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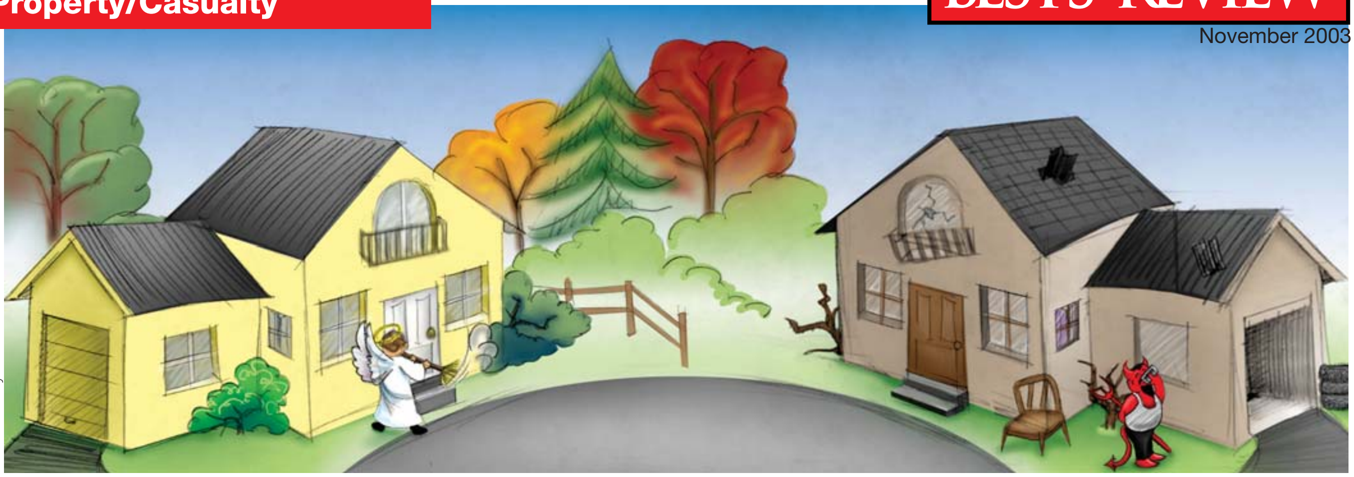

Illustration by Karen McNamara

Getting to Know You

As homeowners writers see personal property claims rise, they're taking a closer look at insureds' personal characteristics.

by Joseph S. Harrington

Most property/casualty professionals are aware of the link between credit scores and insurance losses in personal lines. This correlation is driving most personal lines carriers to use credit-based insurance scoring for underwriting and, in some cases, for rating personal lines accounts. The correlation, however, appears to be far more pronounced for homeowners insurance than for personal auto.

Using data from ChoicePoint, an Alpharetta, Ga.-based provider of identification and credential verification, consultant Richard Dorman said, "There is a 3-to-1 disparity in homeowners loss ratios between individuals with the worst credit scores and those with the best. In auto, the disparity is only 2-to-1." In other words, individuals with the worst 10% of credit scores had, on average, homeowners loss ratios that were three times those with the best 10%, while their auto loss ratios were twice those of the best 10%. Similar relativities are projected by Fair Isaac Inc., a company that develops credit-scoring models.

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"There's a very simple reason for this disparity in impact of credit scores," said Dorman, a former vice president of marketing for Progressive Insurance who now runs his own firm in Beachwood, Ohio. "In homeowners insurance, credit scores were among the first things we considered regarding the individuals who live in a house. Historically, we have long captured information on the driver in personal auto," he said. "The fact that information on accidents and driving records was already recorded in the underwriting and rating process meant that credit scores did not add as much information [in personal auto insurance]."

"For years we ignored the 'who' in homeowners," Dorman noted in an address to the 2003 Annual Conference of the American Association of Insurance Services. If you took a group of homeowners living in the same development, he said, "virtually all homeowners programs rated them the same, whether they were saints in one house or sinners in another."

Today's homeowners class rating plans still put too much emphasis on the property and not enough on the occupants, said actuary Jeffrey Kucera, a consultant in the suburban Chicago office of Pinnacle Actuarial Consultants. "Up until a few years ago, it mattered little who might reside [in a home], unless they might qualify for a senior discount," Kucera wrote in his firm's newsletter. While noting the substantial progress made in recent years to incorporate credit scoring and prior loss history into homeowners underwriting and rating, Kucera wrote that "companies need to continue to look for ways to bring the occupants of a home into the equation."

Shifting Focus

Jeff Holaway, a manager of personal lines pricing for the American Association of Insurance Services, an advisory organization based in Wheaton, Ill., recalls veteran underwriters telling him how in the past they contacted neighbors of a homeowners insurance customer to ask their opinion of the applicant's character and conduct. The information gathered was imprecise and subjective, but considered useful for determining whether the applicant maintained his home properly and avoided risky behaviors, Holaway said.

By the time Holaway began his career in underwriting in the mid-1980s, such inquiries were effectively prohibited by regulation or standards of business conduct. Any information on the insured would have to come from the insured, and most companies would not know what to do with it if they had it. "We didn't have anything in the underwriting guide regarding personal characteristics of insureds," Holaway said. "The overwhelming amount of information on the homeowners application [dealt] directly with the structure."

For decades, homeowners rating was based almost exclusively on factors related to the main residence structure, such as construction (brick, frame, etc.), fire protection (protected, partially protected, unprotected) and territory (for windstorm, wildfire, crime and other hazards). This approach worked well enough and appeared to be adequate because the vast majority of homeowners losses were property claims. "Many people have historically felt that homeowners losses were fortuitous, or an act of God, and therefore the individual had no bearing on them," Kucera said. That mindset has changed in recent years.

At the 2002 annual meeting of the Casualty Actuarial Society, Kucera told attendees that homeowners rating plans should be modified to reflect the growth in personal liability claims, which arise directly from the actions or omissions of insureds. Even property claims have some relation to the character of occupants, said Dorman. "Granted, a tornado can't tell who lives in the house," Dorman said in an address at the 2003 AAIS Annual Conference. But, he added, a tornado will cause greater damage to a home whose shingles and shutters have not been regularly repaired or replaced.

"There are a number of property losses caused or controlled by the insured," Dorman said. "These include fires caused by careless smoking or leaving the stove on, thefts caused by not protecting possessions, as well as liability losses caused by not keeping your property clean of objects and debris." A shift in focus started in the 1990s when major carriers introduced homeowners underwriting "scorecards" that systematically tallied characteristics the company deemed relevant to the risk assumed, said Holaway.

Among the characteristics captured on scorecards used by Holaway were number of children, age of insureds and employment status, as well as credit score and others. Characteristics were given point values to represent potential correlations to loss experience, and the total score was used to help determine if an application should be accepted or rejected, and, in some cases, to assign the applicant to a rating tier.

"Underwriting the insured is one of the main evolutions I've seen in our personal lines area over the years," said John DiStefano, portfolio manager for Preferred Mutual Insurance Co., New Berlin, N.Y., at the AAIS event. "For example, credit information helps us predict the ability of an insured to maintain a home. If an applicant is having cash flow problems, will he be in a position to replace a 20-year-old roof before high winds or winter weather causes a loss?"

Claims and Credit

Observers point to the rapidly growing use of rating factors based on an individual's claims and credit history as significant indicators of the growing importance given occupant characteristics in homeowners insurance. Almost as soon as the service was launched in the early 1990s, insurers began ordering claims reports on applicants and houses from the Comprehensive Loss Underwriting Exchange, a service of ChoicePoint. "It's been used systematically in underwriting for 10 years," said Richard Collier, vice president of ChoicePoint's marketing and sales. Today, 85% of domestic carriers routinely consult CLUE reports for four out of every five applications, he said.

Like underwriting scorecards, CLUE reports were first used simply to accept or decline applicants, or place them in pricing tiers, Collier said. "We started seeing CLUE-based rating factors about five years ago. Like everything else in the market, it started slowly, then progressed quickly. As a result, consumers are seeing a shift in pricing practices. Carriers are pricing

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[homeowners insurance] a lot more like auto," Collier said.

Credit-based insurance scoring enjoyed an equally rapid rise from innovation to standard application. Introduced in the early 1990s, insurance scoring is now used in some form to underwrite or rate almost all new and renewal business in homeowners and personal auto. While most proponents of credit-based scoring are only willing to say there is a correlation between credit standing and insurance losses, Dorman is among the few willing to say that credit-based insurance scoring reflects personal characteristics that influence claims experience.

"Credit score measures personal responsibility in managing your finances," he said, adding that financial management directly affects one's willingness and ability to maintain property in good repair. The reason credit-based scoring spread so rapidly, however, was that carriers recognized quickly that they ran the danger of being adversely selected against if others used credit-based scoring and they didn't. Many property/casualty executives, like their agents, were reluctant at first to believe that an automated credit score could be more precise in identifying and pricing insurance risk than traditional underwriting. But, ultimately, they were unwilling to watch competitors use scoring to cherry-pick their best risks and leave themselves with books of business composed of people with the lowest credit scores.

Will There Be More?

The same dynamics propelling the use of credit-based scoring into a standard underwriting and rating practice is present for other potential variables related to the characteristics of occupants, said Dorman. The age of the insured, occupation, number of children in the house, and number of years living in the house may all be correlated to loss ratios in homeowners, he said. To develop empirically sound underwriting criteria and rating factors, however, carriers must invest in the collection and analysis of data over years to determine what, if any, correlation exists. There may be many dead ends. "Data collection is costly," he said. "It's a question of whether you will do it or wait for someone else to do it."

Once a single carrier identifies a meaningful new rating variable, the entire market is affected, said Dorman. Using the factor, that carrier will presumably rate good risks more competitively and bad risks less competitively than the market in general.

As a result, other carriers will increasingly find themselves adversely selected against until they respond with a rating initiative of their own. If they wait too long, carriers may find themselves in a "pricing death spiral," forced to charge more and more to cover losses from an increasingly bad book which gets worse and worse as good customers go elsewhere. Given that the subtlest of innovations can make a big competitive difference, carriers are very tight-lipped about their attempts to identify and develop new rating factors.

Kucera said he knows of homeowners carriers that use age of the named insured and number of occupants as rating variables, and of one company that is currently using occupation as a rating variable. "Those companies who have been leading the way have already seen some of the benefits through rating plans that are better able to predict future losses, and improved segmentation plans (tiers)," he said. "Although it has been slow, more and more companies are moving in this direction, and will continue to do so."

Wayne Holdredge, a principal in the St. Louis office of the actuarial firm Tillinghast-Towers Perrin, wrote in a 2003 edition of the firm's Emphasis newsletter that "stability attributes," such as how long occupants have lived in their homes or worked at their current jobs, may be "underutilized information" that is commonly collected but not recorded electronically for automated analysis.

Limited Application

Fair Isaac has studied various

demographic characteristics, particularly the number of occupants in a home, as they correlate with homeowners loss experience, said Lamont Boyd, director of business development. While some companies have been able to find apparent correlations between such characteristics and loss ratio in their own books of business, it is not clear that demographic characteristics can provide rating variables for widespread application.

When it comes to providing information on large numbers of individuals, demographic databases maintained by the U.S. government and private firms are not nearly as accurate and up to date as commercial credit bureaus and claims databases, Boyd said. Whereas credit bureaus and claims databases track virtually every type of action, even inquiries, demographic data is usually based on survey results that generalize about household composition and rarely provide accurate, up-to-date information on the composition of a particular household.

"[Demographic data] is not as accurate as it should be, not as frequently updated and not as predictive," said Boyd. Nor is there any data for homeowners equivalent to the automated records of motor vehicle violations maintained by state departments of motor vehicles, which are incorporated into auto insurance rating.

Finally, premium volume for homeowners is far less than that for personal auto, making it less cost-effective to invest in searching for correlations that may not be there. "From Fair Isaac's perspective, we haven't been able to find a [demographic] surrogate for credit scoring," said Boyd. "That doesn't mean insurers haven't found any, however. We know that insurance companies have been researching these for years."

Insurers should continue to explore characteristics other than credit, wrote Holdredge, as credit-based scoring becomes a "commodity" used by so many companies that it ceases to carry competitive benefits. "The trick, of course, is to know which attributes in a given insurer's database are most likely to have predictive power. Identifying those attributes is usually more a matter of judgment and experience than sheer number crunching." BR