Fact Sheet

Southwestern Insurance Information Service - A public information organization of insurance companies

"Nothing happens without Insurance"

A Consumers' Guide To Understanding Why Credit Information Is Used To Price And Underwrite Insurance Policies

For several years, insurance companies have increasingly included certain information from credit reports among the factors used both to underwrite and to price insurance policies. As consumers hear more about this practice, they may have questions and concerns, most of them related to the following:

What makes credit information relevant to the likelihood of insurance losses?

What kind of information from a policyholder's credit history helps determines the insurance premium that he or she receives?

In this fact sheet we'd like to explain how insurance companies use credit information, and why. Each insurance company, of course, uses credit history differently, but this guide is designed provide a general overview.

PROMOTING FAIRNESS IN UNDERWRITING AND PRICING

Certain information from credit reports is used as one factor among many others that insurers consider in order to more accurately estimate the risk presented by a given customer. Insurers consider this information due to an ongoing concern about the accuracy of our underwriting and pricing, because it helps control the cost of insurance, and because it helps us make insurance more widely available.

The use of credit history in underwriting is not a new concept. Some insurers have used the credit history of individuals in underwriting insurance since the 1980s.

The information insurers use in credit reports has proved an effective predictor of insurance losses. In fact, independent studies confirm the connection between credit report information and the likelihood of experiencing a loss.

A 1998 study by the American Insurance Association found that scores of individuals in the lowest income bracket were markedly better than individuals with a household income in the $40,000 to $49,000 per year income category and on par with those in the $125,000 and higher incomes.

Credit histories also offer insurers a cost effective means to measure risk. This important tool enables companies that have smaller percentages of the market share the ability to enter a market and expand their business through competition. In the end, consumers less likely to incur loss can benefit from lower premiums and greater value.

The Texas Department of Insurance reports it received only 76 complaints from consumers over the use of credit reports during 2001, even though approximately 11.9 million Texans carry automobile insurance and almost 3.8 million Texans have some kind of residential insurance policy.

CREDIT HISTORY: ONE OF MANY FACTORS CONSIDERED

Credit history is generally only one of many factors used to help determine the premium an insurer charges a customer. Most insurers consider such factors as age and driving experience, driving record, whether a vehicle is being driven in an urban or rural setting, the type of vehicle driven, and other characteristics that affect the potential for loss.

In the case of homeowners insurance, factors other than credit history include the condition of the home, proximity to fire protection, whether it is located in a high or low crime area, and type of construction to, name a few.

The kind of information in credit reports that has proved relevant to calculating insurance risk includes bankruptcies, judgments, collections, and delinquencies. The number and the types of credit accounts a customer has, length of account history, payment history and account balances relative to limits are other factors that may be considered.

WHAT DOES CREDIT HISTORY HAVE TO DO WITH THE LIKELIHOOD OF HAVING A LOSS?

The link between credit history and loss potential has been studied extensively by many scholars outside the insurance industry, in fields such as psychology, safety engineering, occupational medicine, consumer research, and risk perception. Nearly 30 articles and studies point to various possibilities. The two theories that emerge from these studies point to the added stress that financial pressures can bring and the possibility that financial difficulties may indicate a tendency toward risk-taking behavior, either of which can mean a higher likelihood of accidents.

Whatever the reasons behind the relevance of credit information to insurance loss potential, the predictive power of this information is a matter of fact, not of theory or conjecture. Auto insurance policyholders with the least favorable scores are nearly 40% more likely to experience losses that are greater in number and severity than those with the most favorable scores. The difference is even more dramatic among property insurance policyholders. The dollar amount of losses experienced by homeowners policyholders with the least favorable scores is almost twice as much as for those with the most favorable scores.

Consumers with better insurance scores generally have a long-established credit history that is free of major events such as bankruptcies and collections, and reflect either no delinquencies or only delinquencies involving smaller amounts that occurred well in the past. These customers will typically have some credit account activity, but relatively low balances compared to the available credit limits. In addition, they will have few recently opened accounts or inquiries prompted by the seeking of additional credit. While it's difficult to identify specific actions that any customer could take to improve his or her insurance score, customers who manage their finances in a way that is consistent with these characteristics are more likely to have better scores.

WHAT INSURANCE SCORES DO NOT CONSIDER

Insurance credit scoring models do not consider ethnicity, religion, gender, marital status, handicap, address, nationality, age, income, and public assistance sources of income. They are simply not factors.

The Fair Credit Reporting Act provides strict guidelines for company usage of credit in insurance rating that all companies are required to follow.

Credit histories are used by a variety of businesses such as financial institutions and retail stores. Their use helps determine whether a person is eligible for a credit card or qualifies for a mortgage or a vehicle loan.

Credit data/scoring used by lenders measures the ability to repay a debt and can be quite different from data/scoring that measures insurance risk or potential for loss. Thus, ability to secure a loan based on credit may not equate to the best rate for insurance coverage.

THE USE OF CREDIT HISTORY BENEFITS CONSUMERS

Credit histories are a source of affordable, objective information that is readily available in the market and beneficial to consumers. Combined with other underwriting tools, credit histories provide an accurate predictor of loss and an accurate allocate the cost of coverage based on a consumer's loss potential. They provide an objective tool for decision-making that does not consider race, ethnicity, income, or marital

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status. They increase availability and control the cost of insurance and allow insurers to underwrite consumers who may not receive coverage if underwriting were restricted to other factors.

Restricting the use of credit histories could have the effect of making customers with good scores, some of whom could be in low-income households, to subsidize more affluent people who pose greater risks.

For all of the reasons outlined above, the use of credit information by insurers is becoming more common. The relevance of credit information to insurance loss potential is proven by the actual loss experience of the insurance companies using it and by independent studies. These same sources also demonstrate that consideration of credit information increases the accuracy of insurance underwriting, allows many consumers to pay less for insurance than they otherwise would, and enables insurance companies to offer coverage to more consumers than they had in the past.

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