COMMENTARY *By Gerard Smedinghoff*

An Alternative Perspective on Redlining

Redlining, like health care reform and the whereabouts of Elvis Presley, has an element of paradox: The more it's talked and written about, the less it's understood. In fact, the best way to clear the air on redlining is to (1) identify its basic economic and marketing principles, (2) examine some historical case studies, and (3) apply the principles to the insurance market.

Marketing vs. Redlining

For starters: *Every* act of marketing can be categorized as redlining. The only two organizations that don't practice redlining are the U.S. Census Bureau and the U.S. Postal Service, because both try to reach each and every household in the United States. Therefore, since every marketing effort is, in some way, geographically skewed, it is, by definition, redlining.

Banks and insurers are often accused of redlining. Yet countless other organizations, which apply the same marketing practices as banks and insurers, are allowed to conduct their business without attracting the attention of legislators or regulators.

There is, no doubt, a high correlation between the geographic distribution of the American Express customer list and the areas that banks and insurers are attracted to and repelled from. So any organization that rents the customer list of American Express cardholders is "guilty" of redlining, right along with the banks and insurers. Like most other businesses, they want to market their products and services to the people most likely to (1) have the greatest need, (2) have the greatest ability to pay, and (3) provide for the highest profit margins.

We could refer to this practice as "going where the best customers are" or "going where the best prospects are." This strategy is so popular, and so successful, even the Internal Revenue Service (IRS) uses it. Like banks and insurers, the IRS concentrates its auditing efforts among the same group of people—mostly white, most male, and most definitely wealthy. Yet the IRS is never accused of redlining, sexism, or racism.

Why does the IRS skew its audit population like this? They draw their imaginary red lines for the same reasons as banks and insurers. In the words of Willie Sutton, "because that's where the money is."

Another term for redlining is *targeted marketing*. Not to redline, or not to use targeted marketing, is quite simply a waste of resources. An insurer, looking to hire actuaries, might meet with success by sending someone from its personnel department down to the unemployment office with a fistful of employment applications. But it would be much smarter to send the same person to a university to conduct interviews with math majors, or simply pick up the phone and call an actuarial recruiter.

The choice of the term "redlining" over "targeted marketing" also depends on whether it's considered illegal, unethical, or socially unacceptable for a business to choose a market niche. The target market for Lawrence Welk's music was definitely skewed on racial, ethnic, age, and geographic bases. This form of redlining is common practice for bars and restaurants, too. Some even discriminate openly on the basis of sex by offering different prices for beverages: The patrons with testicles have to pay higher prices. And many businesses charge different prices based on their customers' age: Senior citizens get the discounts.

Sometimes, there are racial elements in targeted marketing. A consumer goods company that chooses its celebrity spokesmen from the National Hockey League—almost exclusively white—appeals to a different audience than one that selects from the National Basketball Association—mostly black.

Most people wouldn't consider either example evidence of racism, yet marketers sometimes find themselves facing the same redlining charge as banks and insurers—but for opposite reasons.

Athletic shoe companies are denounced for designing products to appeal specifically to black youths; tobacco companies' marketing aimed at minorities is condemned as exploitation. Phillip Morris, with its "Marlboro Man" theme that's been running for more than three decades, has targeted (or redlined) white male cigarette smokers. Similarly, the Virginia Slims brand targets white females. Yet, Uptown, a brand of cigarettes from R.

J. Reynolds that targets black females, had to be withdrawn in the wake of public protest *(Newsweek*, February 5, 1990, p. 46).

Some companies don't just work at attracting the most desirable customers; they also make specific efforts to avoid the undesirable ones. Banks, via minimum deposits and service charges, try to scare away the lower-income depositors that cost them more than they're worth. Insurers apply surcharges, or even reject, undesirable risks. Software companies like Microsoft would rather not have customers who call for technical support before they've read their user's manual. And computer dating services, more realistic than romantic, don't cater to the abrasive, old, overweight, and ugly.

Types of Redlining

There are four broad categories of redlining: justified redlining, marketing redlining, business judgment redlining, and unjustified redlining.

It's "justified redlining" if neither party would benefit from entering into a contract. The Los Angeles Lakers and the Los Angeles Raiders practice justified, or inconsequential, redlining. Both ignore the sizable population of Asian-Americans in Southern California, and neither has a single Asian-American on its roster. The worst lawyer in the country could convict both teams on charges of racial or sexual discrimination.

Laws prohibiting the sale of alcohol and tobacco products to minors are two more examples of justified redlining. And everyone practices justified redlining on a personal scale when they avoid walking down dark alleys at night.

"Marketing redlining" refers to arbitrary decisions specific to product quality or the company's image. Before the 1980s, the Adolph Coors company refused to sell its beer east of the Mississippi River. Many companies that make brand-name fashions refuse to sell their product lines through discount retailers like Wal-Mart and K-Mart. In the early 1980s, when J.C. Penney tried to change its image and become a more "upscale" retailer, it faced a long and tough battle in its efforts to convince the fashion clothiers to allow Penney stores to carry their brand names (*Wall Street Journal*, February 1, 1994, p. A1).

In "business judgment redlining," a business determines that (1) a particular market is unprofitable or (2) that the risk of attempting the enter of a new market is unjustified, relative to expected rewards and likelihood of success. Some examples:

- Sears, which specifically avoided opening stores in poorer, less populated rural areas
- Ampex, which assumed that there was no mass consumer market for video recorders and confined itself to the industrial market
- Digital Equipment, which rejected the personal computer market and whose founder and CEO, Kenneth Olsen, as late as 1977, proclaimed that "there is no reason for any individual to have a computer in their home" (*Thriving on Chaos*, 1987, p. 244).

"Unjustified redlining" occurs when a business or government, via arbitrary preference or a legal mandate, creates privileged classes of buyers and sellers. Some classic examples of unjustified redlining:

- major league baseball's refusal to employ black players before 1947
- *beryozka* shops in the former Soviet Union, which catered to foreigners and upper-level officials of the Communist Party
- State governments that run lotteries, but won't let other gambling enterprises to enter the lottery business.

There are several forms of unjustified redlining in today's economy. Employees of companies are allowed greater tax advantages, with respect to health care expenses, than self-employed or seasonally employed individuals. Homeowners are allowed to deduct the interest portion of their mortgage, while renters receive no tax relief. And parents who send their children to private schools still have to subsidize the public school system.

Justified redlining is of no concern, since every business is, by definition, guilty of marketing redlining. If society legislates against business judgment redlining, then it is effectively stating that the act of making an incorrect business decision is a criminal offense. The question of concern here is whether financial institutions practice *un*justified redlining.

A foolproof indicator of unjustified redlining is the presence of a ***black market***, which crudely attempts to serve the demands of the redlined population. Examples of black markets are the now defunct negro baseball leagues, jitney cabs, illegal betting parlors, ticket scalpers, and the illegal drug trade. Conversely, the absence of a black market indicates marketing or business judgment redlining.

Case Study: Wal-Mart

Throughout most of this century, Sears & Roebuck, Montgomery Ward, and J.C. Penney practiced redlining. They all steered clear of rural areas for the same reasons that banks and insurers are said to avoid certain geographic areas. There were simply too few potential customers in these areas, it was thought, and the people who did live there didn't have enough money to make a marketing investment profitable—or so the conventional wisdom went.

Instead of pressing his elected officials to pass redlining legislation or fil-

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ing a lawsuit to force the nation's major retailers to serve these markets, Sam Walton decided to challenge the corporate giants' current wisdom and serve (or exploit) these markets himself. Walton drew the same red lines on his maps as Sears—but with the opposite intent.

Because it took over two decades for the rest of the industry to react to what he'd discovered, Wal-Mart eventually grew to become the largest retailer, and Sam Walton died with the title "World's Richest Man."

The Brooklyn Dodgers might have enjoyed the same sort of exponential success as Wal-Mart, had the rest of the major league baseball teams waited two decades (like the nation's major retailers) to react to their competitors. Willie Mays, Willie McCovey, and Juan Marichal would have spent their careers in Dodger uniforms (a horrifying thought for any Giants' fan), and the World Series would have been canceled due to lack of interest.

Wal-Mart's success in serving previously excluded markets was so great that towns targeted as future Wal-Mart sites began to lobby against its presence (we can call this *inverse redlining*). You'd see town meetings, citizen demonstrations, and new ordinances and zoning laws—all in a desperate attempt to keep Wal-Mart from entering a new market. Inverse redlining—or, "Not In My Back Yard" ("NIMBY")—also occurs with X-rated theaters, shopping malls, and off-track betting parlors.

The Wal-Mart case demonstrates another facet of the redlining issue. When there are numbers to count, people just can't help counting them—what William Edwards Deming referred to as "a denigration to counting." A business that chooses a competitive advantage that can be numerically measured and counted, as Wal-Mart has done with price, is subject to countervailing forces that use measurements comparing these numbers as "evidence" of its business practices. Other businesses that compete on service factors that don't lend themselves to countable numbers, such as Nordstrom, Federal Express, and Domino's Pizza, can expand whenever, and wherever, they want—unmolested by governments or community groups.

Wal-Mart is often accused of *predatory pricing*, because it competes on price, and prices are easily measured and compared. Nordstrom, Federal Express, and Domino's Pizza, however, compete on service, a benefit whose relative worth is unique to each customer. These companies practice what we might call *predatory serving*. They serve their customers so efficiently, effectively, and to such extraordinary extremes that no one else could ever hope to compete with them. A jury is more likely to be persuaded by evidence showing Wal-Mart's advertised prices for prescription drugs in relation to its competitors than by verbal testimony recounting the excessive attentiveness of a Nordstrom sales associate compared to a nonexistent or preoccupied salesclerk at Sears.

Applying Redlining to Insurance

Insurers, almost universally, advertise the quality of their service—but usually end up competing on price. And since price is more easily counted and measured, insurers are more often judged on price and other countable factors. But, in fact, insurance is an intangible service that's based on categories that don't directly lend themselves to direct numerical comparison.

For auto insurers, retaining profitability depends on discriminating against a young, single, male, with two speeding tickets, who lives in Cook County, Illinois, and drives a late-model sports car. To what extent and to what degree they should discriminate against him is a matter of highly subjective judgment; pricing actuaries are no more immune to error than retailing executives. But the fact that insurers that specialize in insuring high-risk drivers appear and disappear overnight, without notice, suggests that there is little, if any, opportunity for the insurance equivalent of Sam Walton to appear and reshape the industry.

The young, single, male described is in precisely the same position as a person who's been excluded by a bank's or insurer's red lines. Regardless of how safe a driver he is, and regardless of how small a risk he himself represents to his insurer, he cannot extricate himself from the classes the insurance industry has assigned him to. Even if he represents a profitable risk

to the insurer at half his assigned premium rate, he will never be charged his true risk premium.

This hapless male is hostage to the insurer's pricing scheme: Any insurer that classified him as a preferred risk, and significantly discounted his premium, would immediately and automatically attract a hoard of other young males with similar characteristics. And, by the law of large numbers, this insurer would eventually end up with a block of business consisting exclusively of the very same types of drivers already known to be poor risks, on average.

Insurers could price the risks represented by this young male more accurately by allowing their agents to offer arbitrary discounts to policyholders whom their agents know personally, and who, based on the agent's best judgment, shouldn't be charged the same rate as the others in the same class. But granting this kind of arbitrary pricing authority to agents would pave the way for pricing discrimination based on the whims of each agent—something that can't be numerically counted and compared, and something society would most likely not tolerate, because it would pave the way for arbitrary unjustified discrimination.

Within the discrimination/redlining construct, then, society is left with two options: (1) It can let insurers arbitrarily discriminate among policyholders within defined homogeneous classes to allow them to serve these customers, thereby risking other forms of unjustified discrimination. Or (2), it can legislate against these forms of unjustified discrimination and, as a result, shut these uninsurable risks out of the market or force them to pay excessive rates.

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For government to levy fines against banks and insurers for redlining is absurd. If government officials believe that redlined areas in fact represent profitable opportunities, then they're effectively fining financial institutions for not making as much money as they could. On the other hand, if they're persuaded that serving these areas wouldn't be profitable, and they simply want to subsidize them from the profits from banks and insurers, what they should do, to garner the money they want, is raise insurers' corporate tax rates.

If Sam Walton were alive, he might offer advice along these lines:

If you think a profitable market has been deliberately ignored by the financial services industry, don't commission a research study, don't write your congressman, and don't spread the word and organize a public demonstration. Keep your mouth shut, and focus all your efforts instead on raising enough capital to serve this market, and exploit a golden opportunity. □

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