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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

- In June, yields of government bonds issued in the Eurozone reached their lowest level since the introduction of the common currency.
- A credit score of 800 or above will place the consumer among the top decile in terms of credit risks. All 3 reporting agencies use similar methodology in compiling their scores.

The Link between Credit Scores and Insurance Rates

The importance of good credit is well recognized within the financial planning community. Access to funds for essential purchases like a home or a car comes faster and cheaper to those with an established track record of prompt loan repayment. Lesser known: home and auto insurers have long utilized information from credit reports to underwrite policies *without* permission from the customer. Insurance companies are given this authority under the Fair Credit Reporting Act.

The insurance industry believes in a strong correlation between an individual's credit score and their risk as an insured. In March 2003, the University of Texas and the Bureau of Economic Research released a report confirming this strong relationship. There are far reaching implications that will be discussed in this newsletter.

The data produced by the University is compelling. The study factored out losses explained under existing underwriting variables such as age, geography and type of car. The 10 percent of policyholders with the lowest credit scores had loss ratios (the ratios of losses to premiums) about 53 percent higher than expected. The 10 percent of policyholders with the highest credit scores had loss ratios about 25 percent lower than expected.

Almost all auto insurers -- 92 of 100 polled in a recent survey by the research firm Conning & Co. -- are now using credit information to decide whether to issue a policy on a car and/or home. Notably, only 14% use it to when policies come up for renewal.

The Texas insurance industry mirrors the national data. The vast majority of auto insurers in Texas utilize credit information and about 40 home insurers do as well. The latter group includes the Lloyds associations of Allstate, Nationwide, Travellers and USAA Lloyds. State Farm will join this group in January. At that point, virtually all home insurance underwriting in Texas will utilize credit information.

For most drivers and homeowners, credit scoring saves money when it used to set rates. Up to two thirds of policyholders have lower premiums because of their good credit records. Those premiums can be 30% lower than poorer credit risks.

The individual clearly has an incentive to insure that his credit score is accurate. Under the Fair and Accurate Credit Transactions Act of 2004, consumers are entitled to a free report each year from the three major credit bureaus – Equifax (800-525-6285) , Experian (888-397-3742) and TransUnion (800-680-7289). Consumers should verify that no adverse event has been improperly entered on their record.

Apart from determining accuracy of credit rating, the consumer should try to improve their rating. Insurance companies do not rely explicitly on a credit score. Rather, they cull data from the credit report to construct a proprietary insurance rating. Progressive insurance has listed pros and cons of credit information that factor into the company's insurance score. The positives are:

- Long-established credit history
- No late payments
- No past due credit card accounts
- Low use of available credit

While the negatives are

- Numerous past-due payments
- Recent past-due installment loan payments
- High use of available credit

Credit Scores (Cont)

For those insured that suffer an adverse action as a result of a negative credit rating, one reasonable response is to raise one's deductible. It costs an insurance company $200 to $400 to investigate each claim. The consumer can capture some of this value by setting the claim threshold higher. In addition, electing a high deductible signals his insurer that he is unlikely to make a claim and is a better than average risk.

There is a social dimension to the use of credit scores. Lower credit scores are distributed disproportionately among lower income individuals and minorities. This finding was recently reaffirmed by the University of Texas study. The Austin-based consumer advocacy organization, the Center for Economic Justice, maintained the study results "confirm what CEJ has been saying for years - that insurance credit scoring causes higher insurance rates for low-income and minority consumers".

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In fact, there has been legislation enacted at the state level to regulate the use of credit in insurance underwriting. Use of credit information in insurance has generated significant public policy debate in more than 40 states during the past few of years.

The National Council of Insurance Legislators (NCOIL) has developed a model law to insure the protection of consumer rights subject to the vagaries of credit reporting. Texas has adopted all five of its major provisions. Those include

1) prohibitions on the use of race, income, or lack of a credit card as a factor in underwriting insurance
2) in the event of an error in credit information, the insurer must rerate the customer within 30 days
3) customers must be told on their insurance application if credit information will be used
4) in the event that an insurer takes an adverse action against an existing or potential customer, the insurer will provide the underlying reasons for the action
5) all insurers using credit information will file their proprietary scoring methodologies with the Texas Department of Insurance.

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Our insurance commissioner has taken the position that credit scoring does not constitute explicit discrimination against a protected class. No administrative action has been undertaken action against insurers beyond what the legislature has adopted. The current regime seems to be working. The number of complaints regarding credit scoring in Texas insurance markets have been low – averaging 300 per year over an insurable base of 10,000,000.

However, some states have gone beyond the adoption of the model law. Maryland, for example, has banned the use of any credit information in the underwriting of homeowners insurance. California insurers are prohibited by Proposition 103 from using credit for auto insurance policies. The state's insurance commissioner has effectively extended the ban to homeowners insurance as well.

The insurance industry is about 100% in favor of the credit scoring - believing that it leads to more efficient allocation of risk. Their position was summarized in an industry editorial published in the Austin American-Statesman earlier this year:

> Insurers use credit scores not only because of their accuracy, but because they are totally objective and focus solely on a person's verifiable credit history. Furthermore, they are "colorblind" and income neutral because race and income are not used.

As a practical matter, credit scores are likely to become an even more relevant variable in the insurance industry. As insurers hone their models, they will likely create additional risk classes that favor the frugal. Good credit will not only invite lower borrowing costs but lower insurance premiums as well.