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Insurance scoring saves consumers money

The majority of consumers benefit from credit-based insurance scoring

While it may be a surprise to some to hear that insurers use credit information to help set insurance rates, it's an established practice that insurers have used for the past two decades to offer lower premiums to consumers.

Despite the fact that credit information saves consumers anywhere from 30 percent to 59 percent on their car insurance (with some carriers providing up to 80 percent of their policyholders with a discount), the use of credit information by insurers remains a perennial subject of legislation in state houses across the country. There are those who seek to keep consumers from receiving a lower premium for having good credit because they feel the consideration of credit information isn't fair to some. ***We believe, however, that it is unfair to deny a majority of consumers a lower insurance rate and force them to subsidize those who represent a higher risk.***

AN ESTABLISHED PRACTICE

The federal Fair Credit Reporting Act (FCRA) first authorized insurers to consider credit information nearly 40 years ago. Within the past 15-20 years, however, the use of credit information spread to personal lines insurance as insurers recognized just how accurate such information is in helping to predict a claim. Numerous studies, including a 2007 study by the Federal Trade Commission, confirm there is a very high correlation between insurance scores and the likelihood of filing insurance claims. (See sidebar for a list of those studies.)

Consumers benefit when insurers use a highly accurate predictor of risk like credit information because it provides insurers with the confidence to offer more competitive prices and accept more business than they would have without it.

Study after Study Confirms: Credit Information is Predictive of Loss

Georgetown University Law Center, October 2015
This new study is co-authored by a National Association of Insurance Commissioners funded consumer liaison and it concludes that credit-based insurance scores do not act as a proxy for income.

Colorado Division of Insurance, January 2010
The Colorado Division of Insurance Credit-Based Insurance Study noted that any insurer that wishes to use credit-based insurance scores must provide actuarial or statistical justification to the Division demonstrating its use is predictive of future losses.

St. Ambrose University, December 2009
Authors of a consumer survey commissioned by the Iowa Consumer Advocate observe, *"We think the current evidence for the predictive power of insurance credit scoring is overwhelming."*

Federal Trade Commission, July 2007
In a study of the use of credit information in association with automobile insurance, the FTC concluded, *"Credit-based insurance scores are effective predictors of risk under automobile policies. They are predictive of the number of claims consumers file and the total cost of those claims. The use of scores is therefore likely to make the price of insurance better match the risk of loss posed by the consumer. Thus, on average, higher-risk consumers will pay higher premiums and lower-risk consumers will pay lower premiums."*

Texas Department of Insurance, 2005
"For both personal auto liability and homeowners, credit score was related to claim experience even after considering other commonly used rating variables. This means that credit scores provide insurers with additional predictive information distinct from other rating variables. By using credit scores, insurers can better classify and rate risks based on the difference in claim experience."

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INSURANCE SCORES ARE NOT CREDIT SCORES

It is important to understand how insurers use credit information and to note that there are significant differences between the more widely known credit scores used by lenders and credit-based insurance scores used by many, but not all, insurers. Although both are derived from information found on credit reports, the information is measured differently. Insurers use credit information in developing insurance scores to predict the likelihood of future insurance loss. Credit-based insurance scores provide an objective measurement of how a person manages the risk of credit. Lending institutions, on the other hand, use credit scores to determine the availability, amount and price of credit products offered to the consumer; they use them to determine the likelihood of repayment. The most significant difference between insurers and lending institutions is that insurers never consider income.

It is also important to note that, while credit scores encapsulate all information on a credit report, most state laws place limits on the information that may be considered in calculating an insurance score. ***For example, in most states insurance scores cannot consider any medical bills listed on a credit report.*** Also, if shopping around for the best interest rate on either a car loan or mortgage results in multiple hits (i.e., pulls) of a credit report, insurers may consider such inquires *but only* if they treat multiple inquires made over the course of a month as one inquiry. This means consumers are not penalized for shopping around for the best interest rate.

WHY IS INSURANCE SCORING SO ACCURATE?

In every discussion regarding insurance scoring, the question of why insurance scoring is so accurate is inevitably asked. Some of the studies previously cited have considered this question. Probably the most widely circulated theory is that how one manages his or her credit reflects how that person is likely to behave in other aspects of their life. For example, someone who is fastidious about their finances is also likely to prove fastidious with how they drive or maintain their home. Conversely, a person who is less attentive to their finances will also tend to be less attentive in other matters as well.

"82% of consumers either received a discount for credit or it had no effect on their premium."

Report to the Arkansas Legislature by the Insurance Department, June 2016

Regardless of the actual reason for why insurance scoring works, however, it is important to remember insurers are not required under the law to explain why a particular rating factor is accurate. They must merely prove that it is accurate. There are numerous other long-standing rating factors, such as age, gender and marital status, insurers have considered for years but for which there is no definitive explanation for why those factors are predictive either.

What happens when a state bans the use of credit?

In 2002, Maryland did just that with respect to homeowners insurance, and rates went up. ***They went up*** at a faster rate than the rest of the country (53% vs. 36%) between 2002 and 2007, and they went up at a faster rate than they did in neighboring states. **At least one company stopped writing in the state as a result of the ban.**

MOST CONSUMERS SAVE MONEY BECAUSE OF THE USE OF CREDIT

In discussing just how many consumers save money because of insurer use of credit information, it is important to keep in mind that insurance companies use credit information is different ways and to different degrees. Some consider it only in deciding whether to offer coverage, some only in determining premium. Others use it for both, but slowly phase out the impact it has on price the longer a consumer holds the policy. With that said, an annual survey issued since 2005 by the Arkansas Insurance Department consistently shows that about 40 percent of consumers in that state see a discount in the price of their insurance because of credit, while only 10 percent see an increase. The remaining 50 percent of consumers are otherwise unaffected by the use of credit information. It is important to keep in mind, though, that these are aggregate numbers and will vary company by company.

In its 2007 study of auto insurance, the FTC concluded that the use of insurance scoring results in 59 percent of consumers enjoying a decrease in their premiums.

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INSURANCE SCORES ARE OBJECTIVE AND BLIND TO RACE AND INCOME

Credit-based insurance scores do not consider a consumer's income, race, age, address, marital status or nationality because insurers are legally prohibited from considering such information when calculating a score. An insurance score only measures risk-relevant variables (i.e., payment history, public records, etc.) that are indicators of potential future risk.

Living within one's means and paying bills on time are not traits that are restricted to any particular race or income bracket: they are universal qualities that exist regardless of race or income.

ALMOST ALL STATES ALLOW INSURERS TO CONSIDER CREDIT INFORMATION

Precisely because the use of credit information benefits so many consumers, almost all states allow insurers to use it subject to reasonable restrictions, including several already cited. ***Almost all states, for example, require insurers that use credit to also consider other information when they underwrite and/or rate a policy.***

Many states also require insurers to provide reasonable exceptions to their use of credit information for those consumers suffering from extraordinary life circumstances, such as loss of employment, divorce, death in the family, identify theft and other similar events.

Only two states, California and Massachusetts, ban its use entirely. Two other states, Hawaii and Maryland, ban its use for specific types (auto and homeowners, respectively). All other states allow insurers to use credit information subject to reasonable consumer protections.

WHILE NEW TECHNOLOGY IS PROMISING, IT REMAINS TO BE SEEN HOW USEFUL IT WILL BE

Some say that new tracking technology will render predictive tools like insurance scoring obsolete. While insurance companies are always looking for ways to distinguish themselves from the pack by offering the most competitive price and service, insurance scoring has shown itself to be one of the most predictive rating factors currently available to insurers, ***more predictive than even driving history.*** Whether having access to more detailed driving habits will prove more predictive than credit remains to be seen. However, it is unlikely that any one single rating factor will ever supplant the use of multiple factors in varying combinations.

ULTIMATELY, IT'S ABOUT EACH PERSON PAYING THE RIGHT PRICE FOR THE LEVEL OF RISK THEY REPRESENT

Ultimately, the business of insurance is about predicting the level of risk any one driver represents, and charging accordingly. Over the decades, insurance companies have discovered credit information helps them do just that. While insurers also consider many other types of information, credit is proven to be an incredibly accurate predictor of risk. The use of credit information helps most consumers, both directly and indirectly. Directly because most consumers have good credit and therefore benefit accordingly. Consumers also benefit indirectly because the use of credit information increases competition among insurers, driving down rates overall.

*Under federal law, consumers are allowed one **FREE** copy of their credit report each year from each of the three national credit bureaus. Consumers may access their **FREE** report at*

www.annualcreditreport.com.

For more information, visit www.pciaa.net.

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