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The Honorable Melvin Watt
Chairman
Subcommittee on Oversight and Investigations
U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Testimony of Commissioner J. P. Schmidt, Hawaii Insurance Division
On Credit-Based Insurance Services
Testimony: October 2, 2007, 2 p.m.
2128 Rayburn House Office Building

Dear Chairman Watt and Committee Members:

Thank you for this opportunity to testify on credit-based insurance scoring and to explain why Hawaii's policymakers have banned this practice in the 50th State.

In 1987, the Hawaii Legislature amended the Hawaii Revised Statutes to prohibit discriminatory practices in the pricing of automobile insurance premiums.[1] The law applies to rating plans, ratemaking standards, and underwriting standards and bars use of race, creed, ethnic extraction, age, sex, length of driving experience, **credit bureau rating**, marital status, or physical handicap in the direct or indirect pricing of Hawaii's automobile insurance premiums.

Then, as now, arguments were made that credit scoring is an accurate predictor of the number of and total cost of claims consumers will file and thus an effective tool for insurers to match risk to premiums. Arguments were also proffered both for and against the premise that credit scoring results in unfair or discriminatory pricing for low-income and minority groups.

In its deliberations on this issue twenty years ago, the Hawaii Legislature determined that the use of credit bureau rating reports could result in discriminatory rating practices and acted to specifically include credit bureau rating in the list of prohibited criteria. Two decades later, a

[1] HRS §431:10C-207 Discriminatory practices prohibited.

report to Congress by the Federal Trade Commission[2] reports that credit-based insurance scores are distributed differently among racial and ethnic groups and that this difference is likely to result in higher insurance premiums, on average, that these groups pay.

While it has been actuarially demonstrated that there is a correlation between an individual's credit score and the propensity for that individual to be involved in future claim activity, that relationship provides only a portion of the information needed to develop and to regulate an insurance rate regulatory system. It is essential that policymakers have the flexibility to consider any corollary effects that may result from the criteria used in the insurance classification system. A good legal regulatory structure balances the various and varied factors providing appropriate consumer protection with as little government intrusion as possible. The result should be a healthy competitive market providing fair treatment and rates to consumers.

It was determined by the Hawaii Legislature that any benefits inuring to some consumers by allowing credit bureau scoring as a rating factor in automobile insurance pricing were outweighed by the potential for harm to a greater number of the State's citizens and to its economic well being. In this regard, the Legislature's policy decision accomplished a major goal of a risk classification system: to produce rates that are not unfairly discriminatory. In other words, a classification system should provide a means to pool the experience of insured risks based upon their expected levels of insurance risk.

It is essential to recognize and acknowledge that credit scoring, if allowed in a given jurisdiction, will perforce result in all insurers giving consideration to use of credit-based insurance scores regardless of whether they would have opted to use the criteria on their own.

If some insurers employ a system using credit scores while do not use credit scores in their rating and underwriting programs, consumers with more favorable credit scores will tend toward the insurer providing commensurate discounts. Other insurers are then forced to adopt a similar system or they will end up with a preponderance of the more "adverse" risks from a credit score standpoint. This concept, known as "adverse selection" will leave the "credit scoring" insurer with the more favorable risks. The result for the "nonparticipating" insurer would be an inadequate rate for the business it attracts (mostly consisting of insureds with less than stellar credit scores). The negative effects of an inadequate rate level include a decrease in competition or at its worse, the financial insolvency of the insurer with the noncompetitive rates.

Another important factor to consider is that credit scoring likely may present obstacles to employers – particularly small businesses – during less than favorable economic times, which would be counter to the economic goals of the state and nation. A small business owner may have to borrow funds during economic downturns in order to keep the business going (and to keep employees on the payroll). A rating system based upon credit scores may add additional

[2] Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance – A Report to Congress by the Federal Trade Commission, July 2007

surcharges and burdens when those burdens are most potentially harmful, adding to the economic problems due to intolerable marginal cost increases associated with the purchase of insurance.

Hawaii is a State unlike any other. But one thing we hold in common with our 49 sister states is our firm belief in home rule. Legislative and regulatory processes must be tailored to best fulfill the needs of a particular region taking into consideration its demographics, business climate, and social structure. As in other areas of law, one size does not fit all in establishing a legal structure for auto insurance. This concept is embodied in the guidelines of the Actuarial Standards Board of the American Academy of Actuaries[3] which avoid placing undue restraints upon the actuary or lawmakers by not requiring a specific system of specific rating criteria while allowing the balance of numerous pertinent factors under tested actuarial guidelines.

In summary, twenty years of experience has provided no evidence that Hawaii's statutory exclusion related to the use of credit bureau ratings in the pricing or underwriting of insurance has diminished the efficacy of the Hawaii insurance market. The current automobile insurance environment in Hawaii is competitive and healthy. And while the argument continues over whether credit scoring discriminates unfairly against low-income and minority groups, I can assure you with 100% confidence that such discrimination does not exist today in the Aloha State.

Thank you, again, for the opportunity to address this honorable body and to share with you Hawaii's approach to – and experience with – this important insurance law policy.

Sincerely,

J.P. SCHMIDT
Insurance Commissioner

[3] Actuarial Standard of Practice (ASOP) Number 12