Most consumers learn early on the importance of building a good credit record. A wallet full of maxed-out credit cards or a reputation for late payments can lead to sky-high interest rates or restrictions on new credit. Many, however, don't realize just how far their credit rating extends, and how much that rating can affect areas of their lives seemingly unconnected to their credit cards.

Insurance companies, landlords and even prospective employers now routinely use consumer credit scores to determine how much you pay for insurance, or if they will lease you an apartment or hire you as an employee. A particularly low credit score can in some cases prevent you from being insured at all. This practice has stirred complaints across the country from consumers who feel the use of credit scoring for services unrelated to credit is both discriminatory and invasive. The issue has inspired lawmakers in at least 34 states to seek legislation that would prohibit or greatly restrict the use of such credit information when establishing insurance coverage or rates.

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At the crux of the matter is just how the three-digit credit score is determined. Fair Isaac, a California-based research firm that designed and still owns the mathematical model for establishing such scores, set the industry standard for credit scoring in the 1950s. Called the FICO score, the model has been imitated many times and in many ways, leaving a consumer's exact rating up to the individual companies who are processing credit information, often leading to consumers having different scores from different companies.

The mix of information that makes up the score, which ranges from around 350 to a high of 850, includes much more than just the timeliness of payments. Also in the mix are such things as the consumer's overall dollar amount of carried balances and the number and type of open credit lines. Keeping low balances and a regular payment schedule does not guarantee a good score, as some formulas give a greater credence to higher amounts of debt than to smaller or zero credit balances.

But no matter who does the rating, a low credit score is bad news. Insurance companies, for one, look at someone with a score of 400 as being far more likely to file claims than someone whose score is 750. This practice irks critics, who say there is no data showing a correlation between low scores and an inclination to file claims.

In California three different Democrats have authored bills -- AB 227 from San Diego Assemblyman Juan Vargas, SB 64 from San Francisco Senator Jackie Speier, and SB 691 from South Los Angeles County Senator Martha Escutia – that are working their way through legislative committees. Each would enact a complete ban on using credit scoring in any phase of insurance.

Thanks to Proposition 103, California already prohibits the use of credit scoring in establishing automobile insurance rates, and the California State Department of Insurance forbids its use in homeowner’s policies. But the Department claims the practice is still in use by some companies, even in rating automobile policies. The Department has an enforcement hearing in May to deal with just such a homeowner’s claim against one of the state’s largest insurers, Allstate

Indemnity, with another hearing in June to address the company's alleged automotive insurance violations. Allstate recently paid a $1 million fine for using the state DMV database to improperly access the private records of California residents.

The situation clearly rankles California State Insurance Commissioner John Garamendi.

"The use of credit scoring is nothing more than an excuse for insurance companies to red-line undesirable consumers," says Garamendi. "It is discriminatory, and we won't stand for it."

Doug Heller, Senior Consumer Advocate for the Southern California-based Foundation of Taxpayer and Consumer Rights (FTCR), agrees, saying there is an "insidious connection between credit scoring and racial bias in setting insurance rates."

Pete Moraga, of the non-profit Insurance Information Network of California, disagrees. Moraga says there is significant data to support the low score/high claim correlation. He also says his state does not use credit scores but rather a variation of them called an insurance score, which he states is "only a gauge of how a particular consumer pays his or her bills," a factor that comes into play when consumers are paying premiums in installments. Moraga says the use of such scoring is actually beneficial to 75% of consumers because it does not reference age, race or economic status.

Garamendi claims that logic is absurd.

"You can *call it* anything you like," he says, "But the bottom line is that if it walks like a duck and it quacks like a duck, then it's probably a duck."

Garamendi says another major problem with using credit scoring is the lack of consistency in how those scores are established, and an unwillingness of the part of the scoring companies and insurers to reveal publicly how they individually determine scores. Without a standard to fall back on, and without those credit scoring companies being required to reveal how they tabulate their numbers, he says there is no way to ensure consumers are protected from discrimination.

Diane Colborn, Vice President for Legislative and Regulatory Affairs for the Personal Insurance Federation of California (PIFC), says she understands consumers have a hard time correlating their credit history with their insurance risk, but she says fears over the use of credit scores are unfounded.

"We don't know why there is a correlation between credit history risk, but there is a lot of hard data that shows there is an overwhelming connection," she says. "But we certainly don't think minorities are likely to have a lower score than anyone else, and studies also show no disparate impact based on income or race."

Bill Gausewitz, Assistant Vice President of the American Insurance Association, also says there is no credible evidence of any discrimination in the use of credit scoring for insurance purposes. He adds that numbers don't lie.

“Credit scoring is a lot like good student rates,” he says. “We statistically know that students who get good grades are less likely to have accidents than students who don’t get good grades. We can’t tell you why it’s like this, but statistically the correlation is overwhelming.”

During recent hearings debating SB 64 the Association of California Insurance Companies testified, “there is a solid body of actuarial research that establishes the strong correlation between insurance scores and risk of insured loss. By in large, the utilization of insurance scores benefits more consumers than it detriments.”

The industry points to studies like the one recently released by the University of Texas to back up their assertions. In that study an analysis of 150,000 policyholder records indicated that there was a “significant relationship” between credit scores and insurance losses for those policies.

Other states have also chimed in with research of their own. A study released in February by the Alaska Division of Insurance showed that more Alaskan consumers have been placed in standard or preferred rating categories than they were before the advent of insurance scoring in the mid- to late-nineties, particularly in less affluent and minority areas. For example, three rural zip codes in Alaska with high percentages of ethnic minorities and lower income residents, saw declines in percentages of policyholders placed in non-standard rating categories from 36 to 15 percent, 22 to 15 percent, and from 29 to 16 percent.

The Alaska study also found that one of the state's highest income zip codes had more people in substandard rating classes and fewer in preferred or standard categories than any other individual zip code or group of zip codes surveyed, contradicting to some extent the notion that as a consumer’s income rises, so does her credit-based insurance score.

The response from the FTCR’s Heller is a resounding, “So what?”

“Insurance companies trot out statistics that show whatever they want them to show,” Heller argues. “They can probably show that people with brown hair are more likely to file a claim, and if not, then they would say it is people with blonde hair. The bottom line is that if they can’t show an absolutely direct physical connection between credit scores and insurance risk – and they have admitted that they can’t – then those scores should not be used. Period.”

“This is really an issue of poverty,” Heller adds. “People who live in poverty are far more likely to have lower credit scores, and for a variety of reasons that don’t have anything to do with not paying their bills. For example, if I pay my VISA bill on time, my credit score will probably be fine. But a poor person who doesn’t have a credit card, or who might use payday loans that charge outrageous interests rates that I would never dream of paying, will not get credit for those payments no matter how diligent and on time they are. Why should that person pay more for insurance than me, based solely on that?”

Heller also notes the people of color comprise a the great majority of those who live below the poverty line.

Garamendi and Heller are not the only people who are not convinced about the use of credit

scoring. The recent SB 64 committee hearings drew support for the legislation from, among others, the Los Angeles County Board of Supervisors, Congress of California Seniors and the non-profit Consumers Union. Former Insurance Commissioner Harry Low also spoke out against the practice, saying it is not a permissible way to establish rates or eligibility.

Although her organization opposes a complete ban on the use of credit scoring, PIFC's Colborn says there is room for negotiation on the issue, and that regulation by the Insurance Commissioner's office of the use of credit scoring would be "appropriate."

That idea is based on a proposal from the National Conference of Insurance Legislators (NCOIL), which suggests that scores be used only after the Insurance Commissioner's office determines there is a "direct and relevant correlation" between credit scores and claim history, and only if the Commissioner determines they are not discriminatory. The NCOIL concept also requires full disclosure to the Insurance Commissioner of the methodology used to determine the score, and how the end score will be used.

Both PIFC's Colborn and AIA's Gausewitz say their organizations support using the NCOIL model. The Department of Insurance is currently reviewing similar studies and models, but Garamendi has made it clear that he supports legislation to make the use of credit scoring illegal in California, and has publicly voiced his support for AB 227. He has also indicated he is willing to at least listen to alternative proposals, but that in the end, his chief concern is protecting consumers, not insurance company profits.

-- *By Rich Ehisen*