

# CREDIT SCORING IN UNDERWRITING

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The use of credit scores in the underwriting process is on the rise. Insurers assert that credit scores allow them to better underwrite risks and set rates more accurately. Various interest groups and regulators claim it is a discriminatory practice. Many states are legislating in this area. With all of the controversy surrounding this issue, it is important to understand why credit scores are used by insurers, and to separate fact from fiction.

## *What Credit Scoring Is and Why Insurance Companies Would Use It*

Credit scores are based on the credit information contained in credit reports. Each item of information in an individual's credit report has a value assigned to it and the data is run through a credit scoring model in order to derive a three-digit number (zero to 999); the higher the number the less likely it is that individual will file a claim.<sup>2</sup> The rankings are confidential and do not include any information on the individual's income or race.<sup>3</sup> Credit scoring is used by insurers in underwriting personal lines insurance.

Credit scoring agencies such as Fair, Isaac & Co. and Choice Point, among others, develop scoring models to which many insurance companies subscribe.<sup>4</sup> The scoring model assigns a value to certain characteristics, which increase or decrease the score. Examples of negative characteristics include late payments, unpaid bills, high balances on credit cards, and pursuit by collection agencies.<sup>5</sup>

Credit scores are used by insurers to assist them in differentiating between lower and higher risk applicants. When credit scores are combined with other factors, such as years driving, past accidents, the type of car (or home), and where the insured lives and drives, an individual's likelihood of filing a claim is more accurately reflected in his or her premium.<sup>6</sup> The likelihood of filing a claim and an individual's credit score are highly interrelated<sup>7</sup> – some researchers have found the correlation to be as high as 99%.<sup>8</sup> Credit scores are a useful tool in determining whether to issue a new policy or renew an existing one.<sup>9</sup> To stay competitive, insurance companies need to be able to set their premiums accurately; given the high degree of correlation between claims filed and credit score, the use of credit scoring is useful to that end.<sup>10</sup> Motor vehicle records (containing items such as accidents, speeding tickets, and drunk driving convictions) are often incomplete. One study found that one in every five convictions is missing from motor vehicle records, and another found that only 40% of reportable accidents are in motor vehicle records.<sup>11</sup> Motor vehicle records alone may result in inaccurate underwriting. Credit scoring is useful in evaluating risk because it treats all applicants objectively<sup>12</sup> with regard to how well an individual manages his or her finances, not the individual's income level.<sup>13</sup>

## *Criticisms of Credit Scoring and Why Those Criticisms are Unfounded*

The use of credit scoring has been criticized because various interest groups, including the National Association of Professional Allstate Agents, and state regulators believe that credit scoring unfairly discriminates against minorities. Critics believe the current trend of using credit scoring is a new way of "redlining," where prior to the Fair Housing Act of 1968, insurers refused to sell automobile or homeowners insurance in poor or minority neighborhoods.<sup>14</sup> A related practice was the use of race in setting life insurance rates.<sup>15</sup>

Studies have analyzed whether credit scoring discriminates against minorities. Race and income have been shown to be inaccurate predictors of credit scores.<sup>16</sup> Additionally, no studies have proven credit scores discriminate,<sup>17</sup> and, in fact, the use of credit scores has been found to reduce the risk of discrimination.<sup>18</sup> Supporters of credit scoring indicate that credit scores are "blind" to race, ethnicity, gender, and income<sup>19</sup> and that the Fair Credit Reporting Act, 15 U.S.C. §1681, provides a level of protection for consumers by requiring that credit reporting agencies adopt systems that produce fair and accurate reporting and respect the consumer's right to privacy.<sup>20</sup>

The use of credit scores can lead to potential liability for insurers. In 2002, a class action suit was filed against

Allstate Corporation alleging discrimination based on its use of credit scores.<sup>21</sup> The plaintiffs alleged that credit scores were used to sell to and target non-Caucasians for more expensive policies.<sup>22</sup> The court did not rule on whether Allstate's practices were discriminatory. However, the court did find that the plaintiffs had alleged sufficient discriminatory acts to survive a motion to dismiss.<sup>23</sup> This case is still pending.<sup>24</sup> Also, in *National Fair Housing Alliance, Inc. v. Prudential Insurance Company of America*,<sup>25</sup> the plaintiff sued alleging, among other things, that Prudential's use of credit scores was discriminatory.<sup>26</sup> The court similarly felt that the plaintiff stated sufficient claims to survive a motion to dismiss.<sup>27</sup>

Critics of credit scoring argue that since insurers do not know the specific reason why there is such a high correlation between credit scores and insurance risk, it should not be used for underwriting purposes. However, insurers counter that the correlation is understood better than other similar correlations that are used without objection.<sup>28</sup> For example, discounts are given to students with high marks because they have been found to be involved in fewer accidents; the exact reason for the correlation is unknown.<sup>29</sup> One explanation is that people who are responsible with their finances are more likely to be overall responsible people, causing them to be more likely to avoid accidents.<sup>30</sup>

Issues may arise for consumers that do not have credit scores. These consumers fall into the "no hit" category. They are typically very young and have not yet started using credit, or they are retired and have paid off their mortgages. These groups account for four percent of the population.<sup>31</sup> Penalizing people in the "no hit" category is potentially unfair because it is difficult to tell whether they would handle credit well or poorly. Most state regulations require that individuals in these categories be treated as an average risk (i.e., prohibit those individuals from being penalized) despite some indication that these groups do suffer greater losses.<sup>32</sup>

### ***State Regulation***

In 2002, State legislatures began to heavily regulate the use of credit scores, with the trend continuing throughout 2003.<sup>33</sup> State laws governing the use of credit scores can be grouped as follows: (i) states which regulate, (ii) states which restrict, and (iii) states which prohibit.<sup>34</sup> Twenty-six states regulate the use of credit scores.<sup>35</sup> The laws generally give allowance for the use of credit scores, require notice that credit scores are being used, establish reporting requirements, or require that decisions related to credit scores be based on standards that are ascertainable and objective.<sup>36</sup>

Twelve states have enacted statutes that restrict the use of credit scores.<sup>37</sup> The statutes prohibit using credit scores as the only reason for making a determination in underwriting.<sup>38</sup> Insurers may also be required to explain to insureds specifics as to how credit scores are used.<sup>39</sup> Some restrictions apply only to certain lines of insurance.<sup>40</sup>

Three states, Maryland, Utah, and Washington, prohibit the use of credit scores.<sup>41</sup> In Maryland, automobile insurers cannot require specific payment plans based on a credit score. There is also a general prohibition against refusing to insure or increasing a premium based on credit score.<sup>42</sup> Utah prohibits insurers from making underwriting decisions based on credit scores,<sup>43</sup> and Washington bars insurers from canceling policies because of credit scores and denying coverage because of a lack of credit information.<sup>44</sup> The use of credit scores are also restricted in setting premiums and eligibility.<sup>45</sup>

### ***Conclusion***

Credit scores can assist underwriters in more accurately determining insurable risks. Credit scoring has drawbacks, and carries with it potential liability and litigation over whether its use results in discrimination against minorities and low-income earners. Insurers must be careful to use credit scores fairly and within the confines of the laws of the states in which they sell insurance.

### ***Endnotes***

1. This article was written with the assistance of Christine Blethen, a summer associate with Edwards & Angell, LLP.

2. Consumer Alert from the NAIC, *Credit Scoring: How Does it Affect You?*, at [http://www.naic.org/pressroom/consumer\\_alerts/creditscoring.pdf](http://www.naic.org/pressroom/consumer_alerts/creditscoring.pdf); Indiana Farmers Mutual Insurance Group, *Insurance Credit Scoring*, at <http://www.indianafarmers.com/docs/credit%20score%20brochure%20final%20version.pdf>.
3. Insurance Information Institute, *Credit-Based Insurance Scoring*, at <http://www.iii.org/media/hottopics/insurance/creditscoring> [hereinafter *Credit-Based Insurance Scoring*].
4. American Academy of Actuaries, *The Use of Credit History for Personal Lines of Insurance: Report to the National Association of Insurance Commissioners*, at [http://www.actuary.org/pdf/casualty/credit\\_dec02.pdf](http://www.actuary.org/pdf/casualty/credit_dec02.pdf) (November 15, 2002); Indiana Farmers Mutual Insurance Group, *supra* note 2.
5. *Id.*
6. *Id.*
7. Bureau of Business Research, *A Statistical Analysis of the Relationship Between Credit History and Insurance Losses*, at <http://www.insurancecouncil.org/news/2003/UTCreditstudy.pdf> (last updated March, 2003) (finding the correlation between “credit score and credit loss ratio [to be] .95, which is extremely high and statistically significant).
8. *Credit-Based Insurance Scoring*, *supra* note 3; Doug Johnson, *Why Credit Based Insurance Scoring is Good for Consumers*, *Insurance Journal*, at <http://www.insurancejournal.com/magazines/southcentral/2002/04/29/partingshots/19103.htm> (April 29, 2002).
9. National Association of Insurance Commissioners, *supra* note 2.
10. *Credit-Based Insurance Scoring*, *supra* note 3.
11. *Id.*
12. Johnson, *supra* note 8; Federal Trade Commission, *FTC Facts for Consumers: Credit Scoring*, at <http://www.ftc.gov/bcp/online/pubs/credit/scoring.pdf>.
13. *Credit-Based Insurance Scoring*, *supra* note 3; American Insurance Association, *AIA Comments to Georgia Commissioner of Insurance on Insurers’ Use of Credit*, at <http://www.flains.org/newfic/mediapublic/latebreakingnews/CreditReports/aiageorgia.htm> (last updated Oct. 17, 2001).
14. Brian Brow & Pallavi Gogoi, *Insurance: A New Way to Squeeze the Weak?*, *Business Week Online*, at [http://www.businessweek.com/magazine/content/02\\_04/b3767072.htm](http://www.businessweek.com/magazine/content/02_04/b3767072.htm) (last updated January 28, 2002); Chris Pummer, *Insurers Face Regulatory Backlash for Use of Credit Scores*, at [http://www.napaausa.org/Features/Credit\\_Action\\_files/dubios.htm](http://www.napaausa.org/Features/Credit_Action_files/dubios.htm) (last updated Feb. 13, 2002); Center for Economic Justice, *Redlining*, at <http://www.cej-online.org/redlining.php>.
15. Kareem Faheem, *Life at a Premium*, at <http://www.villagevoice.com/issues/0238/fahim.php> (last updated Sept. 18-24, 2002); See Jill Gauldin, *Race, Sex, and Genetic Discrimination in Insurance: What’s Fair?*, 80 CORNELL L. J. 1646 (1995).
16. National Association of Mutual Insurance Companies, *Insurance Scoring Methods*, at <http://www.namic.org/regulatorykeyissues/scoring.asp> (last updated April 2002) [hereinafter *Insurance Scoring Methods*]; American Academy of Actuaries, *supra* note 4.
17. Werner E. Kruck, *Use of Credit for Rating and Underwriting Insurance*, <http://www.freeinsuranceinfo.com/>

[articles/creditscores.htm](#) (last updated May 10, 2002).

18. *Id.*

19. Robert P. Hartwig, *The Use of Credit Information as an Underwriting Tool in Personal Lines Insurance: Analysis of Evidence and Benefits*, Insurance Information Institute, Power Point Presentation, at <http://www.iii.org/media/presentations/credit/> (last updated Feb. 27, 2003).

20. Mark D. Lonergan, *Predatory Lending*, 1361 PLI/Corp 11, 16 (2003).

21. *Dehoyos v. Allstate Corp.*, No. Civ.A.SA01CA1010FB, 2002 WL 1491650 (W.D. Tex. Apr. 5, 2002).

22. *Id.* at \*1.

23. *Id.* at \*5.

24. The United States Chamber of Commerce, *NCLC List of Active Cases*, at <http://www.uschamber.com/nclc/caselist/issues/reform.htm>

25. 208 F. Supp.2d 46 (D.C. 2002).

26. *Id.* at 50.

27. *Id.* at 62.

28. Johnson, *supra* note 8.

29. *Id.*

30. *Insurance Scoring Methods*, *supra* note 16.

31. *Credit-Based Insurance Scoring*, *supra* note 3.

32. *Id.*; Insurance Information Institute, *Legislative and Regulatory Issues for Credit and Insurance*, at <http://www.howcreditworks.org/legisl.htm>. Similar laws prohibit the use of divorce, a former spouse's debt, medical debt collection if it adversely affects scores. *Id.*

33. *Credit-Based Insurance Scoring*, *supra* note 3; National Association of Mutual Insurance Companies, *State Laws Governing the Use of Credit-Based Insurance Scoring*, at <http://www.namic.org/state/credithistory.asp> (last updated April 9, 2003) [hereinafter *State Laws*].

34. *Id.*

35. *Id.* The states which regulate are: AZ, CA, CO, DE, FL, GA, ID, KS, ME, MD, MA, MO, MT, NE, NH, NJ, NY, OH, OR, RI, SC, TX, UT, VA, WA, and WV. *Id.*

36. *Id.*

37. *Id.* The states which restrict are: AR, GA, HI, ID, IL, LA, MN, MO, MT, OK, WA, and WI; GA, ID, and WI also have general regulatory requirements. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.* ■

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