

## Unfair Discrimination in Insurance: A Look at Three Issues

This invited paper session examined three issues related to unfair discrimination in insurance. Holly Hunts, Montana State University, presented a paper on redlining. Brenda Cude, University of Illinois, presented a paper discussing issues surrounding the use of credit history and credit scores in underwriting insurance coverage. Joan Koonce Lewis, University of Georgia, presented the third paper focusing on the home service method of marketing insurance. A summary of each presentation follows.

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While all insurance is based on discrimination, the insurance industry has been accused of unfairly discriminating against certain consumers. The three papers that follow present three different aspects of the debate about unfair discrimination in insurance.

### Redlining in Homeowners Insurance

"Discrimination on the basis of race or national origin in the provision of property insurance is prohibited by the Fair Housing Act of 1968" (Committee on Banking, Housing and Urban Affairs: U.S. Senate, 1994, p. 49).

Holly Hunts examined the claim of consumer advocacy groups that unfair discrimination occurs in housing insurance, the insurance industry's counterclaim that it does not, and the actions being considered to resolve the dispute. Racial discrimination is clearly and specifically outlawed in housing legislation. Yet it continues to be a hotly debated topic within the area of housing insurance because housing insurance is, by definition, based on the principles of discrimination. Recently, concerned consumer advocacy groups have charged that the insurance industry has knowingly and systematically refused to conduct business (or has conducted business in an unfair way) in minority neighborhoods. These charges have clearly caught the attention of the U.S. Senate and the U.S. Department of Housing and Urban Development and have been brought to the attention of the Justice Department.

The consumer advocacy groups note that in

major cities across the United States a large number of minority and low-income homeowners live without insurance coverage, especially in comparison to their white and high-income counterparts. For example, ACORN (Association of Community Organizations for Reform Now) testified before a Senate Committee that in Chicago, only 51.1% of occupied, single-family units in low-income neighborhoods and only 57.6% of units in minority neighborhoods were covered by any type of insurance, compared to 90% coverage in high-income neighborhoods and 85.7% coverage in white areas (Committee on Banking, Housing and Urban Affairs, 1994, p. 4). The consumer advocacy groups also note that while some practices may not appear to be racially or ethnically motivated they do have a disparate effect on minorities. For example, many insurers refuse to insure homes valued at less than \$50,000 and 47% of black households (compared to 23% of white households) live in homes valued at less than \$50,000. So consumer groups advocate that while refusing to insure low-value homes may not appear to be "unfair" discrimination, it is, in fact, unfairly discriminating against blacks (Committee on Banking, Housing and Urban Affairs, 1994, p. 19).

The insurance industry counters these claims with studies of their own stating almost entirely conflicting evidence. For example, the American Insurance Association testified that in their survey of 1,502 urban homeowners in Chicago, Los Angeles, Atlanta, Brooklyn, Cleveland, and Philadelphia less than 2% of all homeowners did not carry any insurance. They found virtually no differences between black and white households. In fact, in their study 99% of black homeowners were found to be insured with most (92%) having comprehensive coverage and a much smaller

percent (7%) having more basic policies (Committee on Banking, Housing and Urban Affairs, 1994, p. 70). The insurance industry counters claims of unfair discrimination based on factors such as value and age of the home in two ways. One counterclaim is that state FAIR plans are specifically designed to help subsidize these "higher risk" (because the replacement cost far exceeds the market value) homes. Because of FAIR plans, insurance is available and at a relatively competitive price so consumers are not being harmed. A second counterclaim is that discrimination based on risk is the prerogative of the firm and is not only not unfair, it is good business sense.

Clearly, the mountains of conflicting evidence suggest the need for further research. It is imperative that this research be conducted by an impartial and well-trained researcher. While much of the evidence presented by both sides is compelling at first glance, nearly every study suffers from serious statistical problems.

#### **Use of Credit History As an Underwriting Tool in Property Insurance**

Brenda Cude discussed the industry's use of credit history in insurance underwriting. The industry considers credit history to be a measure of "financial responsibility" and an excellent predictor of the likelihood that one will file a claim. Insurance underwriters say they do not use credit history to predict whether policyholders will pay their premiums on time (S. Sorich, personal communication, June 2, 1995). Nor are they concerned with credit worthiness. Instead they use credit history to underwrite the insured as well as the property.

Allstate has been very open in discussing its use of credit history. However, it is unclear how many other companies use credit history as an underwriting factor.

Only three states have systematically asked insurers about their use of credit history in underwriting personal lines insurance. Both Maryland (in 1995) and Texas (in 1993) found that only a small proportion of insurers considered credit history (NAIC, 1996a). Arkansas found 60% of the insurers they surveyed using credit history in underwriting in 1996 (Arkansas Department of Insurance, 1996).

Some insurers use credit history as a screening device and reject applicants solely on the basis of their credit history. Others consider credit history as just one of several factors.

Most insurers who use credit history use it to

underwrite new applications. However, some insurers use credit history to reassess policies currently in force when there is activity such as an unusual number of claims filed.

There are two different ways in which insurers obtain information about credit history. Some (including Allstate) review credit reports. Some look at the credit report primarily to confirm information given them by the applicant. Others only consider certain factors. Allstate looks only at certain "serious indicators;" examples include unsatisfied or unresolved foreclosures and bankruptcies (S. Sheffey, personal communication, June 2, 1995). Allstate will even reject an applicant with a clean driving record if he or she has a poor credit history.

A second primary way in which insurers consider credit history is through the use of credit scores. Credit report data are passed through a software algorithm, which reduces the data to a single score. Insurers use the services of a scoring vendor or their own software to produce a credit score. Some insurers use credit scores to reject applicants without considering other information (Scism, 1995).

Fair, Issac & Co., a data-analysis company, claims to have evidence of a strong correlation between certain items typically reported in a credit report and auto and homeowners insurance loss ratios. However, they consider most of the evidence to be proprietary (NAIC, 1996a).

Opponents to the use of credit history in insurance underwriting object to the practice on a number of grounds. These include the industry's failure to demonstrate a causal relationship between credit history and risk of loss; the suspicion that credit history is used as a proxy for other variables that by law cannot be used to underwrite insurance; the ability of insurers to use credit history as another way to redline; the concern that insurers will use credit reports inconsistently; and the fact that when credit scores are used, consumers are being evaluated based on a score they will never see.

The use of credit history to underwrite insurance has implications for insurers, regulators, researchers, and educators. Insurers who use credit history and disclose that information on the application can avoid some complaints from consumers who learn about the practice after the fact. Insurers should also adhere to the principles the industry has developed (NAIC, 1996a).

Insurance departments can develop legislation and regulation to protect consumers. Recommended protections include: (1) requiring insurers to follow

written guidelines on the use of credit history, disclose in writing when credit history is used, and make public underwriting guidelines; (2) prohibiting insurers from using credit history to cancel or nonrenew coverage, making underwriting decisions based solely on credit history, and using credit history to determine premium; and (3) regulating firms that create credit scores for insurance underwriting.

Consumer researchers can address two important research questions:

- When used in insurance underwriting, is credit history a proxy for other variables that are prohibited from use by law?

- Are protected classes (low-income, minority) unfairly discriminated against by the use of credit history in insurance underwriting?

Consumer educators can deliver information and education to ensure that consumers know about this practice and know that not all insurers consider credit history when underwriting insurance.

### **Home Service System of Marketing Life Insurance to the Poor**

The home service method of marketing insurance is one of the oldest methods of insurance distribution. This method of insurance distribution began in the 1800s and is still used by many insurance companies today (Blicksilver, 1990; Dalzell, 1993; Life Insurers Conference, 1995).

The National Association of Insurance Commissioners (NAIC) defines the home service method of marketing insurance as "any method of marketing insurance, regardless of type or the name by which such business is commonly known, the policies (or contracts) that are marketed, sold, serviced, issued, delivered and renewed through a system of distribution whereby initial and renewal premiums of such policy are collected on a monthly or more frequent basis at the payor's home or business by an agent of the company as an ordinary course of business" (NAIC, 1996b, p. 3). Various types of insurance are sold through this system (Dalzell, 1993; Quinn, 1995); however, life insurance makes up the majority of home service sales (Quinn, 1995). Home service companies represented 14% of the life insurance industry, and the home service life insurance sales of these companies represented approximately 29% of all life insurance policies sold (Dalzell, 1993; Savitz, 1990; Seaman, 1993).

Prior to the 1970s, industrial life insurance was the popular product sold by home service

insurance agents (Dalzell, 1993). These policies were typically sold to low-income people who worked in factories to cover funeral expenses (Life Insurers Conference, 1995; Savitz, 1990). Industrial life insurance, as noted by the NAIC, has been defined by state statutes as "a life insurance product with premiums based upon the Commissioner's Industrial Life Mortality Table, written in amounts of \$2,000 or less, premiums payable monthly or more often, has a facility of payment clause, has a conversion privilege and has the word industrial in the name of the type of the policy" (NAIC, 1996b, p. 6). These policies are not sold as much today, but there are still many in force. Further, the marketing method used to sell these policies still exist. Small face value policies are still marketed to low-income households by life insurance agents collecting premiums in their homes (Savitz, 1990).

The small face value life insurance policies that are sold today are called monthly account or monthly debit ordinary life insurance policies (Dalzell, 1993). The face values of these policies are somewhat higher than industrial policies (Savitz, 1990). Industrial and monthly account or debit ordinary life insurance, as well as the system by which these policies are marketed, have been criticized for many years (Savitz, 1990). In 1979, the Federal Trade Commission (FTC) issued a report indicating that the home service industry was issuing policies that are "too costly for policyholders and too profitable for insurers, has an unacceptably high lapse rate, and often is sold by agents who utilize unethical sales practices" (National Association of Life Companies [NALC], 1979, p. 19). The FTC also noted that these policies are marketed to low-income consumers and because of the high costs associated with this industry, low-income consumers are paying more for life insurance than high-income individuals (Savitz, 1990).

In a more recent article, the Arkansas Department of Insurance investigated a case and found the following information. The cost of the total premiums paid by a policyholder was much more than the death benefit of the policy. This same policyholder had purchased 25 or more small face value policies on various relatives, many of which had lapsed because he could not afford the premium. No cash value had accumulated in these policies; thus, the policyholder received nothing when these policies lapsed. In many cases proper receipts were not given, and some of the policies had a facility of payment clause (Quinn, 1995). The State Insurance Department in West Virginia conducted a survey and found that a little over half of

all policies sold through home service agents lapse within the first couple of years (Quinn, 1995). Another criticism of the home service industry is that policyholders continue to pay higher costs for personal services even when the premiums are no longer collected by the agent in their home. Today, premiums for both industrial and monthly account or debit ordinary life insurance policies are sometimes mailed in or collected via automatic bank drafts. In 1990, approximately 55% of premiums paid for insurance sold by home service agents was paid by bank drafts (Dalzell, 1993; Savitz, 1990).

The information above provided an overview of industrial and monthly account or debit ordinary life insurance and the home service distribution system used to market these kinds of insurance. To date there is virtually no research that addresses the issues surrounding these types of insurance nor the method by which these types of insurance are marketed. Research conducted by the NAIC has surveyed life insurance companies only. As can be seen by the information above, some problems may exist. Thus, consumer research is necessary to determine if these types of insurance, as well as the home service method of marketing, are indeed viable alternatives for low-income consumers to obtain life insurance protection or if there are other options more beneficial to this population group.

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### Endnotes

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