INSURANCE REFORM
PROJECT

RISK-BASED HOMEOWNERS INSURANCE UNDER SIEGE:

THE SLIPPERY SLOPE FROM REDLINING CHARGES TO DISPARATE IMPACT CLAIMS

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November 1997

ISSN# 1085-9051

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EXECUTIVE SUMMARY

For nearly three decades, fair housing activists have campaigned to limit insurance companies' use of risk-based methods for underwriting and pricing homeowners insurance. Recently, the campaign has entered a new phase. In the past, groups such as the Association of Community Organizations for Reform Now (ACORN), the National Fair Housing Alliance (NFHA), and Consumers Union accused insurance companies of "redlining" – practicing "unfair discrimination against a particular geographic area." Increasingly, however, the assault on many forms of risk-based insurance is facilitated through the jurisprudence of "disparate impact," a legal doctrine which holds that a policy or practice based on race-neutral criteria may nevertheless constitute illegal discrimination if it has a disproportionate adverse impact on racial minorities or women and cannot be justified by a showing of "business necessity."

An examination of the methods used by insurers to underwrite and price homeowners insurance policies reveals that insurers do indeed "discriminate" among their customers – on the basis of risk. Such discrimination is reasonable, in that it results in decision-making that is economically sound from the standpoint of insurance companies, and fair from the standpoint of insureds, whose coverage and premiums are a function of their insurer's costs. Nevertheless, one consequence of the universal application of risk-based insurance criteria is that, compared to other homeowners, residents of predominantly minority inner-city neighborhoods often pay more for homeowners insurance, while frequently receiving less coverage. The fundamental reason is risk. These urban areas have much higher rates of crime, more abandoned buildings, a greater incidence of arson, more older homes with substandard heating and wiring components, and greater experience of losses.

Inasmuch as risk-based insurance "redlining" operates to the detriment of predominantly minority communities, the problem of insurance availability and affordability in such areas has taken on the trappings of a civil rights issue. The Clinton administration, acting through the Department of Housing and Urban Development (HUD) and the Department of Justice, has used the 1968 Fair Housing Act to bring formal charges of illegal racial discrimination against several major insurance companies. In March 1995, the Justice Department entered into a consent decree with the American Family Insurance Company in which the insurer agreed to pay $14.5 million to hundreds of unnamed minority residents of Milwaukee, Wisconsin. Significantly, the decree calls upon the insurer to abandon many traditional risk-based underwriting and pricing standards, insofar as they appear to operate to exclude inner-city blacks disproportionately from access to premium homeowners insurance policies, or cause them to pay more than predominantly white suburban homeowners.

Examination of the terms of the American Family consent decree, as well as internal HUD memoranda and the public statements of HUD officials, indicates a determined effort on the part of the Clinton administration and fair housing advocacy groups to apply disparate impact analysis to the business of homeowners insurance. A pending federal court case, *Canady v. Allstate Insurance Co. et al.*, would use disparate impact analysis to invalidate traditional risk-based underwriting standards employed by 23 named insurance companies. An amicus brief filed by the Justice Department strongly endorses this approach.

If HUD, the Justice Department, and their clientele of federally funded fair housing advocates succeed in formally codifying the disparate impact approach to allegations of insurance redlining, the result will be a radical transformation of the nature of homeowners insurance. One can imagine a future in which insurers will be required to document a precise cause-and-effect relationship between each underwriting and pricing variable they use and its associated level of risk of losses. They will then be required to show that no "less discriminatory" risk assessment technique is available. Where it is not possible – or too costly – to meet this burden, insurers will have no choice but to abandon the use of those risk selection practices and cost-based pricing mechanisms that yield a disparate racial impact.

In such an event, an insurer would have, in theory, two options. It could distribute the expected, more frequent, and higher claim-costs of one group of homeowners among another group of homeowners who present lower risk, in effect creating a cross-subsidy. That, however, would lead inevitably to "adverse selection." Alternatively, the insurer could ignore economic reality and treat high-risk insureds as if they presented low risk. This strategy eventually would either drive the insurer from the market or cause it serious solvency problems. Continuing to do business in a market that demands underpricing of risk would over time threaten not only the insurer's profit levels, but its very ability to stay in business.

RISK-BASED HOMEOWNERS INSURANCE UNDER SIEGE:
THE SLIPPERY SLOPE FROM REDLINING CHARGES TO DISPARATE IMPACTS CLAIMS

Robert R. Detlefsen

INTRODUCTION

In March 1997, Nationwide Mutual Insurance Company, one of the nation's largest property and casualty insurers, agreed to pay $13.2 million to settle allegations of property insurance "redlining" brought by the U.S. Department of Justice. Less sensationally, but perhaps more significantly, Nationwide also agreed to substantially revise its standard underwriting criteria with respect to the urban homeowners market. No longer would Nationwide make underwriting decisions on the basis of such objective factors as the age or market value of a home.[1]

Redlining once meant refusing to insure properties located in certain geographic regions.

The Nationwide "settlement" is only the most recent instance of a major insurance company succumbing to government pressure to change its underwriting practices for urban property insurance. Allstate, State Farm, and American Family had all agreed to do so earlier, after the federal government and "fair housing" activists accused them of racial redlining in the inner city. While the sudden flurry of federal lawsuits and settlements is a new development, the redlining issue itself is not.

Redlining once meant refusing to insure properties located in certain geographic regions.[2] That is still the case insofar as state insurance regulation is concerned, where redlining has been universally prohibited for decades. Historically, the concern over redlining extended to areas far removed from

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[1] Pierre Thomas, "Nationwide Insurance Settles Bias Claim," *Washington Post*, March 11, 1997, p. A9.

[2] The traditional definition of redlining is stated by Robert Klein, former director of research for the National Association of Insurance Commissioners: "The term *redlining* is defined [...] as unfair discrimination (i.e., discrimination that is not based on differences in cost or risk) against a particular geographic area." See Robert W. Klein, "Availability and Affordability Problems in Urban Homeowners Insurance Markets," in Gregory D. Squires, ed., *Insurance Redlining: Disinvestment, Reinvestment, and the Evolving Role of Financial Institutions* (Washington, DC: Urban Institute Press, 1997), p. 43. *Webster's College Dictionary* defines redlining as "a discriminatory practice by which some financial institutions refuse to grant mortgages or insurance in urban areas that they consider to be deteriorating."

the inner city, in situations where race was not even remotely a factor.[3] To be sure, fair housing activists in the 1960s and 1970s frequently invested the redlining phenomenon with racial overtones – as when they noted that the areas allegedly discriminated against are usually inner-city neighborhoods whose residents are disproportionately black and Hispanic. But allegations of racial discrimination per se were not formally the basis of their campaign. Today, however, the challenge to current forms of risk-based property insurance in the inner city is conceived explicitly as an effort to prohibit discrimination against racial groups.[4] The current assault on risk-based insurance is being facilitated, moreover, through the jurisprudence of "disparate impact" – a controversial legal doctrine which holds that a standard or practice is presumptively illegal if it has the effect of disproportionately excluding members of legally protected groups – even though the challenged practice makes no reference to race or ethnicity, and even though the resulting adverse group impact was inadvertent. Such a presumption then can only be rebutted by evidence of "business necessity" – proof that the standard or practice is necessary for the safe and efficient operation of the business in which it is used.

The shift in emphasis from redlining to disparate impact is a tactical move that seeks to recast the debate over what constitutes "fairness" in insurance underwriting, marketing, and pricing. For fair housing activists, the tactical advantages of articulating their objections to insurance industry practices in the language of civil rights are twofold: First, it has enabled them to enlist the federal government's formidable civil rights enforcement apparatus in behalf of their cause. Second, they have succeeded in transferring the redlining debate from state legislatures and insurance regulatory commissions to the federal judiciary – the branch of government that is least accountable to the public, and most responsive to the political predilections of modern liberalism.[5]

The shift is a tactical move that seeks to recast the debate over what constitutes "fairness" in insurance underwriting, marketing, and pricing.

This paper reviews the anti-redlining agenda and the underwriting and pricing methods for homeowners insurance that have inspired charges of redlining and racial discrimination. The discussion includes a consideration of "reasonable discrimination" as the touchstone of risk-based insurance. The paper then describes the result of efforts, led by the U.S. Department of Housing and Urban Development and the Department of Justice, to apply the Fair Housing Act of 1968 to allegations of racial discrimination in homeowners

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[3] The National Association of Insurance Commissioners notes that "the availability and cost of property insurance also is a significant problem in some rural areas, particularly those areas with severe weather exposures and limited police and fire services." See NAIC Insurance Availability and Affordability Task Force, "Urban Insurance Problems and Solutions: Interim Report," December 6, 1994, p. 7. See also James Ridgeway, "Redlining the Coasts," *Audubon*, July 1993, p. 16.

[4] See, e.g., Penny Loeb, Warren Cohen, et al., "The New Redlining," *U.S. News & World Report*, April 17, 1995, pp. 51-58.

[5] See, e.g., Robert H. Bork, *Slouching towards Gomorrah: Modern Liberalism and American Decline* (New York: Regan Books, 1996), pp. 96-119.

insurance. It explains the disparate impact theory of discrimination, and examines the role it played in a major insurance consent decree and subsequent settlements to resolve allegations of racial discrimination against property insurers. After describing and analyzing recent developments in the continuing effort to apply disparate impact analysis to the business of homeowners insurance, the paper concludes that if the federal judiciary endorses that approach to redlining allegations, the business of homeowners insurance would be completely transformed, with profoundly negative consequences for profits, solvency, and fairness.

The question that ought to concern us is not whether insurers engage in discrimination, but whether they discriminate in a manner that is unfair.

RISK-BASED HOMEOWNERS INSURANCE AND THE ANTI-REDLINING AGENDA

The term "redlining" evokes the image of a map, with red lines drawn around certain neighborhoods that signify their undesirability as insurance markets[6] and hence their status as targets of discrimination by insurers. For anti-redlining activists, any evidence of such discrimination is immediately seized upon as evidence of insurer perfidy. Redlining, however, involves unfair discrimination. The question that ought to concern us is not whether insurers engage in discrimination, but whether they discriminate in a manner that is unfair.

The Ambiguity of "Redlining" and "Discrimination"

The word "discrimination" has acquired profoundly negative connotations. Many people reflexively assume that discriminating among people and their characteristics can never be fair. Nevertheless, we are constantly called upon to make decisions that require us to discriminate among people, places, organizations, and objects. If our decisions are not based on faith or caprice, they must be based on a calculated judgment. The soundness of our judgments are determined by the reasonableness of the criteria that we use to discriminate. Reasonable criteria also help ensure fair judgments with respect to the person or thing that is judged. Certain criteria may be reasonable in some contexts and unreasonable in others. Some forms of discrimination may not be reasonable under any circumstances. Discrimination based on race, for example, is generally prohibited under U.S. law.

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[6] The origin of "redlining" as both a descriptive term and a political issue appears to lie in a report issued in 1968 by the National Advisory Panel on Insurance in Riot-Affected Areas (also known as the Hughes Panel). The report quoted a passage from an insurance underwriting manual that advised underwriters to mark "the questionable areas on territorial maps" by "the use of a red line" to indicate those areas representing relatively poor insurance risks. See "Meeting the Insurance Crisis of Our Cities," *President's National Advisory Panel on Insurance in Riot-Affected Areas* (Washington, DC: U.S. Government Printing Office, 1968), p. 6.

In the insurance business, discrimination takes the form of assessing and classifying varying degrees of risk among applicants for insurance. From the perspective of insurers, classifying people and their property according to the risk they present, and treating similar risks similarly, is a form of discrimination that is eminently reasonable, and hence fair. On the other hand, treating similar risks differently would constitute unfair discrimination.[7] This distinction between fair and unfair discrimination is implied in the NAIC[8] Model Unfair Trade Practices Act, which prohibits:

> Making or permitting any unfair discrimination between individuals or risks of the same class and of essentially the same hazard by refusing to insure, refusing to renew, canceling or limiting the amount of insurance coverage on a property or casualty risk solely because of the geographic location of the risk, unless such action is the result of the application of sound underwriting and actuarial principles related to actual or reasonably anticipated loss experience.[9]

Essentially, the Model Act equates unfair discrimination with unreasonable discrimination. It affirms that only unreasonable discrimination should be prohibited.

Redlining rhetoric often obscures the crucial distinction between reasonable and unreasonable discrimination as applied to insurance underwriting, marketing, and pricing. When discrimination based on "actual or reasonably anticipated loss experience" means that homeowners insurance is both less available and more expensive for residents of inner-city neighborhoods than for residents of suburban communities, fair housing activists insist that insurers are guilty of redlining. Charges of redlining have an aura of plausibility because many fair housing activists, in effect, deny the validity of the concept of "reasonable discrimination."[10] One may better

Redlining rhetoric often obscures the crucial distinction between reasonable and unreasonable discrimination as applied to insurance underwriting, marketing, and pricing.

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[7] For a detailed discussion of risk assessment and classification, see Kenneth S. Abraham, "Efficiency and Fairness in Insurance Risk Classification," *Virginia Law Review*, vol. 71 (1985), pp. 403-51.

[8] The National Association of Insurance Commissioners (NAIC) is composed of the insurance commissioners of all fifty states. The organization addresses problems that concern the insurance industry nationwide, and it drafts model laws and regulations to aid state decision-makers in establishing policy.

[9] "Unfair Discrimination," Sec. G(3), Unfair Trade Practices Act, *NAIC Model Regulation Service*, January 1993, pp. 880-84. As of July 1996, 46 states had enacted legislation based upon the Model Unfair Trade Practices Act. For a list of these states, see ibid., pp. 880-915.

[10] Some more "moderate" fair housing advocates, of course, may instead choose to dispute whether particular insurers' practices meet a rather tight standard of "actuarial" fairness under which they allegedly fail to accurately reflect differences in risk.

appreciate the reasonableness of insurance discrimination,[11] however, once one understands the rudiments of standard insurance underwriting and pricing practices.

Distributing and Assessing Risk: The Price of Insurance

Insurance helps us cope with our inability to predict the future.

Insurance helps us cope with our inability to predict the future. None of us knows for certain what hazards lie ahead, but the prudent person understands that he is vulnerable to any number of misfortunes. If he owns a house, he knows that it could be damaged by fire or a weather-related calamity. If he owns an automobile, he knows that it could crash or be stolen. But he cannot know for certain if – or when – any of these things will happen. Nor can he know the amount of his losses in the event that misfortune does occur. The prudent person can, however, insure against the possibility of future losses by joining other individuals in contributing to an insurance fund, from which compensation will be paid to any individual contributor in the event that he incurs a loss.

The insurance business is unlike others in that the price of insurance is determined by future costs that are extremely difficult to predict.

Insurance is thus a cooperative enterprise, made possible by the willingness of each insured to make what he regards as a reasonable payment now in order to protect himself from the possibility of financial disaster in the future. The essential purpose of the enterprise is to transfer risk from insured to insurer. That is, in return for payment of a regular and predictable premium under an insurance contract, households and businesses can transfer to insurance companies at least part of the financial risk associated with insured-against events. However, for consumers and insurance companies to regard their insurance contract as mutually beneficial, each must regard the price as reasonable. A rational consumer will decline coverage if he believes that, relative to the probability and size of his potential loss, the amount he is being charged is excessive. In such an event, the consumer will have decided that insurance is "just not worth it."[12] Establishing the price of insurance is thus critical to the business of insurance.

The insurance business is unlike others in that the price of insurance is determined by future costs that are extremely difficult to predict. With respect to each policy it writes, the insurer's cost will be determined by the amount it must pay to compensate the insured for whatever future losses it incurs. In setting a price for insurance, or in deciding how much coverage to

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[11] The rhetoric of redlining allegations also obscures the distinction between discrimination due to bigotry and discrimination arising from more benign intentions. "Statistical discrimination," for example, can arise if race is correlated with some determinants of riskiness that are difficult and costly to discover and measure directly. Alternatively, cultural affinity problems might make insurers less able to accurately determine a minority applicant's riskiness. See Stanley D. Longhoffer, "Rooting Out Discrimination in Home Mortgage Lending," *Economic Commentary*, Federal Reserve Bank of Cleveland, November 1995.

[12] See Catherine England, "The Business and Regulation of Insurance: A Primer," Competitive Enterprise Institute, March 1996, p. 8, n. 13.

offer, the best that an insurer can do is to draw upon its own experience, together with that of thousands of other insurers, to discern the particular factors that are associated with risk.[13] Identifying and analyzing these factors, so as to predict the likelihood and size of any future losses, is a process known to insurers as risk assessment.

The process of risk assessment often reveals significant disparities among various personal characteristics in terms of the relative degrees of risk they present. Certain characteristics or traits suggest a high probability of future loss.[14] In some people, these high-risk characteristics will be altogether absent, while other characteristics associated with a low probability of future loss will be manifest. Similarly, variations in the condition and use of the item to be insured will translate to variations in risk.

Risk assessment made through classification of insureds into groups that pose similar risks will necessarily limit the amount of risk distribution achieved through an insurance arrangement, because it uses knowledge about risk expectancies to set different prices for members of different groups.[15] The only risk that is truly "spread" among all insureds is random risk – the risk that cannot be predicted or estimated at least in part based on the particular characteristics, background, and traits that a group of similar insureds may share within a given risk pool.

Risk classification by insurers can promote economically efficient behavior by encouraging insureds to compare the cost of insurance with the cost of investment in loss prevention.

Insurers cannot avoid incurring risk classification costs and simply charge each individual a premium based on the average expected loss of all its insureds (plus profits and expenses) because they must compete for "protection" dollars. They compete against such alternatives to insurance as self-insurance (accumulating savings as a cushion against possible loss), direct spending on loss prevention, or spending on other goods and services that are valued more highly. Risk classification by insurers can promote economically efficient behavior by encouraging insureds to compare the cost of insurance with the cost of investment in loss prevention. Efficient risk classification discourages them from purchasing insurance when they can more cheaply protect against risk by investing in loss prevention. When risk assessment is inaccurate but insurance is still available, inefficient behavior is more likely. When such activity is less safe than it would be in the absence of insurance, it is called the "moral hazard" of insurance.[16]

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[13] State regulators have come to appreciate the insurer's predicament with regard to pricing: "The basic principle of insurance regulation is that the price of an insurance policy should reflect the cost of providing the coverage plus a reasonable margin for profit." See Orin Kramer and Richard Briffault, *Inner City Insurance: Problems and Solutions* (New York: I.I.I. Press, 1994), p. 18.

[14] For example, "there is a verifiably strong relationship between how people handle their financial affairs and the amount of insurance losses they create or incur." Michael P. Duncan, "The Fair Housing Act and Property Insurance: The Call for Congressional Action," National Association of Independent Insurers, August 1995, p. 2.

[15] This point and much of the ensuing discussion of the process of risk classification is derived from Kenneth Abraham, *Distributing Risk: Insurance, Legal Theory, and Public Policy* (New Haven, CT: Yale University Press, 1986), pp. 64-100.

[16] Ibid.

To the extent possible, risk classes that create loss prevention incentives should be based on variables within each individual's control. Such control encompasses not only the capacity to conduct activities more safely, but also the capacity to vary levels of activity or production to reduce or prevent losses. Even when risk classification variables are based on noncontrollable characteristics, such "feature rating" (as distinguished from "experience rating") can affect activity levels by encouraging insureds to reduce the level of their involvement in the insured activity.[17]

One of the benefits to many consumers of risk classification is that it allows insurers to offer low-risk individuals lower prices and thereby sell more insurance to them. But risk classification is worthwhile to an insurer only when the gains produced from extra sales and fewer pay-outs outweigh classification costs plus the costs of lost sales (involving higher risk potential customers). Thus, risk classification efforts will not be pursued beyond the point where the costs of gathering data needed for further refinement exceed the competitive benefit that can be derived from that refinement. When an insurer can no longer attract or make enough profit from additional low-risk insureds to justify discovering and classifying them, an equilibrium is reached and no further refinement occurs.[18]

Distributing risk among a pool of low-risk insureds will keep costs down and result in lower premiums.

To keep premiums low and thus prevent adverse selection,[19] insurers have developed the practice of classifying insureds into groups posing similar risks. Why treat individuals as members of groups for risk classification purposes? Because group probabilities provide the credibility necessary to the predictions that are at the heart of the insurance system. Until an individual insured is treated as a member of a group, it is impossible to know his expected loss because, for practical purposes, such statistical predictions must be based on group probabilities. Distributing risk among a pool of low-risk insureds will keep costs down and result in lower premiums. By the same token, distributing risk among a pool of high-risk insureds will lead to higher

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[17] Ibid.
[18] Ibid.
[19] Adverse selection occurs "when the applicants for insurance represent a sample of the population which is biased toward those with a greater loss exposure rather than representing a true random sample. In flood insurance, for example, only those persons and businesses with readily identifiable flood exposures are likely to desire coverage. Also, adverse selection may result when the premium charged is inadequate for the 'risk' involved." Bernard L. Webb et al, *Insurance Company Operations: Volume II* (Malvern, PA: American Insurance Institute for Property and Liability Underwriters, 1978), pp. 169-70. Adverse selection is likely when a group of potential insureds is treated alike, regardless of the characteristics that might distinguish their expected losses. In applying for such insurance, higher risk applicants will get a "better bargain" than low-risk applicants. If a disproportionately high percentage of adverse risks then apply for insurance coverage and low-risk insureds leave the insurance pool, this will necessarily increase the costs borne by insurers and drive up premiums.

costs, and hence, higher premiums.[20] In each case, the price of insurance and the type of coverage offered are a function of the insurer's assessment of the risk presented by the insured.[21]

Risk Factors Associated with Natural and Social Environments

Among the more reliable criteria for assessing risk among applicants for homeowners insurance are the age of the home, its market value, and its geographic location. The latter criterion is often cited as a violation of anti-redlining laws that typically prohibit unfair discrimination against particular geographic regions. Most insurers do engage in "territorial rating," a practice that assumes a relationship between risk and location. Under this type of insurer "discrimination," homeowners in some areas will be charged higher premiums, or are more likely to be offered "limited" coverage, than those whose homes are located elsewhere.

Among the more reliable criteria for assessing risk among applicants for homeowners insurance are the age of the home, its market value, and its geographic location.

Is discrimination against certain geographic territories inherently unfair? Particularly when there might be "sound underwriting and actuarial principles related to actual or reasonably anticipated loss experience"[22] that justify such discrimination?[23]

Consider those geographic regions that are unusually prone to devastation by natural forces such as tornadoes, floods, earthquakes, and wildfires. As noted, the modern business of insurance demands that insurers assess individual risks as accurately as they can on the basis of available information. The next step is to classify insureds into homogenous risk pools. In this way, risk is distributed among people with similar risk profiles, which ensures that the price of insurance will vary according to the degree of risk that one presents. It follows that insurance companies would have to consider territorial environmental hazards when assessing the risk posed by a given homeowner. People whose homes are located in areas that are relatively free of environmental hazards would expect to be grouped together with other

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[20] Insurers may pool dissimilar risks, in order to reap the risk diversification and economics of scale offered by large pools, but they then must counteract adverse selection by varying prices to insureds according to their relative risk (i.e., charging an actuarially fair premium to each member of the pool). Conceivably, the risk posed by some individuals will be so great that they cannot fit into any existing risk pool without driving up costs and encouraging adverse selection. Or the rating structures of insurers will not be able to accurately price that kind of risk. Such people will be deemed uninsurable.

[21] Abraham, 1986

[22] Model Unfair Trade Practices Act.

[23] For example, a 1988 study conducted by the National Association of Independent Insurers found that cities with high auto insurance premiums had a much higher frequency of claims and greater claim-costs than the average levels in their respective states. *Factors Affecting Urban Auto Insurance Costs*, December 1988. See also Scott Harrington and Greg Niehaus, "Dealing with Insurance Availability and Affordability Problems in Inner Cities: An Analysis of the California Proposal," *Journal of Insurance Regulation*, Vol. 10, No. 4, 1992, pp. 564-84 (finding that the prices insurers charged in different areas were closely related to claim-costs).

low-risk insureds – and would expect to pay a premium commensurate with the pool's low probability of loss due to environmental factors. By the same logic, people whose homes are located in areas that have a history of natural devastation would expect to be classified among high-risk insureds. Indeed, in the case of a territory that is known to be extremely hazardous – if devastating hurricanes have occurred every year for the past 100 years, for example – an insurer may refuse to offer homeowners insurance at any price.[24]

Deteriorated urban core areas often suffer from relatively high rates of crime, arson, and building abandonment.

In the modern American city, risk factors associated with territory are often attributes of the social rather than the natural environment. Deteriorated urban core areas often suffer from relatively high rates of crime, arson, and building abandonment. Accidental fires are also more prevalent; the large number of old, substandard structures characteristic of depressed areas increases the probability of fire damage even to buildings in good repair. As the Hughes Panel explained in 1968, houses in urban neighborhoods "may be older and less fire resistant. . . . They may have defective heating and electrical systems. . . . The density of construction and the closeness of properties may invite the spread of particular fires."[25]

The quality of municipal services in urban areas can also affect the likelihood and magnitude of losses. For example, the equipment, training, and manpower of local fire fighting units – and the degree of rigor in local housing inspections – can affect the frequency and severity of fires. Property losses resulting from criminal activity are in part a function of the effectiveness of local police forces and criminal justice systems. The riots that occurred in South-Central Los Angeles in 1992 were a powerful reminder of yet another risk factor associated with the social environment of some urban territories – the possibility of conflagrations due to civil unrest.

Other social factors play a role as well. Claim-costs tend to be highest in neighborhoods where there are fewer owner-occupied structures, maintenance is substandard, repairs are more costly, and crimes against property are high.[26] The prevalence of such crime in inner-city communities is an especially serious risk factor. According to statistics compiled by the Bureau of Justice in 1991, 162.9 American households out of every 1,000 were the subject of a property crime, such as burglary or larceny. In central cities, however, that figure rose to 223.4 households; in central cities with populations between one quarter million and one half million, the number of households victimized by property crime rose to 229.2 per thousand. The latter figure is more than 40 percent higher than the rate for the nation as a

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[24] See Ridgeway.
[25] *President's National Advisory Panel on Insurance*, p. 6.
[26] Kramer and Briffault, p. 22.

whole. The gap between city and suburb is particularly striking. For example, burglaries involving forcible entry occurred in 11.1 per 1,000 households in the suburban areas surrounding central cities with populations between one quarter and one half million. In the central cities, by contrast, there were 32.9 per 1,000 households, or nearly three times the suburban figure.[27]

Other Factors Associated with Risk

If certain characteristics of the social environment of urban communities raise the level of risk for insurers, so too do the age and market value of homes in these communities. Experience has taught insurers that older homes often have deteriorating wiring and faulty heating systems, which greatly increases the likelihood that they will be struck by fire. In older homes that are in good condition, the presence of uniquely crafted decorative features, such as carved wooden cornices and stained glass windows, can push repair or replacement costs significantly above a home's market value. Consequently, many insurers decline to offer owners of older homes the option of a full replacement-cost policy,[28] regardless of whether they live in an expensive Victorian mansion in suburbia or a more modest home in the inner city. Instead, owners of older homes may purchase a market-value policy that pays rebuilding costs derived from conventional building materials and construction techniques.

Experience has taught insurers that older homes often have deteriorating wiring and faulty heating systems, which greatly increases the likelihood that they will be struck by fire.

In addition to older homes, insurers often regard homes with extremely low market value ($40,000 is the cut-off point established by many insurers) as posing a heightened level of risk. Almost by definition, such homes are likely to have heating, plumbing, and electrical systems that have not been modernized, or a roof that is in poor condition. Defects such as these greatly increase the likelihood of loss due to fire and water damage. Moreover, a low-value home that is insured for its full replacement cost is a prime candidate for one of the more common forms of insurance fraud – arson-for-profit. At a minimum, an owner of such an insured home may be less likely to invest in loss prevention measures such as updating wiring and heating systems and installing smoke alarms. Thus, as with older homes, if private insurance coverage is offered at all, it usually takes the form of a "limited," or market-value, policy rather than a replacement-cost policy.

If insurers simply charged higher premiums under full-replacement-value homeowners policies to cover the higher risk of loss that is represented by older homes and homes with extremely low market value, such replacement-value insurance would be very expensive, if not unaffordable, for many owners of those types of homes. Given that not many buyers would be able

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[27] Bureau of Justice Statistics, *Criminal Victimization in the United States, 1991*, Table 33, (household crimes, 1991).
[28] As the most comprehensive homeowners policy offered by property insurers, the replacement-cost policy pays to rebuild the structure as it currently exists.

to purchase those relatively higher-priced homeowners policies, insurers would find fewer profit opportunities as well. Hence, many insurers choose to offer to owners of old or low-market-value homes policies that do not include (and do not charge for) full replacement value.

There can be little doubt that territorial rating, combined with the insurance industry's reluctance to fully insure homes that are more than 40 years old or valued at less the $40,000, has had the effect of making homeowners insurance somewhat less available and somewhat more costly for inner-city homeowners than for homeowners elsewhere. It would be a mistake, however, to exaggerate the extent of the "availability problem." Surveying numerous empirical studies of inner-city insurance availability in 1994, Orin Kramer and Richard Briffault concluded that "the vast majority of urban residents – including minority and low-income individuals – are able to obtain residential property insurance in the voluntary market."[29]

The vast majority of urban residents – including minority and low-income individuals – are able to obtain residential property insurance in the voluntary market.

In those instances where private insurance is not available, residual market mechanisms – principally in the form of the federal government's Fair Access to Insurance Requirements (FAIR) program – "generally assure the availability of . . . residential property [insurance]."[30] FAIR Plans, however, are not generally perceived as a desirable source of coverage. Designed as "residual market" facilities to serve homeowners who cannot find an insurer who will sell them coverage voluntarily, FAIR Plan coverage typically is more limited and can cost relatively more than purchasing coverage through the voluntary market.[31] Kramer and Briffault thus maintain that "affordability problems in some urban areas, [which are] due to the juxtaposition of high claim-costs and the low incomes of many urban residents," remain a problem in the urban core.[32]

R*edlining Rhetoric and the Effort to De-legitimize Risk*

Is the affordability problem – or the availability problem, to the extent that it exists – attributable to unreasonable discrimination? Many fair housing activists seem to believe that is the case, even while conceding that redlining as traditionally understood is no longer common. "By the late 1970s," writes Richard J. Ritter, a former trial lawyer in the Civil Rights Division of the U.S. Department of Justice, "classical redlining seemd [sic] to be on the wane." Today, he continues, "claims of racial discrimination in lending and insurance focus on seemingly race-neutral marketing and underwriting practices that may be applied in a racially discriminatory manner or have racially discriminatory effects."[33] D.J. Powers, a former

[29] Kramer and Briffault, p. 2.
[30] Ibid.
[31] Klein, p. 51.
[32] Kramer and Briffault.
[33] Richard J. Ritter, "Racial Justice and the Role of the U.S. Department of Justice in Combating Insurance Redlining," in Gregory Squires, ed., pp. 188-89.

general counsel for the Texas Department of Insurance and now at the Center for Economic Justice in Austin, Texas, believes that "for the members of the protected classes who are denied homeowners insurance, the denial is the same and the discrimination just as insidious whether based on a red line around the neighborhood or an underwriting guideline that no homes in the neighborhood can satisfy."[34] Insurers, he concludes, "should not be permitted to thwart [the intent of anti-discrimination laws] by using underwriting guidelines that are race based – either intentionally or through disparate impact."[35]

David Badain has argued that "even statistically fair discrimination must be subordinated to definitions of societal fairness and the equitable distribution of losses."[36] Badain does not disclose which "definitions of social fairness" he has in mind. But he is quite certain that "the principle of social fairness is most directly tested by territorial rating schemes." At length it becomes apparent that social fairness is abrogated by territorial rating because "redlining in the form of territorial classifications is contrary to the stated national policy goal of urban revitalization."[37]

To some commentators, citing risk and loss costs to justify reasonable discrimination is a subterfuge that diverts attention from the essential bigotry of the insurance industry.

To some commentators, citing risk and loss costs to justify reasonable discrimination is a subterfuge that diverts attention from the essential bigotry of the insurance industry. That, evidently, is the view of Cable News Network (CNN) correspondent Mark Feldstein, who calls redlining an "institutionalized form of corporate racism."[38] Insurance companies, he informs readers of *The Nation*, have

> subtle ways of discriminating against minorities. One method is to require that homes have a minimum square footage or be under a certain age – something that effectively penalizes minorities, who often live in smaller, older homes. Another strategy is simply not to locate insurance offices in urban areas, reducing the need to come up with such ruses in the first place.[39]

To Feldstein, the fact that the minimum-square-footage criterion is race-neutral – and that hence it "effectively penalizes" anyone who owns a smaller home – is merely a "ruse" that is designed to conceal discrimination motivated solely by racial prejudice. Insurers, he apparently believes, are so consumed by their hostility to blacks that they are willing to forego lucrative

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[34] D.J. Powers, "The Discriminatory Effects of Homeowners Insurance Underwriting Guidelines," in ibid., p. 119.
[35] Ibid., p. 135.
[36] David Badain, "Insurance Redlining and the Future of the Urban Core," *Columbia Journal of Law an Social Problems*, vol. 16 (1980), p. 16.
[37] Ibid.
[38] Mark Feldstein, "Hitting the Poor Where They Live," *The Nation*, April 4, 1994, p. 450.
[39] Ibid., p. 454.

business opportunities by shunning black customers, as well as white ones. Unlike Badain, who at least acknowledges that insurance standards that operate to the detriment of inner-city residents constitute "statistically fair discrimination," Feldstein assumes that any standard that is disproportionately adverse to blacks must be rooted in bigotry.

Gary Wolfram of Hillsdale College, on the other hand, argues that as long as the government has not set up barriers to entering the market for insurance in a particular neighborhood, other insurance companies that already exist, or new insurance companies, will enter a market in which potential customers are willing to pay an amount that covers the marginal cost of selling the insurance. The possibility of making profits will ensure that insurance will be provided.[40] Wolfram draws on the work of Nobel Laureate Gary Becker to suggest that, to the extent that some insurance companies have "a taste for discriminating" against particular groups, any high profits that they make through overcharging relative to risk in particular neighborhoods inevitably will attract to those markets other insurers with a somewhat lower taste for discrimination. These firms will in turn be displaced by firms with a still lower taste for discrimination, until finally the market will provide insurance at a rate which results in no discrimination at all.[41]

Defenders of risk-based insurance have generally succeeded in convincing insurance regulatory commissions that the industry must be allowed to practice reasonable discrimination.

Robert W. Klein, who from 1988 to 1996 was the research director and chief economist of the National Association of Insurance Commissioners, notes that, in regard to the empirical record, "the research to date remains inconclusive as to whether inner-city residents pay too much in premiums for the claims payments they receive."[42] Earlier work by Klein in 1994 also concluded, "The negative relationship between the extent of insurance coverage and minority concentration shown in previous studies is a matter of concern but no statistical analysis to date has determined how much of this relationship is attributable to unfair discrimination by insurers."[43]

For the most part, territorial rating and other risk-assessment techniques have survived intact despite the efforts of fair housing activists. Defenders of risk-based insurance have generally succeeded in convincing insurance regulatory commissions that the industry must be allowed to practice reasonable discrimination, whether challenged on social fairness grounds or by recourse to anti-redlining rhetoric. The fact that regulation of the insurance industry takes place almost entirely at the state level is also responsible for

[40] Gary Wolfram, "Insurance 'Redlining' and Government Intervention," *The Freeman*, June 1997, p. 366.
[41] Ibid.
[42] Klein, p. 73. Klein adds that more recent studies did not find that loss ratios for insurers are lower for minority neighborhoods than for nonminority neighborhoods.
[43] Robert W. Klein, "A Preliminary Analysis of Urban Insurance Markets," Paper presented to the NAIC Insurance Availability and Affordability Task Force, October 17, 1994, p. 22.

the persistence of risk-based insurance. Individual states will naturally be reluctant to curtail the use of risk-based standards for fear of impairing the effective functioning of their insurance markets or even driving insurers out of their state altogether.

It is not clear, however, that risk-based homeowners insurance will survive current efforts to turn the redlining debate into a federal civil rights issue. Recent attempts to enlist Congress in the anti-redlining effort have taken the form of bills that would require insurers to collect sales data showing the distribution of homeowners policies by race, gender, and geographic territory. Their prospects for approval faded, however, after Republicans captured both houses of Congress in 1994.[44] Nevertheless, recent events strongly suggest that the challenge to risk-based homeowners insurance – and the reasonable discrimination entailed by it – has only just begun.

It is not clear, however, that risk-based homeowners insurance will survive current efforts to turn the redlining debate into a federal civil rights issue.

THE EMERGENCE OF REDLINING AS A CIVIL RIGHTS ISSUE

Notwithstanding the predominance of state insurance regulators and the presence of Republican majorities in Congress, there exist two potentially fertile sources of federal involvement in the anti-redlining campaign: the judiciary and executive branch agencies. The strategy for engaging them was foreshadowed more than a decade ago by David Badain. "Although the concept of federalism is important in American society," Badain wrote, "federal involvement in areas such as the protection of civil rights has been widely accepted. It could be argued that insurance availability is a civil right."[45] That argument would find a highly receptive audience with the advent of the Clinton administration in 1993. Indeed, the Clinton administration would become the first presidential administration to use the federal Fair Housing Act to pursue allegations of insurance redlining.[46]

To apply contemporary federal anti-discrimination law to any commercial industry is to subject it to an extraordinary legal and regulatory regime. As David Frum recently observed:

> Federal anti-discrimination law has never been more zealously enforced than it is today. Never have the business practices of Americans been more intensely regulated. Never have the incentives for private litigation glittered more alluringly.

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[44] A detailed analysis of these bills is contained in Catherine England, "The Anti-Redlining Agenda: An Assault on Risk-Based Insurance," Competitive Enterprise Institute, July 1994.
[45] Badain, p. 20 (emphasis added).
[46] Viveca Novak, "American Family, an Insurer, Settles U.S. Redlining Lawsuit for $16 Million," *Wall Street Journal*, March 31, 1995, p. B6.

Never has the government threatened malefactors with such heavy punishments."[47]

With the election of President Clinton, the anti-discrimination juggernaut would be brought to bear against the business of property insurance. On January 17, 1994, President Clinton issued Executive Order 12892, which ordered the Department of Housing and Urban Development (HUD), the agency responsible for implementing the Fair Housing Act, to exercise national leadership to end discrimination in mortgage lending, the secondary mortgage market, and property insurance practices. In directing HUD to promulgate regulations describing the nature and scope of coverage and the conduct prohibited under the Act, the executive order specifically included "property insurance discrimination," as well as mortgage lending discrimination.[48] HUD announced that it was forming a special task force to investigate redlining of homeowners insurance, and HUD Secretary Henry Cisneros pledged to make the issue one of his top priorities in office.[49] Under President Clinton, HUD and the Department of Justice (DOJ) would promote the use of the so-called "disparate impact" theory of racial discrimination to attack risk-based insurance practices.

With the election of President Clinton, the anti-discrimination juggernaut would be brought to bear against the business of property insurance.

Homeowners Insurance, the Fair Housing Act, and the Courts

The notion that insurance availability is a federally protected civil right has been tested in the federal courts at least since 1984. The statute that bears most directly on the question is the Fair Housing Act of 1968 (FHA), as amended in 1988, which prohibits certain discriminatory housing practices. Section 3604 of the Act makes it unlawful:

(a) To refuse to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or rental of, or otherwise make unavailable or deny, a dwelling to any person because of race, color, religion, sex, familial status, or national origin.

(b) To discriminate against any person in the terms, conditions, or privileges of sale or rental of a dwelling, or in the provision of services or facilities in connection therewith, because of race, color, religion, sex, familial status, or national origin.[50]

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[47] David Frum, "Undiscriminating Discrimination: Where Civil Rights Law Went Wrong," *The Weekly Standard*, December 2, 1996, p. 28

[48] See Senate Committee on Banking, 103 Cong., 2d Sess., 1994 (Statement of Roberta Achtenberg, HUD Assistant Secretary, at May 11, 1994 hearing).

[49] Feldstein, p. 451.

[50] 42 U.S.C. sec. 3604.

Note that the text of the Act, while obviously concerned with discrimination in the sale and rental of housing, does not specifically mention insurance. Thus, when the first cases alleging racial discrimination in insurance were brought under the FHA, courts could conclude either that Congress's failure to refer to insurance signaled its intention to deliberately exclude the business of insurance from the Act's provisions, or that subsection (b)'s reference to "the provision of services or facilities in connection therewith" could reasonably be construed to include homeowners insurance.

Clearly, a judge with a policy agenda could use subsection (b)'s capacious "services and facilities" language to cloak his judicial activism. A judge who wished to rule in accordance with the intent of Congress, on the other hand, would find much in the language and legislative history of the Fair Housing Act to suggest that Congress did not mean for the Act to apply to insurers. For example, section 3605 of the Act, which immediately follows the section quoted above, sets forth nondiscrimination requirements specifically relating to financing and appraising:[51] The wording of section 3605 shows Congress at pains to indicate precisely which "residential real estate-related transactions" are covered by the Fair Housing Act. They include mortgage lending, brokering, and appraising – but not property insurance.

A judge with a policy agenda could use subsection (b)'s capacious "services and facilities" language to cloak his judicial activism.

Since the Fair Housing Act was enacted in 1968, Congress has on four occasions rejected attempts to extend the FHA's coverage to include insurance. In 1980, for example, the Senate rejected an amendment that sought to make it "unlawful for property insurers to discriminate . . ." In a remarkably prescient speech on the Senate floor following the vote, Senator Howell Heflin (D-Ala.) declared:

> I am aware HUD has proposed regulations under Title VIII that would cover the business of insurance – a business the Senate has decided should not be addressed by this legislation. I hope it is clear from these proceedings that HUD should not attempt to achieve by regulation what the Senate has declined

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[51] (a) In general, it shall be unlawful for any person or other entity whose business includes engaging in residential real estate-related transactions to discriminate against any person in making available such a transaction, or in the terms or conditions of such a transaction, because of race, color, religion, sex, handicap, familial status or national origin.

(b) Definition

As used in this section, the term "residential real estate-related transaction" means any of the following:

(1) The making or purchasing of loans or providing other financial assistance –
  (A) for purchasing, constructing, improving, repairing, or maintaining a dwelling; or
  (B) secured by residential real estate;

(2) The selling, brokering, or appraising of residential real property.

(c) Appraisal exemption

Nothing in this subchapter prohibits a person engaged in the business of furnishing appraisals of real property to take into consideration factors other than race, color, religion, national origin, sex, handicap, or familial status. 42 U.S.C. sec. 3605.

> to do, namely, to amend Title VIII to cover the business of insurance.[52]

While the amendment was being debated, Senator Orrin Hatch (R-Utah) voiced similar misgivings about HUD's apparent eagerness to expand the scope of its authority:

HUD, however, was relentless in its pursuit of authority over insurers.

> If Title VIII is extended to property insurance, insurers might be forced to underwrite unsound risks to avoid the wrath of overzealous HUD officials armed with oversimplified statistics.[53]

HUD, however, was relentless in its pursuit of authority over insurers. Congress created a window of opportunity for the agency in 1988, when it amended the Fair Housing Act to give explicit authority to the Secretary of HUD to issue administrative rules to implement the Act. The following year, HUD promulgated new regulations that addressed "other prohibited sale and rental conduct." These included:

> Refusing to provide municipal services or property or hazard insurance for dwellings or providing such services or insurance differently because of race, color, religion, sex, handicap, familial status, or national origin.[54]

As the decade of the 1990s approached, the stage was nearly set for a new, federally directed assault on risk-based insurance underwriting and pricing standards.

The effect of HUD's rewriting of the Fair Housing Act was realized soon afterward in the courts. In 1984, the Fourth Circuit Court of Appeals in *Mackey v. Nationwide Insurance* had thrown out a claim brought against an insurer under the FHA. It found that the law's sole purpose was to eliminate "discriminatory practices of property owners, real estate brokers, builders, and home financiers."[55] In that same year, however, the Supreme Court established a new precedent that requires courts reviewing the validity of agency rules to limit themselves to asking whether a challenged rule "is based on a permissible construction of the statute."[56] This meant that, rather than concentrating on the FHA's text and legislative history to determine whether the law properly encompasses property insurance (as the Fourth Circuit did in Mackey), courts would now defer to HUD's "construction" of the FHA, except where they found it "impermissible." Thus, as the decade of the 1990s approached, the stage was nearly set for a new, federally directed assault on risk-based insurance underwriting and pricing standards.

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[52] 125 *Cong. Rec*. 32991 (1980).
[53] Ibid.
[54] 24 C.F.R. sec. 100.70(d)(4).
[55] *Mackey v. Nationwide Insurance Co*., 724 F.2d 419, 423 (4th Cir. 1984), citing comments of Sen. Walter Mondale (D-Minn.), the original sponsor of the Fair Housing Act.
[56] See *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc*., 467 U.S. 837, 842-43 (1984).

The McCarran-Ferguson Act

Even if the federal courts were to agree that the Fair Housing Act applied to insurance, there remained the question of whether it could be applied to insurers doing business in states that subject insurers to their own regulatory regimes. The McCarran-Ferguson Act of 1945 provides that:

> No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance.[57]

The law's purpose was to prevent the federal preemption of state statutes enacted "for the purpose of regulating the business of insurance." Because the Fair Housing Act is broadly concerned with housing discrimination and thus cannot be said to "specifically relate to the business of insurance," applying it to insurance practices that are regulated under state law seemingly would constitute a "preemption" in violation of the McCarran-Ferguson Act.

Recent rulings have determined that the Fair Housing Act cannot be said to "invalidate, impair, or supersede" a state insurance law unless the FHA and the state law are in conflict.

That argument, however, has been rejected by the courts. Recent rulings have determined that the Fair Housing Act cannot be said to "invalidate, impair, or supersede" a state insurance law unless the FHA and the state law are in conflict. In *NAACP v. American Family Mutual Insurance Co*., the Court of Appeals for the Seventh Circuit in 1992 observed that, while the Fair Housing Act might indeed duplicate a state insurance law that specifically prohibits redlining or unfair discrimination, "duplication is not conflict."[58] The court described the factors that would have to be present for American Family to successfully invoke the McCarran-Ferguson Act:

> If Wisconsin wants to authorize redlining, it need only say so; if it does, any challenge to that practice under the auspices of the Fair Housing Act becomes untenable. American Family has not drawn our attention, however, to any law, regulation, or decision in Wisconsin requiring redlining, condoning that practice, committing to insurers all decisions about redlining, or holding that redlining with discriminatory intent (or disparate impact) does not violate state law.[59]

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[57] 15 U.S.C. sec. 1012(b).

[58] *NAACP v. American Family Mutual Insurance Co.*, 978 F.2d 287, 295 (7th Cir. 1992).

[59] Ibid., at 296. A similar ruling was handed down in *Nationwide Mutual Insurance Co, v. Cisneros*, 52 F.3d 1351 (6th Cir. 1995), cert. denied, 116 S.Ct. 973 (1996).

This observation strongly suggests that an effective way to thwart federal enforcement of the Fair Housing Act through disparate impact analysis would be for a state legislature or insurance board to enact a rule specifically rejecting fair housing claims against homeowners insurance carriers based on disparate impact, and insisting instead that such claims be based on disparate treatment.

As to the question whether the FHA covers insurance, the Seventh Circuit examined the 1989 HUD rules and decided that "section 3604 is sufficiently pliable that its text can bear [HUD's] construction . . ."[60] The court made clear which precedents it regarded as decisive:

An effective way to thwart federal enforcement of the Fair Housing Act would be for a state legislature to enact a rule rejecting fair housing claims against insurance carriers based on disparate impact.

> Events have bypassed Mackey . . . No matter how a court should have understood the Fair Housing Act in 1984, however, the question today is whether the Secretary's regulations are tenable. They are. Section 3604 applies to discriminatory denials of insurance, and discriminatory pricing, that effectively preclude ownership of housing because of the race of the applicant.[61] American Family filed an appeal with the Supreme Court, which declined to review the Seventh Circuit's judgment.[62]

The American Family Consent Decree

The Seventh Circuit's American Family decision addressed only the jurisdictional question raised by the defendant's claim that it was exempt from the Fair Housing Act. It was merely a prelude to the substantive case against American Family, originally brought in 1990 by the National Association for the Advancement of Colored People (NAACP) on behalf of seven black residents of Milwaukee, Wisconsin. Shortly after the Supreme Court announced its decision not to hear American Family's appeal of the Seventh Circuit ruling, the Justice Department informed American Family that it was planning to go forward with a class-action suit claiming that American Family used race as a factor in denying homeowners insurance to blacks. The department disclosed that it had a tape of a white district manager telling his agents that "You write too many blacks. . . . You gotta sell good, solid premium-paying white people."[63]

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[60] Ibid., at 300. This passage also was quoted approvingly by the court in *Nationwide,* 52 F.3d at 1359.
[61] A*merican Family*, 978 F.2d at 301.
[62] 113 S. Ct. 2335 (1993).
[63] H. Jane Lehman, "Insurer to Pay 14.5 Million in Bias Settlement," *Washington Post*, April 8, 1995, p. E1. Lehman failed to point out that the remark in question was made in reference to sales of life insurance policies, by a manager in American Family's life insurance division who had nothing to do with the company's property and casualty lines that include homeowners insurance.

Of course, sentiments such as these would have been difficult to defend or explain away had the case proceeded to trial – notwithstanding the fact that American Family did underwrite 37 percent of the insurance business in Milwaukee's black neighborhoods, and neither the government nor the NAACP ever produced a single individual who claimed he or she was denied a mortgage due to an inability to obtain homeowners insurance.[64] Media accounts of the trial would certainly have fanned the flames of negative public reaction to the comments heard on the tape. American Family officials agreed in April of 1995 to a consent decree under which the company would pay $14.5 million. The terms of the consent decree reveal, however, that the Justice Department's allegations against American Family were not limited to the presence of racial prejudice among agents or supervisors. Rather, they targeted virtually the entire structure of American Family's system for underwriting, marketing, and pricing homeowners insurance. The decree requires American Family to:

American Family officials agreed in April of 1995 to a consent de-cree under which the company would pay $14.5 million.

- Advertise in the black media.
- Hire at least four agents with offices in black areas.
- Permit the NAACP and the Urban League to develop a "penetration strategy" for increasing black insurance clientele.
- Terminate the requirement that to obtain a replacement-cost policy, the market value of the home must be at least 80 percent of the replacement cost.
- Eliminate the requirement that a home or property reach a stated "minimum value" in order to qualify for insurance.
- Employ credit checks that are made only to determine the likelihood of arson, rather than the ability to meet premiums or maintain the house in good repair.
- Sell policies at or below market prices.
- Subsidize individual insureds, including closing costs.
- Provide a compensation package totaling $16 million, part of which would go toward compensating "discouraged applicants" – people who were discriminated against only in the sense of having heard or assumed that American Family was not interested in insuring blacks and hence declined to go through the "hollow gesture" of applying for coverage.[65]

Several of these provisions, such as the hiring quota for black agents, the "penetration strategy," and the insurance premium subsidies, amount to little more than social policy mandates. The "compensation package" for "discouraged applicants" is a transparent income redistribution scheme. But the provisions that call for the elimination of replacement-cost policy eligibility standards, and minimum home-value requirements constitute a frontal assault on the use of risk-based underwriting criteria. In agreeing to

[64] Bob Zelnick, *Backfire: A Reporter's Look at Affirmative Action* (Washington, DC: Regnery Press, 1996), p. 340.
[65] Ibid., pp. 340-41.

measures that run counter to sound actuarial principles, American Family no doubt wished to avoid the negative publicity associated with being the defendant in a racial discrimination case. But the terms of the American Family consent decree are so sweeping and (from the company's standpoint) Draconian that one suspects that American Family's lawyers feared losing the case on the merits if it had proceeded to trial. In other words, maybe the company's policies really were racially discriminatory, and hence legally indefensible, under the terms of the Fair Housing Act:

The Act makes it unlawful to "discriminate against any person . . . because of race, color, religion, sex, familial status, or national origin." Similarly, the 1989 HUD regulations define unlawful insurance discrimination under the Act as "refusing to provide . . . property or hazard insurance for dwellings or providing . . . insurance differently because of race, color, religion, sex, handicap, familial status, or national origin." We noted earlier that risk-based underwriting and pricing methods generally lead insurers to charge higher premiums and write fewer policies in inner-city communities. May we therefore infer, insofar as inner-city residents are predominantly African-American, that insurers who use risk-based underwriting and pricing techniques are practicing "discrimination . . . because of race . . ."?

Defining unlawful discrimination as a form of behavior undertaken because of some factor is a way of making clear that to be unlawful, an act of discrimination must be intentional rather than inadvertent.

Defining unlawful discrimination as a form of behavior undertaken because of some (impermissible) factor is a way of making clear that to be unlawful, an act of discrimination must be intentional rather than inadvertent. Therefore, had the American Family case gone to trial, the Justice Department would apparently have been faced with a formidable burden under such a legal standard – to prove that the company was intentionally discriminating against blacks, by, for example, refusing to write replacement-cost policies for homes whose value was less than 80 percent of the replacement cost. Unless the Justice Department could show that American Family applied this and other challenged underwriting criteria exclusively to blacks, it would seem to have a very weak case. In reality, however, the Justice Department's position may not have been so weak after all, thanks to a legal strategy borrowed from employment discrimination case law.

INSURANCE PRACTICES AND THE DISPARATE IMPACT THEORY OF DISCRIMINATION

The American Family consent decree marked the first time that the Justice Department had used the Fair Housing Act to challenge the conduct of property insurers.[66] That the lawsuit against the insurer could be brought in the first place was made possible by court rulings applying the FHA to the business of insurance. But the consent decree that emerged was, in turn, the result of a strategy devised by tenacious litigators in the Justice Department,

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[66] Lehman.

who understood that a legal doctrine that had altered the common meaning of "discrimination" in the context of race-neutral employment criteria – the so-called disparate impact theory of discrimination – might also be deployed to challenge race-neutral insurance practices. Before considering the relevance of disparate-impact analysis to homeowners insurance, let's examine how this theory evolved.

The Disparate Impact Theory of Discrimination: A Short History

Though it is unfamiliar to most non-lawyers and apparently even to many politicians, the disparate impact theory of discrimination has been a subject of considerable controversy among legal scholars and civil rights policy analysts for 25 years.[67] Its origins can be found in the 1971 Supreme Court case of *Griggs v. Duke Power Co.*[68] As subsequently elaborated and applied by the lower federal courts, the doctrine has had a profound impact on the process by which employers hire and promote workers. Its presence in federal case law is a powerful engine that drives much of the private sector's affirmative action efforts.

The disparate impact theory of discrimination has been a subject of considerable controversy among legal scholars and civil rights policy analysts for 25 years.

In *Griggs*, the Supreme Court was asked to consider whether the application of "facially neutral" employment criteria that disproportionately excluded blacks violated Title VII of the Civil Rights Act of 1964. The Court held that where members of a racial minority group had been intentionally excluded from employment prior to the enactment of Title VII, the use of such criteria – in this case, performance on a general intelligence test and possession of a high school diploma – was *prima facie* unlawful if it produced, as between blacks and non-blacks, a "disparate impact" that was adverse to blacks as a group.

The Court ruled that for an employer to rebut the presumption of illegal racial discrimination that is implicit in such circumstances, it would have to prove to a court's satisfaction that the neutral criteria that produced them were "job-related." Writing for a unanimous Court, Chief Justice Warren Burger declared, "Congress directed the thrust of the [Civil Rights] Act to the consequences of employment practices, not simply the motivation. More than that, Congress placed on the employer the burden of showing that any given requirement must have a manifest relationship to the employment in question." Furthermore, "good intent or absence of discriminatory intent does not redeem" employment procedures or testing mechanisms that operate as "built-in headwinds for minority groups and are unrelated to measuring job capability."[69]

[67] See, e.g., Robert R. Detlefsen, *Civil Rights Under Reagan* (San Francisco: ICS Press, 1991), passim.
[68] 401 U.S. 424 (1971).

Apart from whether Burger's opinion can be reconciled with the relevant statutory language or its legislative history, the *Griggs* ruling assumes that it is possible to distinguish empirically those criteria that are truly "job-related" from those that are not. That assumption is highly problematic, as Thomas Sowell explains:

> Nor can the "job-relatedness" of the standards be assessed in any mechanical way by the nature of the task. Standards that are person-related play the same economic role as standards that are job-related. If people who finish high school seem to the employer to work out better than dropouts, third parties who were not there can neither deny this assessment nor demand that it be proved to their uninformed satisfaction. It makes no difference economically whether this was because the specific task relates to what was learned in high school or because those who finish high school differ in outlook from those who drop out. Neither does it matter economically whether those who score higher on certain tests make better workers because the kind of people who read enough to do well on tests tend to differ from those who spend their time in activities that require no reading.[70]

Standards that are person-related play the same economic role as standards that are job-related.

In short, personal outlook, while not demonstrably "job-related," may nevertheless provide a reliable basis for predicting successful performance on the job.

Apparently oblivious to these considerations, the lower courts throughout the 1970s expanded significantly on the disparate impact theory of discrimination. In *Griggs*, the doctrine was held to apply only to employers who had at one time practiced overt discrimination. That qualification was soon discarded. Moreover, the "job-relatedness" element of the *Griggs* decision rapidly evolved into what has become known as the "business-necessity" doctrine. According to Kenneth Lopatka,[71] the most rigid and widely followed definition of business necessity in the lower courts is as follows:

> The test is whether there exists an overriding legitimate business purpose such that the practice is necessary for the safe and efficient operation of the business. Thus, the business purpose must be sufficiently compelling to override any racial impact; the challenged practice must effectively carry out the

[69] Ibid. (emphasis in original).
[70] Thomas Sowell, *Civil Rights: Rhetoric or Reality?* (New York: William Morrow, 1984) pp. 115-16 (emphasis in original).
[71] Kenneth T. Lopatka, "Developing Concepts in Title VII Law," in Hausman et al., *Equal Rights in Industrial Relations* (Madison, WI: Industrial Relations Research Association, 1977), p. 42.

> business purpose it is alleged to serve; and there must be available no acceptable alternative policies or practices which would better accomplish the business purpose advanced, or accomplish it equally well with a lesser differential racial impact.[72]

Note the stringency with which "business necessity" is defined: Employment criteria which produce a disparate racial impact may be sustained only if they are "compelling," which is to say, "necessary for the safe and efficient operation of the business." The courts applying this test seemed not to recognize that to survive in a highly competitive market economy, it is usually not enough for a firm to operate "safely" and "efficiently"; it must also provide a product or service which consumers regard as superior to that offered by competing firms.

The lower courts also extended the range of employment criteria that were governed by the disparate impact and business necessity doctrines. *Griggs* spoke only of standardized tests and educational credentials, but by 1972 federal case law had established that an employer could not refuse to hire applicants with multiple arrest records (unless he could prove the job-relatedness of this criterion), because national statistics revealed that blacks are arrested more frequently than whites.[73] Because it is often exceedingly difficult to prove to the satisfaction of a judge or a jury that neutral criteria such as these are "necessary" in the sense used by the courts, many employers have responded by simply eschewing any objective criterion that yields a disparate racial impact. Others have either abandoned altogether their practice of administering standardized tests, or have resorted to race-norming (i.e., adding points to the scores of minority candidates) and "supplemental selection" techniques (i.e., choosing from separate lists of minority and nonminority candidates) in order to avoid disparate racial outcomes.

Many employers have responded by simply eschewing any objective criterion that yields a disparate racial impact.

Disparate Impact, Homeowners Insurance, and HUD

HUD made clear its intention to use disparate impact analysis in insurance redlining cases soon after the Sixth and Seventh Circuits decided that the Fair Housing Act applies to property insurance. An internal memorandum dated December 17, 1993, written by Assistant Secretary Roberta Achtenberg, and addressed to "all regional directors" of the agency's Office of Fair Housing and Equal Opportunity begins with the following instruction:

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[72] *Robinson v. Lorillard Corp.*, 444 F.2d 791, 798 (4th Cir. 1971).
[73] *Gregory v. Litton Systems, Inc.*, 316 F. Supp 401, 403 (C.D. Cal. 1970), *aff'd*, 472 F.2d 613 (9th Cir. 1972).

> Cases which have been brought under the Fair Housing Act should now be analyzed using a disparate impact analysis, to the extent that this theory is applicable to a particular case. Under a disparate impact analysis, a policy, standard, practice or procedure which, in operation, disproportionately adversely affects persons protected by the Fair Housing Act coverages may violate the Act.[74]

The memorandum goes on to note that "a respondent may rebut a prima facie case by evidence that the policy is justified by a business necessity which is sufficiently compelling to overcome the discriminatory effect. The business necessity justification may not be hypothetical or speculative." The memo admonishes HUD investigators to wield the disparate impact weapon aggressively, and to regard claims of "business necessity" with a high degree of skepticism:

The content of the American Family *consent decree, which was negotiated by the Justice Department, makes clear that DOJ is just as committed to the use of disparate impact analysis as is HUD.*

> Each [respondent] should be investigated to determine if there are genuine business reasons for the policy. The respondent should also be queried as to whether or not the respondent considered any alternatives to the particular policy, and what the reasons for rejecting the alternatives, if any, were. . . . [T]he investigation should consider whether there are any less discriminatory ways in which the respondent's business justifications may be addressed. These steps are important because if there is a less discriminatory way by which genuine business necessities may be addressed, it may be argued that the respondent should have adopted a less discriminatory alternative.[75]

The content of the *American Family* consent decree, which was negotiated by the Justice Department, makes clear that DOJ is just as committed to the use of disparate impact analysis as is HUD.[76] For example, the decree prohibits the company from "engaging in any act or practice that unlawfully discriminates by intent or effect on the basis of race or color in the

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[74] HUD Memorandum to All Regional Directors, Office of Fair Housing and Equal Opportunity, on "Applicability of Disparate Impact Analysis to Fair Housing Cases," December 17, 1993, p. 1.

[75] Ibid., p. 2. In later congressional testimony on May 11, 1994, Achtenberg indicated that even where insurance is provided, "discrimination still can occur in the disparate treatment of applicants based upon their race or the racial characteristics of their neighborhood." She cited insurers' requirements that insurable property meet minimum value or maximum age requirements as "seemingly neutral policies [that] can have an adverse racial impact and may violate the [Fair Housing] Act." Senate Committee on Banking, 1994.(Statement of Achtenberg).

[76] In late September, 1994, the head of the department's civil rights division, Deval Patrick, told a House subcommittee that "the Department of Justice is fully committed to using all legal theories that support a finding of illegal discrimination, including disparate impact as well as disparate treatment." See House Judiciary Committee, Subcommittee on Civil and Constitutional Rights, 103 Cong. 2d Sess., 1994 (Statement of DOJ Assistant Attorney General Deval Patrick at September 28, 1994 hearing).

provision of homeowners insurance . . ."[77] The insurer is required to "pay particular attention to: 1) the effect of the revised underwriting guidelines it is issuing pursuant to the Decree; and 2) the effect of the usage of credit bureau reports." Any changes in company practices that could have a discriminatory "effect" can be made only if it can be shown that there is "no less discriminatory alternative."[78]

A further indication of the ascendance of disparate-impact analysis in insurance redlining cases can be seen in the reaction of other large insurers to the *American Family* consent decree. On April 7, 1995 – the same day that the *American Family* consent decree was announced – State Farm Fire and Casualty Insurance Company disclosed that it was negotiating with HUD to settle allegations that the company discriminated against minorities in selling homeowners insurance.[79] A year later, in July 1996, State Farm agreed to eliminate restrictions regarding a home's age and minimum market value. It also pledged not to use negative credit information as a reason for refusing to offer coverage, and it agreed to open at least five new sales and service centers in urban areas by 1998.[80] A month later, Allstate Corporation announced that it, too, was giving up its age and minimum value restrictions in order to deflect charges of racial discrimination. At the same time, the company would "beef up inspection requirements" for properties being considered for coverage. "In essence," said Allstate official Al Orendorff, "the company is substituting 'more rigorous inspections' for its previous practice of 'segmentation by age and value'."[81] In February 1997, Allstate settled allegations of insurance redlining brought by the National Fair Housing Alliance. It agreed to expand its minority outreach programs and to hire a group of housing activists to monitor its business practices.

Any changes in company practices that could have a discriminatory "effect" can be made only if it can be shown that there is "no less discriminatory alternative."

Another large provider of homeowners insurance policies, Nationwide Mutual Insurance Company, also was accused of fair housing violations in the aftermath of the *American Family* decree. Unlike State Farm and Allstate, Nationwide refused to voluntarily change its underwriting practices and was sued by the Justice Department. On March 10, 1997, the parties agreed to a settlement that called for Nationwide:

- To not impose any geographic restrictions that have the effect of barring homeowners insurance in minority neighborhoods (effectively ending the use of territorial rating as applied to urban areas);

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[77] Consent Decree, *U.S. v. American Family Mutual Insurance Co.,* No. 9-C-0759 (E.D. Wis. 1995), p. 5.
[78] Ibid., p. 31.
[79] "State Farm Unit Seeks Bias Settlement With HUD," *Washington Post*, April 8, 1995, p. E10.
[80] Leslie Scism, "Allstate Relaxes Standards on Selling Homeowners' Policies in Poor Areas," *Wall Street Journal*, August 14, 1996, p. A3.
[81] Ibid.

- To increase insurance coverage through targeted advertising and community outreach;

- To provide $2.2 million in each of the next six years (totaling $13.2 million) to assist home buyers in minority neighborhoods with down payments, closing costs, below-market loans, second mortgages, and home ownership counseling in 10 cities where the company does business.[82]

The $13.2 million that Nationwide will "invest" in inner-city neighborhoods is best characterized as a government-mandated, privately financed form of urban renewal.

That the lawsuit against the insurer was driven by disparate-impact claims was confirmed by Justice Department officials who emphasized that "Nationwide had policies where it didn't insure homes that sold for less than $50,000 and it didn't insure homes that were more than 30 years old."[83] The government did not allege that Nationwide applied these criteria only to minority homeowners; instead it claimed the standards were "discriminatory" because more than 80 percent of homes in minority neighborhoods in Philadelphia (for example) have a value of less than $50,000.[84] Under the settlement, Nationwide, like State Farm and Allstate, pledged to individually inspect each home to decide if it should receive coverage, rather than refuse coverage because of the age or value of the residence.[85]

The $13.2 million that Nationwide will "invest" in inner-city neighborhoods is reminiscent of American Family's payment of $14.5 million to black homeowners in Milwaukee. Like the American Family payment, it is best characterized as a government-mandated, privately financed form of urban renewal, rather than as a narrowly tailored legal remedy. The switch to individual home inspections agreed to by Nationwide, State Farm, and Allstate may prove effective as a short-term strategy for appeasing HUD and its clientele of fair housing activists, but substituting labor-intensive inspections for simple categorical guidelines will no doubt add considerably to the insurer's costs.[86] Moreover, one may expect that even the criteria used in house-by-house inspections eventually will be subject to legal challenge if they have the effect of disproportionately excluding black homeowners.

HUD's well-earned reputation as an activist agency that constantly seeks to expand its jurisdiction suggests that insurers will continue to be subjected to challenges under the Fair Housing Act. But the agency is hardly

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[82] Thomas.
[83] Paul Hancock, Director of Housing and Civil Enforcement Section, Department of Justice, quoted in Josh Greenberg, "Insurer Settles Justice Dispute In Housing Bias," *Wall Street Journal*, March 11, 1997, p. B5.
[84] Ibid.
[85] Thomas.
[86] In many cases, the expense of generating additional risk information through extensive home inspections may not be cost-effective, and consumers then may not be willing to pay such costs, given their other alternatives.

alone in the organized campaign to root out "discrimination" in homeowners insurance.

"Fair Housing" Advocacy Groups: HUD's Private Investigators

HUD is assisted by an amalgam of putatively private "fair housing" organizations, which are rewarded with substantial funding from the agency. In effect, HUD uses tax revenues to subsidize the operations of private citizens who serve as the agency's self-styled deputies. HUD annually conducts a "Fair Housing Initiative Program" (FHIP) competition, through which the agency awards millions of dollars to private advocacy groups. By dangling lucrative FHIP grants before fair housing activists, HUD provides a powerful financial incentive for them to discover new forms of housing discrimination.

To investigate insurers, paired testers will typically call insurance agents and ask for "quotes" on two similar homes in different areas of a city.

The FHIP was created in 1987. As of February 1995, HUD had awarded more than $2.3 million under the program to a dozen private groups.[87] The following month, HUD awarded nine "additional" grants for fiscal year 1995, totaling more than $5 million. According to a newsletter published by the Fair Housing Council of Louisville, Kentucky, a group of fair housing advocates, "Two awards went to organizations that will carry out national research and outreach projects that will help inform the public and housing industry of their rights and responsibilities under the Fair Housing Act." The other seven awards, the newsletter continues, "are four-year grants to private, non-profit fair housing enforcement organizations that will use the money to conduct enforcement activities including investigating and processing complaints, testing for violations of the Fair Housing Act, and enforcing meritorious claims."[88] Essentially, HUD is paying some private citizens to prospect for lawsuits against other private citizens.

"Testing for violations of the Fair Housing Act" has proven to be a particularly effective means of engaging HUD's formal enforcement apparatus. To investigate insurers, paired testers will typically call insurance agents and ask for "quotes" on two similar homes in different areas of a city. One will be located in a suburb, the other in the inner city.[89] Due to such factors as higher incidence of crime, abandoned buildings, older homes with substandard heating and wiring components, and greater loss experience, the inner-city homeowner (or rather, the "tester" who represents himself as an inner-city homeowner) receives a higher premium quotation. This fact alone

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[87] 60 Fed. Reg. 8411 (Feb. 14, 1995), cited in Daniel J. Popeo, "It's Time to Scrutinize HUD Funding of Activist Groups," *Legal Backgrounder*, Washington Legal Foundation, July 21, 1995.
[88] "HUD awards nine additional FHIP grants," newsletter of the Fair Housing Council, Louisville, KY, (1995).
[89] See Senate Committee on Banking, Housing, and Urban Affairs, *Discrimination in the Homeowners Insurance Industry*, 103 Cong., 2d Sess., 4, 1994 (Testimony of William R. Tisdale, Shanna L. Smith, and Cathy Cloud on behalf of the National Fair Housing Alliance).

is considered by the testers to be evidence of racial discrimination, because of the relatively higher percentage of minorities in the inner city. The group conducting the experiment will then file a complaint with HUD.

According to a report by the Washington Legal Foundation, HUD and the Justice Department routinely launch investigations based solely on tester studies. This often means that, because the testers are not actual homeowners but staffers in the employ of a fair housing advocacy group who pose as customers, the complaint will not divulge even the most rudimentary information concerning the circumstances surrounding the alleged discrimination. Thus in 1994, the *New York Times* reported that the National Fair Housing Alliance, "a federally financed organization," filed complaints with HUD accusing two large property insurers, Allstate and Nationwide, of "improperly denying homeowners insurance to minorities across the country." [90] HUD immediately began an investigation. The complaint was based on NFHA studies – financed through HUD grants – that used testers in Atlanta, Chicago, Louisville, and Milwaukee. HUD investigated the complaint despite its failure to meet HUD's own rules requiring disclosure of pertinent information, such as the address of the aggrieved person, a description of the address and property involved, and a concise statement of the facts, including dates, constituting the discriminatory practice.[91] Do fair housing activists sometimes fabricate or exaggerate their discrimination claims? Consider that the NFHA's complaint specifically cited Nationwide's agents for discriminating against minority homeowners in Milwaukee — despite the fact that Nationwide had no agents operating in the state of Wisconsin.[92]

Fair housing organizations take pride in their role as HUD's de facto deputies.

Fair housing organizations take pride in their role as HUD's de facto deputies. In testimony before Congress, Shanna L. Smith, Director of Programs for the Fair Housing Alliance, boasted that "[p]rivate fair housing agencies have achieved an influence beyond their size and numbers [due to] their success in fair housing enforcement." Smith declared that such groups "play an essential role in enforcement" and complement "the work of the government enforcement agencies."[93] Their partnership with HUD can generate significant revenues for the fair housing groups that go beyond the cash subsidies they receive from the agency. As Daniel Popeo observes, their alliance with HUD and DOJ can yield substantial "monetary rewards from those they are harassing, as many defendants find it easier to settle than fight a protracted and costly battle with both 'public interest' plaintiffs and the

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[90] Michael Quint, "Study Says Two Insurers Show Bias," *New York Times*, May 12, 1994, p. D4.
[91] Letter from Walter V. Valentine, Director of the Office of Fair Housing and Equal Opportunity, HUD, to Allstate Insurance Company (May 11, 1994) (informing addressee of the discrimination complaint filed against it by the National Fair Housing Alliance). Cited in Popeo.
[92] Quint.
[93] See House Committee on Banking, Finance and Urban Affairs, Subcommittee on Consumer Credit and Insurance, *H.R. 1257, The Federal Insurance Administration Act* 103 Cong., 1st Sess., 7, 1993.

Justice Department and its endless resources."[94] (Popeo cites the *American Family* consent decree as an example.) Moreover, having discovered statistical evidence of "discrimination," activists sometimes market themselves as consultants who will, for a price, provide "educational and self-testing services" to the businesses they have accused.[95]

Much more is at stake in the collusive relationship between HUD and its client organizations than the latter's financial enrichment. The enforcement activities of executive-branch agencies are not limited to simple cut-and-dried decisions about whether to enforce "the law" in particular instances. Especially in civil rights enforcement, the law is often ambiguous or in a state of flux, which means that, by strategically pursuing certain kinds of cases, an agency that is so inclined can advance novel statutory or constitutional interpretations before the courts. In this way, administrative agencies can become the architects of new public policies.

Programs like HUD's Fair Housing Initiative Program undermine democracy, inasmuch as HUD has effectively ceded its policymaking authority to private citizens unaccountable to the public.

To be sure, there is nothing unusual – nor, from the standpoint of the Constitution's separation of powers, inappropriate – about administrative agencies seeking to advance a particular interpretation of a statute or constitutional provision before the courts.[96] Because they are part of the executive branch, agencies can be held accountable for the policies they urge upon the courts. Their enforcement records are frequently examined and discussed during presidential election campaigns. But this kind of public scrutiny and accountability does not extend to private interest groups who receive government funding to do an agency's bidding. Indeed, programs such as HUD's Fair Housing Initiative Program undermine democracy, inasmuch as HUD, by transferring a portion of its enforcement budget to interest groups in the form of FHIP grants, has effectively ceded its policymaking authority to private citizens who are unaccountable to the public.[97]

Congressional Efforts to Limit HUD's Authority

In general, ending the federal government's practice of funding groups that claim to act in behalf of "civil rights" has proven nearly impossible, and fair housing groups are no exception. During the 104th Congress, the Republican-controlled House of Representatives approved an

[94] Popeo.
[95] See Jim McTague, "As Ethics Watchdogs Sleep, HUD Signs Up Bias 'Testers,'" *The American Banker*, August 16, 1993, p. 18.
[96] See, e.g., Terry Eastland, *Energy in the Executive: The Case for the Strong Presidency* (New York: Free Press, 1992), pp. 154-64.
[97] For an excellent critique of the policymaking role of private advocacy groups, see Jeremy Rabkin, *Judicial Compulsions: How Public Law Distorts Public Policy* (New York: Basic Books, 1989); see also James T. Bennett and Thomas J. DiLorenzo, *Destroying Democracy: How Government Funds Partisan Politics* (Washington, DC: Cato Institute, 1985).

amendment to HUD's annual appropriation bill that would have prevented the agency from continuing to subsidize private advocacy groups through its Fair Housing Initiative Program. Another amendment would have prevented HUD from regulating the property insurance industry altogether, specifically stating that "none of the funds provided for in this Act may be used during fiscal year 1996 to sign, promulgate, implement or enforce any requirement or regulations relating to the application of the Fair Housing Act to the business of property insurance or for any activity pertaining to property insurance."[98] A similar amendment was attached to the Senate version of the bill.[99] The Senate bill would also have transferred HUD's authority to enforce the Fair Housing Act to the Justice Department.[100]

Sen. Moseley-Braun accosted Majority Leader Bob Dole on the Senate floor and said, "You're not going to let this happen, are you? We'll be riding on the back of the bus again."

None of these efforts came to fruition. In the Senate, a countervailing amendment introduced by Senator Russ Feingold (D-Wis.) to restore HUD's authority to regulate property insurance was adopted on a voice vote,[101] thanks in part to successful maneuvering by Sen. Carol Moseley-Braun (D-Ill.). According to the *Chicago Sun-Times*, Moseley-Braun accosted Majority Leader Bob Dole (R-Kan.) on the Senate floor and said, "You're not going to let this happen, are you? We'll be riding on the back of the bus again."[102] The majority leader "then walked over to Sen. Christopher Bond (R-Mo.), leader of the GOP assault, and whispered to him. Minutes later, Bond surprised senators by canceling his roll call to block Moseley-Braun, and the Senate went along in a voice vote."[103]

As for the amendments to defund FHIP and transfer fair housing enforcement power from HUD to the Justice Department, they were subsequently removed by a House-Senate conference committee.[104] Indeed, the appropriations bill that emerged from the conference committee allocated $15 million to the FHIP program.[105] The move to shift fair housing enforcement authority from HUD to Justice was opposed not only by fair housing activists, but also by the National Association of Realtors, the Mortgage Bankers Association, and other housing groups, apparently because they feared that

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[98] H. Jane Lehman, "Bill Curbs HUD Power Over Property Insurers; Agency Would Be Barred From Policing Industry," *Washington Post*, August 5, 1995, p. E1.
[99] John Yinger, "Fair Housing System Under Attack by GOP," *Bergen Record*, October 2, 1995, p. A13.
[100] John Biers, "1995 Overview H.R. 2099," *Bill Overviews and Outlooks*, November 7, 1995.
[101] Frank A. Aukofer, "Feingold's Move Saves Redlining Enforcement," *Milwaukee Journal Sentinel*, September, 28, 1995, p. 7.
[102] Basil Talbott, "Moseley-Braun Gets GOP to Spare Fair-Housing Rule," *Chicago Sun-Times*, September 28, 1995, p. 22.
[103] Ibid. In the end, the Senate Appropriations Committee recommended allocating $30 million for "Fair Housing Activities" for fiscal year 1997, half of which was earmarked for the FHIP. These amounts matched the previous year's appropriations. See Senate Committee on Appropriations, *Report 104-318, Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Bill, 1997*, 104 Cong., 2d Sess., July 11, 1996.
[104] "Senate Lifts Constraints on HUD Insurance Powers," *BestWire*, December 4, 1995.
[105] "HUD Has Motive to Keep a Hand in Insurance Issues," *BestWire*, August 12, 1996.

fair housing enforcement under Justice would be more likely to take the form of litigation, as opposed to HUD-style conciliation.[106]

The challenge to HUD failed despite aggressive lobbying by an insurance industry coalition organized by the National Association of Mutual Insurance Companies. The coalition consisted of such industry stalwarts as the National Association of Independent Insurers, the American Insurance Association, the Alliance of American Insurers, the Independent Insurance Agents of America, the National Association of Professional Insurance Agents, the Council of Insurance Agents and Brokers, State Farm, Allstate, USAA, Travelers, Cigna, Hartford, Kemper, and Fireman's Fund.[107] They proved no match for HUD's defenders, who repeatedly invoked civil rights rhetoric in their struggle to maintain the status quo. In a letter to Rep. Jerry Lewis (R-Calif.), chairman of the appropriations subcommittee with jurisdiction over the HUD component of the budget, HUD Secretary Henry Cisneros lambasted the offending provisions as "an affront to civil rights."[108] Speaking on the Senate floor, Senator Moseley-Braun declared: "We should not roll back civil rights in the name of regulatory reform. It's shortsighted, counterproductive, and antediluvian."[109]

Supporters of the effort to limit HUD's authority refused to respond to these charges.

Supporters of the effort to limit HUD's authority refused to respond to these charges, preferring instead to change the subject and talk about their desire to "cut duplicative federal programs, maintain the authority of our states and most importantly . . . keep a federal agency from encroaching on the operations of our small businesses," in the words of Rep. Ed Royce (R-Calif.).[110] According to Pamela J. Allen, vice president for federal affairs of the National Association of Mutual Insurance Companies, the insurers who backed her group's effort were not trying to avoid regulation or civil rights laws, but wanted only to maintain state authority over such issues and avoid dual regulation.[111] "The issue has been confused as one that involves civil rights," declared Dave Farmer, senior vice president for federal affairs of the Alliance of American Insurers. "It has never been the intent of the insurance industry to defend any kind of discrimination. This is an issue of dual regulation. The authority to regulate underwriting clearly rests with the states, not with a federal agency."[112]

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[106] Basil Talbott, "Proposed Changes Worry Fair-Housing Advocates," *Chicago Sun-Times*, September 24, 1995, p. 21.
[107] L.H. Otis, "HUD Anti-Redlining Plan In Jeopardy," *National Underwriter* (Property & Casualty Edition), p. 1.
[108] Ibid.
[109] Talbott, September 28,1995.
[110] Lehman, August 5, 1995.
[111] Otis.
[112] "Senate Lifts Constraints on HUD Insurance Powers," *BestWire*.

But HUD's defenders would have none of this. Countered Senator Feingold: "Despite opponents claims to the contrary, this is a fundamental civil rights issue. We cannot allow civil rights protections to be rolled back in the name of regulatory or insurance reform."[113] In retrospect, it seems clear that insurance industry officials and their congressional allies did their cause a profound disservice by failing to address the real issue at hand: that in its pursuit of the disparate impact version of civil rights, HUD would undermine property insurance by preventing underwriters from discriminating on the basis of risk.

Canady v. Allstate Insurance Co., et al.: The Latest Challenge

Insurers are responding willy-nilly to the gradual insinuation of disparate impact analysis into the realm of homeowners insurance.

The decisions by State Farm, Allstate, and Nationwide – perhaps to be followed by other insurers – to revise substantially their pricing and underwriting methods is indicative of a changing legal and regulatory regime. Both the timing and substance of the moves by these insurers are a clear indication of the influence exerted by the *American Family* consent decree. Insurers are responding willy-nilly to the gradual insinuation of disparate impact analysis into the realm of homeowners insurance. Whether insurers will continue to capitulate to the demands of fair housing activists will likely depend on the degree to which the activists, with the assistance of HUD and DOJ, succeed in formally codifying disparate impact analysis with respect to insurance practices.

They could do so by securing a court ruling upholding the validity of the disparate impact approach to proving illegal discrimination against insurers. To date, no court has reached this conclusion. Indeed, the Seventh Circuit panel in the *American Family* case noted that the Supreme Court had yet to decide whether practices with disparate impact violate the Fair Housing Act. Judge Easterbrook also pointed out that insurance works best when the risks in the pool have similar characteristics. The particular procedural history of the case required the Court of Appeals to assume that the defendant intentionally discriminated on account of race. Thus, the court in American Family had to assume that the plaintiff could establish disparate treatment – and not just a disparate impact of decisions made on actuarial grounds.

The Easterbrook opinion suggests that appellate courts will not necessarily leap to apply disparate impact analysis to property insurers charged with violating the Fair Housing Act. It notes that risk discrimination is not race discrimination,[114] and states that all the court decided in *American*

[113] U.S. Senator Russ Feingold, official press release, September 27, 1995.
[114] The court in *Nationwide Mutual Insurance Co. v. Cisneros* also concurred with this view and pointed out that nothing in the nature of insurance implies that hazard insurers need to engage in disparate *treatment* to draw lines on the basis of race rather than risk.

Family was whether the complaint stated claims on which the plaintiffs might prevail if they established that the insurer had drawn lines according to race rather than actuarial calculations. A Legal Opinion Letter published by the Washington Legal Foundation observed that the Seventh Circuit panel in the American Family case "expressed its skepticism that the theory [of disparate impact] can be applied at all in the insurance context."[115] The Easterbrook opinion highlighted the key point regarding differences between the disparate treatment and disparate impact approaches – disparate treatment assigns burdens of proof and persuasion to the plaintiff, while a disparate impact approach places them on the insurer. Given the difficulty in drawing inferences, this allocation of burdens will make the key difference in who wins in many cases."[116]

The factual circumstances and allegations presented by Canady *are similar to those posed by* American Family.

Neither the voluntary revisions undertaken by State Farm and Allstate, nor the *American Family* and *Nationwide* consent decrees, have value as legal precedent. If, however, the anti-redlining activists were to succeed in establishing the disparate impact theory in the federal case-law that applies the Fair Housing Act to property insurers, their hand would be greatly strengthened. A legal juggernaut would be unleashed whose impact on insurance underwriting and pricing methods could conceivably transform the business of insurance at least as dramatically as employee hiring and promotion practices were altered in the 1970s and 1980s by the *Griggs* decision and its progeny. That is why a case filed last year in a federal district court in Missouri, *Canady v. Allstate Insurance Co. et al.*, warrants close attention.

The factual circumstances and allegations presented by *Canady* are similar to those posed by *American Family*. The Canady plaintiffs are two black homeowners in Kansas City, Missouri who purport to represent a class consisting of all minorities in Missouri who own property in predominantly minority neighborhoods. According to Steven Sprenger, a lawyer for the

[115] Thomas M. Crisham and Mary Patricia Benz, "Insurers Oppose HUD's Efforts to Apply Disparate Impact Theory," *Legal Opinion Letter*, Washington Legal Foundation, July 26, 1996

[116] *American Family*, 978 F.2d at 291.

[117] Tom Jackman, "23 Insurance Companies Target of Lawsuit; Class-Action Case Alleges Bias Against Minority Homeowners," *Kansas City Star*, February 16, 1996, p. C1. However, the future of the case as a class action remains in doubt, following a ruling on June 19, 1997 by U.S. District Judge Fernando J. Gaitan, Jr. Judge Gaitan denied the plaintiffs' motion for class certification and dismissed the case without prejudice for the plaintiffs' failure to meet standing requirements "to bring suit, as a group, against individual, unrelated insurance companies when no proposed representative plaintiff has alleged to have been aggrieved by all the defendants, nor has any claim of joint action or conspiracy been brought by the complaint." The court noted that the plaintiffs needed to allege that the defendants had some relationship beyond simply engaging in the same business or being members of the same industry. (On October 2, 1996, the court had dismissed several counts of the plaintiffs' complaint that alleged causes of action for conspiracy among the defendants and others.) At this time, the federal district court decision is being appealed to the United State Court of Appeals for the Eighth Circuit. Absent class certification, each plaintiff who chooses to do so still may refile a complaint against the defendant or defendants with whom each plaintiff has alleged grievances. *Canady v. Allstate Insurance Co. et al.* (W.D. Mo.), Docket No. 96-0174-CV-W-2.

plaintiffs, the class may include as many as 50,000 people statewide.[117] The plaintiffs' formal complaint, supported by the Justice Department as amicus curiae, alleges that 23 named insurance companies have engaged in underwriting and sales practices that, while proper under state law, are nevertheless illegal under the Fair Housing Act because they deny residents of the plaintiffs' neighborhoods access to homeowners insurance under the same terms that are available to residents of other neighborhoods.

According to their complaint, the "central questions of fact" raised by the plaintiffs' lawsuit "are whether Defendants have engaged in underwriting and sales practices that prevent minority persons from purchasing homeowners insurance, and that result in minority persons paying greater premiums for less coverage when they are able to purchase homeowners insurance."[118] Although several of the plaintiffs' allegations are vaguely worded or lack specificity, a number of their other allegations are identical to those made against American Family and can only be proved by recourse to disparate impact analysis. These include charges that the insurers are guilty of:

Each of these practices exemplifies the sort of reasonable discrimination that insurers must practice if they are to accurately assess and classify risk.

- maintaining underwriting guidelines and practices that mandate denial of coverage based upon the age of residential property;
- maintaining underwriting guidelines and practices that mandate denial of coverage for homes below a minimum property value;
- maintaining underwriting guidelines and practices that use credit history to deny coverage;
- steering minority persons toward buying "limited" policies rather than standard or comprehensive homeowners policies;
- maintaining underwriting guidelines and practices that deny coverage to homeowners whose coverage was terminated by another company;
- refusing to sell or renew policies to homeowners in certain urban areas who have incurred a loss.[119]

Each of these practices exemplifies the sort of reasonable discrimination that insurers must practice if they are to accurately assess and classify risk. Virtually all state insurance boards recognize this, which is why the NAIC's model anti-redlining law – with its exception for discrimination based on "sound underwriting and actuarial principles related to actual or reasonably anticipated loss experience"[120] – has been adopted by 46 states. In the *Canady* litigation, however, application of disparate impact analysis would mean that each of these practices would be subjected to the stringent

[118] Ibid., Plaintiffs' Complaint, pp. 8-9.
[119] Ibid., p. 9.
[120] Unfair Trade Practices Act.

business-necessity test.[121] The insurers would need to convince lay jurors that a challenged practice is necessary for the safe and efficient operation of their business; that the purpose of the practice is sufficiently compelling to override any racial impact; that the practice does, in fact, effectively carry out the legitimate purpose it is supposed to serve; and that there exist no alternative practices that would accomplish the insurers' purpose equally well with a lesser disparate racial impact. Moreover, the insurers must engage in this exercise with respect to each and every challenged practice for which a disparate racial impact can be shown. One need not be a seasoned litigator to appreciate the magnitude of this burden.

Thomas Sowell's critique of the "job-relatedness" test announced by the Supreme Court in *Griggs v. Duke Power* is apposite here. The *Griggs* Court had declared that an employment standard that produced racially disparate outcomes would be invalid if it could not be proven that the attribute sought by the employer was a prerequisite to satisfactory job performance. Sowell argued that the Court's position was specious because it refused to recognize that it is reasonable for an employer who observes a correlation between personal characteristics and level of job performance to hire accordingly. The Court effectively disallowed the use of personal characteristics as a predictor of job performance, and insisted instead that employers ask only whether a job applicant would be capable of performing a given job, based on his formal training and experience.

The insurers would need to convince lay jurors that a challenged practice is necessary for the safe and efficient operation of their business.

The application of disparate impact theory to the business of insurance would have similar consequences. It would not matter that characteristics such as the age of a home, its market value, the credit record of its owner, the owner's experience with other insurers, or the geographic location of the property are all accurate predictors of risk. As Richard M. Esenberg has observed, a statistical correlation can often exist between race and factors which might be relevant to the marketing and underwriting of insurance, such as lower household income and housing values, older dwellings, and higher frequencies of loss.

Although race does not "cause" these things, they co-exist. To the extent that factors such as these are related to underwriting criteria traditionally

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[121] The issue in *Canady* is not whether insurers should be prohibited from invidious discrimination, because virtually all states prohibit intentional discrimination on the basis of race, religion, and national origin. "Rather, the issue is whether insurers should be forced to abandon true risk-based practices, or to justify them in the courts when they affect protected classes to a greater degree than others." Crisham and Benz. The authors also raise another issue: "[I]nsurers would find it difficult, if not impossible, to meet requirements of the inherently inconsistent, dual regulatory systems which would be imposed on them by the States on the one hand and HUD on the other. State regulatory authorities would continue to require that property insurance be priced fairly to reflect risk, while HUD and private litigants will attack underwriting standards whenever they are perceived to have an adverse effect on members of a protected class." Ibid.

relied upon by insurance companies, those criteria may have a disparate impact and will be subject to regulatory or judicial attack.[122]

Esenberg further notes that aggressive regulators and private litigants will demand, and courts may agree, that business justification must be established by statistical studies that demonstrate unequivocally the relationship between the criteria in question and risk. In many instances, these studies will not exist and would be difficult and costly to perform. For example, if an insurance company tested the proposition that overinsurance (providing replacement cost coverage for homes whose market value is low but replacement cost is high) leads to a higher level of losses, it would be conducting an experiment with real money and, perhaps, creating an incentive for real arson. Moreover, insurers faced with the onerous task of sorting out cause and effect to fully satisfy or deter potential plaintiffs may choose not to "validate," but to abandon, business practices that have served them and their policyholders well for many years. The easier course will be to "insure by the numbers." The cost in distortion of markets will be hidden, warns Esenberg.[123]

Anti-discrimination law as enacted in the 1960s was designed to prevent behavior inspired by racial bigotry.

Underwriting criteria, moreover, will not be the only target of attack by federal regulators and private litigants. Insurers who do not sell their "fair share" of inner-city policies will be challenged to justify their share of the central-city market, and to explain why they have fewer agents and sell fewer policies in minority neighborhoods.[124]

ANTI-DISCRIMINATION LAW VERSUS REASONABLE DISCRIMINATION: A BUSINESS DILEMMA

The situation in which insurance companies find themselves today is shared by a growing number of businesses. Anti-discrimination law as enacted in the 1960s was designed to prevent behavior inspired by racial bigotry. It was persuasively argued at the time that discrimination based on race was both morally wrong and economically irrational. Hence civil rights laws would benefit both the minorities that had historically been the objects of unreasonable discrimination and those who would practice discrimination against them – the latter because the law would eventually wean them away from their prejudices by teaching them that there was economic profit to be had by refraining from indulging one's prejudices. Today, however, anti-discrimination law is more interested in correcting statistical disparities

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[122] Richard M. Esenberg, "Courts Should Strike Down HUD's Attempts to Regulate Property Insurance," *Legal Backgrounder*, Washington Legal Foundation, December 15, 1995.
[123] Ibid.
[124] Ibid.

among groups, even when they occur inadvertently through the application of race-neutral business practices.

Property insurers, whose use of economically sound risk-based underwriting and pricing criteria is said to constitute racial discrimination, are victims of this trend. But insurance companies are not the only businesses that have run afoul of anti-discrimination law by behaving reasonably. David Frum sketches the larger dimensions of the problem:

> It's less and less true that the defendants in anti-discrimination actions are behaving irrationally, sacrificing material welfare to raw prejudice. More and more often, Americans find themselves on the wrong side of the law not because they acted in a prejudiced and irrational way, but because they behaved in a way any economist would regard as perfectly reasonable: They hired the employee who didn't need $50,000 worth of access ramps and elevators, they retained the advertising firm whose executives spoke the most fluent English, they granted the partnership to the associate who didn't ask for time off to give birth.
>
> A bigot is a person whose harsh prejudices blind him to the facts. The people who find themselves on the wrong side of the anti-discrimination police nowadays are seldom bigots in that plain sense of the term. They are people who are being asked to pay a higher wage bill, or to widen the doorways of their hotel, or to rearrange a new mother's hours of work. Their resistance to those demands emerges not from blindness, but from a very clear-eyed awareness of costs. In the name of anti-discrimination, what we are really doing is imposing crushing and arbitrary taxes on randomly selected employers, landlords, and other unmalicious businessmen.[125]

Insurance companies are not the only businesses that have run afoul of anti-discrimination law by behaving reasonably.

To the organized civil rights establishment, the suggestion that "discrimination" may sometimes be rational is a dangerous heresy. Property insurers are understandably dismayed at the cavalier manner in which epithets such as "redlining" and "corporate racism" are hurled at them by fair housing activists. But they must understand that anti-discrimination law, no less than the civil rights establishment itself, always starts from the premise that all racial disparities are caused by racism.

No one disputes that, compared to other homeowners, residents of predominantly minority inner-city neighborhoods often pay more for homeowners insurance, while frequently receiving less coverage. When

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[125] Frum, p. 30.

insurers explain that this is because of greater risk factors and higher losses in the inner city, fair housing activists answer that the disparities between inner-city residents and suburbanites translate to racial disparities, and racial disparities are caused by racial discrimination. Indeed, fair housing activists apparently believe that inner-city neighborhoods represent a vast, lucrative market for property insurers. From their perspective, the general reluctance of property insurers to tap into this market – and, indeed, the fact that no firm has attempted to capture the inner-city market by offering the same rates and coverages that are offered to suburban homeowners – can be attributed only to racial bigotry.

What is needed is nothing less than a complete overhaul of anti-discrimination law.

Disparate impact is the legal doctrine by which reasonable discrimination that produces racial disparities is equated with racial bigotry. There is ample reason to fear that the federal judiciary might endorse the disparate impact approach to redlining allegations that has been urged upon it by HUD and its client organizations. Insurers will thus be tempted to seek special legislation from Congress – an updated version of the McCarran-Ferguson Act, perhaps – that would effectively rescue homeowners insurance from the vicissitudes of anti-discrimination law. In lieu of an industry-specific legislative remedy, however, insurers should consider making common cause with the myriad other businesses that now routinely "find themselves on the wrong side of the anti-discrimination police." What is needed is nothing less than a complete overhaul of anti-discrimination law. That may seem unlikely, given the reluctance of business leaders and politicians to do or say anything that will permit their adversaries to portray them as enemies of civil rights. Yet for property insurers, the likely alternative is a wholesale transformation of the business of homeowners insurance, with profoundly negative consequences for profits, solvency, and fairness.

One can easily imagine a future in which insurers will be required to document a precise cause-and-effect relationship between each underwriting and pricing variable they use and its associated risk. Moreover, they will also be required to show that no "less discriminatory" risk-assessment technique is available. Despite the difficulty and expense of meeting this burden, insurers will have no choice but to abandon the use of those risk selection practices and cost-based pricing mechanisms that yield a disparate racial impact. In such an event, an insurer would have, in theory, two options: It could distribute the expected, more frequent, and higher claim-costs of one group of homeowners among another group of homeowners who present lower risk, in effect creating a cross-subsidy. That, however, would lead to "the underwriter's nemesis: adverse selection."[126] Alternatively, insurers might devise ways to circumvent the effects of a disparate impact prohibition.

[126] Rosemary Baptiste, James Carson, et al., "Redlining, Property Insurance and Urban Markets: Concepts, Issues, Initiatives, and Solutions," *Chartered Property & Casualty Underwriters Journal*, Summer 1996, p. 82.

As Gary Wolfram observes, "When the government requires firms to sell at a lower price, they will do one of two things. They will either try to reduce the quality of the product, charging the same premium for less coverage, or they will decide that doing business . . . is too costly and exit the market."[127] Neither option will benefit the urban minorities who are the intended beneficiaries of the mandate to sell insurance at unprofitable rates.

Pretending that insurance affordability and availability problems in the inner city are caused by invidious racial discrimination on the part of insurance companies has further destructive consequences. First, it diverts attention from the real problems that affect inner-city communities. Simply put, property insurance is relatively expensive and scarce in these communities because the people who live in them have low incomes (which means that their housing is older and less safe), and suffer from high rates of crime. Government efforts to coerce insurers to lower their rates in such areas below levels needed to cover their loss costs will only make insurance companies more reluctant to enter those markets in the first place. But so-called urban redlining would disappear if individual incomes were increased and crime were reduced in inner-city areas to the levels that prevail in middle-class suburbs.

So-called urban redlining would disappear if individual incomes were increased and crime were reduced in inner-city areas to the levels that prevail in middle-class suburbs.

One way to accomplish those objectives is to concentrate on reducing the regulatory costs and high taxes that currently face businesses willing to consider locating their operations in urban areas. The likely result would be improved job prospects for inner-city residents, enabling them to upgrade their housing stock and reduce insurance costs. Improving educational opportunities for inner-city residents will, over time, also lead to higher incomes. Current evidence shows that policy innovations such as education vouchers and charter schools can significantly raise achievement levels among inner-city students. As for the crime problem, more effective enforcement of laws protecting property rights and deterring theft and arson would have a direct, salutary effect on the cost of insurance.

Another approach to confronting the real problem of insurance availability and affordability is for policymakers to examine the regulatory hurdles that may discourage potential entry of new competitors into urban insurance markets or the expanded operation of insurers already located there.[128] They could provide incentives for the creation of community-based insurance cooperatives that might specialize in servicing urban areas more efficiently than the larger insurers that may have to rely on less specific data to set rates.[129] If insurers had greater pricing freedom and faced fewer obstacles in trying to exit from urban markets, more competitors would be likely to take on the higher risks and uncertainties of entering them in the first

[127] Wolfram, p. 367.
[128] See England, 1994, p. 17.
[129] Wolfram, p. 369.

place. Policymakers also should improve the information available to insurers and consumers, such as through expanding and improving state insurance consumer programs that counsel homeowners on how to purchase property insurance, voluntary market assistance plans that match consumers seeking coverage with insurers willing to provide it, and other state insurance programs that educate insurers on economic opportunities in inner-city areas.[130]

There are more efficient and transparent ways to redistribute risk wholesale than through the restrictive regulation of insurance risk classification.

Finally, if it becomes politically necessary, there are more simple, efficient, and transparent ways to redistribute risk wholesale than through the restrictive regulation of insurance risk classification. Public subsidies to reduce the cost of insurance for high-risk individuals with limited resources can be provided either directly (e.g., vouchers, general income assistance), via residual market mechanisms (FAIR plans, with improved pricing), or through public funding of special purpose vehicles (similar to the community development banks that finance inner-city borrowing).

For some activists and politicians, however, there is evidently more to be gained from demonizing the insurance industry than from honestly confronting inner-city social and economic problems and offering creative solutions.

A second and, in some ways, more insidious consequence of the redlining canard is that it heightens the perception that the problems of minorities in the United States are invariably caused by racial prejudice. The federal government, especially under the Clinton administration, appears only too eager to seize every opportunity to depict majority-white institutions, their managers, and employees as engaged in a relentless and systematic campaign of racial discrimination. When the behavior of such organizations and their members is actually inspired by nothing more sinister than the profit motive and competitive markets, the effect of government lawsuits and incendiary public pronouncements is not only to besmirch the reputations of the accused parties. Tragically, the government's misguided efforts will also exacerbate the suspicion and mistrust that already characterize U.S. race relations.

[130] See Klein, 1997, p. 76.

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