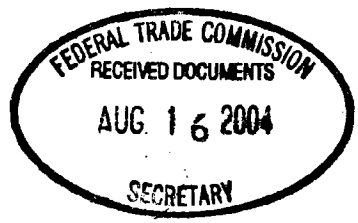
State Farm Insurance Companies



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Federal Trade Commission
Office of the Secretary
Room H-159 (Annex N)
600 Pennsylvania Avenue, NW
Washington, D.C. 20580

Re: FACT Act Scores Study, Matter No. PO44804

Dear Sir or Madam:

This comment letter is sent on behalf of State Farm Mutual Automobile Insurance Company and its affiliates ("State Farm") in response to the notice for public comment published in the *Federal Register* on June 18, 2004. State Farm appreciates the opportunity to submit comments as requested by the notice. Our comments will be restricted to the study of credit information in property and casualty insurance.

State Farm is the leading underwriter of private passenger automobile insurance in the United States, and is also the largest homeowner insurance carrier in the United States. State Farm specifically became interested in developing credit-based insurance risk models because they:

- Inhibit adverse selection resulting from the use of models by competing insurers;
- Serve as an efficient and inexpensive risk assessment tool; and
- Allow State Farm to compete more successfully and to underwrite more insurance business.

The State Farm group of companies provides insurance products and financial services to consumers across the United States. State Farm is generally recognized as a leader among insurers, with 71.6 million policies in the United States and Canada. It also meets consumers' financial needs through the State Farm Bank® and it offers mutual funds and variable products. The primary means by which State Farm serves its consumers is through State Farm licensed agents. More than 16,700 State Farm agents provide services and assist millions in meeting their insurance and financial product needs.

Section 215 of the Fair and Accurate Credit Reporting Act ("FACT Act") requires the Federal Trade Commission (FTC) and the Federal Reserve Board to conduct a study on the effects of credit scores and credit-based insurance scores on the availability and affordability of financial products. State Farm's understanding is that the FTC will be responsible for conducting a study of credit-based insurance scores, and our comments

focus specifically on methodology and research design recommendations for studying these scores.

The use of credit information for underwriting insurance is expressly permissible under the Fair Credit Reporting Act. Just as insurers discovered many years ago that age of the driver is predictive of future automobile insurance losses, they have more recently determined that certain credit characteristics are as well. Advanced technologies have allowed insurers to create insurance risk models that efficiently and objectively compile and interpret factors from consumer credit reports and produce credit-based insurance scores that are highly predictive of expected future insurance costs. The models incorporate sound underwriting and actuarial principles that promote insurance availability and encourage a competitive marketplace. Insurance risk scores are not used to assess "creditworthiness," but rather serve as one predictor of insurance loss cost. Insurance risk scores are used along with many other insurance risk factors, to more accurately assess insurance risk and to determine prices which are fair and appropriate.

1. ***How should the effects of credit scores and credit based insurance scores on the price and availability of mortgages, auto loans, credit cards, other credit products, and property and casualty insurance be studied? What is a reasonable methodology for measuring the price and availability of mortgages, auto loans, credit cards, other credit products, and property and casualty insurance, and the impact of credit scores and credit based insurance scores on those prices and availability?***

   It is most important that the FTC investigate whether the personal lines property and casualty insurance market is functioning properly and efficiently, and that different insurance companies are competing vigorously with one another to attract customers. We believe competition is the most important consideration when examining price and availability.

   We suggest the FTC might use a standard written survey and/or interviews with individual companies, in order to learn how those companies use credit information and/or risk scores, how their use has affected the availability and affordability of insurance coverage, and how it has affected market behavior and the level of competition in the insurance market.

   General industry measures should also be investigated, such as:

   - *Home ownership rates*
   - *Car ownership rates*
   - *Size of personal insurance residual markets*
   - *Percentage of consumers who are uninsured*
   - *Level of competition in the insurance markets*

   General economic relationships should also be considered. For example:

- *If risk scores are an efficient and inexpensive tool which help to predict future insurance risk and loss cost, then it stands to reason that their use would reduce the uncertainty and riskiness of the risk assessment and insurance process, and also reduce the expense associated with that process.*
- *If insurers are better able to measure risk and are therefore more confident in their ability to determine accurate prices, it stands to reason that they would be more able to provide coverage.*
- *If insurers are better able to measure risk and determine accurate prices, it stands to reason that the volatility of insurance results could be reduced, resulting in less capital requirement.*
- *If variations in the use of risk scores by companies result in more differences in the specific manner in which insurers assess risk (in fact, some companies might not use credit information at all), it stands to reason that those differences would lead to increased competition among insurers, and more choices for individual consumers.*

One reasonable quantitative approach to studying automobile or homeowners insurance risk assessment would be to first develop one aggregated database from the insurance industry and insurance risk score providers, and then apply multivariate analysis in order to investigate the role of credit information in the insurance risk assessment process.

The aggregated database would probably need to be organized so as to provide standardized individual characteristics, individual insurance risk scores and subsequent individual insurance loss (total cost, or claim frequency) results. Extreme care would be required to protect the confidentiality of individual consumers and insurance companies, as well as to comply with all FCRA requirements.

The insurance industry could provide a list including customer identification, insurance risk characteristics and subsequent insurance loss results. One or more providers of insurance risk scores could then append a standard insurance risk score. A dataset could then be provided to the FTC, without individual consumer or company identification information.

The FTC could then apply multivariate analysis to the data, in order to develop models which would predict future insurance loss results. This would allow the FTC to investigate the role of credit-based insurance risk scores in the insurance risk assessment process.

2. ***An effect can often only be measured relative to a counterfactual (that is, relative to some hypothetical alternative situation). To determine the effects of credit scores on the price and availability of credit products, what is a reasonable counterfactual to the current use of credit scores? To determine the effects of credit-based insurance scores on the price and availability of property and casualty insurance, what is a reasonable counterfactual to the current use of credit-based insurance scores?***

Similar to our response to Item 1, we believe competition is what benefits consumers the most as it relates to economic supply, demand, and price. Thus, we suggest that the FTC examine how the use of credit-based information has affected the competitive market place. If the use of credit information has enhanced competition through inexpensive, timely, objective and highly predictive risk assessment, then it stands to reason that it adds to the health of the overall insurance market as it relates to availability and price.

From a statistical perspective, State Farm suggests the FTC could build a multivariate analysis (a "cost of insurance model" or a "claim frequency model") which does not include a credit-based insurance score as an independent variable, and another model (or models) which does include score. The multivariate model which excludes the risk score could act as a baseline of comparison.

3. ***Paragraph (a)(2) of section 215 requires a study of "the statistical relationship, utilizing a multivariate analysis that controls for prohibited factors under the (ECOA) and other known risk factors, between credit scores and credit-based insurance scores and the quantifiable risks and actual losses experienced by businesses." (The ECOA "prohibited factors" are race, color, religion, national origin, sex or marital status, and age.) What is an appropriate multivariate technique for studying this relationship? What data are available to undertake such an analysis?***

In order to conduct a proper statistical study, State Farm suggests a multivariate analysis technique such as multiple regression should be used. For each individual consumer, the analysis would need to include a number of the most important other insurance risk variables (such as geography, age of driver and prior driving record, for auto insurance), in addition to credit-based risk scores and demographic factors of interest to the FTC.

The insurance industry could provide an aggregated database which could include the necessary other insurance risk factors, as well as subsequent insurance loss results. A vendor, such as Fair Isaac or ChoicePoint, could provide a standard insurance risk score. We believe a standard vendor score should be utilized for this study.

To properly conduct this type of study would require obtaining accurate and reliable information about each individual's income, ethnicity and race. This demographic information would need to be obtained from some other source, since it is not available from insurance companies. We are unaware of any data source that could be used to attach accurate and reliable information about each individual consumer's income, ethnicity or race. This type of data can be purchased commercially, but its source of origin, accuracy and reliability are very questionable, making such data inappropriate for use in an exacting study such as this. Therefore, the FTC may

conclude that the data is not available to perform this type of study properly and correctly. However, based upon other questions posted later in this notice, we recognize the FTC anticipates that it may be necessary to conduct the study using proxies for individual demographic information. If proxies for individual demographic information are used, extreme care is needed to avoid erroneous conclusions.

4. ***What is an appropriate methodology to determine whether the use of credit scores or credit based insurance scores results in "negative or differential treatment" of ECOA-protected classes?***

Any risk factor will affect some consumers negatively and others positively. Any rating factor will cause some consumers to pay more and others to pay less. No risk factor can be expected to be totally neutral. So, it is important for the FTC to determine standards or thresholds before the study results are derived.

State Farm suggests that "negative or differential treatment" should be studied only along with insurance risk. Indeed the purpose of using credit information is to help predict future insurance risk.

State laws require that insurance rates be based upon the expected cost of providing coverage. Rates which are not cost-based would be unfairly discriminatory.

When a group of customers represents a different level of risk than other groups of customers, that first group is not being treated unfairly just because it is asked to pay a higher premium (or average premiums). A group of customers should only be considered to be treated negatively and unfairly if the premium charged is different, but is not associated with a difference in the insurance risk or expected loss.

Indeed, any rates which would be forced to be "not based on cost" would be unfair and would negatively impact the overall market, and all consumers.

For example for some types of automobile insurance coverage, rates vary according to the make and model of car. It is generally more expensive to replace or repair a new expensive car, than a smaller, older and less expensive car. This results in differences in the expected cost of insurance loss, a difference in the insurance risk. Therefore, insurance rates are higher for the newer, more expensive car. If insurers are allowed to vary prices according to the model of car, then it stands to reason that coverage can be made readily available to all consumers at a fair price, regardless of what car they own. This is good and fair for everyone.

However, if "model of car" were not permitted as a risk factor for insurers to consider, everyone would be worse off. There would be less competition in the market, and in the end, consumers would be hurt. For example if rates were required to be the same, people who own the older and less expensive cars would be unfairly required to pay higher prices, more than their fair share. One might think that those

who own newer and more expensive cars would benefit, but it stands to reason that if insurers are asked to insure these cars at inadequate rates (prices less than the expected total cost to provide insurance coverage), that availability of coverage would suffer. No one wins, everyone loses.

The use of insurance risk scores is not related to collecting more money or less money in total. It is related to collecting the fair and right amount from each consumer, to make insurance rates fair for everyone. If credit information were not considered, customers less likely to submit claims would pay more than their fair share so that consumers more likely to submit claims could pay less than their fair share. Consequently, if insurance risk scores are predictive of insurance risk, this difference in risk should not be ignored even if the scores result in different effects on different classes.

In order to study "negative treatment," State Farm suggests the FTC might investigate whether or not credit information is predictive of future insurance loss cost, within certain groups or classes of consumers. Another possible alternative would be for the FTC to investigate whether insurance risk scores could be used to successfully predict an individual consumer's demographic class or group.

- *If risk scores are found to be predictive of expected loss within the different demographic classes or groups (income, ethnicity, race) as well as overall, then it stands to reason that all groups or classes would be receiving the same treatment.*
- *If risk scores could not be used to successfully predict an individual's class or group, then it stands to reason that insurers could not use scores as a method of unfair discrimination and that all groups would be receiving the same treatment.*

5. ***What is an appropriate methodology to determine whether the use of specific factors in credit scores or credit based insurance scores results in "negative or differential treatment" of ECOA protected classes?***

State Farm uses the insurance risk score for decision-making, not each individual credit element. We believe that many or most other companies do the same. State Farm suggests that if the insurance risk score does not result in negative and unfair treatment, then each individual credit element need not be investigated.

If it is found that the scores do result in negative and unfair treatment, then the individual credit elements used to determine the score could be investigated. However, this would add a great deal to the data and analysis requirements.

6. ***What is an appropriate methodology to determine whether there are factors that are not considered by credit scores or credit based insurance scores that result in "negative or differential treatment" of ECOA protected classes?***

If the question refers to identifying other credit elements which might result in "less negative or differential treatment," we would point out that the method of building the risk score models identifies those credit elements which are most predictive of future insurance loss. Therefore, restricting the variables used to develop a risk score would reduce the predictive power of the models. In turn, this would be harmful to competition, the insurance market and ultimately to insurance consumers.

Also, it should be pointed out that there would be an endless set of different possibilities to investigate, and there would be no clear finishing point. An appropriate methodology should not be construed to require scrutiny of every single combination of credit factors and their possible variations, but should recognize the expense and labor involved in light of the possible outcomes.

7. ***In order to address paragraphs (a)(2) and (a)(3) of section 215, data are needed on the geography, income, ethnicity, race, color, religion, national origin, age, sex, martial status, or creed of borrowers, potential borrowers, insurance customers, or potential insurance customers. Are these data available, and if so, where?***

An aggregated database from insurers could provide information about some but not all of these factors.

Information on race, color, religion, ethnicity, creed, national origin and income is not requested in State Farm's applications forms, nor is it requested in subsequent transactions with policyholders. To our knowledge, there is no insurance database which includes this information.

This demographic information would need to be obtained from some other source, since it is not available from insurance companies. We are unaware of any data source that could be used to obtain accurate and reliable information about each individual consumer's income, ethnicity or race. This type of data can be purchased commercially, but its source of origin, accuracy and reliability are questionable, making such data inappropriate for use in an exacting study such as this. Therefore, the FTC may conclude that the data is not available to perform this type of study properly and correctly.

There are many other problems associated with studies related to demographic factors like income, ethnicity and race;

- *They introduce a divisive issue where it does not belong*
- *They are based upon false stereotypes that certain groups do not manage finances as well as other groups*
- *They perpetuate those same false stereotypes*
- *They can lead to poor public policy decisions that result in harmful economic consequences*

- *They can lead to unfair negative treatment of others, such as people who file fewer insurance claims, including millions of minority and low income consumers.*

8. ***If the data discussed in question 7 are not available, what proxies are available for the geography, income, ethnicity, race, color, religion, national origin, age, sex, martial status, or creed of borrowers, potential borrowers, insurance customers, or potential insurance customers?***

   If accurate and reliable data about income, ethnicity, race, color, religion, national origin and creed of individual consumers is not available, the study cannot be conducted properly. But if such a study is to be conducted with proxies, the best alternative might be to use a very granular unit for which reliable and accurate information can be obtained. That might be 2000 U.S. Census data or 9-digit ZIP Code. It is State Farm's understanding that only summarized Census data would be available for this purpose, and that Census data regarding things like income, ethnicity, race, religion and creed would be subject to uncertainty.

   Furthermore, extreme care and attention will be required to control for the other risk factor of geographic area, especially if some geographical area such as Census block is to be used as a proxy for individual demographic information. It will be important for the FTC to work with one or more insurance experts with appropriate actuarial credentials who understand the specific data elements, insurance risk assessment processes and insurance pricing systems.

9. ***If there are proxies for the geography, income, ethnicity, race, color, religion, national origin, age, sex, marital status, or creed of borrowers, potential borrowers, insurance customers, potential insurance customers, what type of analysis would allow inferences to be drawn using the proxies instead of actual data on individual characteristics? What limitations are there to the inferences that can be drawn using proxies in place of data on individual characteristics?***

   If the study must be conducted with proxies for individual information, granular aggregations like 2000 Census block might work best.

   However, even if the FTC were to study Census blocks which are predominately of a certain demographic group or class as a proxy for that group, many members of the group would be excluded.

   For example, the FTC might investigate the predictability of insurance loss cost based on credit information, only for a subgroup of the population made up of those Census blocks with a high concentration of residents, of a certain group. Such a study would ignore all of the group members who live in all other Census blocks (this could be a majority of the group). Furthermore, the higher the percentage of the population that is required for any Census block to be used as a proxy for a given group or class, the more of that group residing in other Census blocks will be

excluded from the analysis. Yet the lower that same required percentage is set, the less likely the Census block appropriately serves as a proxy.

Something more specifically related to insurance loss cost might also need to be included in this part of the study. Certainly, care will need to be taken to properly recognize and control for other risk factors (like geographic location) if comparisons are made between different demographic classes or groups. Failure to do so may produce false and spurious results, because other study variables would act to compensate for the omitted or incomplete controls in the regression model. Without proper controls, any differences identified in the study, for example, might be entirely due to differences in geographical location.

10. ***One potential proxy for individual characteristics may be Census data about the location where a borrower or insurance customer resides. What type of analysis would allow inferences to be drawn using data about the characteristics of the location where a borrower or insurance customer resides instead of data on individual characteristics? What limitations are there to the inferences that can be drawn using data about the characteristics of the location where a borrower or insurance customer resides in place of data on individual characteristics?***

    It is good that the FTC recognizes the critical importance of the geographical risk factor. Special and extreme care will need to be taken to properly recognize and control for geographic location differences if comparisons are made between different demographic classes or groups. We suggest that the FTC work with one or more insurance experts with appropriate actuarial credentials who understands the specific data elements and how geographic location can affect insurance risk assessment and insurance pricing.

Once again, State Farm expresses its appreciation for the opportunity to comment on the notice. If you have any questions or if we can be of assistance to you, please do not hesitate to contact us.

Sincerely,

Regina K. Dillard

Rkd/det