Insurance credit scoring: 21st century redlining and the end of insurance

By Birny Birnbaum

You've just been laid off from your job. Or your daughter has a major medical problem that your health insurance (if you have any) doesn't fully cover. Or you've just gotten a divorce. These three life events account for 87 percent of family bankruptcies, according to the Consumer Bankruptcy Project's report titled, "The Two Income Trap" published in 2001. To help you out in this stressful time, your insurance company will raise your homeowners and auto insurance rates because of insurance credit scoring.

The disagreements about insurance credit scoring really boil down to what "fair" means. For insurers, "fair" means that an insurer can produce some kind of data showing a statistical relationship between credit scores and insurance losses. For consumer groups, such a statistical relationship is a necessary, but not sufficient, definition of fair insurance practices. Fair rating factors must also not penalize consumers for rational behavior, for factors outside of their control and for arbitrary practices of insurers and lenders. Fair means that consumers who are the victims of some economic or medical catastrophe or natural disaster are not penalized because they were unlucky enough to lose their jobs, have a family member get sick, get divorced or become displaced by a hurricane or flood.

Insurance scoring undermines the loss prevention role of insurance because it deemphasizes rating factors under the consumer's control and encourages consumers to spend time and money on manipulating credit information.

The list of reasons why insurance scoring is arbitrary and unfair is long. Here are just a few.

Good credit, bad score

Because credit score depends on having the right kind of information in a credit report, someone can have a perfect credit history and still get a bad credit score. Contrary to insurer credit scoring myths, credit score has nothing to do with financial responsibility. Fair Isaac, the inventor of credit scoring models, estimates that 20 percent of the population is unscorable with traditional credit bureau reports because of "thin" files and this group of "unscorables" is disproportionately poor and minority.

Insurance scoring penalizes consumers for the business decisions and practices of lenders. Abuses by credit card companies and lenders place many consumers in financial distress. Consumers should not be penalized with higher auto and homeowners insurance rates because of abusive subprime mortgage lending or because a lender decides not to report information to a credit bureau.

Insurance scoring has a disproportionate impact on poor and minority consumers. A recent study by the Missouri Department of Insurance found that a consumer's race was the factor most predictive of insurance score. And despite relying on data hand-picked by insurers, the recent report by the Federal Trade Commission (FTC) found that insurance scoring was a proxy for race. If insurers are prohibited from using race as a risk classification, they should not be able to use a proxy for race.

FTC report biased and flawed

Insurers will tout the FTC report as affirmation of insurance scoring, but the report is so biased and methodologically flawed that one of the FTC commissioners voted against issuing the report and wrote a detailed criticism of the report. The report appears to have been written by the insurance industry. It dutifully repeats all the unsupported insurer claims about credit scoring. Insurers claim that credit scoring, by allowing "more accurate" pricing, promotes greater insurance availability and affordability. In fact, insurance scoring has led to lower loss ratios, excessive rates, higher numbers of uninsured motorist and more consumers in residual markets — refuting insurer claims that credit scoring is simply about more accurate pricing.

Insurance scoring undermines the key public policy goals of insurance. Insurance is essential for individual and community economic development for two reasons. First, insurance is an essential financial security tool that enables individuals and businesses to avoid financial ruin in the aftermath of a catastrophic event. Second, insurance is the primary mechanism for loss prevention and loss mitigation — preventing and minimizing loss of life and property from catastrophic events. Insurance accomplishes loss prevention by providing economic incentives for less risky behavior and economic disincentives for more risky behavior.

Insurance scoring undermines these policy goals because it makes insurance less affordable and available for those consumers who most need the economic protection of insurance — poor and minority consumers. Insurance scoring undermines the loss prevention role of insurance because it deemphasizes rating factors under the consumer's control and encourages consumers to spend time and money on manipulating credit information. Instead consumers should spend that time and money on activities that actually lead to lower losses — like weatherproofing homes or installing anti-theft devices in vehicles.

Insurance scoring represents 21st century redlining and the end of insurance as insurers develop ever more-detailed rating schemes based more on economic status — credit score, education, occupation, prior liability limits — than risk of loss and should be prohibited. IJ

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