

# FTC'S REPORT ON CREDIT-BASED INSURANCE SCORING, ONE YEAR LATER

by

Debra Ballen

In July 2007, the Federal Trade Commission (FTC) issued a congressionally mandated report examining the impact of credit-based insurance scores on the availability and affordability of private passenger automobile insurance, the statistical relationship between credit information and insurance risk, and the effects of such scores on members of racial and ethnic minority groups.<sup>1</sup> A follow-up FTC report on homeowners insurance is underway.

In its report, the FTC affirmed the strong predictive value of credit-based insurance scores in claiming experience and found that the use of such scores may result in consumer benefits, including wider availability and lower prices. The FTC also found that credit scores have little, if any, effect as a surrogate for race and ethnicity; moreover, despite substantial efforts, the FTC staff was not able to develop a model that predicted risk as effectively while narrowing the differences of scores among selected groups.

Although the FTC report builds on the already solid case regarding the benefits of credit-based insurance scores, it has done little to quiet the debate. To the contrary, the rhetoric has intensified, in many instances based on misunderstanding regarding the equity and efficacy of this proven risk-assessment tool.

This LEGAL BACKGROUNDER examines some of the salient issues that have arisen during the past year regarding credit-based insurance scores and the FTC report.

***FTC Report Confirms Use of Insurance Scores as Key Risk Assessment Tool.*** Insurance is a system based on risk. Consumers buy insurance to remove risk, and insurance companies must assess risk accurately in order to remain both competitive and solvent. One way they do this is by identifying risk factors (e.g., age of driver, driving record, etc.) that are associated with insurance losses among broad populations of policyholders. The basic cause-and-effect relationship between risk factors and loss has been described as follows: "Living in a river valley does not 'cause' a flood. But there is a predictive relationship between the risk of a flood loss and the construction of a home in a flood plain."<sup>2</sup> No single risk factor causes losses, but together they have been shown over time to predict both the likelihood and size of losses among large numbers of policyholders.

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<sup>1</sup>Federal Trade Commission (FTC), "Credit Scores: Impacts on Consumers of Automobile Insurance," July 24, 2007, available at: [http://www.ftc.gov/os/2007/07/P044804FACTA\\_Report\\_Credit-Based\\_Insurance\\_Scores.pdf](http://www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf).

<sup>2</sup>Miller, Michael J., "Statement of Michael J. Miller and EPIC Consulting Regarding Credit-Based Insurance Scores," testifying before a hearing by the Illinois House Insurance Committee, Apr. 16, 2008, at 2.

**Debra Ballen** is Executive Vice President, Public Policy Management, at the American Insurance Association.

For over a decade, insurers have used credit-based insurance scores as one of many risk assessment tools. While no one has suggested that credit scores *cause* loss, experience has proven they are an accurate and efficient predictor of claims losses. This experience has been corroborated by government, academic, and actuarial studies that preceded the FTC report.<sup>3</sup> According to the FTC itself, “The use of scores is therefore likely to make the price of insurance better match the risk of loss posed by the consumer. Thus, on average, higher-risk consumers will pay higher premiums, and lower-risk consumers will pay lower premiums.”<sup>4</sup> The FTC report fully supports the predictive value of credit-based insurance scores and reaffirms their importance as a risk assessment tool.

***Questions About “Proxy Effect.”*** Over the years, consumer advocates and civil rights groups have raised concerns that the use of credit-based insurance scores results in members of certain minority groups paying more for insurance simply due to their race or ethnicity. Congress specifically directed the FTC to examine this issue. The FTC did this by attempting to determine whether credit-based insurance scores are correlated to differences in insurance risk, or whether the scores are instead a “proxy” for race or ethnicity.

Not surprisingly, the most hotly debated section of the report is the discussion of “proxy effect,” or lack thereof. Unfortunately, the report raises more questions than it answers on this important point. The roughly 1 percent proxy effect for race or ethnicity the FTC purported to find is more likely a measurement error due to limitations within the FTC’s methodology, as discussed below.

The FTC conducted three related analyses. In two of them, the FTC cites evidence that is inconsistent with the theory that credit scores are a proxy for race and ethnicity. In the third, the FTC’s finding that the scores have “little effect” as a proxy for membership in racial and ethnic groups misstates a non-existent relationship, according to a careful review by experts who have studied the report closely.<sup>5</sup>

In its first relevant analysis, the FTC examined whether credit-based insurance scores predict risk within racial, ethnic, and income groups. If such a relationship exists, the use of credit information as a risk assessment tool is valid regardless of racial, ethnic, or income group. The FTC observed an overall pattern across demographic groups and types of coverage, wherein the amount paid out in claims decreases as credit-based insurance scores increase. Based on these relationships, the FTC concluded that, “in short, because scores do predict risk within racial, ethnic, and income groups, they do not act solely as a proxy for these characteristics.”<sup>6</sup>

In the second analysis, the FTC considered whether average risk differed substantially by race, ethnicity, and income, finding that “there were substantial differences in the average risk of consumers in different racial and ethnic groups.”<sup>7</sup> Moreover, the FTC found that scores predict claims strongly even if controls for race, ethnicity, and income are included in the risk models, “which means that scores do not predict risk primarily by acting as a proxy for these characteristics.”<sup>8</sup>

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<sup>3</sup>See, e.g., 1) Lacey, William R., Arkansas Insurance Department, “A Report to the Legislative Council and the Senate and House Committee on Insurance and Commerce of the Arkansas General Assembly on the Use and Impact of Credit in Personal Lines Insurance Premiums,” July 20, 2007; 2) Texas Department of Insurance, “Report to the 79<sup>th</sup> Legislature on the Use of Credit Information by Insurers in Texas,” Dec. 30, 2004; and, 3) Miller, Michael J. and Richard A. Smith, Epic Actuaries LLC, “The Relationship of Credit-Based Insurance Scores to Private Passenger Automobile Insurance Loss Propensity,” June 2003.

<sup>4</sup>FTC report, at 3.

<sup>5</sup>Miller statement, at 3-5; Powell, Lawrence S., Supplemental Information on Insurance Scoring Requested by the United States House of Representatives Financial Services Committee, Subcommittee on Oversight and Investigations, June 23, 2008.

<sup>6</sup>FTC report, at 64.

<sup>7</sup>*Ibid*, at 66.

<sup>8</sup>*Ibid*, at 68.

Having determined that scores do not act *solely*, or *primarily*, as a proxy for race, ethnicity, or income, the FTC conducted a third analysis to determine whether there is *any* such effect. Here, the FTC added controls for race and ethnicity. Almost all of the difference in predicted loss was explained by other risk factors (e.g., age, driving record, geographic location), but approximately 1 percent of the difference could not be explained by a modeled factor other than race or ethnicity, according to the FTC. This statistically small differential was labeled a “proxy effect,” but outside reviewers believe it is more likely a data analysis or mathematical error.

In this regard, actuarial expert Michael Miller, who was directly involved in designing the auto insurance database that was used by the FTC, testified before the Illinois legislature that “the FTC simply did not have a database that was refined enough to accurately identify such a small proxy effect of 1.0% or less.”<sup>9</sup> According to Miller, “it is highly likely that the 1% and less proxy effect which the FTC ascribes to race would have disappeared entirely had the FTC been able to precisely and accurately control the analysis for all known risk factors.”<sup>10</sup> In Miller’s opinion, “the proper conclusion to be drawn from the FTC Study is that credit-based insurance scores are *not* proxies for race or income.”<sup>11</sup> (emphasis added)

University of Arkansas Professor Lawrence Powell examined the FTC report in detail when preparing testimony for a hearing of the House Financial Services Committee, Subcommittee on Oversight and Investigations. In a supplemental statement responding to questions asked during the hearing about the FTC’s third analysis of the so-called “proxy effect,” Professor Powell “conclude[d] without reservation that flaws in the model render the race and ethnicity findings invalid.”<sup>12</sup> Professor Powell focused on the FTC’s creation of an inaccurate territorial risk variable<sup>13</sup> that does not reflect the way that insurance companies actually use territorial risk, along with the application of this risk variable to several types of auto insurance for which its accuracy is even more problematic because of different claiming patterns for each type of coverage. For property damage liability, where the FTC was able to control more adequately (albeit still imperfectly) for geographic risk, the FTC researchers found “very little difference in the impact of credit-based insurance scores on predicted risk based on whether the model included controls for membership in a protected class.”<sup>14</sup> Because there was not a statistically significant valid proxy finding in the area where the data was the most accurate, Professor Powell has concluded that “the [estimated proxy] effect [in the other coverages] is actually the result of measurement error.”<sup>15</sup>

**Data Collection and Analysis.** Unable to refute that credit-based insurance scores benefit the insurance marketplace, critics instead have focused negative attention on the FTC’s data collection and analysis procedures.

The FTC report examined data voluntarily provided by five insurers representing 27 percent of the U.S. private passenger auto insurance market. The data included loss history as well as the applicable ChoicePoint credit-based insurance scores covering a two-year period. Because insurers do not have any data concerning the race and ethnicity of their policyholders, the FTC obtained such information from the Social Security Administration and Census Bureau. According to a statement by FTC Chairman Deborah Platt Majoras (joined by two other commissioners), issued upon release of the report, “all of this information was combined to create the FTC database, which the agency’s economists then used to evaluate the relationship between credit-based

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<sup>9</sup>Miller, at 4.

<sup>10</sup>*Ibid.*

<sup>11</sup>*Ibid.*, at 5.

<sup>12</sup>Powell, at 2.

<sup>13</sup>The territorial risk variable relates to the geographic area where insured automobiles are garaged and driven. Differences in territorial risk exist due to many factors, such as traffic density, safety initiatives, litigation climate, etc.

<sup>14</sup>FTC report, at 67-68.

<sup>15</sup>Powell, at 5.

insurance scores and risk, as well as the effects of these scores on racial, ethnic, or other protected classes.”<sup>16</sup>

The Chairman’s statement refutes assertions that the study data is unreliable because it was voluntarily provided by insurers. Moreover, regarding the FTC’s examination of the proxy issue, the Chairman’s statement reiterates a crucial point: “Because insurance companies do not acquire or maintain information about the race and ethnicity of their customers, they could not have manipulated the data with regard to race and ethnicity.”<sup>17</sup>

Nonetheless, the political volatility surrounding the credit issue has assured that, for some critics, the question of data collection has subsumed the report’s important findings regarding credit scores and insurance risk. Although major homeowners insurers had begun the process of working voluntarily with the FTC on the development of a separate homeowners insurance database, the Commission has bowed to political pressure and approved a resolution directing the use of a compulsory process for the collection of insurer data.<sup>18</sup>

There are many problems with this approach. As a legal matter, the FTC does not have the legal authority to use a compulsory process for this data collection. Moreover, even if such authority did exist, the FTC’s proposed order is broader than necessary to obtain the information needed for the homeowners study, raises serious privacy concerns, and imposes significant financial burdens on insurers subject to the order as well as the FTC.<sup>19</sup> The FTC is now considering comments received on the proposed order, and it is unclear how the data collection process for the homeowners study will proceed.

***Is There an Alternative to Credit-Based Insurance Scores?*** The final issue that the FTC was asked to assess was whether the Commission could develop a credit-based insurance score model that both predicted risk effectively and decreased the differences in scores among racial and ethnic groups. Despite substantial efforts, the FTC staff was not able to do so. As explained by Chairman Platt Majoras, “The FTC undertook a comprehensive empirical analysis of a reliable data set. We were not able to reach a conclusion about whether a model could be constructed with the desired effects. It is very difficult to prove that something could not exist, and so the conclusion that we do not really know if such a model could be constructed is not particularly surprising.”<sup>20</sup>

***What Lies Ahead?*** Credit-based insurance scores are likely to remain a volatile political issue. Policymakers should not lose sight of the significant consumer benefits that these scores have brought to the insurance system — benefits that are readily acknowledged by the FTC. “For example, scores permit insurance companies to evaluate risk with greater accuracy, which may make them more willing to offer insurance to high risk consumers . . . Scores also may make the process of granting and pricing insurance quicker and cheaper, cost savings that may be passed on to consumers in the form of lower premiums.”<sup>21</sup>

The danger is that politicians will disallow this beneficial underwriting tool even though there is not a feasible alternative. To do so would elevate political expediency over sound actuarial analysis and economics, to the ultimate detriment of the very consumers the politicians claim to serve.

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<sup>16</sup>Platt Majoras, Deborah, William E. Kovacic, and J. Thomas Rosch, statement entitled “Study of Insurance Scores Pursuant to Section 215 of the Fair and Accurate Transactions Act of 2003,” July 24, 2007, available at: [http://www.ftc.gov/os/2007/07/P044804\\_facta\\_statement\\_chairman\\_commissioners.pdf](http://www.ftc.gov/os/2007/07/P044804_facta_statement_chairman_commissioners.pdf), at 3.

<sup>17</sup>*Ibid*, at 6.

<sup>18</sup>Federal Trade Commission, “Resolution Directing the Use of Compulsory Process To Study the Effects of Credit Scores and Credit-Based Insurance Scores Under Section 215 of the FACT Act,” May 16, 2008, available at: <http://www.ftc.gov/be/080516riskscorecompulsoryprocessresol.pdf>.

<sup>19</sup>See American Insurance Association and National Association of Mutual Insurance Companies, “Credit-based Insurance Score—Homeowners Insurance—P044804,” June 18, 2008, available at: <http://www.ftc.gov/os/comments/homeownersinsurancemodelorder/535987-00008.pdf>.

<sup>20</sup>Platt Majoras, et al., at 9.

<sup>21</sup>FTC report, at 82.