PRINCIPLES OF RISK MANAGEMENT AND INSURANCE
REVISION: Answers for the review questions.
Try *your own understanding or discuss with a friend to do so.*

1. (a) Pure risks have two possible outcomes: a loss or no loss. Speculative risks have three possible outcomes: loss, no loss, and gain. Pure risks are readily insurable, while most speculative risks are not privately insurable.

(b) Diversifiable risk is risk that affects individuals or small groups, and not the entire economy. It is risk that can be reduced or eliminated through diversification. Nondiversifiable risk is risk that affects the entire economy or large numbers of persons or groups within the economy. It is risk that can't be eliminated or reduced through diversification.

2. By identifying hazards before losses occur, the risk manager may be able to reduce the likelihood that the hazard will lead to a loss. By preparing for losses caused by perils before they occur, risk managers are in a better position to respond when losses occur. Some physical hazards that may be important to the risk manager at your college or university include: hazardous substances in chemistry labs, crowded classrooms with limited building exits, ice on campus roads and sidewalks, unattended dormitory rooms, unattended vehicles in the parking lot, and unruly crowds at athletic events and concerts held on campus.

3. Attitudinal hazard increases the chance of loss because the individual is indifferent to loss because of insurance. Thus proper loss control activities may not be undertaken. Moral hazard is more severe. Here an individual commits dishonest acts in an effort to collect from the insurer. Attitudinal hazard does not involve an action; moral hazard involves committing dishonest acts.

4. Adverse selection is the tendency for persons who have a higher-than-average chance of loss to seek insurance at average rates, which if not controlled by underwriting, results in higher-than-expected losses. Insurance companies attempt to deal with the problem of adverse selection through careful underwriting and contractual provisions. Underwriting refers to the selection and classification of insureds. Underwriters determine if the policy should be written by the insurer, and if so, what premium should be charged and what restrictions should apply.

5. Just because the risk cannot be insured privately does not mean that the risk is uninsurable. Some risks that cannot be insured privately are covered by government insurers. For example, it is difficult for private insurers to write flood insurance and unemployment insurance. These coverages can be made available, however, through government involvement.

6. Although insurance is often confused with gambling, there are two major differences between insurance and gambling. First, gambling creates a new speculative risk that was not present before, while insurance is a method of dealing with a pure risk that is already present. Second, gambling is socially unproductive, since the winner's gain comes at the expense of the loser. Insurance is socially productive, since both the insurer and the insured have a common interest in loss prevention and both parties benefit if a loss does not occur.

7. There are many examples that could be cited. Some personal loss exposures include the risk of premature death, the risk of poor health (sickness and disability), the risk of unemployment, and the risk of economic insecurity during retirement. Some property risks are the damage, destruction or theft of property (e.g., a fire damaging the home, physical damage to an auto, theft of valuable property) and any consequential loss associated with the direct loss. Liability may arise from injuring someone, damaging someone's property, or personal injury, such as libel or slander. In addition to the risk of an adverse legal judgment, legal defense costs may be incurred defending the claim.

8-The underwriting cycle is an interesting phenomenon in property and liability insurance markets. Premium levels, underwriting stringency, and underwriting results exhibit a cyclical pattern over time. In a "hard insurance market," premiums are high and underwriting standards are tight. Business written during this time is usually profitable, helping the industry to build/restore surplus. When the industry is in a strong surplus position, a natural consequence is price competition and a "soft insurance market." In a soft market, insurers compete by lowering prices and loosening underwriting standards. This business is often unprofitable, and the insurer must draw upon the surplus to fund the losses. As surplus is eroded, rate hikes and a return to tighter underwriting standards are warranted. Surplus is restored, and the cycle repeats itself.

9- If events are independent, the occurrence of one event has no impact upon the occurrence of the second event. A fire at a production facility in Toledo has no impact upon whether a fleet vehicle will be damaged on a highway in Arizona. If events are dependent, then the occurrence of one event can affect the occurrence of the second event. For example, if two buildings are located close together, the probability of the second building having a fire loss is greater if there is a fire at the first building. If events are mutually exclusive, the occurrence of one event means that the second event cannot occur. For example, if you have a small tract of land, it may only be large enough for one business. Building a gas station on the property precludes building a retirement home on the land, and vice versa.

10- In the absence of insurable interest, there would be a severe moral hazard problem. Individuals could purchase life insurance on strangers or property insurance on property they did not own. Then they would have an incentive to bring about a loss in order to collect the insurance settlement. The insurable interest requirement prevents such losses.

11- Although Katia's offer sounds generous, insurance contracts are personal in nature. An insurance company will want to consider the insurability of the new homeowner. While underwriters consider the property that will be covered, they also consider the character of the property owner. The purchaser, for example, may have several arson convictions or may be close to declaring bankruptcy. The purchaser of Katia's home should secure his or her own homeowners insurance.

12- Named-perils coverage lists causes of loss that are covered under the policy. If the peril causing a loss is not named, the loss is not covered. All-risk coverage provides protection against all risks, except those that are specifically excluded. If the peril causing the loss is not excluded, the loss is covered.

13- Exclusions are used in insurance contracts for several reasons. Some risks (e.g., war) are not privately insurable. Some exposures are too hazardous to insure. Coverage may be provided elsewhere so it does not need to be provided under the contract. Exclusions are also needed to protect against losses attributable to moral hazard. Finally, some coverages may not be needed by a typical insured.

14- Insurers have an incentive to make contracts more readable and more easily understood. Ambiguity in an insurance contract is construed against the insurer. To provide clarity, insurers specifically define the meaning of key words and phrases.

15- The purpose of endorsements and riders is to add to, delete from, or in some other way modify an insurance contract. For example, a renter can change the personal property coverage in his or her policy from actual cash value coverage to replacement cost coverage by adding a replacement cost endorsement to the renter's insurance policy.

16- Several situations give rise to the transfer of liability from one person to another person. One example is the employer-employee relationship. When acting on behalf of the employer, the negligent acts of the employee may be imputed to the employer. Another situation in which liability can be imputed from one person to another involves use of an automobile by someone other than the owner. Through vicarious liability laws and the family purpose doctrine, liability for negligent acts may be imputed to the owner of the auto. In a joint business venture, one partner may be responsible for another partner's acts. Finally, under dramshop laws a business that sells alcoholic beverages may be responsible if an impaired customer injures someone.

17- The reasons for lawsuits against physicians, in addition to medical errors, include: the intimate relationship between patients and physicians that existed in the past has been lost, people are more litigious than in the past, physicians are now more willing to testify against other physicians in malpractice actions, the media have made more people aware of the vulnerability of physicians to malpractice claims, attorneys may file malpractice actions because of high fees they collect if they are successful, and growing resentment against large for-profit health care firms and managed care plans.

18- Janet named all three parties because each party may bear some responsibility. Also, she wants to make sure all of the damages are paid and/or that she collects the largest award possible. If her state permits joint and several liability, any plaintiff that is responsible may have to pay a disproportionate share of the damages. The driver of the vehicle that hit Janet and her child was directly involved in the accident. As an individual, however, the driver might not have enough financial resources to pay the damages. The local restaurant franchise might be responsible from a safety and design perspective. The exit from the drive- through window may not be easily visible to patrons leaving the restaurant. Perhaps a speed bump in this lane would force drivers to reduce their speed. The franchise owner may be in a better financial position to pay for the damages than the driver of the car. Naming the national restaurant chain as a defendant brings the "deepest pockets" of all to the claim. If local franchises are required to use a specific building design, the national chain may bear some responsibility for the accident.

Janet and her child may be awarded special damages for losses that can be determined and documented; general damages for pain, suffering, and mental anguish; and punitive damages to punish the tortfeasor and deter similar negligent acts.

19- The three types of coverage provided through a homeowners policy are: property coverage (dwelling, other structures, personal property, and loss of use), personal liability insurance, and medical payments to others.

20- The base rate for auto liability insurance is determined largely by the territory where the auto is principally used and garaged. An urban driver normally pays a higher rate than a rural driver pays because of the higher number of automobile accidents in congested urban areas. Use of the vehicle is another important rating factor. Insurers classify autos based on how the car is used (e.g. for pleasure, to and from work, business use, and farm use). Age of the driver is another rating factor. Young drivers are involved in a disproportionately high number of accidents, therefore they must pay more for their coverage.

21- There are a number of approaches available for compensating automobile accident victims. These approaches include: financial responsibility laws, compulsory insurance laws, unsatisfied judgment funds, uninsured motorists coverage, low cost auto insurance, “no pay, no play” laws, and no-fault automobile insurance.

22- Inland marine floaters have a number of common characteristics. They are: the ability to tailor coverage to meet specific types of personal property, the desired amount of coverage can be selected, broader and more comprehensive coverage can be obtained, world-wide coverage is provided, and inland marine policies usually do not impose a deductible.

23- The major classes of ocean marine insurance include: hull insurance, cargo insurance, protection and indemnity (P&I) insurance, and freight insurance. The major classes of inland marine insurance include: domestic goods in transit, property held by bailees, mobile equipment and property, property of certain dealers, and means of transportation and communication coverage.

24- The major general liability loss exposures that businesses face include: premises and operations, products liability, completed operations, contractual liability, and contingent liability. Some other general liability loss exposures include: pollution, fire legal liability, liquor liability, directors and officers liability, personal injury liability, damage to property in the insured’s care/custody/control, and employment-related practices liability.

25- Products liability refers to the legal liability of manufacturers, wholesalers, and retailers to persons who are injured by defective products or property damage from defective products. Completed operations refers to liability arising out of faulty work performed away from the premises after the work or operations are completed.

26- Errors and omissions insurance provides protection against losses incurred as a result of some negligent act, error, or omission by the insured. A wide range of professionals need the protection provided by errors and omissions insurance. Some examples include lawyers, accountants, employee benefit managers, insurance agents and brokers, and architects.

27- There are two parties to an insurance contract, three parties to a surety bond. Insurers expect losses to occur and charge premiums reflecting expected losses. Sureties expect no losses to occur, theoretically, and charge a premium that can be viewed as a service fee to substitute the surety’s credit for that of the principal. The insurer does not have the right to recover loss payments from the insured, while a surety has a legal right to recover payments from a defaulting principal. Finally, insurance covers unintentional losses that are outside of the insured’s control. Surety bonds guarantee the principal’s character, honesty, integrity, and ability to perform. All of these qualities are within the principal’s control.

28- The major types of surety bonds include: contract bonds, license and permit bonds, public official bonds, and judicial bonds. There are some other miscellaneous types of surety bonds, as well.

29- A number of costs are associated with premature death. These costs include: loss of the family's share of the breadwinner's future earnings, costs associated with death itself (unpaid hospital bills, funeral expenses, probate and estate costs, and taxes), possible reduction in the standard of living, and noneconomic costs such as emotional distress and loss of a parental role model.

30- The purchase of life insurance can be justified economically based on financial dependency. If an individual is earning an income, and others are dependent upon the income for their well-being, life insurance can be used to replace the income.

31- A single adult with no children likely has no one financially dependent upon him or her. If no one is financially dependent, death of the single person will not create financial hardship for others. Other than a small amount of life insurance to cover costs associated with death (funeral, estate clearance, uninsured medical bills, etc.), large amounts of life insurance usually are not needed by single adults with no dependents. Premature death of the family head in a single-parent family can cause severe economic insecurity for the surviving children. There is a need for large amounts of life insurance on the family head in most single-parent families.

32- Life insurers treat lies about age as "misstatements" rather than "misrepresentations." If someone misstates his or her age, the insurer will simply adjust the life insurance proceeds to the amount of coverage that the premiums paid would have purchased had the correct age been provided.

33- Simply knowing the rating without knowing who assigned the rating or the rating scale provides an incomplete picture. In addition, each of the rating services considers different aspects of an insurer's financial condition when assigning a rating. You should purchase a policy from an insurer that has received high ratings from several ratings services.

34- If a private retirement plan meets certain standards, favorable income tax treatment is afforded the plan. These tax benefits include: the employer's contributions are tax deductible up to specified limits as an ordinary cost of doing business, the employer's contributions are not considered currently taxable income to the employee, the investment income accumulates on a tax-deferred basis, and benefits attributable to employer contributions are not taxed until the employee retires or receives the funds.

35- The basic characteristics of social insurance programs include:

- ✓ Compulsory programs
- ✓ Benefits intended to provide a floor of income
- ✓ Emphasis on social adequacy rather than individual equity
- ✓ Benefits loosely related to earnings
- ✓ Benefit prescribed by law
- ✓ No means (needs) test
- ✓ Full funding unnecessary
- ✓ Financially self-supporting

36- An insurance agent is someone who legally represents an insurer and has the authority to act on the insurer's behalf. Brokers legally represent insurance buyers who are seeking coverage. Brokers don't have authority to bind an insurer. Both agents and brokers are compensated through commissions.

37- The primary methods of marketing life insurance coverage include: the agency building system (which includes the general agency system and managerial system), the nonbuilding agency system, and the direct response system.

38- Underwriters are charged with selecting and classifying the applicants for insurance. Just because an agent forwards an application to a home office or a regional office does not mean that the coverage will be written. The underwriter may reject the applicant. If the applicant is acceptable, the underwriter must assign the applicant to the appropriate rating category. The classification of acceptable risks is designed to assure equity in the rating classes. Thus, riskier applicants must pay more for their coverage than insureds who are less risky.

39- Underwriters obtain information from a variety of sources, including: the application, the agent's report, an inspection report, physical inspection, physical exams and physician's report, and the medical information bureau.

40- Production refers to the sales and marketing activities of insurers. Agents who sell coverage are known as "producers." In addition to agents who are visible in the field, there is a production department at the insurer's home or regional office.

41- The assets of an insurance company are primarily financial assets. The assets for other types of businesses often consist of plant, equipment, and inventory. Insurance companies use premiums and retained earnings to invest in financial assets. Insurers use these invested assets to generate investment income. Property and liability insurers are required to maintain two principal types of reserves: the unearned premium reserve and the loss reserve. The unearned premium reserve is a liability reserve that represents the unearned portion of gross premiums on all outstanding policies at the time of valuation. The fundamental purpose of the unearned premium reserve is to pay for losses that occur during the policy period. The loss reserve is another important liability reserve for property and liability insurers. A loss reserve is the estimated cost of settling claims that have occurred but that have not been paid as of the valuation date.

42- The two major sources of income for an insurance company are premiums paid by policyowners and income generated from investments. Property and casualty insurance companies will sometimes lose money on their underwriting activities, but offset the loss with investment income, and still post a profit for the accounting period.

43- Regulation of the insurance industry is necessary to maintain insurer solvency, to protect consumers who have inadequate knowledge of insurers and insurer practices, to ensure reasonable rates, and to make insurance available.

44- Insurers are primarily regulated through legislation, court decisions, and through state insurance departments.

45-a. The difference between an insurer's assets and liabilities is known as the policyowners' surplus.