

Should we Ignore Credit Scores to Set Insurance Premiums?

implications for economic opportunity and
business strategy

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Credit Scoring a summary of the issue

- Despite efforts at the capitol in recent years to end the practice, property and automobile insurance companies in Florida are allowed to use a customer's credit history in setting premiums, something opponents say could ensnare more Floridians as the economy weakens. (Larrabee 2009)
 - Forty-four states currently have laws or regulations limiting or conditioning the use of insurance credit scoring, and four states - CA, GA, HI, and MI - have effectively banned the use of credit scoring with respect to all or select lines of insurance. (Karlinsky, Fidei, and Erdelyi 2009)
- In November 2009, Florida Senator Rhonda Storms (R-Brandon) filed a bill (SB 662) to prohibit insurers from considering credit scores for rate-making purposes.
- The bill has been referred to committees on Commerce and Banking & Finance, and would become effective on July 1, 2010 if passed into law.

Ignoring Information is Bad Business but can make for good politics

- **Credit scores** do not affect how we drive, or how we maintain our homes. But they do **provide information** about our propensity to file insurance claims.
 - As credit scores decline, insurance claims become a substitute for conventional financial services.
- While ignoring such information can weaken the insurance sector's performance, and shrink economic opportunities more generally, **legislating ignorance** can nevertheless make for **good politics**.
 - Government Sponsored Enterprises (GSEs) and Congressional committees *knew*, for example, that loan performance deteriorated when borrowers did not document income.
 - They nevertheless promoted the securitization of no-doc loans, and thus encouraged resources to flow to an unproductive (labor intensive) sector and weakened the financial sector's collateral-base.
- **Markets don't fail - rules of the game do!**
 - People want to do as well as they can. Whether they pursue this goal at the expense of others, or in a manner that generally expands economic opportunities, depends on incentives from the law.
 - But the law ultimately depends on what wins elections. And here, distribution can trump efficiency.
 - "I want to role the dice a little bit more in this situation towards subsidized housing" (then ranking member of the House Committee on Financial Services, Barney Frank (D-MA), responding in 2003 to warnings of growing risks to the housing market). Let's not role the dice again!

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Illustrating the Potential for Problems

Falascchetti (2009) *How Accountability Can Go Too Far in Politics, Law, and Business*

- Are credit-constrained individuals *really* strategic enough to pursue insurance claims as a substitute for financial services? Consider the case of *Allstate v. Jackson*. Following Hurricane Katrina, Mary Jackson claimed \$16,000 of wind-damage to her home. Allstate, however, did not immediately pay. And while Ms. Jackson waited, her house burned down, leading to an additional claim of \$280,000.
- Did Allstate collect premiums up front, then opportunistically deny claims after the fact? Additional evidence suggests that it was Ms. Jackson who acted opportunistically. At the time of her policy-application, Ms. Jackson had filed for bankruptcy twice during a four-month period, and claimed fire-related losses four times over a ten-year period. She was attempting to sell her house when it burned down, and these facts appear to have been unavailable to Allstate when it wrote Ms. Jackson's policy.
- A jury concluded that Ms. Jackson's **insurance claims were motivated by financial distress**, not legitimate losses. In terms of standard "adverse selection theory", prospective insurance clients like Ms. Jackson can be characterized as "lemons". Suppliers of insurance services, like demanders of automobiles, want to avoid lemons. But **to the extent that insurers cannot distinguish lemons from non-lemons, they will instead demand higher premiums from everyone**. And if too many non-lemons balk at these inflated premiums (because self-insuring is more economical than cross-subsidizing individuals who strategically hide their likelihood to file claims), then **insurers will be reluctant to participate in the market**.

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Concern: Credit Scores Correlate with Race but ignoring them won't help the unlucky poor

- The concern here is legitimate. But let's not repeat disastrous policies from the "politics of poor" - i.e., keeping constituents "alive" for another day, long enough to reciprocate with political support, but short enough to sustain dependence on inefficient redistribution.
- Katrina, for example, was *not* a natural disaster - it was a political disaster, one that impoverished citizens from a rich country until they couldn't run to save their lives.
 - The storm clearly pulled back the curtain on *generations* of policies that served inefficient political goals over general economic opportunity, and highlights for others what can happen if they keep doing the same.
- And rather than begin to get it right, policy responses damned another generation to the same inferior life chances.
 - A Midwest Senator described Katrina as a disaster for his state's farmers, while a Louisiana Congressman (from outside of New Orleans) strongly pushed a bill to bail out systemically unimportant banks. And even local officials lobbied to put people back in harm's way - otherwise, they wouldn't have had anyone to govern.
- Will Florida continue on a qualitatively similar road, one that has inflicted and sustained poverty wherever it is followed? Or will its policy makers choose to expand opportunities in general, and thus break the back of an economic determinism that arbitrarily separates those who have from those who do not?
 - And if race-based ratings truly exist, then let's get competition policy right, not micro-manage the insurance sector.

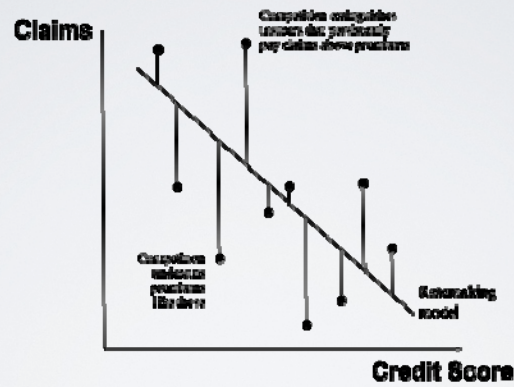
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Concern: Transparency is a Slippery Slope but productively-governed insurance sectors are transparent on *all* sides

- Some have argued that credit scoring is a slippery slope - if we mandate transparency here, then we would logically mandate disclosure of pre-existing health conditions, or even genetic predispositions. But health insurance is *really* expensive when this type of information predicts bad outcomes.
- Ignoring information intensifies the "lemons problem", thus increasing the price at which insurance is readily available and shutting out individuals for whom insurance would make sense in a more transparent market.
- Rather than facilitate such inefficient transfers, insurance regulations could do better by lowering the cost of bringing "insurance options" to market.
 - UnitedHealth now lets you buy the right to future insurance—insurance against developing a pre-existing condition. (John Cochrane, 2009).
 - Doing so would allow for the benefits of transparency (e.g., early detection) and *efficiently* lower the price of insurance.

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Concern: Credit Scores are Noisy but competition rewards only the informative part



- All information is noisy, whether it comes from loss histories or credit scores.
- But noise cannot consistently enter an insurer's rate base, unless the laws that govern insurance *fail* to create a competitive market. **Regulation should strengthen competition, not weaken it** (as a ban on credit scoring would do).

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The Fundamental Dilemma

- Government intervention is frequently rationalized by references to “market failure”.
- But why would government do better, if winning office requires us to focus more on narrow electoral distributions than widespread economic opportunity?

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Non-Market Strategies opportunities in politics, law, and business

- Broaden **competition policy objectives** from a focus on consumer surplus to a less distributive-minded standard of economic performance.
- We readily accept rules that restrict channels for too much producer influence. We may want to seriously consider how **democratic governance** mechanisms can create too much consumer pressure (e.g., selection processes for regulators, campaign finance restrictions, term limits, federal versus state regulatory jurisdiction).
- **Courts** may give voice to “efficiency lobbies”. Prominent authors have argued, for example, that judges are more readily convinced by an argument’s efficiency consequences (e.g., see Scalia and Garner). Let’s be careful about proposals such as “jail for judges”.
- Non-market strategies are necessary complements to even the best technical operations. We know a lot about how different institutions and interests interact, and can thus **price the regulatory and litigation risks** that regularly face sectors like insurance. Similarly, both qualitative and quantitative **business analytics** can highlight when those risks are growing, and thus when lobbying or organizing efforts can be most productive.

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The Big Idea in principle

- Markets do not operate in a political vacuum.
- Our objective is *not* “maximize well-being subject to the limit of our genius to engineer financial services”.
- Being clever about financial engineering is certainly important. But we also have to address omnipresent distributional forces that shape the political-legal risk-environments in which we operate.

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The Big Idea in practice

- We readily employ **business analytics** to improve operating strategies. Why wouldn't we do the same for the more complex non-market environment?
- Analytics can guide **lobbying efforts** toward their most cost-effective uses, and thus better insulate producers from inefficient distributive forces.
- Our chances for creating a more productive non-market environment increase with **public support** (e.g., why is Boeing advertising green?), and analytics can measure this support as opportunities and risks fluctuate in real time.
- Even taking our non-market environment as given, analytics can let us be more precise about how costly are the political risks (many of us are already in the business of pricing natural risks, why not **price political risks?**).

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Additional Reading

- Bremmer, Ian and Preston Keat (2009). *The Fat Tail: The Power of Political Knowledge for Strategic Investing*. Oxford University Press.
- Calomiris, Charles (2009). Banking crises and the rules of the game. NBER Working Paper 15403.
<http://www.nber.org/papers/w15403>
- Cochrane, John (2009). What to do about pre-existing conditions? August 14, *Wall Street Journal*.
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Through 20 years of experience in business, policy, and interdisciplinary research and teaching, **Dino Falaschetti** (PhD, MBA, CPA) has managed financial statement audits and corporate finance operations, created innovative business analytics and litigation support strategies, and developed novel solutions for policy problems at the White House and state legislatures.

Currently, Dr. Falaschetti is Associate Professor of Law and Economics at the Florida State University College of Law, Professor (by courtesy) in the Departments of Economics and Political Science, Member of the Spending and Budget Initiative at George Mason University's Mercatus Center, and Principal of Economic Advisors, LLC, a business analytics and litigation support firm. Dr. Falaschetti previously served the President of the United States as Senior Economist for the Council of Economic Advisers (with responsibilities for regulation and financial services), held academic appointments at Stanford University, Montana State University, University of California at Berkeley, University of Tennessee, and Washington University in St. Louis, and managed a \$1 billion money market portfolio and financial statement audit-engagements for a Fortune 100 conglomerate.

He earned a PhD in economics from Washington University in St. Louis (with fields in political economy, economic theory, and industrial organization), an MBA with high honors from the University of Chicago Booth School of Business (with concentrations in economics and finance), and a BS with distinction from the Indiana University Kelley School of Business (with a major in accounting and work-in-depth in philosophy).

About the Speaker

