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CREDIT-BASED INSURANCE SCORES

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What determines how much a consumer will pay for automobile insurance? The usual considerations immediately come to mind: accident history, average miles driven each year, number of speeding tickets and location of insured are a few factors that are evaluated. In almost every state, however, the consumer's credit score also can play an important role in determining eligibility for coverage and the insured's monthly premium.

To many, this news comes as a surprise. A report released this summer by the National Consumer Law Center and the Center for Economic Justice found that only 36 percent of Americans are aware that their credit histories can impact their insurance rates and coverage. For a variety of reasons, awareness and scrutiny from consumer groups, state regulators and Congress is growing.

What Are Credit-Based Insurance Scores?

Insurers are constantly in search of new and more reliable ways to evaluate and price risk. In the mid-1990s, insurers began to consider consumers' credit histories as one factor in their risk analysis after studies showed a strong correlation between credit history and the likelihood of loss and the submission of a claim. The practice eventually became standard among automobile insurers, and today major automobile insurers in almost every state consider consumers' credit histories when underwriting and pricing policies.

Credit scores are formulated based on consumers' credit histories, which contain information about their borrowing, spending and repayment habits. This data is compiled by three national credit bureaus. These bureaus take certain information - such as the age of a credit card account or the number of late payments on a home equity loan - and plug the information into a formula that produces a credit score. This credit score may be used by other lenders to determine, for example, whether a consumer qualifies for a mortgage or what interest rate he or she receives on a department store charge card.

Insurers are not alone in their reliance on this information. Credit scores have become the modern financial benchmark by which consumers are judged. Banks, credit card companies, insurers and other financial institutions all rely on credit scores to gauge the level of risk a consumer poses in entering into any particular transition in order to price that risk, with varying degrees of success.

Insurers, however, use consumers' credit histories somewhat differently than other financial institutions. Instead of relying solely upon credit scores to make underwriting or pricing decisions, insurers combine credit scores with other data to derive a new measure of risk: credit-based insurance scores. Insurers then use these scores to evaluate and price the risk associated with an application for coverage. Essentially, credit scores become one part of the formula used to determine whether to offer coverage or to set the premium.

Why Are Credit-Based Insurance Scores Important?

In simplest terms, insurance scores matter because they impact the bottom line. For insurers, insurance scores

function as an actuarial tool, enabling them to evaluate their risk assessment and price risk accordingly. Insurers argue that better accuracy in the underwriting and rating of risks is achieved by use of credit scores, which in turn, allows them to reliably match price with risk and leads to lower premiums for many consumers who fall into the middle and upper credit score tiers.

In the wake of this summer's consumer credit crisis, national attention has focused on those consumers who do not fall into the higher tiers. This summer, the Federal Trade Commission (FTC) released a report that evaluated the role of insurance scores in the automobile insurer industry and, particularly, the effect those scores have on ethnic and racial minority groups.

The report found that the average predicted risk for African-Americans and Hispanics increased significantly when credit-based insurance scores were used - meaning they often pay more for automobile insurance and may have greater difficulty obtaining coverage than Asian-Americans and Caucasians. Despite these findings, the FTC report concluded that insurance scores generally did not serve as a proxy for racial discrimination and cited studies showing a strong correlation between credit history and the likelihood of loss.

At a congressional hearing held earlier this month, consumer advocates and state regulators attacked the FTC's findings. Critics argued that credit histories are notoriously incomplete and inconsistent, making them poor predictors of risk. They also rebuked the FTC for relying on data voluntarily submitted by insurers; one FTC commissioner even dissented from the report, stating that insurers should have been compelled to provide more comprehensive data.

The critics' main argument, however, focused on the impact of credit-based insurance scores on racial and ethnic minorities. Because African-Americans and Hispanics are significantly over-represented in the lowest credit score tiers, they tend to pay higher premiums. Consumer groups argued that this result was fundamentally inconsistent with public policy because it made insurance less available and less affordable to low-income groups - the segment of the population least able to absorb losses.

Outlook

To some extent, the federal government regulates insurers' use of credit-based insurance scores through the Fair Credit Reporting Act (FCRA). FCRA requires that insurers provide notice to consumers when they take "adverse action" - such as not offering the best available rates or coverages - based on the information contained in credit reports. However, the power of the federal government in this area is limited, as evidenced by a recent United States Supreme Court decision that found FCRA's protection inapplicable to first-time applicants.

Ultimately, the states will continue to bear primary responsibility for regulating insurers and their reliance on credit-based insurance scores. Currently, 48 states have enacted laws that regulate the use of insurance credit scores. Most of these states passed versions of the model law promulgated by the National Conference of Insurance Legislators, but some have gone even further. Hawaii banned the practice outright 20 years ago, and Florida is taking aggressive action by attempting to require that insurers affirmatively demonstrate their underwriting and pricing practices do not discriminate against protected classes, including racial and ethnic minorities.

Consumer advocates have urged states to take additional action, such as requiring insurers to improve the transparency of their insurance-scoring methodologies and registering their models with the applicable state regulators. Congress also has expanded its inquiry into the issue, ordering the FTC to produce another report on the role of credit-based insurance scores in homeowners' insurance. For now, the debate continues to rage as the insurance industry, consumer groups and state and federal officials attempt to strike a balance between actuarial principles of pricing risk and public policy.