Trends and Insights:
Race and Insurance Pricing

INSURANCE INFORMATION INSTITUTE
Affiliated with THE INSTITUTES

There is no place for discrimination in today's insurance marketplace. In addition to being fundamentally unfair, to discriminate on the basis of race, religion, ethnicity, sexual orientation – or any factor that doesn't directly affect the risk being insured – would simply be bad business in today's diverse society.

Concerns have been raised about the use of credit-based insurance scores, geography, home ownership, and motor vehicle records in setting home and car insurance premium rates. Critics say using such data can lead to "proxy discrimination," with people of color in urban neighborhoods sometimes charged more than their suburban neighbors for the same coverage.

Insurers say these tools reliably predict claims and help them match premiums with risks – preventing lower-risk policyholders from subsidizing higher-risk ones. Confusion around insurance rating is understandable, given the complex models being used to assess and price risk. To navigate this complexity, insurers hire teams of actuaries to quantify and differentiate among a range of risk variables while avoiding unfair discrimination. Answering to regulators in 50-plus jurisdictions, insurers have strong incentives to comply with anti-discrimination regulations and statutes of anti-discrimination rules.

Learning from history

Insurers are well aware of the history of unfair discrimination in financial services. While it would be disingenuous to suggest that all traces of bias have been wrung out of the system, the insurance industry has been responsive over the decades to concerns about fairness and equity:

- In 1912, insurance regulators conducted a study of fraternal benefit societies that targeted African-Americans with high-premium, low-value policies;
- In 1940s, the National Association of Insurance Commissioners (NAIC) adopted the Unfair Trade Practices Act, which prohibits unfair discrimination by insurers;
- In the 1960s and 1970s, NAIC members took up redlining and insurance availability and race-based premiums in life insurance and, more recently, have studied credit-based insurance scores and investigated racial premium differences in life insurance.

The insurance industry's focus on diversity and equity go well beyond pricing. Through collaborations like Triple-I's partnership with HBCU I.M.P.A.C.T., insurers actively seek to cultivate a more inclusive work environment with multiple paths of opportunity.

In addition to tackling tough questions about how the legacy of racial bias might continue to influence insurance availability and affordability in the 21st Century, the industry has worked hard to make diversity, equity, and inclusion key components of talent recruitment and development.

Respecting protected classes

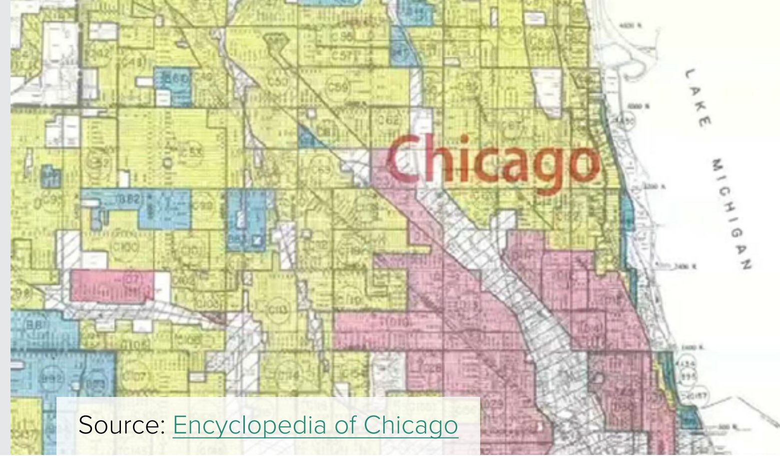
The United States recognizes "protected classes" of people – groups who share common characteristics and for whom federal or state laws prohibit discrimination based on those traits. Race, religion, and national origin are most commonly meant when describing protected classes in the context of insurance rating.

Insurers generally do not collect information on these "big three" classes. Therefore, any discrimination based on these attributes would have to arise from use of data that can serve as proxies for protected class.

Interrogating the algorithms

Recently approved Colorado legislation requires insurers to show that their use of external data and complex algorithms does not discriminate against protected classes.

Redlining was the practice of arbitrarily denying or limiting financial services to specific neighborhoods, generally because its residents are people of color or are poor. The New Deal's Home Owners' Loan Corporation (HOLC) instituted redlining by developing color-coded maps of American cities that used racial criteria to categorize lending and insurance risks. Banks and insurers soon adopted the HOLC's maps and practices to guide lending and underwriting decisions.



Source: Encyclopedia of Chicago

Algorithms and machine learning hold great promise for ensuring equitable pricing. However, research has shown these tools also can amplify biases that can creep into their programming. The actuarial profession has been researching and attempting to address these concerns for some time. The American Academy of Actuaries has offered extensive guidance to Colorado's insurance commissioner on implementation of his state's legislation, and the Casualty Actuarial Society recently published a series of papers (see links below) on the topic.

Credit as a key underwriting variable

Insurers use credit-based insurance scores to determine the likelihood that a potential policyholder will file a claim. While not the same as credit scores, they do consider credit history. Insurers use these scores because actuarial studies suggest that how people manage their financial affairs – which is what these scores indicate – is a proven predictor of claims. These scores are not the sole factor used to underwrite and price insurance.

Legislative efforts to thwart risk-based pricing

Federal and state legislators have introduced measures that would affect insurance pricing factors. U.S. Senate Bill 4755 – which would have prohibited 12 factors from being used to price auto insurance, including credit-based insurance scores, gender, education and occupation – and the related House Bill 3693 were not enacted into law.

Washington State Insurance Commissioner Mike Kreidler in February adopted a rule prohibiting insurers from using credit scoring to set rates for auto, homeowners', and renters' insurance. The American Property Casualty Insurance Association (APCIA), the Professional Insurance Agents of Washington, and the Independent Insurance Agents and Brokers of Washington challenged it, and the measure is now on hold.

Claire Howard, APCIA senior vice president, wrote that the rule would "continue to throw the Washington insurance market into chaos and raise rates for over one million consumers."

Why would such restrictions cause rates to rise for low-risk policyholders? Because denying insurers the use of actuarially sound rating tools would force them to price risk less precisely than they can with existing methods. As a result, the cost of insuring cars and homes across the state would have to be spread more evenly across the insured population, with less regard to relative risks.

A transformative partner

Nothing here is intended to absolve insurers from paying assiduous attention to concerns about proxy discrimination and "disparate impact." These terms reflect awareness of structural inequities in our society and economy whose origins run much deeper than insurance pricing.

The actuarial discipline and the insurance industry are well positioned to continue helping policymakers and decisionmakers understand these inequities and play a constructive role in the policy discussion.

© Insurance Information Institute, April 2022

New Research From the Casualty Actuarial Society:

- Defining Discrimination in Insurance
- Methods for Quantifying Discriminatory Effects on Protected Classes in Insurance
- Understanding Potential Influences of Racial Bias on P&C Insurance: Four Rating Factors Explored
- Approaches to Address Racial Bias in Financial Services: Lessons for the Insurance Industry