Keir Digest

with

Assessment Questions for

HS 311

2015

For use with text
Fundamentals of Insurance Planning, 6th Edition

TABLE OF CONTENTS

TABLE OF CONTENTS, CONTINUED

Chapter 1

Basic Concepts of Risk and Insurance

Learning Objectives

1-1.   Key definitions in this Chapter with which you should become familiar are as follows:

- Risk is the possibility of loss.

- Loss exposures are potential losses, or losses that might occur.

- A direct loss is the initial loss following the occurrence of a peril.

- An indirect (consequential) loss follows from or is a by-product of a direct loss, such as extra expenses to live in a hotel, following a fire at one's home.

- Uncertainty is a state of mind whereby one is not sure of something. Note that there is no necessary relationship between risk and uncertainty. Risk may be present or absent, large or small: at the same time, uncertainty may be absent or present, small or large.

- A peril is a cause of loss, such as a fire, a sickness, or a flood.

- A hazard is an act or condition that increases the chance that a loss will occur or increases the severity of the loss if it does come to pass.

- Physical hazards are physical conditions, such as ice on a road, that increase the likelihood or size of a loss.

- Moral hazards are dishonest tendencies, such as pyromania, that increase the likelihood or size of a loss.

- Attitudinal, or morale, hazards are careless or indifferent tendencies, such as laziness, that increase the likelihood or size of a loss.

1-2.   Risk can be measured through either deductive or inductive processes. Deductive (*a priori*) reasoning is a type of logic that attempts to measure risk by physically examining all the possible outcomes of an experiment to see how many of them represent a loss. For example, the risk of drawing a spade on a single draw from a deck of cards can be measured deductively as 1 in 4. Inductive reasoning is a type of logic that attempts to measure risk based on statistical analysis of past results. Accuracy in measuring risk inductively requires both mass and homogeneity in the statistical group being studied so that the law of large numbers will operate.

- The law of large numbers is a mathematical principle which holds that as the size of the sample in an experiment is increased, the actual results will increasingly reflect the true underlying probability.

- Mass means a large enough volume of data so that the true underlying probability will emerge in the results.

- Homogeneity means comparability, or similarity, of characteristics.

Risks can be classified in several ways. One way is to distinguish between financial and nonfinancial risks. Financial risks are risks that involve monetary losses, such as damage to property or loss of income. Nonfinancial risks are risks that involve losses other than monetary losses, such as loss of memory or loss of mobility.

Another way is to distinguish between particular risks and fundamental risks. Particular risks are risks that affect only one or a few people per occurrence, such as the risk of an auto accident. Fundamental risks are risks that affect large segments of society in a single occurrence, such as lost purchasing power due to inflation.

A third classification of risks distinguishes between static risks and dynamic risks. Static risks are risks that are present even if there are no changes in society or the economy. An example is the risk of a major earthquake. Dynamic risks are risks that arise out of changes in society or in the economy, such as lost business profits due to a change in consumer tastes.

Another classification system is to differentiate between pure risks and speculative risks. Pure risks are those that involve only two possible outcomes: loss or no loss. An example is the possibility of loss due to tornado winds. Either the loss will happen, or it will not happen. In contrast, speculative risks involve three possible outcomes: loss, break even, or gain. An example is stock market speculation, where the stock's value may rise, remain the same, or fall.

Another way of classifying risks is to distinguish among personal risks, property risks, and liability risks. Personal risks are risks to a person involving death, sickness or accident, old age, or unemployment. Property risks are risks of direct or indirect loss from damage to or destruction or loss of property. Liability ("third-party") risks are risks that one may be held legally responsible to another because of injury or damage to that person.

Lastly, we could classify risks as insurable risks versus uninsurable risks.

Chapter 1

Basic Concepts of Risk and Insurance

1. Lightning is most accurately characterized as a (an):

   (LS 1.2-1.5)

   (A) Risk
   (B) Peril
   (C) Uncertainty
   (D) Hazard

2. A loss exposure is a loss that:

   (LS 1.4)

   (A) Has already occurred
   (B) Rarely occurs
   (C) Might occur
   (D) Is certain to occur

3. Which of the following statements concerning uncertainty is (are) correct?

   (LS 1.4-1.5)

   I   Uncertainty always results from the presence of risk.
   II Uncertainty differs from person to person in the same set of circumstances.

   (A) I only   (C) Both I and II
   (B) II only   (D) Neither I nor II

4. Which of the following actions suggest(s) the presence of attitudinal (morale) hazard?

   (LS 1.7)

   I   Jack has high blood pressure.
   II Jill usually drives at an excessive rate of speed.
   III Joe is a heavy gambler.

   (A) I only   (C) III only
   (B) II only   (D) II and III only

5. We know that the probability of drawing the king of hearts from a deck of playing cards is one chance in 52. The way we reach this knowledge is by:

   (LS 1.7-1.8)

   (A) Statistical analysis
   (B) Inductive reasoning
   (C) Drawing one card from the deck 52 times, replacing it after each draw
   (D) Deductive, or *a priori*, reasoning

6. Effective operation of the law of large numbers requires which of the following?

   (LS 1.8-1.9)

   I   A large volume of homogeneous statistical data
   II A large group of insureds with widely different risk characteristics

   (A) I only   (C) Both I and II
   (B) II only   (D) Neither I nor II

7. The principal difference between a pure risk and a speculative risk is that a pure risk:

   (LS 1.12-1.13)

   (A) Is particular
   (B) Is static
   (C) Has fewer possible types of outcomes
   (D) Is not insurable

8. All the following are personal risks, EXCEPT:

   (LS 1.13-1.14)

   (A) The risk of disability
   (B) The risk of unemployment
   (C) The risk of being held legally responsible for injury to another

(D)   The risk of old age

Chapter 1

Basic Concepts of Risk and Insurance

1.   B is the answer, by definition of the term "peril" (cause of loss). Risk is the possibility, not the cause, of loss, so A is incorrect. C is incorrect because uncertainty is a state of mind. D is incorrect because a hazard increases the possibility or severity of a loss. For example, standing under a tree with a metal golf club is a hazard associated with the peril of lightning.

2.   C is the answer, by definition.

3.   B is the answer. I is incorrect because one may be oblivious to the existence of risk, in which case, no uncertainty is present.

4.   B is the answer. Statement I suggests the presence of a physical hazard, while III suggests the presence of a moral hazard.

5.   D is the answer. A, B, and C are essentially the same approach to measuring risk. D involves physical examination of the deck of cards to deduce the probability of drawing the king of hearts.

6.   A is the answer. Not only must there be mass and homogeneity in the statistical group, there must also be mass and homogeneity in the insured group. Therefore, II is incorrect.

7.   C is the answer. A pure risk has two possible types of outcomes: loss or no loss. A speculative risk has three possible types of outcomes: gain, loss, or no loss.

8.   C is the answer. This is a liability risk.