

Credit Scoring

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Insurance companies have been using credit information for decades as a way to better predict an individual's loss propensity. Only recently, however, have advances in computing power enabled insurers to condense hundreds of pieces of data contained in a credit report into a single number, a process known as credit scoring, or more accurately, insurance scoring.¹

Because credit history correlates so highly with insurance losses, the insurance score can then be used, along with other relevant rating variables, to predict loss experience and insurance rates.

As evidence of this predictability of loss propensity, a study conducted in June of 2003 by EPIC Actuaries on six different private passenger automobile insurance coverages showed that using insurance scores significantly improved the predictability of loss frequency for each coverage across all 50 states, even when fully adjusting for interrelationships with the other risk factors. Another study published in 2003 found a strong correlation between credit history and both the size and frequency of auto insurance claims. To counter studies like this, consumer advocates typically answer with a host of criticisms. One criticism is that the use of insurance scores leads to discrimination based on illegal factors such as race and income. However, two independent studies conducted in 2004 in Missouri and Maryland failed to support this hypothesis due to flawed methodology and insufficient data.

Consumer advocates also argue that those insureds whose premiums increase as a result of their credit information are unfairly harmed. However, theoretically those insureds who receive a higher premium were actually receiving an unfair rate before the increase, since the previous rate underestimated their true loss propensity. More importantly, the "worst" or highest

¹ Credit scoring is used to predict the likelihood of an individual fulfilling a potential financial obligation, whereas insurance scoring (or "credit-based insurance scoring") is used to predict the frequency and/or severity of a potential insurance claim. Consequently, the elements of a credit report that are used to determine a credit score can differ significantly from the elements used to compute an insurance score. Specifically, insurance companies cannot use any data that indicates an individual's income. Despite this distinction, most people use credit scoring when referring to insurance scoring.

risks are often unable to find coverage at all in the regular market, and are therefore forced to pay much higher rates in the residual markets. Credit-based insurance pricing allows policies to be sold to these individuals at prices lower than those in residual markets. Understanding this tendency for insurance scoring to lower premiums and expand the insurance market, voters in Oregon demonstrated their support for insurance scoring in late 2006 when they rejected a potential ban on insurance scoring by a nearly two-to-one margin. The insurance industry believes this outcome may set a precedent for the rest of the nation.

Opponents of insurance scoring, however, have made some progress. For example, in Washington State, whenever an insurer informs a policyholder of an adverse event (e.g., an increase in premium) that results from one's insurance score, the insurer must explain what element in the credit report caused the event, how that event affected the insurance score, and how the insured can improve that element of their report. A more restrictive policy exists in Delaware, which currently prohibits insurers from increasing renewal premiums based on a change in credit history, unless specifically requested to do so by the insured. Furthermore, in late 2002, the National Conference of Insurance Legislators (NCOIL) adopted a model law that restricts the use of credit information by insurers. As of February 2007, 26 states have filed bills based largely on the NCOIL model law. These laws typically contain provisions such as prohibiting insurers from penalizing insureds with no credit history and restricting insurers from using certain credit information, including total available credit and number of credit inquiries.

Despite this progress, these laws are far from completely eliminating the use of insurance scores in insurance pricing. Insurance scoring has survived primarily because insurance companies, lawmakers, and consumers appreciate that its strong predictive value leads to a more competitive market place, and ultimately, to lower prices for insurance.