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Financial Credit Data: Its Impact on Personal Insurance

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Why does your neighbor pay less for homeowners insurance when your homes are nearly identical? Why is your brother-in-law's auto insurance premium twice as much as yours, although you drive similar cars?

These are questions we have heard more than once. The answer is not always simple…and it might have more to do with your financial credit rating than anything else.

Traditional Underwriting Practices

As you may know, insurance companies use numerous factors to determine the premium rate you pay for your homeowners and automobile insurance.

For automobile insurance, these factors have traditionally included such things as the driver's age, marital status, prior claims and moving violations, zip code, and annual mileage, as well as the value and performance of the vehicle.

For example, most people would expect a 17-year-old single male driver with a new sports car to pay a higher premium than a 45-year-old married male driver with an older sedan.

For homeowners insurance, similar characteristics are used, including age and construction material of the home, zip code, prior claims, and home replacement value. A $1 million older frame home along the beach will usually have a higher premium than a $300,000 newer brick home in a non-coastal area.

These elements and others are combined into different formulas by insurance company actuaries to develop the company's proprietary premium rating structure. Through that, they attempt to predict losses, which allows them to accurately set their premium rates.

The more reliably companies can predict future losses, the more precisely they can set their premiums. They strive to charge a competitive premium rate in the marketplace, while still maintaining a profit.

Insurance companies continuously search for additional criteria to give them an edge over their competition, trying to find other non-traditional factors that contribute to loss-predictability. For example, some insurance companies have added job occupation and level of education as components of their calculations.

Surprising and Somewhat Controversial Method of Predicting Losses

A paper titled "The Impact of Personal Credit History on Loss Performance in Personal Lines"

(James E. Monaghan, ACAS, MAAA, 2000) is based on a study that would eventually revolutionize homeowners and automobile insurance premium rating.

The study looked at information from new automobile insurance policies that were issued between 1993 and 1995 by one insurance company. It reviewed loss experience gathered from 170,000 policies and found an interesting correlation between losses and the policyholders' financial credit ratings.

Specifically, drivers with the best credit characteristics had lower overall losses than drivers with the worst credit characteristics. In addition, the study showed no clear-cut difference in this correlation by territory (urban vs. non-urban) or other traditional rating factors.

Subsequent studies have verified that there is a very strong causal relationship between loss prediction and credit data that applies to both homeowners and automobile insurance.

At first this data was disputed as possibly being used to discriminate against low-income individuals. However, it has generally been accepted that credit data is a very effective predictor of loss and that it accurately reflects an individual's level of responsibility, rather than his or her level of income.

It can be inferred that those who are financially responsible will also be responsible in the care of their home and belongings, as well as in their driving habits.

Use of Financial Credit Data Today

Insurance companies currently select certain financial credit data and create what they call an "insurance score." This is somewhat different than the normal financial credit score, because it only includes aspects of the financial data that are deemed pertinent to loss predictability. Also, applying for insurance does not negatively affect your credit score the way applying for a loan might.

An example of how an insurance company might use this information in its rating of an automobile policy is as follows:

- Traditional underwriting and rating data is gathered and applied to develop a preliminary factor.
- Next, prior accident and moving violation data is factored in.
- Then, the "insurance score" is used as a final factor, with the policy being placed into one of 20 or more different "tiers."

How Can You Benefit from This Information?

Today, nearly all insurance companies use credit-based data as part of their rating and underwriting for homeowners and automobile insurance.

If you have been insured with the same company for many years (especially if prior to 2005), it is possible that your credit data may not have been utilized in establishing your premium rate.

If you have a favorable credit score, you could potentially see a significant reduction in your premium by simply asking your insurance company or agent to provide a rate for a new policy.

If your credit score has improved since the time your insurance policies were written, even if that was just a few years ago, you should ask if your insurance company can "re-run" your credit information when your policy renews. It may result in a lower premium rate.

What if your credit score is less than stellar? Since all insurance companies have their own proprietary methods for calculating premium rates, and because some companies use the credit component to a lesser degree than others, it makes sense to obtain quotes from several companies when you are seeking insurance, since the premium rates could vary considerably.

If we can be of assistance, please contact Nancy Albanese, Vice President, Personal Insurance Division, at 610.527.1881.

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