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CREDIT AND INSURANCE SCORES

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Credit scores are used by the banking industry for consumer, automobile, and home loans. Insurance scores are used by insurers to help assess risk for personal automobile and homeowner's insurance. Proponents of the use of credit scores maintain that they result in a more objective process for approving credit. Insurers claim that the use of insurance scores can reduce the cost of insurance coverage. Similarities exist between credit and insurance scores because each score type is based on consumer credit information.

The potential impact of a low score has consumers concerned about how these scores are used, why they vary, what a score means, and if accurate and updated information is used to compile a score. Other concerns include privacy issues and potential misuse. This *Issue Brief* answers some of the frequently asked questions pertaining to credit and insurance scores.

The Development of Scoring

Credit scores were first developed in 1956 by Fair, Isaac and Company (FairIsaac) to bring more uniformity to the banking industry's credit approval process. In 1987, FairIsaac developed insurance scores to make the insurance underwriting process more objective. Insurance scores are based on information in consumer credit reports and are generally referred to as *credit-based* insurance scores.

FairIsaac credit (FICO) scores are the most widely used credit scores. In addition to FairIsaac, there are other vendors who provide scores to consumers (via the Internet) and creditors. The source of insurance scores is more divided because some larger insurers develop their own scoring models and other insurers obtain scores from vendors (other than FairIsaac) who develop more company-specific models. Given the variety of models, credit and insurance scores may have scoring ranges that vary from the 100s to 900s.

Credit Scores

When consumers apply for credit, the creditor obtains a credit report, which provides detailed information on a consumer's credit history, and a corresponding credit score from one or each of the three national credit bureaus (Equifax, Trans Union, and Experian). Credit scores measure how likely a borrower is to repay a loan by taking into account a person's track record for paying off debt. Creditors use a common range of scores to determine whether to give preferable interest rates or issue credit.

How do creditors use scores? Consumers with higher scores are more likely to secure credit. Although standards differ, consumers with scores above 620 may be offered preferable interest rates. Recent studies show that nearly 80 percent of mortgage lenders use credit scores as the primary determinant of an individual's credit risk. For other types of credit, creditors consider employment history, assets, financial statements, and application information in addition to credit scores.

Can scores vary? Each credit bureau uses different scoring models to generate scores, and consumers may find that their scores differ significantly among credit bureaus. Scores are based upon the data in a borrower's credit report. Scores vary because data can differ as it is being updated independently by each credit bureau. Some creditors may average or use the lowest of the three scores.

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Credit-Based Insurance Scores

Credit-based insurance scores are used as a predictor for future insurance losses. There is no set standard for a good score among insurers. Generally, scores are not provided when consumers apply for insurance. In place of a score, insurers may provide information on the factors that impact or lower a score.

How do insurers use scores? Insurers use scores in conjunction with driving records, loss reports, and application information to issue insurance coverage. State regulation prohibits insurers from using scores as the sole basis for insurance decisions. According to industry analysts, about 90 percent of insurers use scores to underwrite, renew, or deny auto insurance policies.

Can scores vary? Insurance scores are based on information in consumer credit reports and can vary for the same reasons that credit scores vary. To add to the variability, some larger insurers may also use in-house scoring models or contract with other vendors for a score source that best suits a company's needs based on previous claims and underwriting guidelines.

Factors that Impact Scores

Credit information that is used in both credit and insurance scoring models include: payment history, collections, and bankruptcies; outstanding debt; length of credit history; new applications for credit; and the types of credit in use. Credit scoring models cannot consider race, color, religion, national origin, sex, marital status, age, occupation, or the length of time in a present residence. In contrast, insurance scoring models may consider age, sex, residence, marital status, or occupation.

How can scores be improved? Both types of scores may be raised by paying bills promptly, maintaining low credit card balances, using new credit only as needed, checking credit reports annually for inaccuracies, and using credit so that a credit history can be established and maintained.

What factors reduce scores? Scores may be lowered by delinquent bill payments, high levels of outstanding debt, many credit accounts, errors in credit reports, short credit histories, bankruptcies, and foreclosures. Consumer-initiated credit inquiries may also reduce scores minimally. It is important to note that whenever consumers initiate the same type of credit inquiry for comparison purposes, inquiries made within a one-month period are treated as one inquiry.

Federal and State Law

If credit information results in an adverse action against a consumer, such as credit or insurance denial, the federal Fair Credit Reporting Act (FCRA) requires the creditor or insurer to provide consumers with the contact information for the credit bureau that provided the credit information. The FCRA also provides an appeal process to dispute and correct information in a consumer's credit file.

Colorado's Consumer Credit Reporting Act (CCRA) has provisions that pertain to a consumer's ability to dispute information or gain free access to information in his or her credit report. Under this state law, insurers must notify consumers whenever insurance scores are used. Neither federal nor state law requires a credit bureau to provide an individual with a *credit score* when an agency provides a free credit report to a consumer.

Effective July 1, 2003, upon consumer request, state law requires creditors or credit bureaus arranging home mortgages to disclose a consumer's credit score. The factors (not to exceed four) that adversely affect the credit score, the score's creation date, and the range of scores used must also be disclosed.

Upon consumer request, insurers must provide the credit factors that impact a policyholder's score. Insurers are also required to use current credit information and make premium adjustments whenever an insurer fails to use correct credit information.

Obtaining Scores

Consumers can generally obtain their credit score for free from a creditor whenever an application for credit is completed and the consumer requests their score. Consumers can also obtain their credit scores for a surcharge via the Internet at any of the three major credit bureau sites. For a surcharge, insurance scores can be obtained at www.choicetrust.com. Scores obtained from the Internet may differ from the scores used by creditors or insurers when consumers apply for credit or insurance coverage.