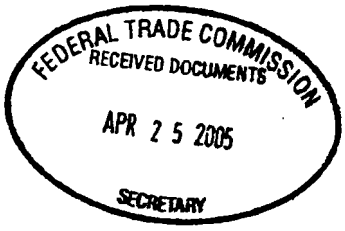
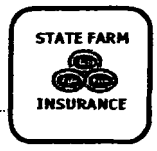
State Farm Insurance Companies

ORIGINAL





1900 M Street, N.W., Ste. 730
Washington, DC 20036

Regina K. Dillard
Federal Affairs Counsel
Phone: (202) 263-4400
Fax: (202) 263-4435

April 25, 2005

Federal Trade Commission
Office of the Secretary
Room H-159 (Annex Z)
600 Pennsylvania Avenue, N.W.
Washington, DC 20580

Re: FACT Act Scores Study, Matter No. RIN 3084-AA94

Dear Sir or Madam:

This comment letter is sent on behalf of State Farm Mutual Automobile Insurance Company and its affiliates ("State Farm") in response to the notice for public comment published in the Federal Register on February 17, 2005. State Farm appreciates the opportunity to submit comments as requested by the notice. Our comments will be restricted to the study of credit information in property and casualty insurance.

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

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

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

State Farm will be responding to section B of the Request for Comments (Credit Based Insurance Scores and Property and Casualty Insurance). The use of credit information

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

We understand that the National Association of Mutual Insurance Companies is providing answers to your questions from an industry perspective. The following provides more specific information about State Farm's use of credit information.

Questions 1-3 : The questions ask about model development and usage.

State Farm began using credit information in our insurance scoring models with new auto insurance business in a few states during September of 1999. The use of scoring models for auto business was gradually expanded to other states and is currently used in 45 states and the District of Columbia. We began using credit information in our insurance scoring models with new homeowners business in August of 2000 and it is currently used in 36 states and the District of Columbia. We use different scoring models for auto insurance business than for homeowner insurance business because we are measuring different risks. We use approximately 16 different insurance risk scoring models that use credit information primarily to comply with differing state regulatory requirements. We also use credit information in our scoring models for pre-screening leads for auto and homeowner insurance business. The new business prospect is sent a firm offer of insurance, in accordance with the requirements of the FACT Act.

We use certain credit information in our insurance scoring models because it is highly predictive of future insurance loss. State Farm's models do not measure credit worthiness, but were developed to be predictive of future insurance loss experience. When we say the models are predictive of loss experience, we do not mean that a certain score will cause the predicted loss experience. This is true of other insurance risk factors as well. For example, a traffic violation in the past does not cause a future accident or insurance loss, but we all know it is very predictive of the loss potential of the group of individuals who have had a violation. Similarly, good grades do not cause better insurance loss experience, but our good student discount is justified because good grades are very predictive of the future loss experience for that group of good students.

State Farm developed its own proprietary models which generate an insurance score using the combined elements from insurance loss history reports and consumer credit reports. To develop the models, we used a large sample of policies drawn from State Farm data and matched with the archived loss history and consumer credit reports. Various data modeling techniques and software were used to objectively identify those factors which were found to be most predictive of future insurance risk. The models

which were developed in this manner were further tested or validated on an independent hold-out data sample. We do not use factors that are not predictive of future insurance risk. At no point in the model development process did we consider an applicant's address, income, gender, race, ethnicity, creed or disability. In addition, we deleted from consideration items on a credit report that can be identified as collections on medical and utility bills, and credit inquiries which are promotional, related to insurance or which were requests for a consumer's own report.

While these models are extremely valuable to the underwriting and rating process for auto and homeowners insurance, there are many other factors that are considered. The auto insurance rating process includes many other factors such as the age and driving record of the operators, the make and model of vehicle being insured, the usage of the vehicle such as annual mileage, the primary location of garaging the vehicle and the number of vehicles insured, among others. The homeowners insurance rating process also includes many other factors including type of contruction, age of the utilities, security systems, among others.

There are a number of generic models which are commercially available for purchase and use. Although we do not know how many different models are used by the entire insurance industry, we do know that many different models are available though various vendors and consultants. These models use many different elements of credit, in many different ways.

Some other insurers might use these generic commercial models, but we chose to develop and use our own unique models in most states. We believe our own models help us to compete more effectively and to determine more accurate risk assessment and prices. Credit-based risk scores have quickly become a critically important competitive tool among insurers, especially in those states which permit broad use of credit information.

Besides there being many different models, different insurers also use credit information and model scores to make different decisions, in different ways. For example some use credit-based risk scores for eligibility decisions, others use them for rating, others for both, and some may not use credit information at all. To the extent that different insurers use different models, in different ways, insurance consumers are offered more choices.

Questions 4-11: These questions ask about the impact of credit-based insurance scores on the cost and availablity of auto and homeowners insurance.

We believe that competition is the most important consideration when examining price and availability. Competition is what benefits consumers the most as it relates to economic supply, demand, and price. If the use of credit information has enhanced competition through inexpensive, timely, objective and highly predictive risk assessment, then it stands to reason that it adds to the health of the overall insurance market as it relates to availability and price. It is our opinion that the auto and homeowners insurance markets are extremely competitive which can be seen in various measurements including:

- *Level of car ownership rates*
- *Minimal size of personal insurance residual markets*
- *Percentage of consumers who are uninsured*
- *Level of insurance advertising*
- *Market share concentration*
- *Shifts over time in market shares among competing companies*

To answer the question specifically of the impact of credit-based insurance scores on the level of competition and thus the cost and availability, we conclude the following:

- *Risk scores are an efficient and inexpensive tool which help to predict future insurance risk and loss cost, and thus it stands to reason that their use has reduced the uncertainty and riskiness of the risk assessment and insurance process, and also reduced the expense associated with that process.*
- *Risk scores allow insurers to better measure risk and therefore be more confident in their ability to determine accurate prices; thus it stands to reason that insurers are more able to provide coverage.*
- *Risk scores allow insurers to better measure risk and determine accurate prices, thus it stands to reason that the volatility of insurance results could be reduced, making insurers more able to provide coverage.*
- *Variations in the use of risk scores by companies result in more differences in the specific manner in which insurers assess risk (in fact, some companies might not use credit information at all); thus it stands to reason that those differences have lead to increased competition among insurers, and more choices for individual consumers.*
- *Risk scoring models are themselves an important new tool by which companies compete with one another. Any and each competitor can gain an important competitive advantage by designing a better risk assessment model.*
- *Risk scores have allowed State Farm to write some business that otherwise would not have been eligible.*
- *Risk scores have improved the accuracy of risk assessment for both pricing and underwriting.*
- *Most state insurance laws regulating the use of credit in property and casualty insurance typically allow consumers with no credit history to be treated as having an average (neutral) score.*

It is true that for some individuals, the use of credit will result in higher prices, due to related higher risk assessment. But there are just as many or more who benefit from lower prices. Those individuals whose prices are increased by some insurers, will benefit from more choices and availability of product. In any case, insurers have more incentive to make coverage available. There is absolutely no reason to believe that fewer people have access to insurance coverage due to the use of credit.

As for the various demographic groups, within any group some will have better-than-average risk scores and others will have worse-than-average risk scores. For any demographic group, many consumers will benefit with lower prices, and the entire

market of insurance consumers will benefit from a more competitive and healthy insurance market.

Prohibiting or severely limiting the use of credit information would lead to higher rates for most consumers. Also, the economic realities of the marketplace would tend to make insurance coverage for cars operated by higher-risk drivers based on a risk score, difficult to obtain. Competition in the auto insurance market would be reduced. State Farm opposes any effort to eliminate this and other factors which are appropriate in developing an actuarially justified rating classification system.

There are currently no auto insurance rate classification systems as accurate as those which include an insurance risk score.

We believe that the use of credit-based risk models has had many important effects upon the personal insurance market, including the following:

- *A new way for insurers to compete, to strive for the best risk assessment models*
- *More choices for consumers when they shop*
- *More accurate predictions of individuals' expected insurance claim costs leads to fairer prices, reduced uncertainty, reduced business risk, reduced risk premium, lower prices, and increased availability of product*
- *Objective, faster and more efficient risk assessment*

Questions 12-13: These questions ask about the impact on consumers in the ECOA protected classes.

To properly conduct this type of study would require obtaining accurate and reliable information about each individual's income, ethnicity and race. This demographic information would need to be obtained from some other source, since it is not available from insurance companies. We are unaware of any data source that could be used to attach accurate and reliable information about each individual consumer's income, ethnicity or race. This type of data can be purchased commercially, but its source of origin, accuracy and reliability are very questionable, making such data inappropriate for use in an exacting study such as this. We are aware that certain information might be available at an individual level from various government sources, but we are uncertain about its completeness, reliability and accuracy. Therefore, the FTC may conclude that the data is not available to perform this type of study properly and correctly. However, based upon other questions posted later in this notice, we recognize the FTC anticipates that it may be necessary to conduct the study using one or more of the individual-data sources and/or proxies for individual demographic information. In either case, extreme care is needed to avoid erroneous conclusions.

As described above, information on race, color, religion, ethnicity, creed, national origin and income is not requested in State Farm's applications forms, nor is it requested in subsequent transactions with policyholders. To our knowledge, there is no insurance database which includes this information. At no point in the model development process did we have this type of data or consider any of these as potential factors.
We did rigorous testing of our models across various classifications that we do have. For example, we found the models retained their predicitive power within different groups

reflecting age, geographic location and prior driving record, for example. These findings are consistent with other studies such as the EPIC study dated June of 2003. Even more recently in January of 2005, reporting on a study conducted by the Texas Department of Insurance, Commissioner Jose Montemayor summarized in a letter to the Governor:

> *"... By the nature of risk-based pricing and underwriting, all factors used in insurance have a disproportionate impact to some extent. One could make a convincing argument to ban the use of all risk-related factors based solely on disproportionate impact. Effectively, we would ban risk-based pricing and underwriting and revert to a pricing system where we homogenize the risk and essentially charge everyone the same price– regardless of risk. That would be a set-back to all Texans, of all races, especially those of moderate to lower income whose risk remains low.*
>
> *As Commissioner, I have the authority to end a practice that is either unfairly or intentionally discriminatory. However, I do not have a legal basis to ban a practice that has a disproportionate impact if it produces an actuarially supported result and is not unfairly or intentionally discriminatory. Prior to the study, my initial suspicions were that while there may be a correlation to risk, credit scoring's value in pricing and underwriting risk was superficial, supported by the strength of other risk variables. Hence, there would be evidence that credit scoring was a coincidental variable that served as a surrogate for an unlawful factor in rating and underwriting. If this were proven to have been the case, I would have had a legal basis to make the connection between disproportionate impact and intentional discrimination, and either ban credit scoring outright or adopt an allowable rate difference of zero, meaning no rate differences due to credit scoring.*
>
> *The study, however, did not support those initial suspicions. Credit scoring, if continued, is not unfairly discriminatory as defined in current law because credit scoring is not based on race, nor is it a precise indicator of one's race. Recall that not all minorities are in the worst credit score categories. Further, its use is justified actuarially and it adds value to the insurance transaction... "*
>
> *"... banning credit scoring overnight, by rule or law, creates pricing and availability disruptions in a market that has just stabilized and begun a rebound."*

The results from all of these studies make it highly unlikely that a sound study would conclude that credit-based insurance scores have any statistical significance as a proxy for any of the protected classes. As part of your study, the FTC should investigate whether insurance risk scores could be used to successfully predict an individual consumer's demographic class or group. Extreme care and attention will be required to control for the other risk factor of geographic area, especially if some geographical area such as census block is to be used as a proxy for individual

demographic information. Failure to do so may produce false and spurious results, because other study variables would act to compensate for the omitted or incomplete controls in the regression model. Without proper controls, any differences identified in the study, for example, might be entirely due to differences in geographical location. It will be important for the FTC to work with one or more insurance experts with appropriate actuarial credentials who understand the specific data elements, insurance risk assessment processes and insurance pricing systems.

- *If risk scores are found to be predictive of expected loss within the different demographic classes or groups (income, ethnicity, race) as well as overall, then it stands to reason that all groups or classes would be receiving the same treatment.*

- *If risk scores could not be used to successfully predict an individual's class or group, then it stands to reason that insurers could not use scores as a method of unfair discrimination and that all groups would be receiving the same treatment.*

We fully expect you will conclude that the credit-based insurance models retain their predictive power both within and across protected classes.

Question 14: This question asks about the use of credit-based insurance models for pre-screening.

We use credit information in our scoring models for pre-screening leads for auto and homeowner insurance business. The new business prospect is sent a firm offer of insurance with the language required by the FACT Act.

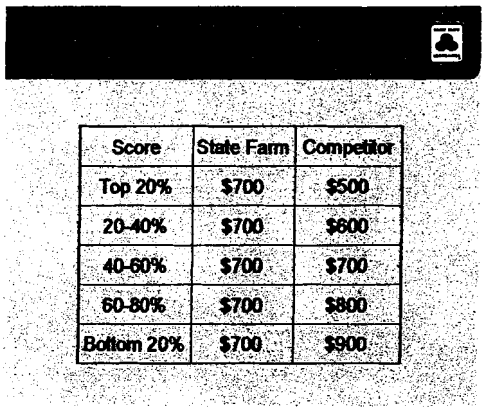
Question 15: This question asks if credit-based insurance models have affected our ability to enter new markets.

On June 13, 2001, State Farm Indemnity Insurance Company filed a Plan of Orderly Withdrawal from the New Jersey auto insurance market at least in part due to regulatory contraints on our ability to accurately price our business. On November 8, 2004, State Farm agreed to re-enter the New Jersey market for various reasons including improvements in the regulatory environment such as the ability to use credit based scoring models. From an economic planning perspective, it is clearly more desirable to grow in markets that permit more accurate risk assessment.

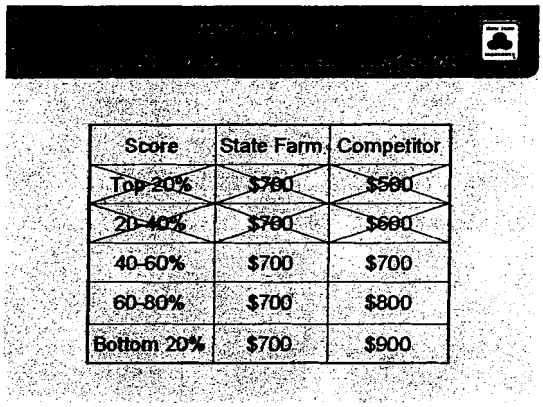
Question 16: This question asks how credit based insurance models affect the price consumers pay for auto and homeowners insurance.

The use of insurance risk scores is not related to collecting more money or less money in total. It is related to collecting the fair and right amount from each consumer, to make insurance rates fair for everyone. Any rating factor will cause some consumers to pay more and others to pay less. No risk factor can be expected to be totally neutral.

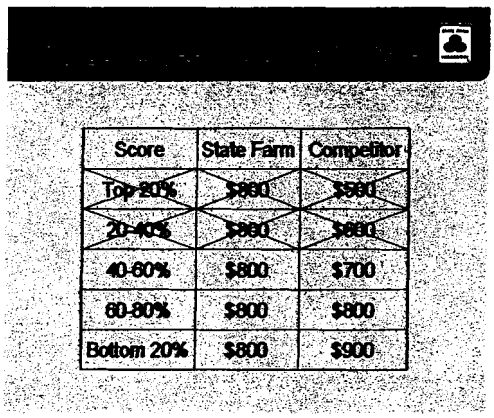
The use of credit-based insurance models is about matching price to risk. In a competitive market, companies that do a better job of matching price to risk will be more profitable and grow due to what is typically called adverse selection. Following is a simple illustration of this important economic concept as it applies to insurance. In the first chart, we assume that State Farm chose not to use a credit-based scoring model, but rather to use a constant rate of $700 across all score groups while a competitor uses a model with five score groups with rates based on expected costs ranging from $500 to $900. The net effect is that State Farm would not be competitive in the first two score groups and would be extremely competitve in the under-priced score groups. This would cause State Farm's market to be restricted to the last three groups. As displayed in the third chart, eventually State Farm would be forced to raise its price to $800 which is the average of the three score groups where it would attract business. That price increase would make State Farm uncompetitive in the third score group causing it to lose more business and eventually force State Farm to raise its overall price level again. With one single price, State Farm would be unable to compete successfully across the broad range of insurance consumers.



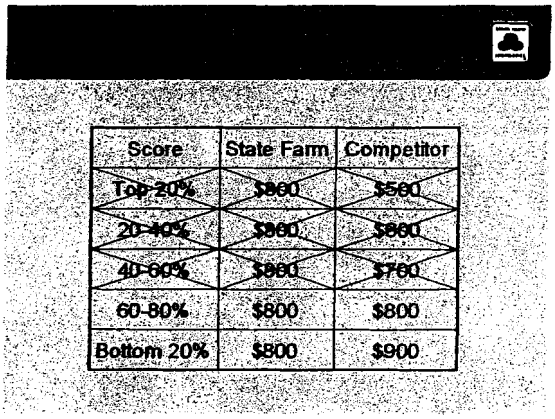
Score	State Farm	Competitor
Top 20%	$700	$500
20-40%	$700	$600
40-60%	$700	$700
60-80%	$700	$800
Bottom 20%	$700	$900



Score	State Farm	Competitor
Top 20%	$700	$500
20-40%	$700	$600
40-60%	$700	$700
60-80%	$700	$800
Bottom 20%	$700	$900



Score	State Farm	Competitor
Top 20%	$800	$500
20-40%	$800	$600
40-60%	$800	$700
60-80%	$800	$800
Bottom 20%	$800	$900

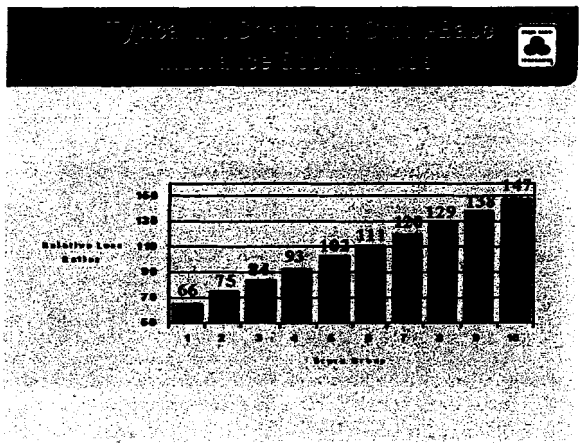


Score	State Farm	Competitor
Top 20%	$800	$500
20-40%	$800	$600
40-60%	$800	$700
60-80%	$800	$800
Bottom 20%	$800	$900

This example illustrates the real-world competitive market. It also demonstrates that consumers benefit from competition.

The last part of the question asks about the magnitudes of the credit-based insurance scoring models on the price of insurance. While this will vary by model, the following lift chart is illustrative of the typical variation in expected costs for our new business models. The chart shows the business distributed across ten equally sized score groups with the average across all score groups being 100. The lowest risk score group has a

factor of 66, meaning consumers in this group have 34% less risk than the average. The highest risk score group has a factor of 147, meaning consumers in this group have 47% higher risk than average.



Question 17: This question asks whether the size of involuntary insurance markets or the number uninsured is informative about the price and availability of auto and homeowners insurance.

Yes, in a healthy and competitive insurance market, the number of consumers that are unable to find an insurer willing to insure them should be small. The size of the residual markets in most jurisdictions is very small. The jurisdictions with larger residual markets tend to be those that have onerous pricing or underwriting regulation. We firmly believe that consumers are best served through availability and affordability through competitive markets.

Prohibiting or severely limiting the use of credit information would lead to higher rates for most consumers. Also, the economic realities of the marketplace would tend to make insurance coverage for cars operated by higher-risk drivers, based on a risk score, difficult to obtain.

Competition in the auto insurance market would be reduced. State Farm opposes any effort to eliminate this and other factors which are appropriate in developing an actuarially justified rating classification system.

There are currently no auto insurance rate classification systems as accurate as those which include an insurance risk score.

Question 18: This question asks about the impact of banning or limiting underwriting or rating factors on the price and availablity of auto and homeowners insurance.

There are numerous examples where insurance rating for auto and homeowners insurance has becomes politicized and overregulated. In State Farm's experience, political interference within a competitive market is counterproductive, often leading to higher rates and market dislocations. State Farm adheres to the principle that competition is the most effective regulator of rates, and we believe all states should enact competitive rating laws. State Farm adheres to all actuarial principles and standards of

practice in maintaining an accurate relationship between the price of the insurance product and the potential for loss and expense implicit in each individual risk insured.

It has been our experience that whenever an underwriting or rating factor is banned or significantly limited, resulting in a departure from cost-based pricing, significant harm is done to the market, thus also harming insurance consumers. For example for some types of automobile insurance coverage, rates vary according to the make and model of car. It is generally more expensive to replace or repair a new expensive car, than a smaller, older and less expensive car. This results in differences in the expected cost of insurance loss, a difference in the insurance risk. Therefore, insurance rates are higher for the newer, more expensive car. If insurers are allowed to vary prices according to the model of car, then it stands to reason that coverage can be made readily available to all consumers at a fair price, regardless of what car they own. This is good and fair for everyone.

However, if "model of car" were not permitted as a risk factor for insurers to consider, everyone would be worse off. There would be less competition in the market, and in the end, consumers would be hurt. For example if rates were required to be the same, people who own the older and less expensive cars would be unfairly required to pay higher prices, more than their fair share. One might think that those who own newer and more expensive cars would benefit, but it stands to reason that if insurers are asked to insure these cars at inadequate rates (prices less than the expected total cost to provide insurance coverage), that availability of coverage would suffer. No one wins, everyone loses.

The state of Michigan provides a classic example of the problems with territorial rate restrictions. In the January 1989 issue of the State Legislatures magazine, a monthly publication of the National Conference of State Legislators, was a summary of what lead to the 1986 repeal of the state's territorial rate restrictions that limited the price differences between Detroit and other locations. That summary was as follows:

> *"The territorial rate restrictions were a devastating failure, which clearly demonstrates the futility of social engineering in the insurance marketplace.*
>
> *Michigan learned that these restrictions resulted in less competition in urban areas, which hurts consumers by reducing availability and increasing cost.*
>
> *Instead of protecting urban consumers, these restrictions caused a division in the market structure. Because of the rate differential constraints, insurers with a greater market share in urban areas could not compete in non-urban areas. Urban writers, as they were called, began to approach insolvency when Detroit became the auto theft capital of the world.*
>
> *Artificial constraints on insurance premiums may have had something to do with the explosion of auto theft, as well. Fluctuations in insurance premiums send an important market signal to a community. When a societal problem affects risk, that is reflected in increased insurance rates. If that message is clearly communicated, those people who receive that message will respond by demanding a remedy from their local governmental agencies.*

But, if that message is distorted, the affected community will not fully understand the seriousness of the program until it reaches crisis proportions.

In Detroit, the auto theft problem was a serious problem for several years, but the rate restrictions held premiums at artificially low levels until a crisis developed. The debates over repealing these restrictions made that community more aware of the nature of the problem.

Unfortunately, that message would have been clear long ago if rates were determined in a free market.

It's still not a free market in Detroit, but we are at least headed in that direction. Hopefully, other states can learn something from our mistake."

In October 1987, the All-Industry Research Advisory Council published a report titled "Unisex Auto Insurance Rating". The report provided an analysis of an October 1, 1985 law in Montana that prohibited insurance companies from using gender and marital status in determining auto insurance rates.

The study found that average auto insurance rates for young women increased $91 to $274 a year, depending on their age, marital status and location. AIRAC surveyed major Montana auto insurers to determine how rates for young drivers changed after the law went into effect on October 1, 1985.

The effect of the new law on young male drivers was mixed, depending mainly on their marital status. Unmarried male principal operators received rate decreases of up to $295 a year, but 23 year old married male principal operators experienced rate increases averaging $124 to $147 a year.

The report also touched on the effects in Hawaii, Massachusetts, Michigan, and North Carolina. The report concludes:

"In addition to these direct effects on rates, the elimination of these rating variables (especially age) has had some side effects on the automobile insurance markets in at least a couple of these states. More of the youthful business has been perceived by insurers as underpriced and is consequently written in the residual market or other "substandard" programs. In Massachusetts, for example, 54.9% of all 1986 auto policies were written in this state's Reinsurance Facility - including over 90% of the young males and 70% of the young females - reflecting the combined effects of the various rate constraints that have been imposed over the years. In North Carolina, over 25% of all business is written in its Reinsurance Facility. This contrasts with the 1 or 2%, or less, written in the residual market program in most states. In both of these states, insurers are required to write all applicants for automobile insurance, either voluntarily or as part of the residual market facility".

If credit information were not allowed to be considered, we can expect the marketplace

to react, similar to restrictions on other factors. It would result in less competition, less availability to some consumers, more subjective underwriting decisions, and customers less likely to submit claims would pay more than their fair share so that consumers more likely to submit claims could pay less than their fair share. Clearly, these are not desirable results.

Question 19: This question asks about the use of inquiries on credit-based insurance scores.

Certain types of credit inquiries related to consumers seeking additional credit can be predictive of insurance risk and are used in insurance risk models.

State Farm does not include inquiries from insurance companies in any of its credit-based insurance risk scoring models. Also excluded are inquiries for a consumer's own information and promotional inquiries. Duplicate mortgage and auto finance inquiries within a 30-day period are treated as one. So, from State Farm's perspective, these should have no impact on insurance risk scores.

State Farm does attempt to monitor the level of consumer shopping and switching behavior. Our studies indicate there has been no decrease in either shopping activity, nor in the level of consumers switching insurance carriers.

Also, it is our understanding that the credit bureaus no longer make insurance inquiries available to credit-granting institutions and other institutions, so that insurance inquiries cannot affect future risk scores used for assessing insurance or credit-granting risk, or other uses of consumer credit reports.

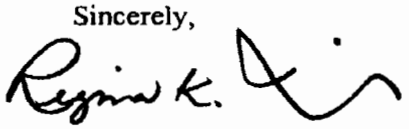
Questions 20-21: These questions ask how we will handle consumers that have inaccurate or incomplete information or have been victims of identity theft.

When ordering an insurance underwriting score for an applicant, the agent is given the four reasons that most impacted the score and those reasons can then be shared with the applicant. These reasons are designed to provide the applicants with an understanding of the factors that most affected their score. In some jurisdictions, these reasons are provided directly to the consumer. Under the FACT Act, the applicant is entitled to a copy of the credit report and the adverse decision letter provides a phone number for the vendor, in case the applicant wishes to obtain additional information regarding items contained on their personal credit report.

We do make exceptions to our use of credit based insurance scores if the credit history was adversely influenced by certain extraordinary life events, such as catastrophic illness or injury, death of an immediate family member, temporary loss of employment, divorce, or identity theft.

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

Sincerely,



Regina K. Dillard

RKD:det