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SOLUTIONS™

Giving Credit Where Credit Is Due

Credit scoring is a valuable underwriting and rating tool, but as controversy mounts, questions arise over what exactly it is, how insurance companies should use it, and how companies can address concerns regarding this tool.

Underwriting is the systematic process by which insurers evaluate new applicants for insurance, as well as their current policyholders. Insurance companies and their policyholders both benefit when insurers make sound underwriting decisions since underwriting is the key ingredient to company solvency and fair pricing.

The underwriting process involves evaluating the applicant or policyholder (the "risk") by using objective information about the risk, selecting those risks eligible for coverage, classifying risks so that policyholders are grouped with those having similar characteristics and likelihood of loss, and rating the risk. Underwriters can never know with certainty which applicants will have numerous future claims, and which will have very few, or even no, claims. However, good underwriters are able to rely on their professional experience along with objective underwriting tools to predict the likelihood, and expected frequency with which, applicants or current policyholders will have claims. Those tools may include motor vehicle records, prior loss history reports, home inspections, and credit history or credit scores.

What is Credit Scoring?

The terms "credit reports," "credit scores" and "insurance scores" are used interchangeably when referring to the concept of considering an applicant or policyholder's credit history as an indication of the likelihood of future loss. But actually, the terms are distinct.

Credit reports are detailed histories of an individual or firm's current and past credit-related transactions. Credit reports include detailed information on revolving credit, mortgages, collections and bankruptcies. There are three major credit bureaus in the United States, Equifax, Experian and Trans Union, which collect this credit information on individuals and businesses.

Credit scores are numerical indicators of risk. Credit scores are derived by selecting specific information from an individual's credit history provided by the credit bureaus, and entering that information into a computer model designed to produce a score. The score represents an objective "snapshot" of the credit habits of an individual.

Banks and lending institutions use credit scores to determine an applicant's ability to repay a loan. Although we use the term "credit scoring" when referring to insurer use of credit, insurance companies actually use scores differently than lending institutions. Rather than using a score to determine the likelihood of repaying a loan, insurers use "*insurance scores*" to predict the likelihood of future losses. Insurers may rely on their own proprietary computer models to determine one's score, or may rely on the models of an independent data vendor such as Choicepoint or Fair Isaac. The models will then produce a numerical score for use in underwriting and/or rating. The score does *not* include specific details from one's credit report, but represents a composite "picture" of an insurance risk. Although many insurers may use scoring information from the same vendor, each company has its own underwriting rules and may consider those scores differently.

How Does it Work?

Insurers have relied upon credit reports and Dun and Bradstreet reports to determine the financial well-being of commercial risks for many years. But the application of credit information to automobile and homeowners underwriting and rating is still a comparatively new practice. There have been several studies documenting a clear correlation between credit score and chance of loss. Statistically, the higher the credit score, the lower the risk of loss. In fact, the statistical studies on the relationship between score and loss frequency are so convincing that opponents of insurer use of credit scores rarely contest their statistical validity.

Despite the statistical evidence, it may still be difficult to understand what credit has to do with risk of loss. What does credit have to do with driving habits or home maintenance? Credit scores reveal a picture of the individual's ability to handle and manage credit – they objectively measure such subjective concepts as responsibility and stability, allowing insurers to gain a more accurate picture of subsequent risk and potential losses. The use of credit reports, then, adds another level of sophistication to the underwriting process that allows insurers to underwrite their business with a higher degree of certainty.

Why Is Insurer Use of Credit Scoring So Controversial?

Credit histories and credit scores have been available to insurers for use in their underwriting and rating decisions for many years. The Federal Fair Credit Reporting Act expressly granted insurers access to their customers credit information as far back as 1971.

However, since 1998, the number of insurers using credit scoring has more than doubled as evidence of its value as an underwriting and rating tool – that is, as an accurate predictor of future loss – continues to mount. A recent study by Conning and Co. found that 92 percent of the largest personal lines insurers are using credit scoring in underwriting and/or rating decisions.

But if the statistical validity of credit scores is widely accepted, and if so many insurers use credit scores, why has this become such an emotional issue? There have been several common concerns voiced by policyholders, insurance agents, consumer advocacy groups, legislators and regulators.

Some opponents of insurer use of credit information have charged that insurers use credit information for the purpose of refusing business or to charge higher rates. This just isn't so. Insurers are in the business of writing policies. Any insurer who would attempt to disqualify as much business as possible, or to unfairly rate their policies, would not remain in business very long. On the contrary, credit information has proven to be an effective tool for insurers, allowing them to underwrite or rate business with a greater degree of certainty and accuracy. In short, use of credit information allows an insurer to write more business – not less, leading to a more competitive marketplace with more choices for the consumer.

Insurers have also been charged by consumer advocates, policyholders, and even their own agents, with failing to be open and honest about how credit scoring is used. Until recently, consumers could not easily review their own credit scores and did not have much information on the process. Fortunately, insurers and independent scoring "modelers" have now gone to great lengths to "demystify" the process by better explaining to consumers how credit information is used in insurance, how credit scores are determined, and how consumers can take control of, and improve, their credit scores. Consumers may now easily obtain their scores from various vendors, along with complete explanations of the factors considered in the score.

Some people have objected to the use of credit information in underwriting by claiming that it is discriminatory toward lower income individuals. In actuality, people of all economic levels have good and bad credit records, and insurers may use credit reports as a tool that increases fairness through the use of another objective standard. Further, federal law prohibits the factors of ethnicity, religion, gender, marital status, nationality, age, income and address from being considered in a credit score.

Some people have also voiced concern over possible inaccuracies or errors in their credit records. While errors obviously occur, their impact on insurance underwriting has been negligible. Often errors found on credit reports are not relevant to the information considered by insurers. One large insurer recently confirmed that out of more than one million records processed, only four records were found to have errors that resulted in an incorrect rating decision – far less than the number of relevant errors revealed on motor vehicle records! For those records found to be in error, the Federal Fair Credit Reporting Act already clearly protects consumers by prohibiting insurers from considering information known to be in error.

Privacy is another issue that has been raised in opposition to the use of credit reports. Today, more than ever, consumers are concerned with privacy and confidentiality of personal records. Fortunately, credit scoring actually allows an underwriter to carefully evaluate a risk *without* the disclosure of sensitive or private information. The use of scoring allows the underwriter to objectively consider credit information and credit management habits without having to scrutinize all the details of one's credit history. Likewise, an applicant or policyholder will not have to fear that every detail of his private credit information will become known to his agent – who may be a family friend or neighbor. Consumers should be assured that their insurer's use of a credit history will not jeopardize their privacy.

Should Insurer Use of Credit Information be Prohibited?

Legislators and/or regulators in numerous states are currently evaluating insurer use of credit information. Many people have called for a prohibition on the use of credit information in the interest of "fairness" to all consumers. Actually, a prohibition on the use of credit information or credit scores would not be fair at all!

Several large companies have now tracked their experience with credit scores long enough to prove that more insureds benefit from the use of credit scores than not. This means that if credit scores could not be used as an underwriting tool, a majority of policyholders would pay *more* than their fair share for insurance.

Further, the use of credit scoring does *not* make it difficult for people to buy insurance. Credit scoring allows insurers to more accurately underwrite and rate their business. And when insurers can evaluate applicants with greater confidence, they are able to accept many applicants they might not have accepted in the past. In short, the use of credit scoring may improve insurance availability.

Finally, it is important to remember that not all insurers will choose to use credit information in their underwriting and rating decisions. Consumers who strongly object to the use of credit information may seek insurers who do not use credit scoring.

Future Political and Regulatory Outlook

Currently, legislators and/or regulators in at least half of the states are reviewing insurer use of credit scoring in personal lines underwriting. Even in some states where legislation was only recently enacted or regulation adopted, the practice is again under review. Despite all the evidence on the value of credit scoring, including evidence supporting improved rating treatment or product availability for the majority of policyholders, allegations still persist that use of credit is "bad public policy." But real company evidence that insureds directly *benefit* from the use of credit scoring may be more compelling to legislators or regulators than any of the currently available statistical studies. ■

President
Rodger S. Lawson, Ph.D.

Editorial Staff
John Lobert Jean Demas
Charlie Schmidt Deborah Sherno

tel: 630.724.2100
fax: 630.724.2190
www.allianceai.org

Alliance of American Insurers®

3025 Highland Parkway, Suite 800
Downers Grove, Illinois 60515

Frequently Asked Questions

What is an insurance credit score and how is it calculated?

An insurance credit score, typically just referred to as a "credit score," is a number that is used to predict the likelihood of future insurance losses. The score is generated by entering specific information from one's financial history, including information related to outstanding debt, the length of one's credit history, late payments, bankruptcies or collections, and types of credit used, into a computer model designed to calculate a score for use in underwriting and/or rating. The score does not include specific details from one's credit report, but represents a composite "picture" of an insurance risk.

How does a credit score relate to driving record?

There is a proven statistical relationship between credit scores and insurance losses. The actuarial firm of Tillinghast-Towers Perrin completed an independent study on credit scores that has been accepted by the National Association of Insurance Commissioners. The study reviewed both the automobile and homeowners policies of several large insurers and found (with a better than 99 percent confidence level) that there is a clear relationship between credit score and likelihood of insurance claims.

Credit scores have been compared to a measurement of care and "responsibility." How one manages debt and financial obligation is actually a very good predictor of how one manages his or her risk of loss.

How can policyholders benefit if insurers use credit scoring?

The majority of people have good credit and resulting high credit scores. Those people will receive better rates overall than those drivers with a statistically higher chance of loss.

Aren't credit scores just an excuse for insurance companies to cancel policies or charge higher rates to their policyholders?

In fact, just the opposite is true. The use of credit scores adds another level of sophistication to the underwriting process that allows insurers to accept business with a higher degree of certainty. This means that credit information, when used as an underwriting tool, provides insurance companies with a greater opportunity to write business in all markets.

Insurers are looking to write more business, not less. Insurance is a very competitive business, and any company that would seek to cancel business or charge high rates wouldn't stay in business very long.

Can consumers see their credit score?

Yes. Several credit bureaus and vendors now make credit scores available to individuals for a small charge. In fact, some credit bureaus recommend that individuals review their own credit information at least yearly to check for any errors or incorrect information.

Don't insurance credit scores allow insurance companies to discriminate against low-income drivers or minorities?

Absolutely not. Federal law is very specific about what factors may **not** be considered in an insurance credit score. Ethnicity, religion, gender, marital status, nationality, age, income and address may not be included within an insurance credit score.

Many people have expressed concern that they will be unfairly discriminated against based on their income. Actually, people of all economic levels have good and bad credit records. A credit score is not a measure of wealth – it's a measure of responsible habits. Further, because credit scoring relies on real data and statistics, it provides an objective method of evaluating a risk – free from either intentional or unintentional subjective or judgmental bias.

Doesn't the use of credit scores make it very difficult for people to buy insurance?

No. Several large companies have now tracked their experience with credit scores long enough to prove that more insureds benefit from the use of credit scores than not. Credit scores allow insurers to more accurately underwrite and rate their business. And when insurers can evaluate applicants with greater confidence, they are able to accept many applicants that they might not have accepted in the past. In short, the use of credit scoring has improved insurance availability.

Isn't insurer use of credit scores an invasion of consumer privacy?

Credit scores provide the insurer only with a predictive numerical score – not with specific details as to credit history. Neither the underwriter nor the agent will know the details of the applicant or policyholder's credit history.