

ALASKA LEGISLATURE COMMITTEE FILES 2001-2002 8672

10345 HOUSE LABOR & COMMERCE

190

Senator Ben Stevens  
Chairman of Senate Labor and Commerce  
March 5, 2002  
Page 4

advise its customer and to furthermore advise its customer of how to obtain corrective action. Any information that is inaccurate, incomplete or unverifiable must be deleted.

The fifth error is the attempt to categorize those the author of this statement claims to be unfairly discriminated against. One must remember that credit based scoring is merely one factor used among many. It is used differently by different insurers. Those who are good risks will continue to be rewarded by the market, so long as the market is allowed to function freely. If the market is allowed to function freely, those who are poor risks will pay a premium commensurate with that risk, a premium which is approved in advance by the Division of Insurance.

It is difficult to respond specifically to anecdotal claims of unfairness without knowing the details of each situation in question. But we do know that the generalizations contained in the Sponsor Statement are not accurate. We do not believe it accurate to claim that any minority is unfairly discriminated against by the use of credit based scoring. To make such a claim is to also claim that any such minority does not responsibly manage their credit, a claim we believe is not supported. Nor is it accurate to claim that credit based scoring favors the wealthy. Credit based scoring does not consider income, but rather whether one responsibly manages his or her credit. Many lower income people do responsibly manage their credit and thus would not be adversely affected by credit based scoring.

We do not believe the implication that people without a credit history usually pay 25% more simply because of credit based scoring is accurate. Credit based scoring is typically used in connection with other factors to determine an appropriate rate. While this tool is used differently by different insurers, we are unaware of any support for such a blanket statement such as this. We likewise are not aware of any support for the implication that small business owners pay 40% more simply because of credit based scoring.

The sixth error we wish to respond to is the argument that Hawaii insurance premiums are among the lowest in the nation, somehow because Hawaii does not allow the use of credit history. We believe the decreases in Hawaii automobile insurance rates are due to significant reform of the Hawaii no fault law and to repeal of the take-all-comers law, which helped restore competition to the marketplace. None of these decreases had anything to do with lack of credit use.

We know of no logical connection between the level of insurance premiums consumers pay as a whole and credit based scoring. Insurance premiums are determined by the frequency of loss and the severity of loss. Credit based scoring has no effect on either. It simply provides insurers with one more tool to use to more fairly allocate the cost of insurance to those with the higher levels of risk. Conversely, those with lower levels of risk pay less.

Senator Ben Stevens  
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Page 5

The seventh error we wish to respond to is the claim that the "insurance industry wants to utilize this easy method to raise rates." We again are not aware of any logical basis for this statement. We have a significant share of both the Alaska automobile and homeowner markets. We are not utilizing credit based scoring to raise rates. To our knowledge, no insurer has utilized credit based scoring to support a claim for across the board rate increases. Even if an insurer tried to make such a claim, we doubt if any regulator would approve it.

The final claim we wish to respond to is the claim that credit based scoring will make it more difficult and expensive for consumers to obtain insurance. That certainly has not been our experience nor has it been the experience of our policyholders. It is hard for us to understand how a tool that has proven to be an accurate predictor of risk and a tool that accordingly will allow insurers to more fairly allocate the cost of that risk will make it either more difficult or expensive for consumers to obtain insurance. The goal of a more fair allocation of the cost of risk is a goal that is in the best interests of all of our policy holders. This tool will help us achieve that goal.

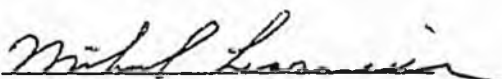
As you consider this legislation, we hope you will keep in mind the fact that as set forth above, the insurance industry is already heavily regulated. Any rate changes already must be approved in advance by the Division of Insurance. It is already an unfair trade practice to unfairly discriminate. Clearly, there are adequate tools already in place to prevent an insurer from somehow misusing credit based scoring, which is the real concern of the sponsor.

We do not believe the intent of the sponsor is to prevent a more fair allocation of the cost of risk. Yet the effect of this legislation is to do just that. We strongly believe this to be contrary to the interests of our policyholders as well as to the vast majority of Alaska consumers.

We thank you for your interest in this legislation. Please let us know should you have any questions relating to this issue.

Sincerely,

LESSMEIER & WINTERS

By:   
Michael L. Lessmeier

cc: Members of Senate Labor and Commerce Committee

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Via Fax: 907 - 465 - 3872

March 5, 2002

The Honorable Ben Stevens  
State Capitol, Room 119  
Juneau, AK 99801-1182

Dear Senator Ben Stevens:

ChoicePoint opposes Senate Bill 320 which if enacted would prohibit the use of credit information for insurance underwriting. ChoicePoint opposes the restriction on the use of credit because consumers and insurers benefit when insurance companies make informed underwriting decisions based on a consumer's complete characteristics. Senate Bill 320 is bad for consumers and insurers and jeopardizes the insurance savings consumers enjoy.

Credit scores are used by insurers as a predictive tool in the insurance underwriting and pricing process and are tied directly to a consumer's behavior, not a classification. A credit score is purely an analytical, non-biased assessment of historical financial information about a consumer without regard to race, income, or gender. The use of credit information in the insurance underwriting process is governed and expressly allowed by the federal Fair Credit Reporting Act (FCRA). The FCRA provides important consumer protections by requiring insurers to notify their customer any time an adverse action is taken based on a credit report. Also, consumers may review their credit reports and challenge any information they believe is in error.

The use of a consumer's credit history, along with other predictive factors such as driving and claims history, in the underwriting process benefits the consumer by providing lower insurance rates. By not basing the underwriting decision solely on credit information and using a consumer's complete characteristics, the insurance company's ability to properly assess future risk and avoid possible loss makes lower insurance rates possible for most consumers. The use of credit information also helps some consumers who might have less than perfect driving records receive lower insurance rates, makes insurance available to some consumers who might otherwise be uninsured, and increases the availability of insurance in the broad market. More than 90 percent of the population have good credit histories. The use of credit reports by insurance companies gives this 90 percent of the population a better chance to find insurance.

Study after study bears out the fact that the better a person is at handling his or her finances, the better that person is at handling his or her insurance. The following studies show a strong correlation between credit histories and insurance risks:

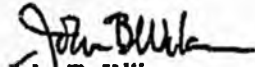
- The Tillinghast-Towers Perrin firm studied data from nine home and auto insurance companies to determine if there is any relationship between credit scores and loss ratios. In eight companies, Tillinghast determined that there was a 99% chance of a relationship, and in the ninth company, it established a 92% probability of a link.
- A survey conducted by the National Association of Independent Insurers (NAII) found that companies that use credit reports for underwriting assessment report that automobile insurance claims are 60% higher for drivers with poor credit rating. Insurance companies

- The Arizona Department of Insurance collected information that insurers used to justify their use of credit reports as a predictor of loss. The Department then turned the information over to an independent actuarial consultant. The consultant verified that the use of credit reports is a valid and sound underwriting tool.

The use of credit information in insurance underwriting decisions is an important benefit to consumers and insurers alike. By restricting its use, you are diminishing the insurance industry's ability to effectively identify risk and write insurance, determine appropriate premiums for insurance coverage, and affecting the insurance industry's ability to offer lower insurance rates to consumers, your constituents. ChoicePoint hopes that this underwriting tool is not taken away from consumers and insurers.

Thank you for your time and consideration of ChoicePoint views on this issue.

Sincerely,



John B. Wilson

Assistant Vice President - Modeling and Analytics

# National Association of Professional Allstate Agents

Toll Free: 877-627-2248 Fax: 877-621-1786 www.napaausa.org  
42015 Ford Road #261 • Canton, MI 48187-3669



Representative Lisa Murkowski  
Alaska House of Representatives  
State Capitol—Room 408  
Juneau, AK 99801

April 19, 2002

Dear Representative Murkowski,

The National Association of Professional Allstate Agents (NAPAA) has studied the issue of "credit scoring," or "insurance scoring," and because Allstate was one of the earliest users of credit scoring algorithms to underwrite and rate insurance policies, Allstate insurance agents have the most experience dealing with this system and its adverse effect on our customers. Our conclusions based on this unique experience are:

- It is a secret methodology, not subject to examination by Insurance Commissioners, which affects the premium and/or acceptance of insurance applicants and existing customers.
- Credit scoring appeared when insurance companies were denied the ability to overtly Redline geographical areas and certain minority groups. Credit scoring is a new method of Redlining meant to replace the old method. It is Redlining by economic class.
- Particularly affected are minorities, low-income groups, senior citizens and others who rarely, or never, make use of credit. Other affected people are those who have divorced, the death of a spouse, large medical bills or even those who check their own credit regularly to be sure the information is accurate.
- The insurance/credit score is a moving target - Today one may have a "score" of 4, next month a score of 2. The consumer just has to hope they get lucky when they apply, because they are stuck with whatever the score happens to be at that time, with no possibility of improvement, for the life of the policy.
- Credit scoring allows a company to take rate increases at their sole discretion by merely adjusting their never examined and secret algorithm by changing the weighting of certain values.

Credit scoring for insurance is not socially acceptable violating values that Americans hold dear. The American way is to be measured on those things that are directly relevant to the subject: Tickets, accidents, vehicle usage etc. for auto insurance and condition of premises, past losses and upkeep for property insurance. Credit scoring for insurance purposes is Redlining; Economic Redlining. NAPAA strongly opposes Redlining, thus we have no choice but to oppose credit scoring.

Insurance commissioners, in various states, are conducting hearings to better understand how the use of credit impacts the insurance consumer. Our members, captive Allstate agents, wish to participate and contribute at these meetings since they are closest to the consumer and see how implementation of credit directly affects their clients. However, they have been discouraged to do so under threat of retaliation by Allstate. If an agent's presence at these hearings were made requested we would make every effort to assure the presence of a NAPAA representative.

It has come to our attention that the Alaska Independent Insurance Agents & Brokers have visited the capitol and expressed their opposition to HB 395. They do not represent the Allstate agents in Alaska. We represent the 52 agents of Allstate in Alaska and have done so since 1989. The AIIAB, according to their website, represents 55 independent agencies (some may have appointments from Allstate) and 43 associate members in Alaska.

Sincerely,

  
Ron Mathison  
Director of Agent Affairs

**Subject: Our Support of HB 395**

**Date: Mon, 22 Apr 2002 13:32:37 -0700**

**From: "NAPAA" <HQ@napaausa.org>**

**To: "Drew Scalzi" <Representative\_Drew\_Scalzi@legis.state.ak.us>, "Eldon Mulder" <Representative\_Eldon\_Mulder@legis.state.ak.us>, "Beverly Masek" <Representative\_Beverly\_Masek@legis.state.ak.us>, "Beth Kertula" <Representative\_Beth\_Kertula@legis.state.ak.us>, "Ethan Berkowitc" <Representative\_Ethan\_Berkowitz@legis.state.ak.us>, "Harry Crawford" <Representative\_Harry\_Crawford@legis.state.ak.us>, "Joe Hayes" <Representative\_Joe\_Hayes@legis.state.ak.us>, "Richard Foster" <Representative\_Richard\_Foster@legis.state.ak.us>**

Dear Representative,

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2. Credit scoring appeared when insurance companies were denied the ability to overtly Redline geographical areas and certain minority groups.
3. Credit scoring is a new method of Redlining meant to replace the old method.
4. Particularly affected are minorities, low-income groups, senior citizens and others who rarely, or never, make use of credit. Other affected people are those who have had divorces, the death of a spouse, large medical bills or even those who check their own credit regularly to be sure the information is accurate.
5. The insurance/credit score is a moving target - Today one may have a "score" of 4, next month a score of 2. The consumer just has to hope they get lucky when they apply, because they are stuck with whatever the score happens to be at that time, with no possibility of improvement, for the life of the policy.
6. Credit scoring allows an insurance company to take rate increases at their sole discretion by merely adjusting their never examined and secret algorithm by changing the weighting of certain values.

Credit scoring for insurance is not socially acceptable. It violates the values Americans hold dear. The American way is to be judged on those things that are directly relevant to the subject: Tickets, accidents, vehicle usage etc. for auto insurance and condition of premises, past losses and upkeep etc. for property insurance. Credit scoring for insurance purposes is Redlining. NAPAA strongly opposes Redlining, thus we have no choice but to oppose credit scoring.

Insurance commissioners, in various states, are conducting hearings to better understand how the use of credit impacts the insurance consumer. Captive Allstate agents wish to participate and contribute at these meetings since they are closest to the consumer and see firsthand how implementation of credit directly affects the customer. However, they have been

discouraged to do so under threat of retaliation by Allstate. If an agent's presence at these hearings were requested or required, we would make every effort to assure the presence of a NAPAA representative.

Sincerely,

Ron Mathison.  
NAPAA  
Director of Agent Affairs  
877-627-2248

★  
**North Star Examinations, Inc.**

*Insurance Regulatory Consultants and Examiners*

P. O. Box 210643

Auke Bay, Alaska 99821-0643

Phone (907) 789-9497

Fax: (907) 789-1287

Email dkoch@alaska.com



April 18, 2002

Honorable Kim Elton  
Senator,  
Alaska State Senate

Juneau, AK 99811

**Re: Credit History and Credit Scoring in Insurance**

Dear Senator Elton

I read in the paper yesterday that you have proposed legislation to prohibit the use of credit history and credit scoring in the State of Alaska for underwriting and selection of personal automobile insurance and homeowners insurance. I support your efforts to do so and would like to offer some observations that may be of interest.

By way of background, I am a retired state employee (as of 3/31/97), having worked at the Alaska Division of Insurance for more than 27 years as its Chief of Market Surveillance. I was responsible for rate review, form review and market conduct examinations. I also spent considerable time working with legislators and staff on a variety of insurance issues. Currently I continue to reside in Juneau and operate a small consulting firm that provides market conduct examination services for state insurance departments. I have no Alaska contracts. States currently using my services include Delaware, New Mexico and North Dakota. For these states I establish examination processes, develop state specific handbooks on how to perform such examinations, train examiners, supervise and conduct examinations. My views do not reflect those of the states for whom I provide services, they are my own.

In 1995 when credit history was first being used by insurers in personal automobile insurance, The National Association of Insurance Commissioners appointed a working group to look into the issue and ultimately develop a white paper as a guide for states considering what to do about the issue. I chaired the initial working group but after several meetings asked Maryland to assume the chair since I was somewhat over-committed at the time. I continued to remain active with the working group. I can recall one meeting in Northbrook Illinois that was of particular interest. We had about a dozen

regulators from a number of states meet with an insurer to gain an understanding why they felt the credit history should be an underwriting consideration. Our group was comprised of a good cross section of expertise including actuaries, economists, and examiners.

The company data presented suggested that there was a considerable correlation between the propensity for loss and credit history. There were several problems for which we could not elicit satisfactory answers and essentially these remain unchanged today. They are:

1. The data was based on the Company's customer database and since that had spent considerable time, effort and money to develop the system, they did not want another company to copy their data and use it as their own. They felt that such action, which is fairly commonplace, would place them at a competitive disadvantage. We were not able to look at the underlying data or supporting calculations. The data would appear to be more supportive of rate differentials rather than selection differentials.
2. In our attempts to understand how poor credit could tie into increased likelihood of loss only one person made an analytical observation that made some sense. He said that the intended form of credit scoring was in a sense a quantification of responsibility. It would appear that poor credit history is a reflection of responsibility and attitude that according to the presenters carried over into how a person drives an automobile or does things that might reduce an insurers exposure to loss. This tie was not demonstrated, it was theorized.
3. The insurer at that point had not developed the process to the point that duplication for factors already considered in other underwriting considerations could be avoided.
4. Fiscal emergencies were not factored out of the process. Someone with a longstanding good credit history who has an expensive medical emergency that temporarily revises the persons payment history would not receive special consideration even though the underlying attitude to paying on their commitments was unchanged. A similar issue arises in a depressed economy when layoffs occur. Being unable to continue to meet obligations is not the same as being unwilling to meet them and credit scoring does not make the distinction.

Many insurers these days are trying to outsource functions or parts of functions to independent vendors. They do this in part because it is difficult for the regulator to achieve a comprehensive view of the company's operations. They also do it for perceived gains from savings on expenses. The savings often come from reduced management oversight of the outsourced function.

During the past few years, I have been involved in the examination of eight major auto and homeowners insurers, six of those directly and the other two as a supervisor. Some do not use credit history, some do not use credit scoring. Some use credit only for placement in a rating tier. Some use credit only on new business. I believe that the

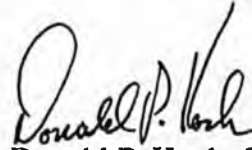
system as I have seen it is inherently flawed and are unfairly discriminatory. Insurance is by its nature discriminatory and that is not unreasonable. Unfair discrimination is quite another story. Some examples of why I think Credit History and Credit Scoring is unfair are:

1. If credit history and credit scoring is intended to reflect responsibility then it is unfair because that connection has not been established and no efficient method has been established to identify exceptions.
2. Most insurers use credit scoring only at the initial underwriting and that is to determine into which rating tier the person should be written. That is unfair since attitudes can change, credit history can change, and no opportunity is provided to assure that the selection criteria and measurement has remained unchanged. If a person's score improves is he/she locked into the tier that resulted from the initial review? This might arguably be a conflict with the federal Fair Credit Reporting Act that contains a limit on how long the information in a credit report can be used.
3. The fact that scoring information is secret is unfair. If the information developed on a person and how it is used is secret, how is anyone to know that it has been properly used? It makes the Insurance Director's job to oversee a fair insurance marketplace very difficult if not impossible to achieve.
4. The nature of the scoring is that a large transaction such as the purchase of a house has a negative influence on the credit score thus presenting the buyer with problems when he/she attempts to insure the house. It's a sort of "Catch 22" kind of effect which comes up frequently in complaints. A contact with other state insurance departments concerning their complaints on credit history and credit scoring might prove enlightening.

At this juncture, my own preference is for an outright ban on the use of credit history and credit scoring for personal lines automobile insurance and homeowners insurance. If the legislature wishes to proceed with some form of limitation, I would urge caution because that would tend to give a flawed program sanction. Better not to act or to assure that the Director of Insurance has adequate rulemaking authority to provide for protection of the public. I would also urge caution about the structure of a ban because there are insurance lines of business where credit history review is appropriate, for example some of the commercial financial products and possibly fidelity and surety products.

I am sorry that my late awareness of this as a legislative issue in Alaska and my somewhat bizarre travel schedule prevents me from providing more direct input. I will be on travel status for the next three weeks but can be reached at my cell phone (907) 321-4084.

Very truly yours,

  
Donald P. Koch, CIE  
President

## National Association of Professional Allstate Agents

Toll Free: 877-627-2248 Fax: 877-621-1786 www.napaausa.org  
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Representative Lisa Murkowski  
Alaska House of Representatives  
State Capitol—Room 408  
Juneau, AK 99801

April 19, 2002

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Sincerely,

  
Ron Mathison  
Director of Agent Affairs

# AARP Alaska

March 2, 2002

Honorable Jim Murkowski, Chair  
House Labor and Commerce Committee  
Alaska Capitol Room 408  
Juneau, AK 99801

*file  
copy*

RE: HB 395 (Crawford) – Support

Dear Chair Murkowski:

On behalf of the 112,000 AARP members in Alaska, we urge you and your colleagues on the House and Labor Commerce Committee to support HB 395, authored by Representative Harry Crawford, a member of your committee.

HB395 addresses problems arising from insurance companies using "credit scores" to set rates for individuals.

As you know, retirees are the group least likely to use credit cards and to have debt. Five factors are primarily used for credit scoring:

- payment history
- amount of debt
- credit account history
- recent credit history
- types of credit

If an individual does not use credit regularly, s/he may face a negative discriminatory score on the credit report.

We understand the industry's interest in using tools that may help them identify poor risks, but we do not believe older individuals who do not use credit should be forced to pay higher insurance premiums simply because they are reluctant to build up debt.

AARP Alaska recommends an "AYE" vote on HB 395.

Should you have any questions about our position, please feel free to contact Marie Darlin (586-3637), Coordinator of the AARP Capitol City Task Force; Patrick Luby (907-762-3314), AARP Legislative Representative; or me (907-245-5259).

Thank you for your consideration.

Sincerely,

*Marguerite Stetson*

Marguerite Stetson - Executive Council Member for Advocacy

Cc: Representative Andrew Halcro  
Representative Pete Knott  
Representative Kevin Meyer  
Representative Norman Rokeberg  
Representative Joe Hayes  
Representative Harry Crawford

## Is this good credit?

- From 1997 to 2001 the total annual of credit increased 76 percent.  
*Federal Reserve Statistical Release*
- Morgan Stanley Dean Witter & Co.
  - personal bankruptcies will continue to rise through the third quarter of 2002 (will peak at 450,000)
  - this is a 29% increase from the third quarter of 2001
  - the number of bankruptcies follows roughly the same path as unemployment
- Between 1990 and the end of 1996, aggregate credit card debt more than doubled  
*Consumer Federation of America*
- 2001 – Average credit card debt rose from \$879 to \$2746 in two years  
*Nellie Mae*
- 2001 - The number of young people filing for bankruptcy increased by 50% in the past ten years.  
*USA Today*
- 2001 – The overall bankruptcy rate increased 40% in the past ten years.  
*USA Today*
- In the second quarter of 2001, the percentage of delinquent credit card payments rose to 5 percent from 4.3 percent. Card write-offs increased to 6.4 percent from 5.6 percent.  
*Newsweek*
- Bankruptcy filings are now on track to surpass the record-breaking year of 1998 when 1,442,549 new cases were filed.  
*Administrative Office of the US Courts*
- The number of Americans seeking credit counseling and entering debt management programs has risen sharply over the last ten years. In 1998 NFCC assisted over 1.4 million Americans, about 504,000 of these consumers who carried a debt of \$2.3 billion.  
*Consumer Federation of America*
- The percentage of 33-35 year-olds who are more than 60 days late on credit payments jumped by more than a third from 1992-1998; for 45-54 the jump was almost two-thirds  
*"Drowning in Debt" Gary Belsky*

AIC  
Winter Meeting  
Chicago, Illinois  
Saturday, December 8, 2001

Market Conduct & Consumer Affairs (D) Committee

*A*

*Public Hearing*

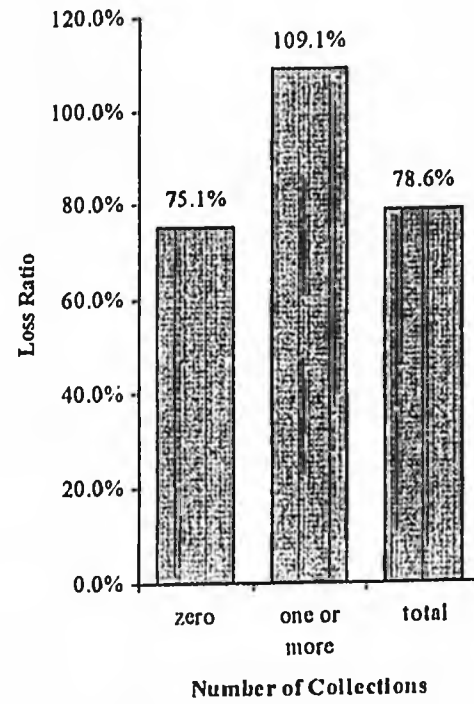
*On*

*The Use of Credit Scores in Underwriting and Rating*

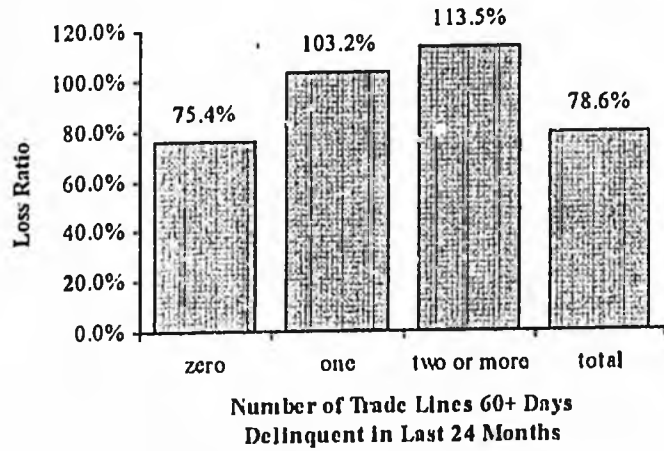
Steven B. Larsen  
Insurance Commissioner  
Maryland

## Relationship of Three Credit Characteristics to Automobile Insurance Loss Ratios

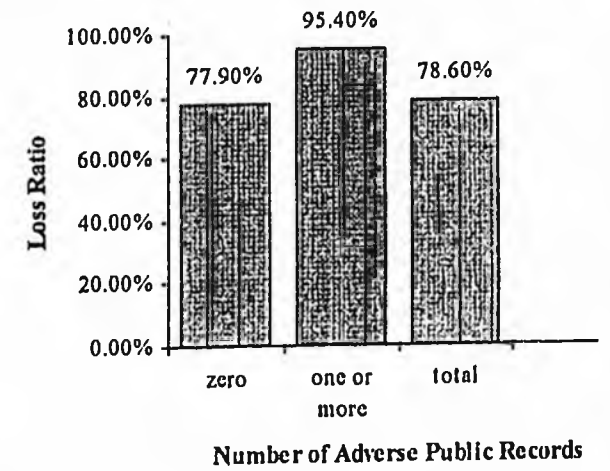
Relationship of Loss Ratio to Number of Collections



Relationship of Loss Ratio to Number of Credit Lines  
60+ Days Delinquent in Last 24 Months

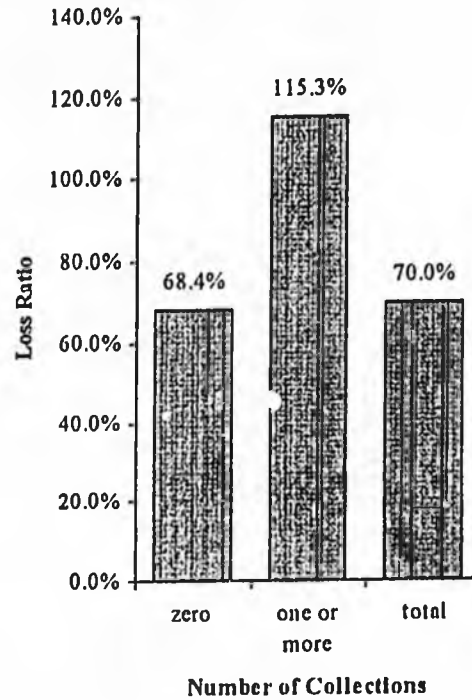


Relationship of Loss Ratio to Number of Adverse Public Records

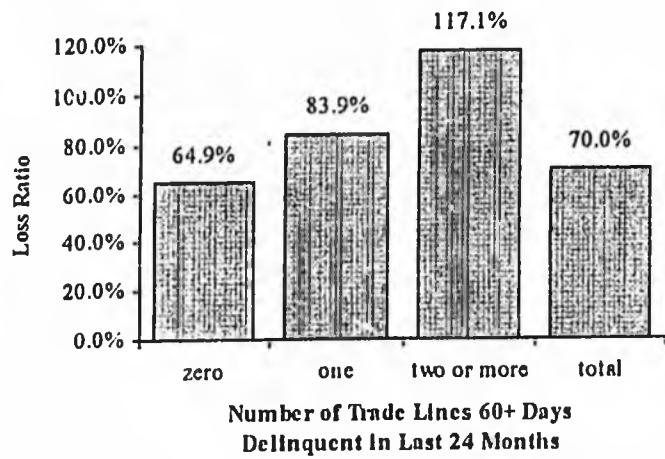


### Relationship of Three Credit Characteristics to Homeowners Insurance Loss Ratios

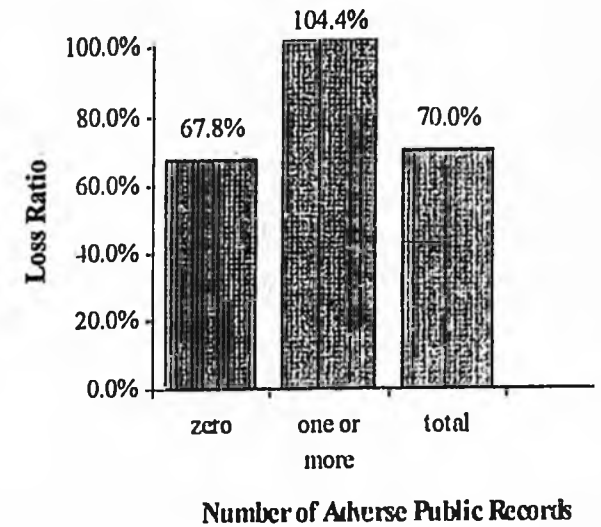
Relationship of Loss Ratio to Number of Collections



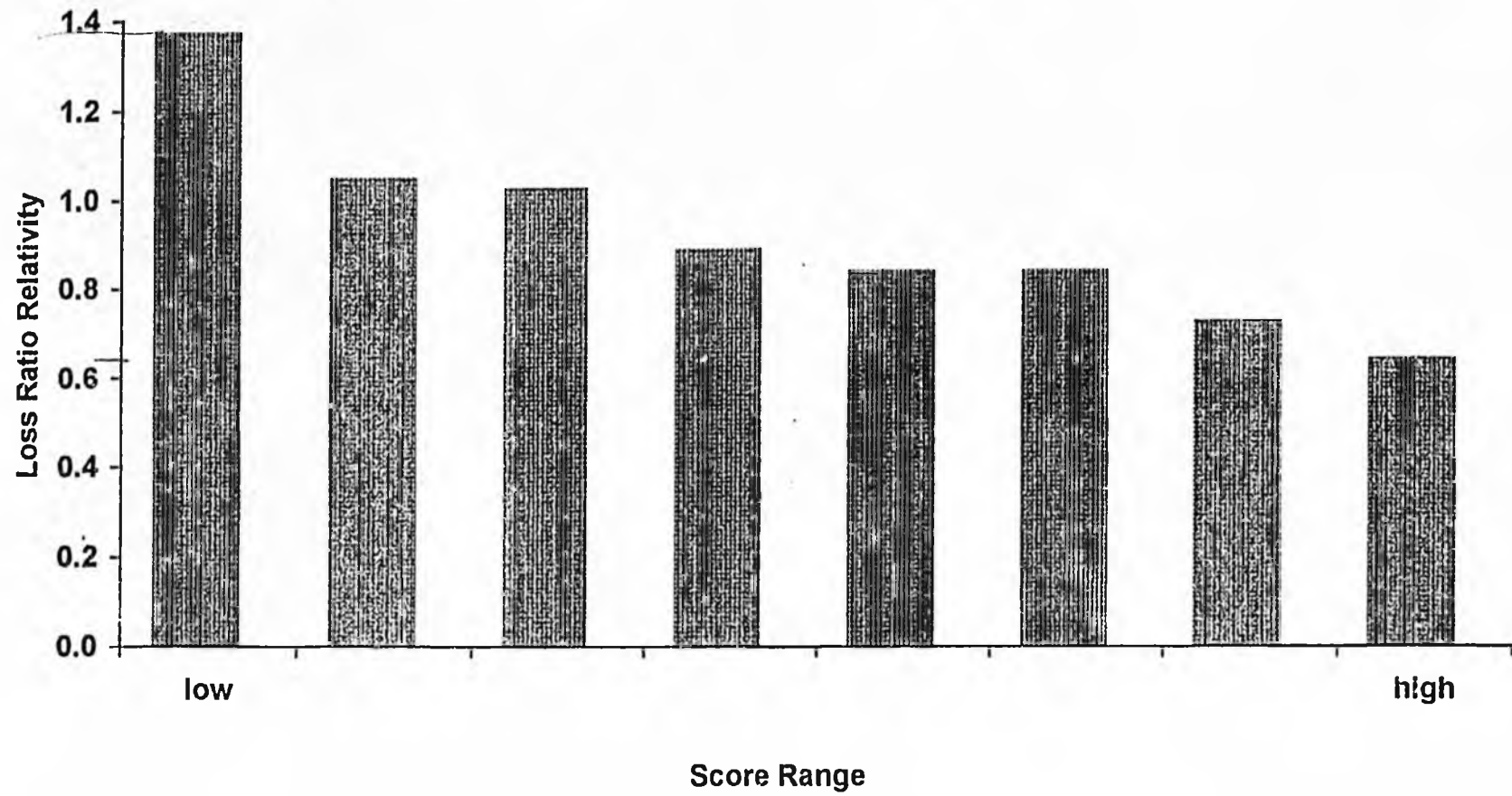
Relationship of Loss Ratio to Number of Credit Lines 60+ Days Delinquent in Last 24 Months



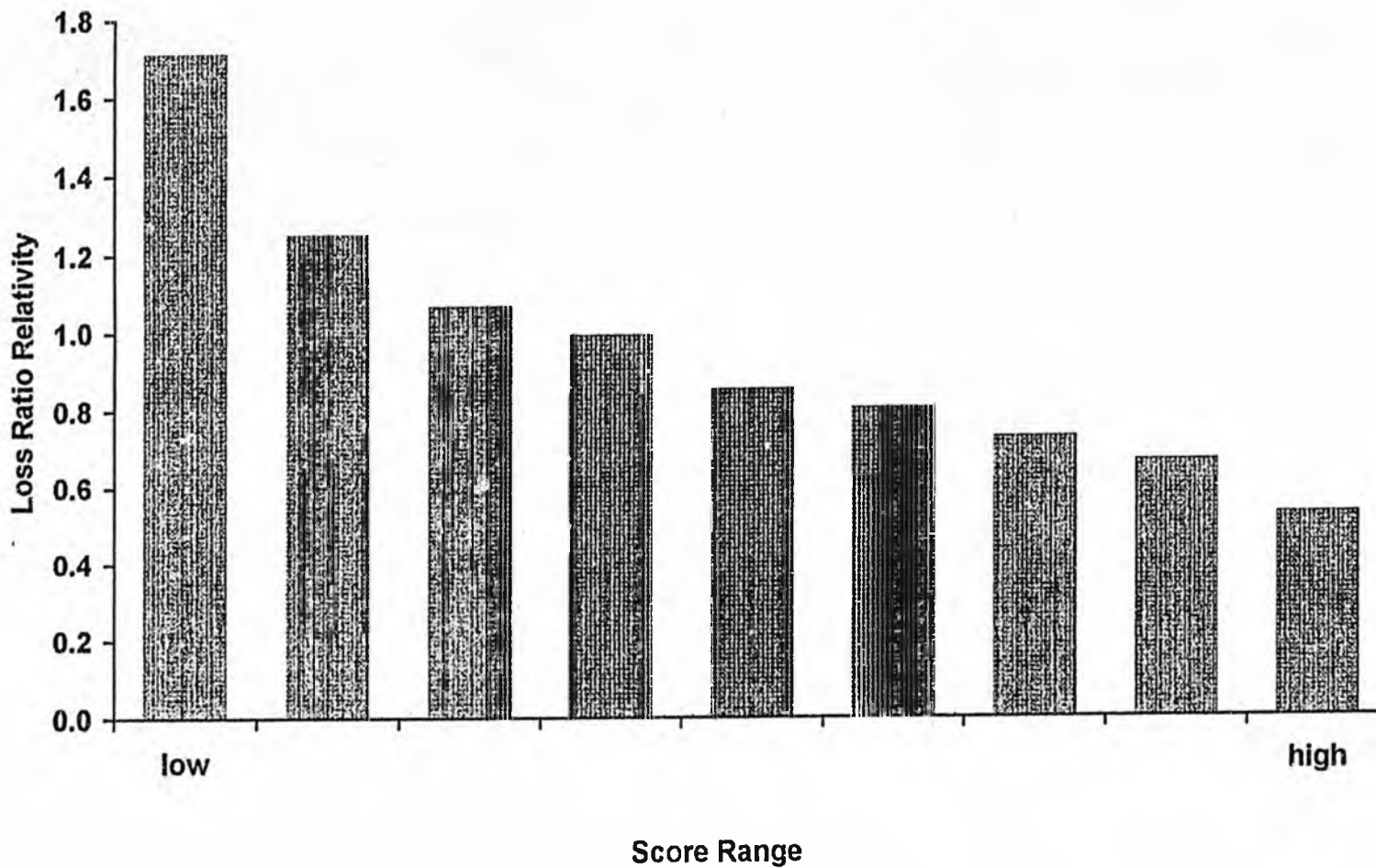
Relationship of Loss Ratio to Number of Adverse Public Records



### Personal Auto Insurance



### Homeowners Insurance

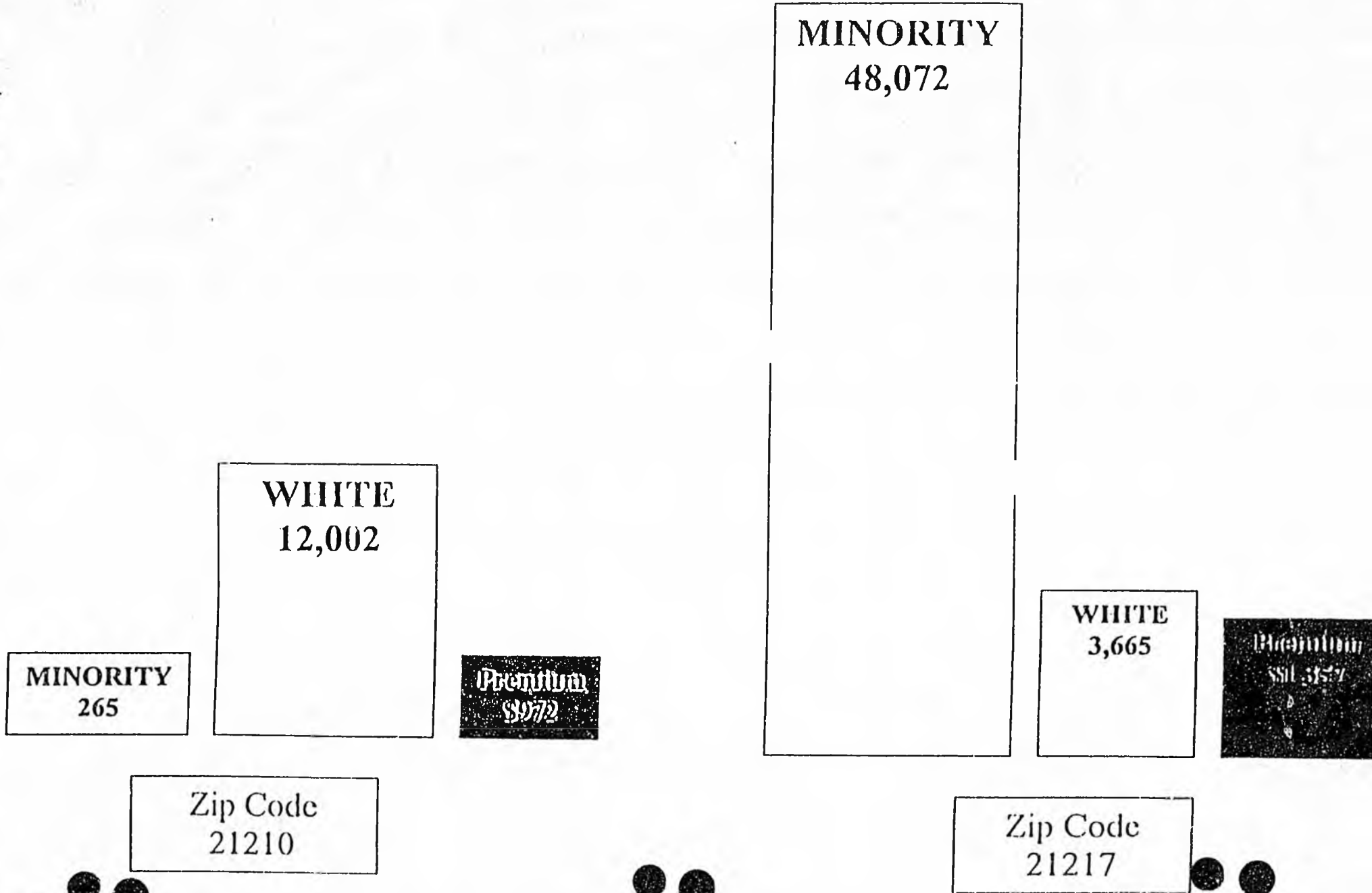


## Comparison of Credit Score by Percentage

Credit Ranges	Zip Code 21217	Combined Totals	Zip Code 21210	Combined Totals
297-325	0.2		0	
326-350	0		0	
351-375	0		0	
376-400	0		0	
401-425	0		0	
426-450	0		0	
451-475	0.2		0	
476-500	1.2		0	
501-525	2.8		1.1	
526-550	5.8		1.1	
551-575	11.4		3.8	
576-600	10.6	<b>31.4%</b>	1.6	<b>7.6%</b>
601-625	12.8		8.7	
626-650	10.8		6	
651-675	10		10.9	
676-700	10	<b>43.6%</b>	9.8	<b>35.4%</b>
701-725	5.4		14.7	
726-750	5.6		7.6	
751-775	2.4		9.8	
776-800	2.8		5.4	
801-825	2	<b>18.2%</b>	8.2	<b>45.7%</b>
826-850	2.8		2.2	
851-875	0.6		3.3	
876-900	0.4		3.3	
901-925	0.6		0	
926-950	0.6		1.1	
951-975	0.6		0.5	
976-997	0.2	<b>5.6%</b>	1.1	<b>11.5%</b>

The median credit range for 21217 is 626-650 and 701-725 for 21210.  
 The mode credit range for 21217 is 601-625 and 701-725 for 21210.

# Comparison of Premium by Population Composition



# Comparison of Premium by Household Income

Maryland Division of Insurance

**INCOME**  
**\$45,998**

Premium =  
1.8%  
of Income

**Premium**  
**\$897**

Zip Code  
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**INCOME**  
**\$14,813**

Premium =  
9.2%  
of Income

**Premium**  
**\$1,357**

Zip Code  
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Wednesday, December 26, 2001 - 12:00 a.m. Pacific

## No credit history? It may raise your insurance

By Peter Lewis  
Seattle Times consumer-affairs reporter

In the war of words over "credit scoring" — a contentious practice used by insurance companies to set rates for drivers and homeowners based on their credit history — there is at least one point of agreement among advocates and opponents:

Those without credit histories cannot enjoy the system's "benefits," meaning they pay as much as 25 percent more for insurance.

Comparing the number of adult Americans counted in the 2000 Census with the number of active-credit files maintained by major credit-reporting agencies, there appear to be between 4 million and 19 million Americans who are 18 and older without credit histories.



State insurance commissioner Mike Kreidler wants to curb credit scoring.

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Critics of the credit industry say most of those are immigrants, older people, those who are culturally uncomfortable or distrustful of credit, certain religious groups or those too poor to qualify.

At its core, credit scoring is based on the belief there is a strong, statistical correlation between personal financial responsibility and the likelihood that someone will get into an accident or otherwise file a claim to recover losses.

As a result, the system works against people who cannot prove through records kept by credit agencies that they have managed their money responsibly.

The consequences of an absence of credit came to light in Yakima, where many Hispanics live, at a public hearing in October hosted by Washington state insurance commissioner Mike Kreidler.

Testifying on the subject was an insurance-agency owner, David Hargreaves of Yakima-based Argus Insurance. In a subsequent interview, Hargreaves said some Hispanics were forced to spend more on expensive policies because they lacked credit histories.

Those w/out credit in same boat as those with credit →

belief is this religion or math? →

It's happened about a dozen times in the past year, he said, mostly in the last quarter, indicating the credit-scoring trend is on the upswing. "The biggest problem we have relative to the Hispanic population is that, culturally, they by and large pay cash and do not have an established credit history," Hargreaves said.

"Even though their 'credit' may be perfectly good, they pay in cash. By virtue of that, when we order a credit score, we get a 'no hit' or it shows 'no credit.' And depending on the various insurance companies, if they solely use credit scoring, then it's a negative, and they get placed in a more 'surcharged' market," he said.

Depending on the particular insurance company's policy, the resulting difference will cost clients without credit histories from 10 to 25 percent more for auto insurance, Hargreaves said.

Kreidler, the insurance commissioner, recounted the impact on Hispanics, among other groups, in a presentation for state lawmakers in November. He used the occasion to announce his intent to introduce legislation in the upcoming legislative session to curb the practice, which has become widespread in the industry.

Kreidler, who fears credit scoring could increase the number of uninsured motorists, wants to ban it as the sole criterion to cancel, nonrenew or deny coverage. He also wants to cap at 20 percent the premium differential tied to credit scoring.

Kreidler acted after listening to scores of consumers at four public hearings last fall. Some consumers questioned the reliability of the underlying data in credit reports, and the potentially discriminating impact of credit scoring on divorced people, those with sudden, staggering medical expenses and victims of identity theft.

#### **Even agents are frustrated**

Credit scoring is an evolving technology that assigns a point value to attributes such as payment history, outstanding debt and the number and types of accounts. No two models are alike, and different companies can give more or less weight to the overall value of credit history vs. more traditional measures, such as driving history, accident records and claims.

Representatives of the insurance industry maintain that credit scoring is an objective, effective tool to place consumers into the appropriate risk categories. They further assert it permits companies to write more policies and to charge lower premiums for many consumers.

But because the companies do not spell out how they arrive at scores (they consider it intellectual property), some insurance agents have become frustrated trying to explain to customers decisions that neither agent nor customer fully understands. Also worrisome, agents say, is the move by some companies to cut underwriting costs by downgrading or ignoring traditional yardsticks.

Even the system's advocates acknowledge that consumers with no credit history become instant losers. "We're not penalizing anybody. But they (people without credit history) won't get a reward for having good credit," said Michael Harrold, northwest regional manager of the National Association of Independent Insurers, an industry trade group with more than 690 members who write \$98 billion in premiums annually.

#### **Discrimination seen**

Among those apparently not getting a reward are members of certain ethnic and religious groups, including Hispanics, Asians, strictly observant Muslims and older Americans who lived through the Depression and do not believe in credit.

"Most immigrant communities have some kind of mechanism where people pool their money with each other to have capital to begin whatever projects they need," said KaYing Yang, executive director of Searac, a Seattle-based advocacy group for the Southeast Asian community. "I believe the Korean name is 'kae.'

"The question about credit is a serious one," Yang said. "People don't want to have debt in the cultures I'm aware of. At the end of the year, before the new year, they pay off debt." This is particularly common in the Vietnamese-American community, she said, "to start the new year fresh."

Then there are observant Muslims. The Koran outlaws the paying of interest. "To make money on money without working for it is not allowed," said Jamil Abdul Razaak, spokesman for Seattle's Idriss Mosque. There are many Muslims who overlook the prohibition out of necessity, he said. But some strict followers of the Koran could interpret ownership of a credit card as a violation, even if they do not allow finance charges to accrue, Razaak said.

Religious  
Discrimination

Others have an aversion to credit because of their life experience. Bruce Reeves, lobbyist for the Senior Citizens Lobby, an Olympia-based advocacy group, said that many older people who went through the Depression "have a pretty jaundiced feeling about who we trust to do business with, and how we handle our money. A number of people don't have credit cards."

Birny Birnbaum, a former assistant insurance commissioner in Texas who now works as a consultant, maintains that credit scoring discriminates against the poor, who generally have a harder time qualifying for credit.

Pete McCorkell, a former vice president for Fair, Isaac, a California-based company that has developed some of the most heavily used credit-scoring models, acknowledged that poor people and minorities are turned down for credit more often than others. But he maintained such outcomes are based on sound data and represent an accurate assessment of the risks they pose.

Acknowledgement  
of Discrimination

Mike Trevino, a spokesman for Allstate Insurance, said his company insures customers without credit histories, but they pay more. They are charged more because data show that such customers "perform worse" than the average Allstate customer. In other words their "loss costs" tend to be 12 percent to 25 percent more than average.

Still, Trevino acknowledged that, intuitively, it feels funny to charge customers more for the absence of certain characteristics rather than for things they actually did, like piling up debt or having too many accidents.

Andy Schoenholtz, a professor at Georgetown University who has studied international immigration, said many immigrant groups "have no idea what the U.S. credit system is." They often come from places with no formal financial structures or where such institutions were reserved for the wealthy or business interests.

New  
immigrants

That does not mean that such people are not credit-worthy, Schoenholtz said. He says he believes that financial institutions need to figure out nontraditional ways of tracking the saving, spending and regular payments made by those in immigrant communities.

It's only smart business to do so, the professor added, because otherwise the financial institutions and insurance companies "are missing a market for

themselves."

Peter Lewis can be reached at 206-464-2217 or [plewis@seattletimes.com](mailto:plewis@seattletimes.com).

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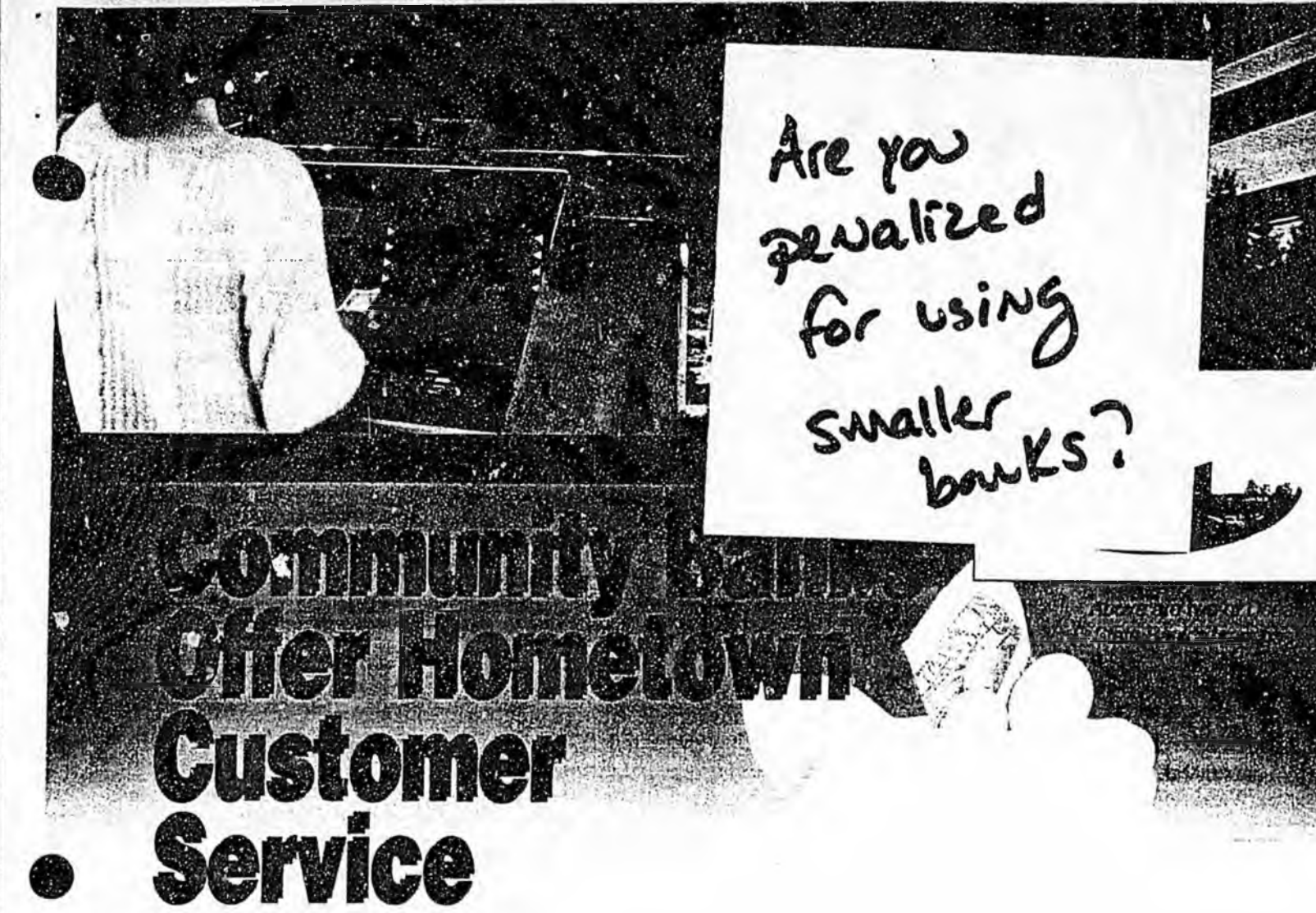
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Are you  
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banks?

## Community Banks Offer Hometown Customer Service

**These Alaskan-owned organizations are finding their niche in localized service.**

BY MELISSA CAMPBELL

**R**emember passbooks? Those little books where a bank teller would enter your deposits and withdrawals, usually for a savings account? Those were the days before technology ruled the banking industry—before online transactions, automated teller machines and loan-by-phone.

Most banks have virtually banned such antiquated notions, forcing passbook-generation customers to adapt. But things are a little different in Alaska.

"We still have customers who want to use a passbook. We even tried to get rid of (the books)," said Craig Dahl, Alaska Pacific Bank president. "And we accommodate those people."

Anchorage is generally seen as the state's banking center, but there is a handful of Alaskan-owned banks outside the big city that are thriving. Talk to those in charge of these non-Anchorage-based community banks and you'll hear a familiar phrase as

to why they are successful in light of huge national organizations taking over or merging with their competition.

"We offer that hometown customer service," said Michelle Bunch, assistant vice president of commercial banking for the Fairbanks-based Mount McKinley Mutual Savings Bank. "It's like going to your hairdresser—we can call you by name."

As in most hometowns, it's not unusual to run into the bank president

to house data of a satellite orbiting 22,300 miles above the equator. According to Holly Bertz, director, marketing and communications, the system is ideal for companies looking for a backup data circuit, a secure private link to remote locations, or reliable high-speed data services where landline options don't exist.

"It's a totally different ball game," she said of the technology being used by the Red Cross, remote school districts and military installations. "Even in a total blackout—no power, no phones, no data lines—Tachyon's satellite keeps humming to branch offices and the Internet."

### Putting it All Together

In a world of ISDNs, IPs, ATMs and more, the ability to understand what systems work best for businesses and how to manage them is becoming even more important. Companies like Compucon, a technology life-cycle services company and CTG, an information outsourcing technology company, help companies decide what is right for them.

"We do everything from A to Z with

respect to information technology," explained Aaron Bunker, general manager, Compucon. "Everything from advising a company how to leverage a technology that's available to disposing of an asset at the end of its life."

In 2002, Bunker expects to see changes in the way businesses leverage new technologies. "Obviously the economy has some impact," he said. "While it will probably mitigate the demand for sexy new technologies for technologies' sake, it also will increase the demand for technologies that impact the bottom line."

In the new year, Bunker said he sees companies continuing to evaluate wireless technologies, and the merging of voice and data networks. "It's the Holy Grail," he says of the technologies that are being designed to combine the two traditional systems.

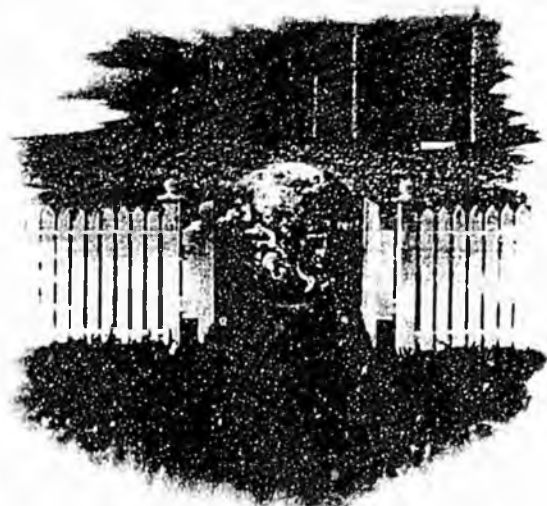
Beth Dolan, managing director, Northwest region, CTG, says she is seeing a shift in how companies think as well. "Information technology clients are now having to understand the business strategy so that they can utilize technology that will enable the

business to be more effective," she said.

"One of the challenges we see facing businesses is how their data is managed and how it is communicated through the organization," she continued. "Often, a business may have a data line that has four or five providers; we may manage their network, but someone else manages the communication lines."

Dolan says that CTG is considering partnering with a telecommunications company to expand the company's depth of expertise, though it is premature to discuss which company is in negotiations.

As the world continues to discover new technologies and improve existing ones, Alaskans will continue to adapt to the changing times. Just as its people have learned how to cover the great distances between them, so will those who manage its communications. □



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at the market or to see the board president at a school function. The banks' decision-makers are accessible, they say, and are at the very least a phone call away from their customers.

"When people have a question, they're not calling Outside or even to Anchorage," said Eric Bjella, vice president of marketing for the Ketchikan-based First Bank. "People in Anchorage don't have a clue about the fishing or timber industries. We do. Our knowledge of the community's economy and its people is integral to what we do."



Bank records also are stored locally, helping decision-makers—and customers—get quick access to whatever they need to do business.

"People appreciate getting answers fast," Bjella said. "That may not seem like a big deal right now, but get a tax

audit. You'll need your records right now, and they are right here."

### Banking on Alaska

Like the rest of the nation, Alaska has seen its share of banks come and go. According to the state Division of Banking, Securities and Corporations, in 1980—during the height of Alaska's economy—there were nine state-chartered banks, five national banks and six savings and loan operations. In the last two decades, some have closed, others have merged and new banks have opened, leaving Alaska now with four state-chartered commercial banks and four national banks.

The state also has one federal savings bank, Alaska Pacific Bank, that emerged from a savings and loan. It started in 1935 as Alaska Federal Savings and Loan, offering only savings accounts and home loans. Banking regulations changed in the late 1970s, allowing savings and loans to also offer checking accounts. The savings and loan followed suit, Dahl said. Throughout the next decade, the bank

held low-interest loans and got into the commercial banking business. During the economic bust of the 1980s, Alaska Federal was the only savings and loan in Alaska to survive, Dahl said.

New regulations allowed the bank in the early 1990s to restructure and change to a full-service bank, offering all the services banks do. Board members then changed the name to Alaska Federal Savings Bank. In 1999, the bank went public on the New York Stock Exchange—the only locally owned bank to do so—and changed its name to Alaska Pacific Bank.

Alaska Pacific, based in Juneau, now has seven branches throughout the Southeast and holds assets of about \$149 million. While assets have grown since the bank went on the public market, the number of branches was recently cut by two. Offices in Wrangell and Juneau were not meeting expectations and were closed in October, Dahl said.

"It was an emotional decision, especially in Wrangell," he said. "We were the smallest of three (banks) in a community that barely justifies two. We didn't



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see the economic viability there."

Residents in those areas still have a locally owned bank to turn to. First Bank, based in Ketchikan, has eight branches, including full-service operations in Wrangell and Juneau. The only Alaskan-owned, independent commercial bank based in Southeast, First Bank holds assets of about \$284 million and has been operating since 1924.

Interior Alaskans also have a couple of local choices. Mount McKinley Mutual Savings Bank is based in Fairbanks and began operations in 1965 primarily as a mortgage lender. Holding about \$166 million in assets, Mount McKinley has two branches in Fairbanks and one in North Pole.

The newest state-chartered bank, Denali State, began operations in 1986, when Alaska's economy was decimated as oil prices plummeted. Local support helped the bank survive and then grow to the current \$160 million in assets, said Gary Roth, bank president. Denali State Bank now has two branches—in Fairbanks and in Tok—and has 75 employees.

### Battling the Stagecoach

For years in the community banking business, one of the biggest competitors was locally owned. What became the National Bank of Alaska opened in Skagway in 1916 with \$50,000 in capital. At the end of 80 years of operations, NBA touted more than \$2 billion in assets and served Alaskans with 53 branch locations in 29 communities across the state.

That ended last year when Wells Fargo bought NBA. Customers may not have noticed the changeover until this summer, as the Wells Fargo stagecoach visited towns around the state, and the red and black signs went up, ending the rein of one of Alaska's own treasures.

Some Alaskans are not happy and are turning to their community banks.

"We've had people come in and plunk down money and say, 'We want to be



Roth

with a local bank," said First Bank's Bjella. "Bigger is not always better.

"Larger companies have their own way of doing things that Alaskans may not like," he added. "That may be where the smaller banks can step in and say we're used to servicing you the way you're used to."

Richard Strutz, president of Wells Fargo Bank Alaska, acknowledges that some customers have left his company, but said those who remain shouldn't notice any differences in service. The same people work in the same branches, and many of the decisions are still made locally.

"The signs certainly are different, but we have streamlined the products offered," he said. "The technology is more sophisticated, allowing us to know better what our customers want."

But Dahl said he has seen firsthand that policy decisions at national banks headquartered Outside may not always reflect local needs. He was president of the state's original bank, the Juneau-based B.M. Behrends, when the Cleveland, Ohio-based Key Bank absorbed it in 1989. Dahl stayed with Key as a regional manager for three years, leaving in part because he felt as if he had little voice in policy decisions that would affect customers in his area. He believes the same will happen with Wells Fargo.

"What will happen is what used to be a local decision will turn to a regional, then a national, decision," Dahl said. "People want to see the person who makes the decisions, not be layers away from that person."

Strutz assures customers that won't be the case, however. During the merger deal, NBA worked to ensure local loan decisions remained in Alaska.

"Wells Fargo is set up in regions and Alaska is a separate region," he said. "There are some things we can't change, like some software for example, that's for the bank. We wanted all loan decisions made in Alaska; this was important to our customers."

But other customers want to keep their money in Alaska, said P.J. Hill, associate professor of money and banking at the University of Alaska Anchorage. Now the former National Bank of Alaska is an Outsider.

"Local banks will survive like the Arctic Roadrunner survives in the

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**-Eric Bjella  
Vice President/Marketing  
First Bank (Ketchikan)**

hamburger market," Hill said. "We like the locally owned. It's a good marketing ploy. But I think they will have to get more sophisticated. They will have problems with computer instruments and the programs available to a large bank."

### Online for Growth

From teenagers to grandmas, people around the globe are doing their banking at home. Online transactions are becoming more popular as Internet technology becomes more secure and easy to operate.

Keeping up with the ever-changing technology is one of the challenges facing locally owned banks. They are making it happen, though sometimes a bit slower than the Outside banks.

First Bank premiered e-banking last spring, waiting until managers felt they could offer the best, safest product for customers. Bjella said that about 8 percent of the bank's depositors had enrolled in online banking.

"We've had a wonderful response," he said. "As the comfort level grows, more will sign up."

All locally owned banks currently offer a host of online banking services and a full range of banking and loan options. For a fee, customers at many banks can transfer money to pay their bills—a great way to save time, stamps and checks. Who knows, it may even entice the passbook generation to join the ranks of the Palm Pilots. □

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TO: David D'Amato

As discussed, I have attached a customer's policy I printed out. Policy renewed today. Because her current carrier went to a one-payment plan, without any warning, she was unable to pay the premium in full.

As noted, she has no accidents, no violations and has prior insurance. She drives to work, has one vehicle. She does not own a home, but rents. Her premium went up \$452.40 more per six months based on her insurance score. We have never had a payment problem with her.

I have a customer, male, in his 50's, good income, married, owns home, has a DWI, which normally, at one time, would have prevented him from being rated with a Preferred Market. He qualified for Progressive's Preferred Market. In fact, with a SR 22 filing he was only paying a little more than he had been paying with his current carrier, who was not doing scoring at the time. As a new customer he never would have qualified with any of our markets. In fact he had had a prior DWI with an accident 5 1/2 years earlier. That was when we found out just how ridiculous this program was.

It's interesting that people who think they have great credit, soon find out that may not be so if they are shopping for insurance. If you have too many credit cards, or too high a balance, but have never had a late payment, you can still have a problem with getting a good rate on your insurance, both home and auto. That makes absolutely no sense.

Loss ratios are supposed to drop with this program. So far I have not seen that happen, in fact those ratios appear to be going up.

We are lead to believe that credit scores do not discriminate, and that there is a correlation between the scores and whether an Insured will likely file a claim. Be we see discrimination all the time. The computer program, which scores you cares not that you recently went through a divorce, or death of a spouse, or a major illness. It doesn't care if you didn't pay a credit card bill because the electricity bill is due and you're short this month. A single parent trying to raise a child or maybe 2 or 3 children will find himself or herself paying more for their insurance than a married couple. What makes it a fact that a single parent will have more claims?

We are asking customers to pay more in insurance premiums when many are already struggling.

I'm not naïve, I know people don't pay their bills on time for all kinds of reasons, but the only ones making a killing on this program are the major credit bureaus, who are doing the scores, and getting paid well for it too.

Page 2

Then we find out that those same credit bureaus are selling marketing lists containing information regarding insurance consumers. That came out in a Property and Casualty newsletter, dated January 18, 2001. Copy of that is attached. We provide these people with information, i.e. social security numbers, date of birth, license numbers, addresses that they normally would not have. Now we are giving credit bureaus information on children when we order driving records, that they would never had until that child gained majority.

When a computer, not your agent, now determines whether you qualify for insurance, or denies you coverage with a carrier, and the agent, or the company, so we're told, can't tell them why, only refer them to a phone number where you then get recycled, can't speak with a human or left holding waiting for someone to talk with you, then something is wrong.

I strongly support any effort to limit insurance scoring and believe the Division of Insurance needs to weigh in on this discussion. I know many people in this field who have the same aversion to what is happening in the insurance industry. We don't want to lose the markets we have in this State, and I think many people worry about that happening, but neither do we want insurance scoring to be the whole basis for determining a rate. No matter what a carrier says, it happens. If a person is denied coverage with a carrier and all information is positive as far as having no losses or violation, you can almost bet the insurance score is the reason.

I hope with this bill that some common sense can be achieved and the consumer comes out ahead.

Thanks.



Preferred market

Term 02/27/2002 To 08/27/2002

Additional Other Interests

Remarks

Auto

Application Term: 02/27/2002 To 08/27/2002

Credits and Surcharges

Applicant

Mailing Address: ANCHORAGE, AK 99503

Co-Applicant

Additional Other Interests

Coverages/Limits of Liability

Vehicles

*work use 1 car Preferred Tier 0 points*

Agency # 0001 / Company # 0001, 1996 FORD ESCORT, Private passenger auto make, 3FASP11J3TR145125, Class 80321040 (\$55.00) \* Premium

*\$ 555. 6 mos*

Combined single limit: Limit 300,000 (214.00)

Medical payments: Limit 10,000 (17.00)

Uninsured motorist combined single limit: Limit 300,000 (\$9.00)

Collision: 500 Ded 1 (179.00)

Comprehensive: 100 Ded 1 (86.00)

Value: New, Purchased 08/1996, Cost New 14,600, Symbol G

Rating Information: Territory 0001

Mileage: , Annual Miles 7,500

Additional Vehicle Info: No anti-theft

Usage: Commute, 3 Miles One Way, 3 Days

Engine: Basic Performance

Garage Address: ANCHORAGE, AK 99503

Credit: Passive restraint 40.000% (0.00)

Loss payee: NATIONAL BANK OF ALASKA NATIONAL

Address: P O BOX 107004, ANCHORAGE, AK 99510

Interest Rank: 1

Drivers

#0001: 10/20/1948, Female, Single

License: #, AK, 10/01/1964 License Date

Vehicle Driven Most: Agency # 0001 1996 FORD ESCORT

Occupation: TYPESETTER

Remarks

Line of business: Payor Code: Insured

Line of business: PP0197, 04/99, - AMENDMENT OF POLICY PROVISIONS -

ALASKA; PP0371, 01/98, - LIMITED ATTORNEY FEE COVERAGE - AK; PP0001, 06/94, -

PERSONAL AUTO POLICY

Line of business: 844, 10/99, - UNINSURED/UNDERINSURED MOTORISTS - AK

Current Carrier - Having to move because Company has gone to 1 payment. She cannot pay in 1 installment  
Printed from system

Company calls this market Standard, but premium in line with Specialty market.

Here is the quotation you requested. In addition to the superior value you receive, you also have the option of numerous payment plans. For full information about these plans, see below. This quotation is provided without cost or obligation. It is not a contract or binder of coverage. If you are interested in further information, contact the SAFECO agent listed on this quote.

Agent:

Proposal prepared for:

[Redacted Agent Name]

[Redacted Client Name]

Anchorage, AK 99503

Home Tel#: (907) [Redacted]

Tel #: (907) [Redacted]

Agent #: [Redacted]

Alt #: (907) [Redacted]

Producer: [Redacted]

Fax #: (907) [Redacted]

Email: [Redacted]

Date Prepared: 02/27/2002

Veh #	Year/Make/Model	Vehicle ID Number	Bodystyle	Class	Territory	Symbol/Cost
1)	1996 FORD ESCORT LX Discounts/Surcharges: PASSR		Other	205210	001	14
				Work Use	car	0 points

COVERAGES	COVERAGE LIMITS	PREMIUM
Combined Single Limits Liability	\$300,000 Ea Occurrence	\$368.20
Medical Payments	\$10,000 Ea Person	\$38.20
Uninsured Motorists	\$300,000/\$300,000 Ea Person/Ea Accident	\$88.00
Uninsured Motorists Property Damage	\$100,000 Ea Accident	\$17.30
Comprehensive	\$100 ACV Less Deductible	\$148.40
Collision	\$500 ACV Less Deductible	\$317.80
Towing and Labor	Yes	\$3.80
Loss of Use	\$50 Per Day	\$25.70

Your 6 month premium for each car is: \$1,007.40

Your total 6 month premium is: \$1,007.40

Payment Options: Monthly Checkless -----	\$167.90	(1 month down payment and No Service Charge)
Monthly by Check -----	\$337.80	(2 months down payment + \$2.00 Service Charge)
Budget -----	\$505.70	(3 months down payment + \$2.00 Service Charge)
Full -----	\$1,007.40	(Total Premium)

No accidents  
No violations  
Prior Insurance  
Rents

*The Impact of Personal Credit History on Loss  
Performance in Personal Lines*

James E. Monaghan, ACAS, MAAA

## 8. Revolving Account Limits

This variable is the denominator in the calculation of leverage ratio discussed previously. It is the sum of credit limits for all revolving-type trade lines on the report for a given individual.

Revolving Limits	Earned Premium	Incurred Loss	Loss Ratio	Relative Loss Ratio
\$0	\$ 41.5	\$ 39.4	95%	1.25
\$1 - \$500	9.8	8.6	88	1.15
501-1000	13.0	12.5	96	1.26
1001-1500	12.0	10.3	86	1.13
1501-2000	11.2	10.8	96	1.26
2001-2500	10.0	8.1	81	1.06
2501-3500	18.8	15.3	81	1.07
3501-5000	26.0	20.6	79	1.04
5001-7500	36.2	28.2	78	1.02
7501-10 K	31.4	24.5	78	1.02
10 - 15 K	50.8	34.8	69	0.90
15 - 20 K	37.7	24.0	64	0.83
20 - 25 K	27.6	19.0	69	0.91
25 - 30 K	18.7	12.9	69	0.91
30 - 40 K	22.0	13.5	61	0.80
40 - 50 K	10.9	7.3	67	0.88
50 K +	16.4	10.7	65	0.85

Correlation coefficient for this regression is (0.78), using midpoints of the limit ranges. The first conclusion that could be drawn is that this correlation only duplicates the one already discussed in the leverage ratio section. This will be addressed in the multivariate section. Another conclusion that has been drawn is that this variable is directly correlated to personal income, and use of revolving limits in any underwriting or rating program is discriminatory towards lower income individuals (disparate impact). This may or may not be true; the data does not contain income information. It would be erroneous however, to assume that all people with low revolving limits are also low-income. Many people choose not to use credit; others may have substantial income but low revolving limits due to the fact that they cannot obtain such credit lines based on their past bill payment performance.

Many other individual variables were reviewed from the credit file. Some exhibited correlation to loss ratio at various significance levels, others had no such correlation. Those displayed thus far, however, show a systematic predictive power that requires explanation and understanding.

### Causality

Explanation of these correlations, for the most part, cannot be found in the data assembled for this research. I would be remiss, however, if I did not at least attempt to set down those arguments which could be made suggesting reasonable causal links between an individual's bill paying history and expected loss experience for insured losses under a private passenger auto insurance policy.

Before listing such arguments, it is first appropriate to review the Actuarial Standards of Practice #12, entitled "Concerning Risk Classification". The relevant section is 5.2, which states the following:

- 5.2 Causality - Risk classification systems provide a framework of information which can be used to understand and project future costs. If a cause-and-effect relationship can be

established, this tends to boost confidence that such information is useful in projecting future costs, and may produce some stability of results.

However, in financial security systems, it is often impossible or impractical to prove statistically any postulated cause-and-effect relationship. Causality cannot, therefore, be made a requirement for risk classification systems.

Often, the term "causality" is not used in a rigorous sense of cause and effect, but in a general sense, implying the existence of a plausible relationship between the characteristics of a class and the hazard for which financial security is provided. For example, living in a river valley would not by itself cause a flood insurance claim, but it does bear a reasonable relationship to the hazard insured against, and thus would be a reasonable basis for classification.

Risk classification characteristics should be neither obscure nor irrelevant to the protection provided, but they need not exhibit a cause-and-effect relationship.

Clearly, the operative word in this Standard of Practice is irrelevant, as the historical data in question is not obscure. Therefore, arguments must be put forth which, despite being speculative, are reasonable statements that a reasonable person would find relevant.

Why would an individual who has current or past difficulties with meeting financial obligations be expected to have above-average costs to an auto insurer? Since there is an administrative expense associated with the processing of insurance premiums and related transactions, it can be argued that subsequent lapses in the individual's payment history is a direct cost to the insurer. This cost would fall under the category of expenses, however. The focus here is loss costs.

#### *Maintenance*

The argument has already been made, and often, that auto insurers' underwriting practices are created for risk selection, and one characteristic that is viewed as favorable for selection is described in various quarters as "stability" or "responsibility". Few, however, could give an objective definition of how one could measure such a characteristic, but historically many customer characteristics have been utilized as an assumed proxy for this nebulous attribute, such as home ownership, marital status, number of vehicles, coverage and limits selected, etc. It is entirely possible that a person's current and historical management of debt is another indicator that could be utilized to identify this quality. If a person manages their financial affairs responsibly such that debts are paid on time, they may also take the same approach to the maintenance of other aspects of their lives, including their automobile. A vehicle kept in good working order and condition is less likely to be involved in an accident than one that is not, all other things being equal. Such an individual may also take greater care in operating that vehicle.

#### *Morale Hazard*

The CPCU textbook "Personal Insurance" defines morale hazard in the following way:

Morale hazard is a condition that exists when a person is less careful because of the existence of insurance. Morale hazard does not involve an intent to cause or exaggerate a loss. Instead, the insured becomes careless about potential losses because insurance is available. Leaving the keys in an unlocked car or allowing fire hazards to remain uncorrected are examples of morale hazard. Morale hazard results in additional losses that drive up the cost of insurance because of injuries and damage that could have been prevented."

The previous discussion of responsibility could lead to the argument that individuals who are careless in the management of finances also present a morale hazard in the area of automobile insurance.

#### *Claims Consciousness*

An insurer's loss experience measures dollars of loss which are paid on claims that are filed. The number of claims filed is less than the number of accidents that actually occur. Consider two risks that are identical in all ways (from an insurer's perspective) except for the fact that one manages their financial affairs much better than the other does. The risk who has a troubled financial history and condition is much more likely to be in debt and to a larger degree; the need for capital to satisfy financial obligations has a bearing on decisions made in many areas of his/her life. Suppose for example, that these two risks are both involved in an auto accident, involving no injuries, but causing property damage to their own vehicles which is some nominal amount (say, \$100) more than the deductible. The risk whose financial condition is more sound has a disincentive to file the claim. It may impact his/her rates at the next renewal; the time and effort involved may not be even worth the compensation obtained. The risk with the poorer record of financial management has a greater incentive to file the claim and obtain the compensation, as it has greater value to that individual.

#### *Fraud: Increased Severities*

Continuing with these same two risks, consider now the situation in which the damage to property was much greater than the deductible; the vehicles each sustained damage measuring in the thousands of dollars. If an auto repair technician suggested a relatively easy way of recouping the deductible for the insured, or the benefits of padding the repair costs, the individual under the greater financial pressure would be more susceptible to acquiesce. This does *not*, however, imply that risks with poor bill-paying histories have any less integrity than other risks. Some people would never commit fraud on any level; others would do so with no need for provocation or encouragement; still others could be convinced to do so only under the proper conditions. This argument only implies that any individual who *could* be induced to participate in this level of fraud would be more likely to do so if they were under financial pressure from other sources.

#### *Fraud: Increased Frequencies*

The presence of severe financial pressure could also produce claims that would not have existed otherwise. There is some segment of the population that either does or could view the insurance mechanism as a financial opportunity. Fraudulent claims in the form of staged accidents, phantom claimants, phantom vehicles or arson are a way that an individual can extract funds from the insurance mechanism. Once again, this argument does not imply anything about the integrity of a risk with poor bill-paying history. What it does assert is that an individual with severe financial pressure could look to all possible sources of funds to alleviate that pressure. Therefore, any individual who was capable of committing this type of fraud is more likely to do so given the existence of that financial pressure compared to the absence of it.

#### *Stress*

The assumption is made here that individuals who are under financial pressure from debt exist under a greater level of stress than average. This stress could exist from the associated worries over future impact of financial condition. Individuals under such stress may be less focused on proper operation of a motor vehicle and make them more susceptible to accidents resulting from chance occurrences or distraction. It would be useful if there were some other condition which could produce this same level of stress, for which loss data was available, to strengthen the argument. A few currently coded customer characteristics could be considered candidates. One such variable is number of children under the age of 16. One must first make the assumption that risks with three or more children under the age of 16 have a higher level of stress than average. Whether or not one agrees with that probably depends on whether or not they are a parent! In any case, the loss ratio for such risks reviewed in a 1993 research study was over 20 points higher than average. Another possible variable candidate could be self-employed risks. The added responsibilities and worries of a small business owner could imply that their level of stress is higher than average. From that same 1993 study, self-employed risks had a loss ratio which was roughly 15% higher than average.

It is important to make note that this list is not suggested as a menu from which to select the one correct answer. It is likely that the impact on losses of financial management history is a cumulative impact of some or all of these situations, as well as others not listed here.

surprising, given that 2 of the 3 criteria for Group A are maintained for many years on the credit file (derogatory public records and collections).

Group B was not as stable over time, significant portions of the population migrated in both directions. Of the original Group B in 1993, 67% were still in the group 12 months later, and 36% 48 months later. At that time, 31% had moved to D, 12% to group C, and 21% to A.

Group C was the least stable. Since this group is defined by better than average characteristics, it is not surprising that as those characteristics continue to improve, much of the distribution migrates to Group D. Only 50% of the group still had the Group C characteristics 12 months later, and only 11% at 48 months. 65% of the entire group migrated to Group D in four years. This is not surprising due to the fact that one of the differences between C and D is age of oldest trade line; for those risks that did not qualify as D, time can be the only factor necessary to cause a migration over the subsequent 3 year period. (Again, refer to the Appendix for exact Group definitions.)

Group D, the best performing group, showed the most stability. Risks with the best credit profiles are more likely to maintain those profiles over time. Of the 23,248 policies in this group, 87% still met the criteria for D 12 months later, and 78% met those criteria 48 months later.

This data was not collected on the original auto cohort, so the above data is for homeowners only. It does provide some indication about the necessity of updating the review of credit profile for the purpose of rating and/or underwriting.

#### **Implications and Other Related Issues**

The impact of credit history on expected loss performance is a major factor influencing whether or not this variable should be utilized in the rating of personal lines insurance premiums. There are, however, many other relevant issues that must be considered.

The credit history contains a large amount of data. The impact on loss performance has been measured in this study as if arising from a single variable, which is one particular accumulation of the credit data. There is of course an enormously large number of ways in which the data can be combined for this purpose of measurement. When the variables are inspected, individually, one finds that there are some that are historic, and cannot change until they are purged from the record (i.e., derogatory public records, collection records, inquiries and delinquent payments). Others contain information about current conditions, such as account status, current balances and limits, and overdue amounts. The method of combination of these variables will determine where the model falls in the responsiveness versus stability spectrum. This study has shown that both types have strong influences on loss performance. How they are combined is currently an open field for individual insurers' discretion. This study utilized a mutually exclusive profiling technique; scoring models can and do utilize a large number of variables, giving numeric weights to each individual characteristic which are then added to obtain a total. Either method can be accomplished using a wide range of variable counts.

An important gap in this study is the impact of credit history on loss performance for customers who have been insured with the same company for a number of years. Recall that the data was assembled from new policies written in a given policy year, and the subsequent three-year loss experience. This data cannot show if long-term customers who have similar credit characteristics are expected to have the same differences in loss performance. The creation of a rating factor based on credit history can affect renewal customers as well as new customers, yet there is currently no data publicly available to my knowledge that shows such relationships. Without such data, it would be speculative at best to assume that the relationships hold true regardless of tenure. Studies have shown that long-tenured customers produce far better loss experience than new customers. Opinions vary as to whether this is due more or less to two (or more) dominant factors which can cause such improvement: 1) the fact that longer term customers have more experience in operating a motor vehicle or maintaining a home, and 2) that the underwriting function of a

given company will selectively non-renew poor performing risks, which could not be identified accurately in the underwriting process when the policies were originally written. The research done with this data has shown that longer-tenured customers tend to have better credit profiles than newer customers. This is one variable, policy tenure, that could be both distributionally and loss performance-linked to credit history.

The question as to how often the credit history needs to be reevaluated is also of concern. Although the motility information above indicates that there is a fair amount of stability over time for credit conditions, there is still significant change that occurs within such distributions. Each reevaluation will cause the creation of an additional inquiry record on the file. Although such inquiries should not be utilized for evaluation, there is no guarantee that all financial institutions and other users of credit data will ignore their existence. When such a reevaluation occurs, there is also the question as to which risks should experience premium adjustment. Is there reasonable justification for an individual risk to experience an increase in premium solely due to a change in a variable within the credit file? A different type of database construction technique would be required to answer such a question.

From an actuarial standpoint, questions arise concerning the nature of the variable. The literature is replete with admonitions concerning the use of variables that are, or can be, under the control of the insured. Although the historic variables are not under the control of the insured, certainly those that measure current conditions are. Worth considering, however, is the argument that such control is not nearly as relevant as other rating factors that are not utilized for this reason. An individual who has a poor history of timely bill payment, and is under a considerable debt load is already experiencing detrimental effects from these conditions. Such conditions are causing economic penalties in the form of monthly interest payment, or debt service, and can also result in higher interest rates charged for credit lines, installment loans and mortgage loans. There already exists a financial disincentive to maintain financial management habits that produce these conditions. Will a difference in auto or homeowners insurance premiums cause a change in such habits, where these other economic disincentives have not? It is likely, in my opinion, that the magnitude of the premium difference would not be as large as the sum of all other financial consequences of such a credit profile in most cases. This may mitigate the concern over the control the risk appears to have over the data contained in the credit file.

Another area of concern that is related to variable control is data accuracy. Reports as to the accuracy of credit history data vary widely depending upon the source. Credit bureau sources quote data accuracy values in the 99% to 100% range. Some consumer groups have quoted this number to be as low as 30% to 40%. This discrepancy is due to the way in which errors are measured. One could obtain the first result if errors were considered to exist only in cases where a) an adverse decision was made for a financial transaction, b) the customer inquired as to the credit data, c) discovered an error, d) contacted the creditor to correct the error, and e) the financial institution reversed the decision based on that correction. Dividing the number of such events by the entire credit warehouse would produce a very high level of accuracy. To produce the second, much lower values, one could simply count every possible error within the file, including seemingly irrelevant errors such as street name misspellings, and divide this count by the total number of records. Neither is a very good measure of data accuracy. For all parties concerned to get a true understanding of accuracy, a good method of measurement must be established. In any case, the utilization of credit history for rating requires the insurance industry to assist its customers by informing them of the method for resolving true inaccuracies on record, and taking those corrections into account through reevaluation.

An outstanding issue that will likely remain outstanding is causality. Although arguments were put forward earlier in this paper which attempted to link financial management responsibility and future expected loss levels, such arguments are unsupported, even if reasonable, speculation. The arguments of causality are generalized; in fact the difference between one rate level and another charged to a given individual could be different due to only one particular variable within the credit file. That individual may ask for an argument of causality pertaining only to the one characteristic that separates him or her from the next lower rate. Such questions may never be answered with statistical causality, even if the entire credit file (however that is aggregated) can be demonstrated to be causal in a way that goes beyond the mathematical correlations.

The issue of acceptance of credit history data in personal lines insurance has more obstacles than mere causality. The social and regulatory acceptance of such data in the rating of personal lines insurance may be restricted for other reasons. Arguments have already been made that indicate that some groups consider its use invasive, and that credit-based rating is a breach of privacy, regardless of its strength as a tool to reduce rate subsidies between risks. The auto line of business has considered past driving record to be a key factor in underwriting and rating. One key characteristic of prior accidents is negligence, i.e., whether the accident was the fault of the insured or not. It is natural for some people to immediately apply this concept to credit history as well. Credit files contain information about derogatory events that an individual may feel are perfectly explainable. Such explanations are commonplace in the area of mortgage financing, where an event is not considered if there is a suitable explanation for its existence in some cases. The key difference, however, is that the use of this data for rating or underwriting is not done for the purpose of credit worthiness. It is not done for the purposes of judging character, lifestyle, integrity or financial soundness. The purpose is to segregate risks by different levels of expected losses only, a point which may be difficult to communicate.

It may be easier to obtain regulatory acceptance compared to social acceptance with regard to the use of credit history as a rating tool. The NAIC White Paper on the use of credit in underwriting, referred to earlier, makes several specific statements which indicate their deference to rating, rather than underwriting. The use of credit in rating requires the filing of a rating plan with supporting documentation. It permits inspection of content by both regulators and consumers. Such filing gives a regulatory body the evidence required to give valid statistical response to constituents who may call to inquire or register a complaint.

The data reviewed in this study produced clear evidence of a strong correlation between credit history and future loss performance. The understanding of this relationship, and its acceptance, have grown rapidly over the last few years. This understanding has come primarily in the form of scoring model results. Hopefully, this paper will serve as a starting point in an effort to place more detailed information from credit history, other than scoring models, and the relationship such data has to personal lines losses, in a public forum. This effort is necessary in order to promote greater understanding of the driving forces behind this relationship, and can only serve to improve the quality of discussion during future debates on the ways in which it will be utilized.

DAVE



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*James Monaghan*

## Monaghan Wins Ratemaking Prize

James E. Monaghan, ACAS, MAAA, won the 2000 Ratemaking Prize for his paper, "The Impact of Personal Credit History on Loss Performance in Personal Lines." Monaghan has worked for Metropolitan Property and Casualty Insurance Company in Warwick, Rhode Island since 1987. He has been responsible for pricing, reserving, strategic planning, research, and developing expert systems. CAS President Alice Gannon presented the Ratemaking Prize and a check for \$1,000 to Monaghan. Papers can be viewed on

the CAS Web Site at [www.casact.org/aboutcas/rtmkpriz.htm](http://www.casact.org/aboutcas/rtmkpriz.htm).



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## Regulators wary of rates based on third-party data.

**Author:** Otis, L. H. **Source:** National Underwriter (Property & Casualty/Risk & Benefits Management Edition) v. 99 (Oct. 2 '95) p. 1 **ISSN:** 1042-6841 **Number:** BBPI95080539 **Copyright:** The magazine publisher is the copyright holder of this article and it is reproduced with permission. Further reproduction of this article in violation of the copyright is prohibited.

What do hurricanes and consumer credit reports have in common?

The answer is that information from both is being processed by independent firms which are selling predictions to insurers for use in their underwriting and rate-request decisions regarding homeowner and auto coverages.

And both are at the center of a debate over disclosure of the data and methodologies of these firms.

As their services are used to justify large insurer rate requests, as well as controversial practices such as withdrawals from coastal markets and the use of consumer credit in underwriting, firms specializing in offering both catastrophe models and products which "score" a consumer's risk of loss based on credit history are increasingly coming under scrutiny.

But when state regulators have sought the basis for these underwriting and rate positions, and are directed to these third parties, they have run into a brick wall, with the firms citing the proprietary nature of (cont. on p.25) their data sets and analytical processes. The issue is part of a broader debate over what industry data and methodology is proprietary and what isn't.

"There has been an increasing trend on the part of the industry to claim that all sorts of things are proprietary, market sensitive and the like," said Bradford Connor, director of market regulation with the Missouri insurance department.

"We are all getting it. It is a rationale being presented to all regulators," Mr. Connor said, adding concerns are rising that insurers are simply trying to evade sensitive issues.

The National Association of Insurance Commissioners has groups appointed to look at the validity of both catastrophe modeling and the use of consumer credit reports in underwriting. At the NAIC's fall meeting in Philadelphia, Mr. Connor noted that both groups are grappling with the same issue of disclosure of proprietary third-party data.

"It's big issue," said Larry Kibbee, vice president for public affairs with the Schaumburg, Ill.-based Alliance of American Insurers. After seeing it come up in several areas in Philadelphia, Mr. Kibbee said he intends to raise the issue with several Alliance committees to begin to develop their own position on it.

"There needs to be at least an exploratory conversation held with perhaps the NAIC leadership, or the committee and working group chairs," Mr. Kibbee said. "Otherwise we'll continue to butt heads" when regulators seek information which insurers and their service-providers consider proprietary, he added.

Insurers' use of proprietary third-party catastrophe modeling data has preoccupied regulators in Florida, New York and elsewhere. In California, the validity of proprietary earthquake modeling is being debated.

Mike Walters, a principal at Tillinghast/Towers Perrin in Parsippany, N.J., said he believes all parties in the issue are not so far apart. With sufficient guarantees that proprietary techniques would not be made public, insurance department staff could make on-site audits and due-diligence investigations of modelers' data and methodology, thereby assessing the models for the public without disclosing modelers' trade secrets, he said.

He acknowledged that the public-policy aspects of the issue are difficult because "rates are probably going to go up as a result of these models" as the catastrophic loss experience of the recent past is incorporated.

(Tillinghast has developed its own proprietary catastrophe model and Mr. Walters is a member of the firm's catastrophe projection team.)

The modelers have a vested interest in full disclosure to regulators because "if they are not satisfied, they will not approve the model," Mr. Walters said.

The current models "are not rocket science," he said, using mostly public data and capitalizing on the ability of computers to run rapid applications on large data sets.

"With the right combination of people and several million dollars you can construct one of them. This is not the Rosetta Stone," he said.

Nonetheless, those who have already developed models "are not going to give away our competitive advantage easily," he said.

But Selwyn Whitehead, president of the Oakland, Calif.-based Economic Empowerment Foundation, said she does not think that allowing insurance regulators to privately assess the models is sufficient. (EEF has intervened on behalf of California consumers in several insurer rate increase requests which use proprietary modeling.)

Earthquake models "use brand new untested technologies based on the worst-case scenario," and consumers are being asked to pay annual premiums derived from such untested and dire predictions, Ms. Whitehead said.

Noting that modelers themselves have acknowledged a 50 percent error factor for earthquake predictions, while in some cases experts have indicated that predicting temblors is not scientifically possible, "as things stand now it is like using a crystal ball," she said.

Relying on her insurance department to assess the complicated modeling techniques would frighten her, being akin to when "someone who has plumbing experience is about to engage in brain surgery," Ms. Whitehead said.

She said that a solution would be for regulators to commission their own model as a standard against which others could be measured. Barring this, a disinterested, neutral and knowledgeable third party could be called on to verify the models, she said, suggesting that the NAIC might fill this role.

Christopher Roe, a counsel with the American Insurance Association in Washington, said the AIA has not addressed the issue in general terms but does believe insurers should not be precluded from using third-party models and services.

But in Texas, regulators may do just that. They have raised the prospect of banning the use of a proprietary credit scoring product marketed by San Rafael, Calif.-based Fair, Isaac & Co. if sufficient information isn't disclosed to them by the company.

Fair, Isaac's credit scoring products are widely used by personal lines insurers for underwriting purposes.

"If Fair, Isaac is unwilling to provide the relevant information necessary to test this relationship (of credit to loss experience) and if insurers have no other support for the use of these guidelines, then the insurers could be prohibited from using these credit history algorithms as underwriting guidelines in Texas," wrote Texas Associate Commissioner Birny Birnbaum in an Aug. 11 letter requesting detailed information from Fair, Isaac on its data and methodologies.

(Fair, Isaac declined to disclose the requested data. Texas has reiterated its request in a subsequent letter.)

In response to questions submitted to the company, Fair, Isaac issued a written response stating it is unable to turn

its data over to regulators because "we work with data supplied by our partners and have agreements in place to protect the confidentiality of the data."

The statement said Fair, Isaac is committed to helping insurance regulators understand its products "but, for competitive reasons, (we) need to stop shy of laying out exact statistical formulas."

Mr. Birnbaum told the National Underwriter that whatever the proprietary concerns of a third-party entity which is not regulated by the Texas insurance department, Texas law requires insurers to justify their underwriting practices as they relate to the risk.

Dozens, if not hundreds, of companies use the Fair, Isaac product in Texas, but "we have no idea if it is fair or not; we have no idea how it is even being applied," he said.

He said if Fair, Isaac does not respond to Texas' second request for data, "our laws are pretty clear."

In general, "I think the issue is going to become more and more important," he said, citing the trend towards traditional insurance data agents linking up with third-party data services firms to offer specific insurance information products.

"There are statistical databases that insurers are coming to rely on more and more which are outside any regulatory authority," he said.

Without oversight of or access to these databases, regulators may be in danger of being left out of an insurer data revolution, which is used in the very underwriting process they are expected to oversee, he said, adding: "It is definitely an issue that should be of concern."

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# Philip Morris' Pro-Death Study Was Landmark

by Wayne Gytting

SEARCH  
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archives:

Good news:  
Premature deaths save government money

**After** decades of sticking their heads in the sand about the hazards of tobacco, Philip Morris has found a new tactic -- promoting the benefits to society of premature deaths from smoking. A study produced for them by Arthur D. Little, one of the "foremost management consulting firms," found the early deaths of smokers has "positive effects" for society that more than counteract the medical costs of treating smoking induced cancer, etc.

This path-breaking research was limited to smoking in Czechoslovakia. It found that in 1999, despite health care costs for dying smokers, the government still had a net gain of \$147.1 million from smoking. From these figures, the American Legacy Foundation calculated the Czech government saved \$1,227 per dead smoker. That's a pretty good return, as Philip Morris proudly informed government leaders in the Czech Republic.

Philip Morris has since come in for a flood of criticism and has publicly apologized for the conclusions, which is too bad, because the report makes fascinating reading. It is, as the authors state, "the results of the exercise of our best professional judgement." (Imagine what we'd get if they were having an off day).

What makes the study such a model of American scholarship is the care taken to leave no stones unturned. Not only did the Arthur D. Little researchers find out precisely how much early deaths save on health care expenses, housing for the elderly, social security and pensions (something we all wanted to know), they also uncovered savings from premature deaths in areas we non-experts would never dream to look.

Who would think to look at the effect of smoking deaths on unemployment? These authors did, and they found that "replacing those who die early... leads to savings in social benefits paid to the unemployed and in costs of re-training." A wonderful gift to society by smokers.

But it gets even better. The researchers, with obvious relish, note that when a smoker dies prematurely, the savings to the state for that year "is only one part of the positive effect." There's more to come. You need to look at all the other years the smoker would have lived had she or he not smoked, because, we are told, "the savings will therefore influence the public finance balance of smoking in future years(!)" It's a gift that keeps on giving.

Lest you think that Philip Morris is alone in recognizing the benefits to society of early deaths, know that they are in good company. Four years ago, the state of Alabama arrived at similar conclusions in a report by their Attorney General that escaped public notice. This story was covered, as far as I know, only by the Opelika-Auburn News.

Alabama Attorney General Bill Pryor found that "smoking-related health costs are not excessive, because smokers die young." This breathtaking conclusion was the result of an entire 89-page report (with footnotes, I'm told). The Alabama study apparently was just the tip of the iceberg, because it pointed to even more studies that "show taxpayers actually save money in costs for nursing homes, insurance, pensions, and Social Security benefits because smokers die earlier than non-smokers."

For those of you inclined to think that reasoning in Alabama takes its own course, know that State Farm Insurance followed the same line in a study defending Sports Utility Vehicles. Their researchers reported: "Sport utility vehicles may actually save insurers money in a few accidents, by killing people who might otherwise have survived with serious injuries. Severe injuries tend to produce larger settlements than deaths." Sounds like public thanks are owed to SUV makers, too.

Obviously, great minds work in the same circles.

It was unfortunate Philip Morris has had to suffer such bad publicity. The company, famous for its slogan "today's teenager is tomorrow's potential regular customer," has been working hard to spruce up its image. This past year it spent \$100 million on charity alone. Of course, it spent \$150 million telling people about their charitable giving, but this 3-to-2 ratio is actually quite good for an American corporation.

The Philip Morris report is no isolated travesty of reason. The language of the study, with all of its "objectivity," "quantification," "demographic data," and "statistical analysis," would be at home in any university or corporation. It's the same brand of impersonal, machine-like reasoning. This is our culture speaking.

We can become so abstract, so disconnected, we cease to live on the planet. We all can. That's why I suggest the executives who brought us the Marlboro Man quit apologizing. Take your case to the people. Be aggressive. Reach out to the families of dying smokers. Get to know their names, their friends, their family stories. Then explain to them the "positive effects" of their approaching fates. Bring lots of charts. Lots.

---

Comments? Send a letter to the editor.

Albion Monitor August 13, 2001 (<http://www.monitor.net/monitor>)

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6 March 2002

**Comments of the Alaska Public Interest Research Group and U.S. Public Interest Research Group (U.S. PIRG) before Alaska House Labor and Commerce Committee**

**in support of proposed Alaska legislation, HB395,  
to ban the use of credit scores for insurance decisions**

by Edmund Mierzwinski, Consumer Program Director [ed@pirg.org](mailto:ed@pirg.org) and Steve Conn, Executive Director of Alaska Public Interest Research Group, [AkPirg@Akpig.org](mailto:AkPirg@Akpig.org)

Thank you for the opportunity to present the views of Alaska Public Interest Research Group and U.S. Public Interest Research Group (U.S. PIRG), public interest advocacy organizations, on the important issue of the growing trend of insurance companies to rely on credit scoring in underwriting, and particularly, non-renewal decisions and the proposed HB395.

**Summary**

Based not only on the significant numbers of errors in credit reports and, concomitantly, resulting errors in credit scores, but also on the tremendous importance society places on the availability of fairly-priced insurance, U.S. PIRG recommends that credit scoring should be prohibited as an insurance rating factor as a matter of public policy. This goal would be achieved by enactment of the proposed bill HB395.

Consumers should not be denied the right to insure a house or a car on the basis, in whole or in part, of a credit score. In addition, the practice of using suspect credit scores as a basis for non-renewal of a customer who has neither failed to make a premium payment, nor bounced a check made in payment of a premium, nor filed excessive or unsubstantiated claims, is particularly outrageous.

**Discussion**

**(1) Credit Scores Are Based On Error-Ridden Credit Reports**

As you may know, the state PIRGs have conducted a series of research reports on the accuracy of consumer credit reports.

The results of our studies are troubling. Our most recent report, the 1998 study *Mistakes Do Happen*. [<http://www.pirg.org/reports/consumer/mistakes/index.htm>], found that 29% of credit reports surveyed contained errors serious enough to cause the denial of credit, insurance,

U.S. Public Interest Research Group, 218 D St SE, Washington, DC 20003  
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**employment or other benefits.** Consumers Union, publishers of Consumer Reports Magazine, has had similar findings in its studies. In addition, our discussions with attorneys representing consumers in litigation against consumer reporting agencies (credit bureaus) lead us to believe that our methodology is conservative and that error rates in credit reports may in fact be significantly higher.

A credit score ("bureau score"), as used in insurance decision-making, is merely a mathematical summary derived from a narrative credit report. If the credit report contains missing information, or falsely derogatory information, the consumer's score will be deflated.

For consumers at either end of a bell curve, with either very bad or very good credit, the errors may not matter. For consumers on the margin, however, errors resulting in a decreased credit score can result either in credit or insurance denial, or with the increased use of risk-based pricing models, significantly higher (sub-prime) credit or insurance premium (high-risk rating pool) costs.

### **(2) Credit Bureaus and Credit Scoring Companies Are Not Adequately Transparent to Consumers for Error Correction or Regulators for Evaluation**

Problems with inaccurate credit reports and scores are exacerbated by the well-documented intransigence of the credit bureaus toward consumers attempting to resolve credit report error disputes. The so-called Big Three credit bureaus -- Experian, Trans Union and Equifax -- are all operating under Federal Trade Commission consent decrees that resulted in a combined \$2.5 million in civil penalties in a 1999 FTC action for failure to, among other things, provide enough staff to answer the phone. The bureaus' incessant use of brain-numbing, voice-mail-jails drives consumers, already driven to frustration by the bureaus' ineptitude and failure to fix errors, into a frenzy.

Worse, however, is the growing use of credit scores derived from these mistake-ridden reports. The Big Three purchase much of their credit scoring software from the market leader, California-based Fair Isaac company, which has a well-deserved reputation for an unacceptable level of secrecy that has prevented independent review of its algorithms.

Fair Isaac's refusal to provide details of its methods extends to rejecting requests by insurance regulators for adequate information to review credit scoring decision-making. [See correspondence between former Texas Associate Insurance Commissioner Birny Birnbaum and Fair Isaac in Appendix to "Credit Reports and Insurance Underwriting," National Association of Insurance Commissioners (NAIC), 1997.]

Recently, under pressure from a new California credit scoring disclosure law and the threat of even broader federal legislation, Fair Isaac has begun to provide credit scores to consumers, for a fee, with limited explanations of its methodology<sup>1</sup>. For years, of course, before an unprecedented coalition of realtors and consumer advocates pushed that crucial California legislation to

<sup>1</sup> See detailed testimony of Edmund Mierzwinski, U.S. PIRG, before Congress, September 2001, on the need to make credit scores part of credit reports and provided free upon consumer request.  
<<http://www.house.gov/financialservices/92100toc.htm>>

passage, Fair Isaac had patronizingly argued that consumers weren't smart enough to understand credit scores. The reality, of course, is that the only thing consumers wouldn't be able to understand is how the credit bureaus and credit scoring companies could make so many mistakes.

The difficulty both consumers and insurance regulators have in dealing with credit bureaus and Fair Isaacs cannot be understated as a problem that magnifies the already-significant problems caused by errors in credit reports.

**(3) Using Credit Scores In Insurance Decisions Or As an Insurance Rating Factor Is Bad Public Policy**

We believe that the well-documented inaccuracy in credit reports and the lack of adequate external review of either the scoring models or the industry-funded studies purporting to substantiate their use in insurance decision-making are all adequate reasons for Alaska to reject the use of credit scoring in insurance decision-making.

**Consumers should not be denied the right to insure a house or a car on the basis, in whole or in part, of a credit score.** In addition, the practice of using suspect credit scores as a basis for non-renewal of a customer who has neither failed to make a premium payment, nor bounced a check made in payment of a premium, nor filed excessive or unsubstantiated claims, is particularly outrageous.



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## U.S. PIRG

6 March 2002

**Comments of the Alaska Public Interest Research Group and U.S. Public Interest Research Group (U.S. PIRG) before Alaska Senate Labor and Commerce Committee**

**in support of proposed Alaska legislation, CSSB320,  
to ban the use of credit scores for insurance decisions**

by Edmund Mieszewski, Consumer Program Director [ed@pirg.org](mailto:ed@pirg.org) and Steve Conn, Executive Director of Alaska Public Interest Research Group, [AKPIRG@AkPIRG.org](mailto:AKPIRG@AkPIRG.org)

Thank you for the opportunity to present the views of Alaska Public Interest Research Group and U.S. Public Interest Research Group (U.S. PIRG), public interest advocacy organizations, on the important issue of the growing trend of insurance companies to rely on credit scoring in underwriting, and particularly, non-renewal decisions and the proposed CSSB320.

### Summary

Based not only on the significant numbers of errors in credit reports and, concomitantly, resulting errors in credit scores, but also on the tremendous importance society places on the availability of fairly-priced insurance, U.S. PIRG recommends that credit scoring should be prohibited as an insurance rating factor as a matter of public policy. This goal would be achieved by enactment of the proposed bill CSSB320.

Consumers should not be denied the right to insure a house or a car on the basis, in whole or in part, of a credit score. In addition, the practice of using a credit score as a basis for non-renewal of a customer who has neither failed to make a premium payment, nor bounced a check made in payment of a premium, nor filed excessive or unsubstantiated claims, is particularly outrageous.

### Discussion

#### (1) Credit Scores Are Based On Error-Ridden Credit Reports

As you may know, the state PIRGs have conducted a series of research reports on the accuracy of consumer credit reports.

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The results of our studies are troubling. Our most recent report, the 1998 study *Mistakes Do Happen* [<http://www.pirg.org/reports/consumer/mistakes/index.htm>], found that 29% of credit reports surveyed contained errors serious enough to cause the denial of credit, insurance, employment or other benefits. Consumers Union, publishers of Consumer Reports Magazine, has had similar findings in its studies. In addition, our discussions with attorneys representing consumers in litigation against consumer reporting agencies (credit bureaus) lead us to believe that our methodology is conservative and that error rates in credit reports may in fact be significantly higher.

A credit score ("bureau score"), as used in insurance decision-making, is merely a mathematical summary derived from a narrative credit report. If the credit report contains missing information, or falsely derogatory information, the consumer's score will be deflated.

For consumers at either end of a bell curve, with either very bad or very good credit, the errors may not matter. For consumers on the margin, however, errors resulting in a decreased credit score can result either in credit or insurance denial, or with the increased use of risk-based pricing models, significantly higher (sub-prime) credit or insurance premium (high-risk rating pool) costs.

#### (2) Credit Bureaus and Credit Scoring Companies Are Not Adequately Transparent to Consumers for Error Correction or Regulators for Evaluation

Problems with inaccurate credit reports and scores are exacerbated by the well-documented intransigence of the credit bureaus toward consumers attempting to resolve credit report error disputes. The so-called Big Three credit bureaus -- Experian, Trans Union and Equifax -- are all operating under Federal Trade Commission consent decrees that resulted in a combined \$2.5 million in civil penalties in a 1999 FTC action for failure to, among other things, provide enough staff to answer the phone. The bureaus' incessant use of brain-numbing, voice-mail-jails drives consumers, already driven to frustration by the bureaus' ineptitude and failure to fix errors, into a frenzy.

Worse, however, is the growing use of credit scores derived from these mistake-ridden reports. The Big Three purchase much of their credit scoring software from the market leader, California-based Fair Isaac company, which has a well-deserved reputation for an unacceptable level of secrecy that has prevented independent review of its algorithms.

Fair Isaac's refusal to provide details of its methods extends to rejecting requests by insurance regulators for adequate information to review credit scoring decision-making. [See: correspondence between former Texas Associate Insurance Commissioner Birny Eirnbaum and Fair Isaac in Appendix to "Credit Reports and Insurance Underwriting," National Association of Insurance Commissioners (NAIC), 1997.]

Recently, under pressure from a new California credit scoring disclosure law and the threat of even broader federal legislation, Fair Isaac has begun to provide credit scores to consumers, for a

fee, with limited explanations of its methodology<sup>1</sup>. For years, of course, before an unprecedented coalition of realtors and consumer advocates pushed that crucial California legislation to passage, Fair Isaac had patronizingly argued that consumers weren't smart enough to understand credit scores. The reality, of course, is that the only thing consumers wouldn't be able to understand is how the credit bureaus and credit scoring companies could make so many mistakes.

The difficulty both consumers and insurance regulators have in dealing with credit bureaus and Fair Isaacs cannot be understated as a problem that magnifies the already-significant problems caused by errors in credit reports.

### **(3) Using Credit Scores in Insurance Decisions Or As an Insurance Rating Factor Is Bad Public Policy**

We believe that the well-documented inaccuracy in credit reports and the lack of adequate external review of either the scoring models or the industry-funded studies purporting to substantiate their use in insurance decision-making are all adequate reasons for Alaska to reject the use of credit scoring in insurance decision-making.

Consumers should not be denied the right to insure a house or a car on the basis, in whole or in part, of a credit score. In addition, the practice of using suspect credit scores as a basis for non-renewal of a customer who has neither failed to make a premium payment, nor bounced a check made in payment of a premium, nor filed excessive or unsubstantiated claims, is particularly outrageous.

<sup>1</sup> See detailed testimony of Edmund Mierzwinski, U.S. PIRG, before Congress, September 2001, on the need to make credit scores part of credit reports and provided free upon consumer request.  
<<http://www.house.gov/financialservices/92100toc.htm>>

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## The Reliability of Consumer Reports<sup>1</sup>

- There are approximately 200 million Americans who have credit reports.
- Consumer reporting agencies provide 2 million credit reports every single day.
- 2 billion pieces of information are updated monthly in credit files.

### The Marketplace

The consumer reporting industry receives and provides vast amounts of information used by consumers to buy cars, refinance homes, obtain college loans, open credit cards to finance vacations or buy birthday presents, or fulfill other consumer needs. Much of the information provided by consumer reporting agencies accounts for what FTC Commission Chairman Tim Muris recently called “the miracle of instant credit.” Chairman Muris also noted that this “miracle is only possible because of our credit reporting system.”<sup>2</sup>

Consumer reports are tested for reliability in the marketplace two million times every single day by tens of thousands of lenders and other businesses, including banks, retailers, car dealers, landlords, employers and insurance companies. The highly competitive nature of the consumer reporting industry is such that businesses will quickly abandon any consumer reporting agency that has inaccurate files. Reliance on inaccurate reports often results in increased losses.

### The Law

#### *Consumer Reporting Agencies*

The federal Fair Credit Reporting Act (FCRA), 15 U.S.C. § 1681 *et seq.* and the Maryland state credit reporting law, Md. Comm. Law § 14-1201 *et seq.*, heavily regulate the consumer reporting industry. Consumer reporting agencies are required to maintain reasonable procedures to assure maximum possible accuracy.<sup>3</sup> Consumers have a right to dispute information on their credit reports with consumer reporting agencies and the laws require dispute resolution in not more than 30 days (45 days in certain circumstances).<sup>4</sup> If a dispute cannot be verified then the information must be removed in the consumer’s favor.<sup>5</sup>

<sup>1</sup> Founded in 1906, the Consumer Data Industry Association (CDIA), formerly known as Associated Credit Bureaus, is the international trade association that represents more than 400 consumer data companies. CDIA members represent the nation’s leading institutions in credit reporting, mortgage reporting, check verification, fraud prevention, risk management, employment reporting, tenant screening and collection services.

<sup>2</sup> October 4, 2001, before the Privacy 2001 conference in Cleveland, Ohio.

<sup>3</sup> 15 U.S.C. § 1681e(b), Md. Com. Law § 14-1205(b).

<sup>4</sup> 15 U.S.C. § 1681i, Md. Com. Law § 14-1208. The majority of reinvestigations are completed in five days or less and 80% are resolved in ten days or less (see below).

## USE OF CREDIT DATA IN THE INSURANCE INDUSTRY

March 24, 2002

The Alaska Independent Insurance Agents & Brokers is a professional trade association representing independent business people throughout Alaska. Our members bring a unique perspective to the issue of using credit data in the insurance industry. We work with our insurance company partners while representing the interests of our clients. Because we deal with the Alaskan consumer on a daily basis, we are particularly sensitive to the needs and concerns of consumers. We believe the best consumer protection is a healthy, competitive insurance marketplace.

The use of credit scoring in both the underwriting and pricing of insurance products is a highly complex issue. On one hand, most agents strongly support tools that foster enhanced competition and the fair and accurate pricing of risk. At the same time, however, the increased use of credit by insurers has forced us all to consider the manner in which credit scoring is used in the marketplace and to evaluate whether changes need to be implemented.

For many years, credit data has been utilized by the financial services industry. Lenders, for example, use such information to evaluate loan applications, determine creditworthiness, and predict the likelihood of default and delinquency. They measure the potential borrowers against millions of other similarly situated individuals. Similarly, the insurance industry uses credit data to predict future losses and claim costs and to determine prices in a more accurate manner. Many studies have shown that an individual's credit history is an accurate predictor of potential for future loss. In 1996 a study by Tillinghast-Towers-Perrin of nine personal insurance companies, concluded that the relationship between credit scores and loss ratios ranged from 92% to 99%. In 1999, the Virginia Bureau of Insurance reached the conclusion that there appears to be concrete data indicating that a correlation exists between credit scores and losses. Thus, insurers have begun to use credit based scoring with other traditional factors to determine who to insure and what price to charge. Why would it be reasonable for one segment of the financial services industry to use credit data and not allow the insurance industry to utilize the same credit data to match the price of their products with the expected cost of those products?

There remain, however, additional concerns: 1) the use of credit data as the exclusive criteria in insurance underwriting or the inflexible use of credit data, 2) the lack of ability for regulators to review the proprietary credit algorithms or formulas as insurer filings can become public information for competitors to review, 3) credit information may be inaccurate and 4) lack of disclosures to consumers that credit information is obtained and its utilization in insurance underwriting or rating.

A consumer reporting agency that violates any provision of either credit reporting law is subject to private rights of action,<sup>6</sup> enforcement by the FTC,<sup>7</sup> the Maryland's attorney general,<sup>8</sup> and the Commissioner of Financial Regulation.<sup>9</sup>

### *Data Furnishers*

In addition to the accuracy standards set by the FCRA on consumer reporting agencies since 1970, data furnishers also have accuracy standards to which they must adhere as established by the 1997 amendments to the FCRA. Data furnishers are prohibited from furnishing data they know is inaccurate and they have an affirmative duty to correct and update information.<sup>10</sup> Furnishers also are liable to consumers if they continue to report data known to be inaccurate.<sup>11</sup>

### **Industry Practices**

There have been a number of tools put in place and refined over the years to promote accuracy of consumer reports. In 1999, ACB rolled out the Metro 2 format. This format is used by thousands of data furnishers and consumer report users. A standard reporting format reduces errors by creating a uniform and universal method of data sharing.

In 1992, ACB went live with the Automated Dispute Verification System (ACDV). This system, upgraded in 1995, reduces the burden on consumers who dispute items on their credit reports since they need only dispute an item with one consumer reporting agency. The ACDV is an electronic messaging system that allows consumer reporting agencies to communicate with those companies that furnish data to a consumer reporting agency. In a continuation of the quest for innovation, ACB, its members, and major lenders are currently beta testing the next generation of technology for automated consumer dispute verification.

An important point to consider in discussion the accuracy of consumer reports is this – what does one consider to be an inaccuracy? The inaccuracy that matters most is one that would reflect on a consumer's ability to obtain credit. Consider the consumer Jonathon Q. Public. Mr. Public's name might appear on some credit cards as John while on other cards or credit, his name might appear as J. Q. Public or Jonathon Public. Mr. Public might feel the discrepancies are errors, but irrespective of his concerns the different names will not inhibit Mr. Public in his desire to obtain credit. The same holds true for Martha Doe who might live at 123 S. Maine Street, but it might show up on some credit information as 123 S. Main, or 123 Maine South. The bottom line is that not all inaccuracies are inaccuracies that reflect on one's ability to obtain credit.

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<sup>5</sup> 15 U.S.C. § 1681i(a)(5), Md. Com. Law § 14-1208(a)(2).

<sup>6</sup> 15 U.S.C. § 1681n-p, Md. Com. Law § 14-1213.

<sup>7</sup> 15 U.S.C. § 1681s(a).

<sup>8</sup> 15 U.S.C. § 1681s(c).

<sup>9</sup> Md. Com. Law § 14-1218.

<sup>10</sup> § 1681s-2

<sup>11</sup> § 1681s-2(b). *See also, Nelson v. Chase Manhattan Mortgage Corp.*, No. 00-15946 (U.S.C.A. 9<sup>th</sup> Cir., March 1, 2002).

While a consumer might find an inaccurate piece of information on his or her report, whether it has an impact on the credit application or not, there are specific standards, some industry and some legal, to resolve those inaccuracies in a quick and efficient manner. In addition to the above-mentioned Metro 2 format and ACDV system, the FCRA requires consumer dispute reinvestigations to be completed, in most cases, in 30 days or less. The reality is that the majority of reinvestigations are completed in five days or less and 80% are resolved in ten days or less.

**National Association of Insurance Commissioners (NAIC)  
White Paper on Accuracy**

Given the often misstated definition of an inaccuracy, there is little scientific data in the marketplace today and one must turn to industry practices and independent sources. The 1997 NAIC White Paper "Credit Reports and Insurance Underwriting" cited the FTC. While the White Paper stated that "... various studies have indicated different results of the accuracy of credit reports," it went on to state that "[a] representative of the FTC, speaking to regulators on October 26, 1995, stated that the FTC is only able to estimate the accuracy of credit reports based upon the volume of complaints it receives. The number of complaints has been decreasing, thus the FTC assumes that the accuracy of credit report information is improving." Since the FTC staff comments preceded the 1997 amendments to the FCRA (adding liability for data furnishers, among other improvements) and the Metro 2 format, CDIA can presume that the accuracy of credit report information, assumed by FTC staff to have improved in 1995, has improved even more since the end of the last century.

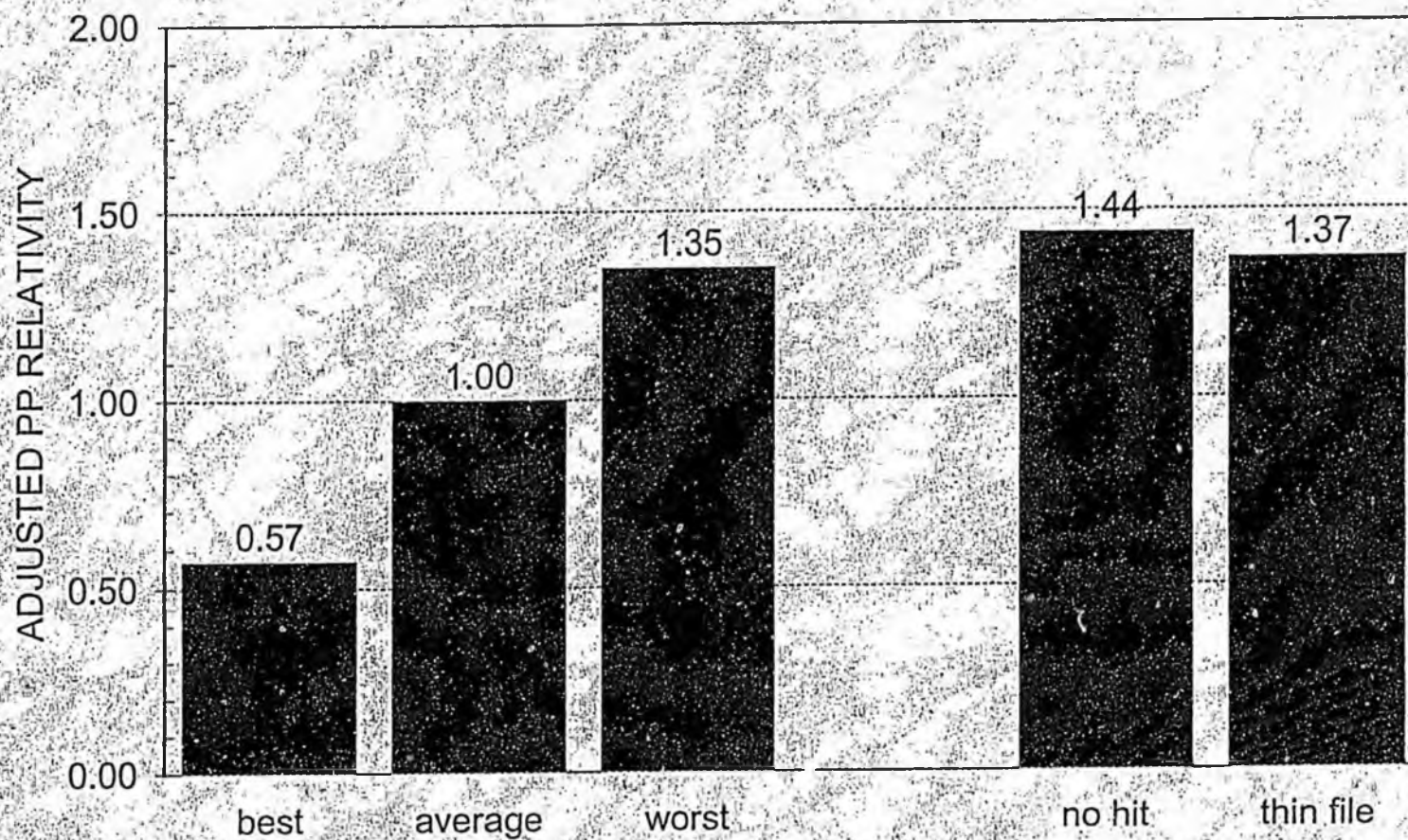
**Conclusion**

Consumer reporting agencies are responsible for the accurate handling of billions of pieces of data every month and the accuracy of the reports they produce is tested in the marketplace every single day. Through a combination of legal mandates and industry-lead initiatives, the consumer reporting agency produces accurate consumer reports and expeditiously completes reinvestigations in those instances where accuracy is questioned.

A final point that causes great concern for our Alaskan members is that a total ban on the use of credit data will likely have unintended consequences and cause more harm than good. One reason for this is the Federal Fair Credit Reporting Act. The FCRA gives insurers the power to prescreen a group of potential insureds by utilizing credit reports and credit data and any effort by the states to restrict that ability, is preempted by federal law. Companies that utilize direct solicitation methods and prescreen consumer records will essentially be unaffected by state attempts to ban the use of credit, but independent agency companies (which are used by our Alaskan members for their clients) will be prevented from using this powerful tool. This would create an uneven playing field for local independent agents and would do little to address the concerns that fuel the desire to enact such reforms. Thus AIIAB opposed all efforts to totally ban the use of credit or to regulate its use in an overly restrictive manner.

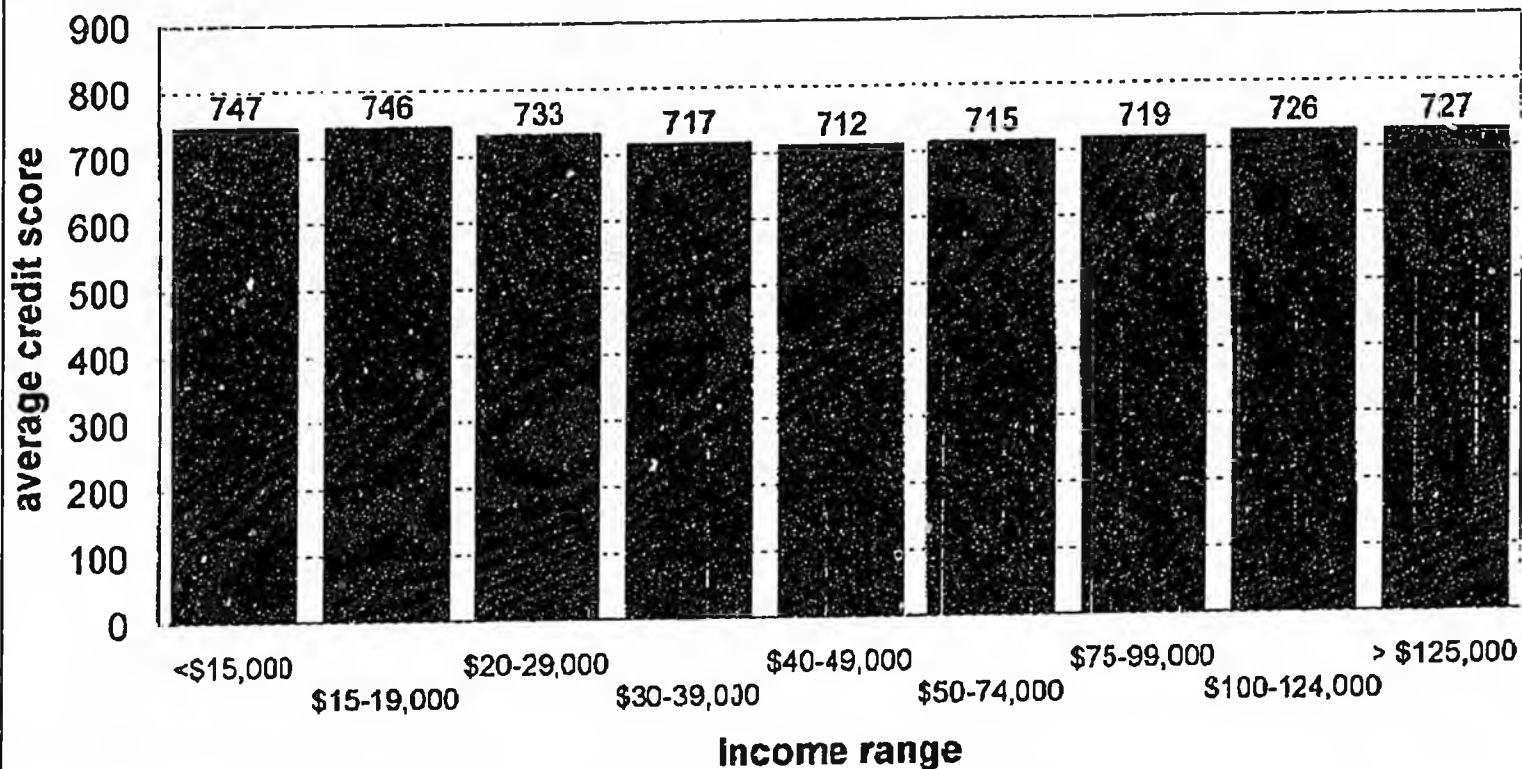
**We would strongly urge the Alaska Legislature to oppose bills, which seek to ban the use of credit data in the underwriting and pricing of insurance products.** This is a complex issue, which cannot be given comprehensive review in the short time remaining in the legislative session. We would urge that the Oregon model be given consideration wherein a task force representing the varied points of view be convened to review, deliberate and reach consensus to find an equitable solution that will foster a healthy, competitive insurance marketplace while protecting the interest of the consumer.

# Credit is a Powerful Predictor



# Myth: Insurance Scores Unfairly Discriminate

## Against Low Income Consumers



source: 1998 AIA study of 794,000 policies

**HB**

**399**

# ALASKA STATE LEGISLATURE

Rep. Lesil McGuire, Chair  
Sen. Robin Taylor, Vice-Chair  
Sen. Lyda Green  
Sen. Georgianna Lincoln  
Rep. Jeannette James  
Rep. Joe Hayes



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## Administrative Regulation Review Committee

February 20, 2002

Representative Lisa Murkowski, Chair  
House Labor and Commerce Committee  
State Capitol, Room 408  
Juneau, Alaska 99801-1182

Dear Representative Murkowski:

Please accept this letter and enclosed documents as a request for the Labor and Commerce Committee to hear HB 399, a Bill to Annul Department of Community and Economic Development Regulations, 12 AAC 21.990, paragraph 7 and 12 AAC 39.992(b) As adopted 01/19/02 for Register 161, April, 2002.

These regulations are a clear contradiction of Alaska Statutes AS 08.40.270, AS 08.40.490 and AS 08.18.171 as they relate to the term "Uniform Mechanical Code."

On behalf of the Committee, a majority of which voted to introduce this bill, I respectfully request scheduling of HB 399 in the House Labor and Commerce Committee at your earliest convenience. Thank you in advance for your time and consideration. If you have any questions please do not hesitate to call.

Sincerely:

A handwritten signature in black ink, appearing to read "Lesil McGuire".

Representative Lesil McGuire  
Chair, ARRC

22-LS1461\c  
Bannister  
2/20/02

**CS FOR HOUSE BILL NO. 399( )**

**IN THE LEGISLATURE OF THE STATE OF ALASKA**

**TWENTY-SECOND LEGISLATURE - SECOND SESSION**

**BY**

**Offered:  
Referred:**

**Sponsor(s): HOUSE RULES COMMITTEE BY REQUEST OF THE ADMINISTRATIVE REGULATION  
REVIEW COMMITTEE**

**A BILL**

**FOR AN ACT ENTITLED**

1 **"An Act annulling certain regulations adopted by the Department of Community and**  
2 **Economic Development relating to the mechanical code that applies to certain**  
3 **construction contractors and mechanical administrators; and providing for an effective**  
4 **date."**

5 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

6 **\* Section 1.** The uncodified law of the State of Alaska is amended by adding a new section  
7 to read:

8 ANNULMENT OF REGULATIONS. The following regulations adopted by the  
9 Department of Community and Economic Development establishing the mechanical code that  
10 applies to certain construction contractors and mechanical administrators are annulled: 12  
11 AAC 21.990(7) and 12 AAC 39.992(b).

12 **\* Sec. 2.** This Act takes effect immediately under AS 01.10.070(c).

# Online Public Notice

State of Alaska Online

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Submitted by	Date Modified	Ak Admin Journal	Attachments	Public (Web edit)
Pat Park-Fisher/DOL/DCED on 01/03/2002 at 10:06 AM	01/10/2002 09:27:58 AM	[not printed]	No files attached	

## Changes to Mechanical Code Regulations Related to Construction Contractors & Mechanical Administrators

Category: Adopted Regulations - Text or Summary of Text

Department: Community & Economic Development

Publish Date: 01/03/2002

Location: Statewide  
Region: Statewide

### Body of Notice:

ORDER CERTIFYING THE CHANGES TO REGULATIONS OF THE DEPARTMENT OF COMMUNITY AND ECONOMIC DEVELOPMENT.

The Department of Community and Economic Development adopted regulations dealing with the mechanical code related to construction contractors and mechanical administrators on November 27, 2001 under the authority of AS 08.18.171, AS 08.40.230, AS 08.40.240, AS 08.40.270, AS 08.40.490, and AS 44.33.020 and after compliance with the Administrative Procedure Act (AS 44.62), specifically including notice under AS 44.62.190 and 44.62.200 and opportunity for public comment under AS 44.62.210.

This action is not expected to require an increased appropriation.

On the record, in considering public comments, the Department of Community and Economic Development paid special attention to the cost to private persons of the regulatory action being taken.

The regulation changes described in this order take effect on January 19, 2002 as provided in AS 44.62.180.

### Revision History:

01/03/2002 10:06:36 AM by Pat Park-Fisher/DOL/DCED/State/Alaska/US  
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Register 161, April 2002 PROFESSIONAL REGULATIONS

~~(Words underlined indicate language being added; words [CAPITALIZED AND BRACKETED] indicate language being deleted. Complete new sections are not underlined.)~~

CHAPTER 21. CONSTRUCTION CONTRACTORS.

12 AAC 21.990 is amended by adding a new paragraph to read:

(7) "Uniform Mechanical Code" has the meaning given in 12 AAC 39.992(b).

(Eff. 7/2/77, Register 62; am 1 / 19 / 2002, Register 161 )

Authority: AS 44.33.020

CHAPTER 39. MECHANICAL ADMINISTRATORS.

12 AAC 39.992 is amended and a new subsection is added to read:

12 AAC 39.992. DEFINITIONS. (a) In this chapter,

...

(b) In this chapter and in AS 08.40.270, AS 08.40.490, and AS 08.18.171, "Uniform

Mechanical Code" means the mechanical code adopted by the Department of Public Safety under

13 AAC 50.023, and includes the International Mechanical Code (Eff. 7/7/94, Register 131; am

11/26/94, Register 132; am 1 / 19 / 2002, Register 161 )

Authority: AS 08.40.230 AS 08.40.240 AS 44.33.020

## Reference 2

Sec. 08.18.171. Definitions.

In this chapter,

- (1) "builder" means general contractor;
- (2) "cash deposit" means a cash deposit or other negotiable security filed with the commissioner in lieu of a surety bond under AS 08.18.071(b);
- (3) "commissioner," unless the text reads otherwise, means the commissioner of the Department of Community and Economic Development;
- (4) "contractor" means a person who, in the pursuit of an independent business, undertakes or offers to perform, or claims to have the capacity to perform, or submits a bid for a project to construct, alter, repair, move, or demolish a building, highway, road, railroad, or any type of fixed structure, including excavation and site development and erection of scaffolding; "contractor" includes a general contractor, builder, mechanical contractor, specialty contractor, and subcontractor;
- (5) "department" means the Department of Community and Economic Development, unless the context indicates otherwise;
- (6) "general contractor" means a contractor whose business operations require the use of more than three trades or the use of mechanical or specialty contractors and subcontractors who are under the supervision of the contractor;
- (7) "mechanical contractor" means a contractor whose business operations involve plumbing, pipe fitting, sheet metal, heating, air conditioning, ventilating, or sprinkler and dry chemical fire protection trades in order to install or modify mechanical piping and systems, devices, fixtures, and equipment or other mechanical materials subject to the following codes as published by the International Association of Plumbing and Mechanical Officials or the International Conference of Building Officials:
  - (A) Uniform Plumbing Code;
  - (B) Uniform Swimming Pool, Spa, and Hot Tub Code;
  - (C) Uniform Solar Energy Code; and
  - (D) Uniform Mechanical Code;
- (8) "residential contractor" means a general contractor whose business and operation involve undertaking the construction or alteration of a privately-owned residential structure of one to four units that is used or intended to be used as a human dwelling;

**Reference 2 (cont.)**

(9) "specialty contractor" means a contractor, other than a mechanical contractor, whose business operations require the use of not more than three trades;

(10) "trade" means a skill used in the field of construction, as defined by regulation by the department.

\*\*\*SECTION 08.18.180 - 08.18.350 [Repealed, Sec. 1 ch 100 SLA 1968].

**Repealed or Renumbered**

**Sec. 08.40.230. Categories of licenses.**

The department may adopt regulations establishing categories of mechanical administrators, qualifications for those categories, and the content of examinations for applicants for each category.

**Sec. 08.40.240. Regulations.**

The department shall adopt regulations under AS 44.62 (Administrative Procedure Act) relating to the examination and licensing of mechanical administrators and the establishing of the continued competency of licensees for license renewal and reinstatement.

**Sec. 08.40.270. Examination of applicant.**

(a) Each applicant shall be examined to determine the applicant's

(1) ability to understand plans, design specifications, and engineering terms commonly used in the mechanical field;

(2) knowledge of mechanical installations and piping;

(3) familiarity with the requirements of the Uniform Plumbing Code, Uniform Swimming Pool, Spa, and Hot Tub Code, Uniform Solar Energy Code, and the Uniform Mechanical Code currently in effect in the state;

(4) [Repealed, Sec. 37 ch 101 SLA 1994].

(5) personal skill and ability.

(b) If an applicant for a license submits proof satisfactory to the department that the applicant is licensed as a mechanical administrator or the equivalent by another state or territory, meets qualifications established by the department under AS 08.40.230, and has passed an examination equivalent to the test administered under (a) of this section, the department shall waive all of the examination required under (a) of this section.

**Reference 2 (cont.)**

Sec. 08.40.490. Definitions.

In AS 08.40.210 - 08.40.490,

(1) "department" means the Department of Community and Economic Development except where the context otherwise requires;

(2) "manufacture" means fabrication or completion of a product or mechanical apparatus exclusive of its completion or installation at a job site;

(3) "mechanical administrator" means a person who is responsible for

(A) installing or modifying mechanical piping and systems, devices, fixtures, equipment, or other mechanical materials subject to the Uniform Plumbing Code, Uniform Swimming Pool, Spa, and Hot Tub Code, Uniform Solar Energy Code, and the Uniform Mechanical Code as published by the International Association of Plumbing and Mechanical Officials and the International Conference of Building Officials; or

(B) certifying that an installation or modification described in (A) of this paragraph complies with the applicable codes;

(4) "mechanical piping" includes piping fixtures, devices, and equipment;

(5) "utility" means every public, cooperative, or other corporation, company, individual, or association of individuals, their lessees, trustees, or receivers appointed by a court, that owns, operates, manages, or controls a plant or system for

(A) furnishing, by generation, transmission, or distribution, electrical service, fuel gas service, district heating, sewage disposal, or domestic water service to the public for compensation;

(B) furnishing telecommunications service to the public for compensation.

Building Department. She had a question for Occupational Licensing. She said that in February 2001, the ICBO had offered an overview of the International Mechanical Code, and that there were administrators at that time who wanted to be licensed under that. She said she was told by the Occupational Licensing Department that a person could not be certified under a code until it was adopted. "So," she said "we're kind of in a Catch 22 here." People did not want to take the tests and pay for them if they couldn't get certified, she said.

Number 0107

MS. REARDON replied that last February, the code change had not been adopted, and continuing education regulations require that an applicant have continuing education in the code that is in effect, which was the Uniform Code. The department had no way of knowing in February that the state regulation change would go through, so did not want to approve continuing education that might turn out not to have been on the appropriate topic.

MS. RONNING said she had received several calls from people who want to renew their licenses, and asked if she offered a class next week, would it be accepted?

MS. REARDON asked Ms. Ronning to contact her office. "Now that we know that the code is, in fact, changing," she said, she would see how rapidly they could approve the continuing education courses in the International Code.

MS. RONNING emphasized, "The training is out there; the problem is getting your office to accept it."

MS. REARDSON said she would call Ms. Ronning to see what could be done.

Number 0132

REPRESENTATIVE JAMES said her big concern was that, "We have regulations that have been written and are going into effect on the fifteenth of September, and we have statutory conflict. In the statute it says that the UMC will be used for mechanical engineers, and that's exactly the problem that Catherine Reardon has indicated." She asserted that the new regulations have overridden statutes, which is a legislative prerogative.

CHAIR MCGUIRE said that she agreed with representative James that, "That is the problem we have been trying to get at." She noted that Ms. Reardon is in a situation where they have to alter their regulations to be able to accept new standards, but, "Until you've adopted your regs which shouldn't be going into effect until September 15, not only can she not do it, but there is some question about whether or not she even has the authority to under statute."

Number 0139

MR. POWELL said he could respond to part of that, but would like to defer the rest to the Department of Law. He said there is a conflict that has existed for a number of years that has never been resolved, and that is if you read the entire statute, it says, "Uniform Mechanical Code as published by ICBO and IATMO." The ICBO no longer participates in that publication, so that in

itself is a conflict ..." He reiterated that the Fire Marshal's office was following the [legal] advice that the problem would be taken care of in a "cleanup" change once it was determined which code would be adopted. At that time, other related references would be changed to match or to harmonize.

Number 0152

MR. STARK said he thought it would be helpful to have the statutes clarified. "It is not clear which codes apply," he said. For example, under the examination of applicants that Ms. Reardon's office supervises, they talk about "the Uniform Mechanical Code currently in effect in the state." He said he thought the courts might well read that broadly enough to include the International Mechanical Code. So it would be helpful for the legislature to clear this up, that and the conflict to which Mr. Powell had referred.

MR. STARK added that he thought it would be helpful for everyone to understand that once a mechanical contractor or mechanical administrator takes the test and passes it, that person never has to take the test again. "So two years from now, people who are licensed at the end of this month will not be taking that new test on the International Mechanical Code," he explained. "They will merely be required to show continuing ... education on the existing code ...."

CHAIR MCGUIRE indicated that she agreed with his statement that there needs to be some clarification, saying that in the meantime, Ms. Reardon is "in a pickle."

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## 2000 EDITION



Adopted at the Seventieth Annual Conference  
September, 1999

INTERNATIONAL ASSOCIATION OF PLUMBING AND  
MECHANICAL OFFICIALS  
A Nonprofit Association

*Alaska* Department of Community  
and Economic Development

Tony Knowles, Governor

Division of Occupational Licensing

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June 7, 2001

Mr. Ross Fosberg  
Code Adoption Coordinator  
Department of Public Safety  
Division of Fire Protection  
5700 East Tudor Road  
Anchorage, AK 99507-1225

Dear Mr. Fosberg,

The following are the Department of Community and Economic Development Division of Occupational Licensing comments on the Department of Public Safety proposed changes to 13 AAC 50.020 and 13 AAC 50.023 regarding the Building Code and the Mechanical Code.

The Department of Public Safety proposes to repeal the Uniform Building Code and the Uniform Mechanical Code and to adopt the International Building Code and the International Mechanical Code. This change would significantly impact the Division of Occupational Licensing and our licensed Mechanical Administrators and Residential Contractors.

The proposed change from the Uniform Codes to the International Codes appears to conflict with the statutes and regulations administered by the Division of Occupational Licensing governing Mechanical Administrators and Residential Contractors. Even if the Mechanical Administrator and the Residential Endorsement statutes can be interpreted in a manner that does not technically conflict with the proposed DPS regulations, the outcome will be conflicting policies and public confusion.

The purpose of licensing Mechanical Administrators as stated in AS 08.40.210 is to, "protect the safety of people and property in the state from the danger of improperly installed or modified mechanical systems by providing a procedure to assure (1) the public that persons responsible for making mechanical installations in this state are qualified; and (2) that a sufficient number of persons are so qualified."

The primary qualification that AS 08.40.270 requires Mechanical Administrators to possess is passage of an examination that must test applicant's, "familiarity with the requirements of the...Uniform Mechanical Code currently in effect in the state." Therefore current Mechanical Administrators have studied and been tested on the Uniform Mechanical Code and not the International Mechanical Code that DPS proposes to adopt.

Furthermore, the continuing education Mechanical Administrators are required to obtain under Division regulations is training in the Uniform Codes. All Mechanical Administrators must renew their licenses by August 31, 2001 and document 8-16 hours of training on specific Uniform Codes. This training will not have familiarized them with the International Codes.



The other reference to specific codes in the Mechanical Administrator statute appears AS 08.40.490 that defines Mechanical Administrator as a person who is responsible for installing or modifying items subject to the Uniform Mechanical Code. These references appear to imply the legislature was intending Mechanical Administrators to be performing under the Uniform Code.

Residential Contractors are required by AS 08.18.025 to hold residential endorsements for which they are tested. The Division tests applicants on the Uniform Building Code and continuing education relates to that code.

The Division contracts with Experior Assessments to write the Mechanical Administrator and Residential Endorsement Exams. Under our contract with Experior, it may cost up to \$2,000 per exam for the revisions necessary to switch to the International Code. Eight separate examinations would have to be revised and the revisions would take four to six months to complete.

A change from the Uniform Code to the International Code would also result in the Division having to revise its own examination and continuing education regulations for Mechanical Administrators and Residential Endorsees. The Division would need to locate providers of continuing education on the International Code and approve their courses.

In conclusion, the Division requests that the Department of Public Safety delay adoption of the International Codes until conflicts with the Mechanical Administrator statutes can be resolved and the transition can be made in an orderly manner.

Thank you for consideration of my comments.

Sincerely,



Catherine Reardon  
Director

CC: Deborah Bchr, Department of Law  
Jeff Bush, Department of Community and Economic Development

# Facsimile Transmission

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of  
Anchorage**



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## Department of Public Works

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Date and time of transmission: Thursday, February 21, 2002 11:15:16 AM  
Number of pages including this cover sheet: 07

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**DATE:** February 21, 2002

**TO:** Alaska Legislators

**SUBJ:** Controversy Surrounding Mechanical Code Adoption

**Brief History of Political Issues Involved with Building Codes:**

In the early 1990's there was a major effort to consolidate all the various codes used in the U.S. into a single package of codes. The federal government, most states, and most national professional, construction, and design organizations supported that concept. The goal was to produce a family of codes by the year 2000, and that goal was achieved in the 2000 International family of codes. Before the process was finished, however, the International Association of Plumbing and Mechanical Officials (IAPMO), supported by the unions, and the National Fire Protection Association (NFPA) pulled out of the process and decided to publish a competing family of codes. Unfortunately, the main reasons for pulling out of the code consolidation process were organizational control of codes and income from the sale of codebooks.

**Problems:**

There are eight different departments within Alaska State government enforcing building and construction codes, in part or in whole. Having an old Mechanical Code reinstated into the Department of Commerce and Economic Development and the Department of Public Safety, that is unrelated and uncoordinated with the new building and fire codes, will create havoc in local and state government, as well as in the design and construction community. Mechanical administrators and journeymen will be tested to one version of the mechanical code, but the local jurisdictions will be enforcing another version of the mechanical code. If the intent of the Administrative Regulations Review Committee and other legislative committees is to reflect the intent of the laws passed by the legislature, then the proposed House Bills 399, 436, and 437 and the unnumbered Senate versions need to be revised to reflect the codes that are currently adopted by the departments. The bills should be revised so there is no specific designation of a proprietary name, version, or publisher, because names, organizations, and standards regularly change. There has not been a currently published version of the "Uniform" Building Code since 1997. The replacement building code is the "International" Building Code. Proposed HB437, Section 3, Paragraph (3)(A) changes the reference to a generic building code. The rest of the code references in HB399, 436, and 437 should be changed the same way. A proposed draft substitution bill that will do that is attached.

If the underlying issue with the Regulations Review Committee is state adoption of codes by regulation, then the process should be changed. In the mean time, do not make a scapegoat of a code just because it is opposed by the plumbing and mechanical unions, and IAPMO. These groups are only a single, narrow segment of the construction and design industry. The plumbing and mechanical trade unions have a very narrowly focused, vested interest, and many of their members are also members of IAPMO, which stands to benefit from adoption of their code. These proposed House and Senate bills will lock in one code for eternity and lock out everything else. The controversies have little or nothing to do with the technical merits of the codes. The