Should Insurance Companies Be Able to Consider Your Credit History?

Nerd Wallet

Most people know that their credit score impacts their ability to get a loan and even a job in some states – but what about their ability to get insurance? While insurance companies don't use your credit score, many – 85% to 95% in most states – use a similar metric, called a credit-based insurance score, to determine whether they'll cover you and/or how much you'll be charged for auto insurance, homeowners insurance and other policies.

Insurers use these scores because they're an incredibly accurate measure of customers' insurability – but they're also controversial. In fact, multiple states, including Massachusetts and California, have banned or severely restricted the practice. Still, most allow some degree of insurance scoring, meaning consumers will see their credit impact their premiums, sometimes for reasons beyond their control.

What is an insurance score?

According to Jim Hawkins, associate professor at the University of Houston Law Center, "An insurance score is an algorithm similar to a credit score that insurance companies use. It uses a limited subset of factors that appear in your FICO score, like accounts past due." High credit utilization and bankruptcies will also affect your insurance score.

Campbell Wallace, government affairs council for Professional Insurance Agents, adds, "It's a blend of factors that are looked at to determine your risk: the likelihood of you suffering a loss, the magnitude of that loss, the likelihood of you maintaining a policy. Essentially, it looks at your suitability to be insured."

What doesn't your insurance score include? Information – like race, ethnicity and religion – that has the potential to be discriminatory. In addition, insurers don't have access to data about your income, information a loan application would include.

Who likes insurance scores?

Insurance scores are so popular because they're highly predictive. The insurance industry considers them one of the most accurate methods of predicting future losses.

The trick? No one knows exactly why. Wallace suggests: "Insurance scores may reflect on your overall

tendency to pay attention to and live by the rules. It's a proxy for conscientiousness."
Insurers who use them are quick to point out that accurate assessment of risk is a positive thing for companies and most) consumers alike. Hawkins explains, "It's good for people, theoretically at least, because those who are a lower risk will pay less." Responsible policyholders won't subsidize irresponsible ones, just as safe drivers pay lower rates than those with poor driving records.

Why are insurance scores controversial?

Despite their efficacy, insurance scores are the subject of much debate. Many states that haven't banned their use face periodic campaigns to do so, supported by consumer groups like Texas Watch.

Texas Watch's executive director, Alex Winslow, offered this statement from the organization's website: "None of the criteria that make up insurance scores directly relates to a policyholder's insurance risk. In fact, many consumers who have never filed an insurance claim find their insurance rates rising based solely on their credit score."

Opponents also argue that insurance scores highlight stark social divides. Texas Watch adds, "Study after study has shown that credit scoring has a disproportionately negative impact on people with lower incomes, senior citizens and racial minorities."

Of course, insurers have a strong counter-argument. In Wallace's words,"An insurance score is objective. The data that's in it is all things you've done."

Some question whether that's truly the case. Amy Bach, executive director of United Policyholders, points out, "It puts a cost burden on people due to things beyond their control such as losing a job, falling ill or becoming disabled) and compounds economic challenges for low-to-moderate income people."

Medical debt – not credit card debt – is the leading cause of personal bankruptcies in the United States. And once a consumer has poor credit, paying higher premiums for insurance and greater interest on loans only makes it more difficult to pay down debt.

In addition, credit reports may not be accurate for reasons beyond a consumer's control. "Credit report errors are very common, yet hard to fix," Bach says. A 2012 study by the Columbus Dispatch showed that many credit report errors took months to fix.

Insurance scoring isn't perfect. Wallace acknowledges, "Say you graduated in 2007 with an English degree. How are you supposed to keep food in your stomach without credit card debt? That's a good argument. What I would say is that, over time, if you truly are a conscientious person, the odds will average out in your favor. If you're 55 and still making that argument, maybe it's not so strong."

Should insurance scoring be allowed?

Those who oppose insurance scores have made compelling arguments and, in some cases. they've been successful. Many states – including Michigan and Kansas – require insurers to consider some causes of poor credit, including long-term unemployment and medical bills. Hawaii has banned the use of insurance scoring forauto insurance policies. Massachusetts has banned the practice completely.

After all, as Bach notes, insurance scores aren't the only way to measure insurability. "Insurers can and do) use people's claim history, the value of their property home and car), driving record, address, education level, and many other risk indicators that are within people's control and that are risk predictors."

However, opponents have suffered more defeats than successes in the battle over credit scores, in part because the method is so effective. "In 2007, the Federal Trade Commission tried and failed to develop an alternative scoring method," says Hawkins. "Not that it couldn't be done, but it hasn't happened so far."

And as long as there is no better idea, it's unlikely the insurance industry will give up without a fight.