PREPARED STATEMENT OF

THE FEDERAL TRADE COMMISSION

on

"The Impact of Credit-Based Insurance Scoring on the Availability and Affordability of Insurance"

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 Lydia Parnes, the Director of the Bureau of Consumer Protection at the Federal Trade Commission ("Commission" or "FTC").[1] The FTC appreciates the opportunity to appear before you today to provide an update on the Commission's study of the use and effect of credit-based insurance scores on consumers of homeowners insurance. Last week, the Commission approved a resolution authorizing the use of compulsory process to obtain data for this study. Pursuant to this resolution, the FTC intends to issue orders to the nine largest homeowners insurance companies in the United States. Using this process will allow the agency to obtain the information it needs to conduct its empirical analysis in a manner that will provide to all interested parties confidence in the results. In addition to this update on the homeowners insurance study, this testimony presents general views on proposed legislation that would accord legal significance to the results of the Commission's studies of the use and effect of credit-based insurance scores on the consumers of automobile and homeowners insurance.

II. Background on Credit-Based Insurance Scores

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 consumers automobile and homeowners 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.,

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

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, along with various other rating variables, to assign consumers to risk pools and to determine the premiums that consumers pay.

Insurance companies and other proponents of credit-based insurance scores contend that these scores 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 the use of these scores results in members of certain racial and ethnic minority groups paying higher insurance premiums than other consumers.

To assist policymakers in evaluating these arguments, Congress, in Section 215 of the Fair and Accurate Credit Transactions Act ("FACTA"),[2] directed federal agencies to conduct empirical studies of the impact of credit-based insurance scores on the availability and affordability of insurance.[3] Among other things, Congress specifically directed that federal agencies focus their empirical analysis on the effects of scores on members of racial and ethnic

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[2] 15 U.S.C. § 1681 (note).

[3] The FTC and the Federal Reserve Board are required to conduct these insurance studies and a credit study. The Commission has undertaken the insurance studies. The Federal Reserve Board has conducted a study of the impact of credit scores on the availability and affordability of credit, and it published its results in a report released in 2007. *See* Federal Reserve Board, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit* (August 2007).

minority groups.

III. FTC Credit-Based Insurance Score Studies

To comply with Section 215 of FACTA, the Commission has undertaken studies of the impact of credit-based insurance scores on consumers of automobile insurance and homeowners insurance. The FTC's automobile insurance study used data that a consortium of insurance firms voluntarily submitted to the agency. Specifically, the FTC staff obtained, through a third-party actuarial firm, automobile insurance policy data for five firms representing 27 percent of the United States automobile insurance market in 2000. Commission staff supplemented and confirmed this data with information it obtained from a variety of other public and private sources. FTC staff then conducted an econometric analysis of this data.

In July 2007, the Commission issued a report describing the results of its automobile insurance study.[4] In the report, the FTC made a number of findings. First, the Commission found that insurance companies are increasingly using credit-based insurance scores in making decisions as to coverage and premiums. Second, it found that credit-based insurance scores are effective predictors of risk measured by the number and total cost of claims policyholders will file. Third, the FTC found that credit-based insurance scores are distributed differently among racial and ethnic groups, and therefore likely have an effect on the insurance premiums that these groups pay, on average, with non-Hispanic white and Asian-American consumers paying less and African-American and Hispanic consumers paying more. Finally, it found that credit-based

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[4] Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* (July 2007), *available at* http://www.ftc.gov/os/2007/07/P044804_FACTA_Report_Credit-Based_Insurance_Scores.pdf. In connection with the issuance of this report, Commissioner Leibowitz issued a concurring statement and Commissioner Harbour issued a dissenting statement.

insurance scores appear to have little effect as a "proxy" for membership in these groups in estimating risk associated with automobile insurance.

Some people who reviewed the automobile insurance study were concerned about the design and methodology used. Among other things, they stated that the data staff collected was insufficiently reliable and robust for a number of reasons, including: (1) the Commission did not choose the insurance firms that provided the data; (2) the participating firms provided only limited data, excluding application data and other information; and (3) the data submitted voluntarily would have been more reliable if it had been submitted pursuant to compulsory process. On October 2, 2007, the Commission testified before this Subcommittee and responded to these concerns.[5]

In addition, the FTC has been moving forward with the homeowners insurance study. To further promote confidence in the results of this study among all interested parties, the Commission last week approved a resolution authorizing the use of compulsory process under Section 6(b) of the FTC Act and Section 215 of FACTA to obtain information for this study from homeowners insurance companies. This week, the FTC also announced that it intends to use compulsory process under that resolution to obtain information from the nine largest private providers of homeowners insurance in the United States. These nine firms had roughly a 60 percent market share of the private homeowners insurance market in 2006. In addition, the nine homeowners insurance companies have significant shares of the homeowners insurance market in every state with a sizeable racial or ethnic minority population.

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[5] *See* Prepared Statement of the Federal Trade Commission, *Credit-based Insurance Scores: Are They Fair?*, before the Subcommittee on Oversight and Investigations, Committee on Financial Services, United States House of Representatives (Oct.2, 2007), *available at* http://www.ftc.gov/os/testimony/P044804_Credit-based_Insurance_Scores.pdf.

The FTC has placed on its website a draft model order setting forth in detail the information it intends to seek from homeowners insurance companies pursuant to compulsory process. The draft order requires that firms provide a combination of data, documents and narrative responses on the following: policyholder information; premiums; details on coverage; risk characteristics; claims; rating and underwriting guidelines, including the use of credit-based insurance scores and credit history information; and agent compensation and pricing discretion. In addition, the draft model order also requires that firms provide any data they maintain on insurance applications and quotes, information that was not included in the database voluntarily submitted for the study on automobile insurance.

The FTC is seeking public comment for thirty days on its draft model order. Soliciting comment is consistent with FACTA's direction that the agency consult with consumer groups, civil rights and housing groups, government officials, and the public on the design and methodology of these studies. Seeking comment also may elicit information as to whether there are means available to obtain necessary data from homeowners insurance companies at a lower cost to insurance companies. After receiving public comments, the Commission intends to make appropriate revisions to the draft model order and then serve it on the nine largest homeowners insurance firms in the United States.

The Commission would be pleased to keep the Subcommittee and its staff informed as to the progress of its study on the effect of credit-based insurance scores on consumers of homeowners insurance.

IV. The Proposed Legislation (H.R. 5633)

On March 13, 2008, Chairman Gutierrez introduced a bill, H.R. 5633, The Nondiscriminatory Use of Consumer Reports and Consumer Information Act of 2008, which would impose limits on the use of credit-based insurance scores. The proposed legislation would amend Section 604 of the Fair Credit Reporting Act ("FCRA")[6] to prohibit credit reporting agencies from furnishing and insurance companies from using a credit-based insurance score in making insurance granting and pricing decisions if the Commission determines that the use of the score results in racial or ethnic discrimination, or represents a proxy or proxy effect for race or ethnicity in these decisions. Any such FTC determinations likely would be made only in the context of the findings and conclusions of the automobile and homeowners insurance research studies conducted pursuant to FACTA.

As demonstrated by its longstanding commitment to law enforcement and educational efforts in fair lending,[7] the FTC believes that it is vitally important to protect consumers from illegal discrimination based on race or ethnicity. The proposed legislation is intended to prohibit insurance companies from using credit-based insurance scores to discriminate on the basis of race or ethnicity. It apparently would impose liability based on the determinations of FTC econometric research studies. The FTC's studies, however, assess the general effect of credit-based insurance scores on consumers of insurance, not the specific impact of a particular commercial[8] or proprietary credit-based insurance score on the customers of any individual

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[6] 15 U.S.C. § 1681b. FACTA is part of the FCRA.

[7] Recent Commission testimony describes in more detail the nature and scope of the agency's fair lending activities. *See* Prepared Statement of the Federal Trade Commission, *Home Mortgage Disclosure Act Data and FTC Lending Enforcement*, before the Subcommittee on Oversight and Investigations, Committee on Financial Services, United States House of Representatives (July 25, 2007), *available at* http://www.ftc.gov/os/testimony/P064806hdma.pdf.

[8] Some insurance companies purchase commercial credit-based insurance scores rather than developing their own proprietary risk scoring models. Even if insurance companies use the same commercial credit-based insurance scores, they may incorporate these scores into their

insurance company. Moreover, even if the FTC's studies did determine the effect of a specific company's use of a particular credit-based insurance score, the Commission is concerned that the proposed legislation would assign liability based on these determinations without allowing those who would be liable an opportunity to offer evidence and arguments as to why they should not be held liable.

The Commission respectfully suggests a different approach if the drafters want to prohibit the furnishing or use of credit-based insurance scores to discriminate on the basis of race or ethnicity in the granting or pricing of insurance. The FTC suggests that the drafters consider the legal standard and enforcement scheme of existing fair lending laws, which prohibit other acts and practices that discriminate based on race or ethnicity, as a possible model for the credit-based insurance score context. The Commission would be pleased to work with the Subcommittee and its staff on any such revisions.

V. Conclusion

The Commission is committed to completing the studies of credit-based insurance scores that FACTA requires. The FTC hopes that its approach to the homeowners insurance study promotes confidence in its results among all interested parties. The Commission also hopes that its views on the proposed legislation are useful to the drafters.

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underwriting and rating processes in different ways and the demographic characteristics of the customers of insurance companies can vary widely. For these reasons, the impact of the use of one of these commercial scores for racial and ethnic groups may well vary widely by company.