and homeowners rates. For automobile insurance, the factors may include the age of the driver, the length of time the insured has been driving, and vehicle characteristics. Homeowners insurance rates may include factors such as the construction of the house, fire protection class, and the loss experience of the insured. In both types of insurance the physical location of the risk – known as the geographic territory – can be used in rating the policy.

In 1986 the Legislature enacted 1986 PA 10 to loosen the constraints on territorial rating that had been imposed by the EIA. It suspended the system of rating constraints, which linked the various geographical rating areas around the state together, and put in place an alternative method of regulating rate increases in Detroit. This expired on April 1, 1992.

The Legislature introduced Senate Bill 691 in March 1992 as an attempt to roll back automobile insurance premiums an average of 15 percent and to cap medical benefits at \$3 million. Governor John Engler vetoed Senate Bill 691. With Senate Bill 691 vetoed and 1986 PA 10 expired, there again were constraints on territorial rating which had the affect of linking the rates of contiguous geographic territories. Subsequently, two more attempts were made to reduce premiums and limit benefits but Michigan voters rejected the efforts in 1992 and 1994.

In 1996, the Legislature passed 1996 PA 98, which removed these territorial rating restrictions and allowed insurers to rate according to the loss experience of a geographic territory, without imposing artificial limits on rates within and between territories. This act liberalized the rate structure under which a company could develop its automobile and homeowners rates.

It is the enactment of 1996 PA 514 that allows the use of credit information under the EIA. The legislation allows an insurance company to establish a premium discount plan using factors that are in addition to those allowed in Section 2111 of the Code, MCL 500.2111. If a company chooses to use a premium discount plan, statute requires that it must be applied uniformly, must be consistent with the purposes of the code, and reflect reasonably anticipated reductions in losses or expenses.