

Should states ban credit-based insurance scoring?

Drivers in Texas who have bruised credit soon could have one less thing to worry about when buying insurance.

A bill pending in the state Senate would prevent insurance companies in Texas from using credit-based insurance scores to determine how much to charge policyholders for insurance premiums.

Currently, insurers routinely use such scores – which are based on an individual’s credit history – when pricing policies throughout the United States.

For example, a 2004 study by the Texas Department of Insurance reviewed rate filings and found that insurers writing about 42 percent of the homeowner’s insurance policies and 55 percent of the personal car insurance policies used credit scoring to some degree.

On its surface, the proposed legislation to end this practice sounds like a win for consumers. However, debate continues about whether eliminating insurance-based scores would benefit policyholders or would end up causing more harm than good.

Credit concerns

Alex Winslow, executive director of the consumer advocacy group Texas Watch, applauds the legislation. He says insurance underwriting and rating should not be based on financial measures like credit scoring.

“Credit scoring concerns your ability to pay bills on time, not your likelihood to be hit by a hailstorm,” he says.

Several years ago, Texas Watch studied insurer credit-scoring models and found that achieving an ideal credit score “is a target that is impossible to hit,” at least in the eyes of insurers, Winslow says.

“For example, with some carriers, having two credit cards was a good thing. For others, it was a bad thing,” he says. “What is a consumer to do?”

In addition, Winslow contends that insurers are under no obligation to reveal to consumers what they can do to boost their insurance scores.

Amy Bach, executive director at nonprofit consumer advocacy group United Policyholders, also thinks it’s unfair to use credit scores to set insurance rates.

“Diligent, skilled, productive employees lose their jobs every day through no fault of their own,” she says. “It’s not fair to penalize people in that situation and make a bad situation worse by charging that now-unemployed person a high rate for the insurance they need to drive to job interviews.”

Winslow says that although insurers argue that credit scores can help them predict someone’s likelihood of filing a claim, the company may have ulterior motives.

“What this really means is that it may profile people who do not have the financial means to pay out of pocket in the event of a covered loss,” he says.

Higher rates?

However, not everyone thinks the Texas proposal is sound. The Property Casualty Insurers Association of America, a trade group, recently spoke out against the bill in testimony before the Texas Senate Committee on Business and Commerce.

The association’s position is that credit-based insurance scoring is a legitimate way to determine risk, and should be allowed, says Alex Hageli, the association’s director of personal lines policy.

“Higher-risk consumers pay higher rates, while lower-risk consumers pay lower rates,” Hageli says. “Fundamentally, it’s about charging consumers fair rates, and we support that.”

Statistics show that people with poorer credit ratings are more likely to file insurance claims, according to the Insurance Information Institute. The nonprofit institute cites a 2007 study by the Federal Trade Commission found that found such a link. The study also concluded that the use of insurance credit

scores leads to more accurate underwriting of car insurance policies.

The Texas Department of Insurance study reached the same conclusion. It found a “strong relationship between credit scores and claims experience on an aggregate basis.”

In a second phase of the study, the department found that “credit scoring significantly improves pricing accuracy when combined with other rating variables in predicting risk.”

Hageli thinks that if the Texas bill becomes law, it will hurt more consumers than it will help. He points to an annual survey in Arkansas that looks at how credit-based scoring affects premiums. The report found that in 2011, credit-based scoring was used for more than 3 million policies written in Arkansas. Of those policies, 43 percent received a discount and just 13 percent saw a rate increase.

Such data supports the argument that passing a law that bans credit-based insurance scoring would result in many policyholders “losing a discount they currently enjoy,” Hageli says.

Looking ahead

Currently, several states have laws similar to the Texas proposal. Hawaii and Massachusetts prohibit the use of credit information in the underwriting or rating of car insurance, while Maryland prohibits the same for homeowner’s insurance.

California does not technically prohibit the use of credit information, but Hageli says that “for all intents and purposes,” its use is banned because credit is not one of the factors listed in Proposition 103, the state law governing car insurance rates. In addition, the California Department of Insurance does not approve rate filings for homeowners that depend on credit, he says.

Winslow maintains that such laws are needed to protect consumers from the use of credit scores.

“Credit reports are riddled with errors,” says Winslow, citing an FTC study that showed 5 percent of consumers had errors on at least one of the three major credit reports, perhaps leading to higher borrowing and insurance costs.

“This industry needs to clean itself up,” he says. “Why are we over-relying on this information in the

insurance context, of all places?”

Bach says that just because a formula establishes a link between low credit scores and a higher likelihood of filing claims does not mean it’s appropriate for insurers to use the formula in setting rates.

“If a number cruncher told us that children of alcoholics are more likely to get into car accidents, we wouldn’t consider that a fair rating factor,” she says.