Principles of Risk Management and Insurance 14th edition Rejda Test Bank

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Principles of Risk Management and Insurance, 14e **(Rejda)**
Chapter 2 Insurance and Risk

1) Which of the following is a basic characteristic of insurance?
A) pooling of losses
B) avoidance of risk
C) payment of intentional losses
D) certainty about specific losses that will occur
Answer: A
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

2) Which of the following is implied by the pooling of losses?
A) sharing of losses by an entire group
B) inability to predict losses with any degree of accuracy
C) substitution of actual loss for average loss
D) increase of objective risk
Answer: A
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

3) According to the law of large numbers, what happens as the number of exposure units increases?
A) Actual results will increasingly differ from probable results.
B) Actual results will more closely approach probable results.
C) Nondiversifiable risk will decrease.
D) Objective risk will increase.
Answer: B
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

4) According to the law of large numbers, what should happen as an insurer increases the number of units insured?
A) The amount the insurer expects to pay in claims should decrease.
B) Underwriting expenses should decrease.
C) Actual results will more closely approach expected results.
D) The insurer's profitability should become more variable.
Answer: C
Diff: 1
Question Status: Previous Edition
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5) Characteristics of a fortuitous loss include which of the following?
I. The loss is certain to occur.
II. The loss occurs as a result of chance.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: B
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

6) From the viewpoint of the insurer, all of the following are characteristics of an ideally insurable risk EXCEPT
A) The loss must be accidental.
B) The loss should be catastrophic.
C) The premium must be economically feasible.
D) There must be a large number of exposure units.
Answer: B
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

7) From the standpoint of the insurer, which of the following is a characteristic of an ideally insurable risk?
A) The loss must be intentional.
B) There must be a small number of unique loss exposures.
C) The chance of loss must be calculable.
D) The loss must be indeterminable.
Answer: C
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

8) Why is a large number of exposure units generally required before a pure risk is insurable?
A) It prevents the insurer from losing money.
B) It eliminates intentional losses.
C) It minimizes moral hazard.
D) It enables the insurer to predict losses more accurately.
Answer: D
Diff: 1
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9) The requirement that losses should be accidental and unintentional in order to be insurable results in which of the following?
I. Decrease in moral hazard
II. More accurate prediction of future losses
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: C
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

10) Which of the following is implied by the requirement that a loss should be determinable and measurable to be insurable?
I. The loss must be definite as to place.
II. The loss must be definite as to amount.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: C
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

11) Methods by which insurers may minimize or avoid catastrophic losses include which of the following?
I. The use of reinsurance
II. Concentrating coverage written in one geographic region
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: A
Diff: 1
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12) Which of the following types of risks best meets the requirements for being insurable by private insurers?
A) most market risks
B) property risks
C) financial risks
D) political risks
Answer: B
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

13) Reasons why market, financial, and production risks are often uninsurable include which of the following?
I. The potential to produce a catastrophic loss is great.
II. The chance of loss cannot be accurately estimated.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: C
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

14) Which of the following types of risks is normally uninsurable by private insurers?
A) personal risks
B) property risks
C) liability risks
D) political risks
Answer: D
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

15) Which of the following is a result of adverse selection?
A) The insurer's financial results will be substantially improved.
B) Persons most likely to have losses are also most likely to seek insurance at standard rates.
C) It is unnecessary for the insurance company to use underwriting.
D) Insurance can be written only by the federal government.
Answer: B
Diff: 1
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16) The tendency for unhealthy people to seek life or health insurance at standard rates is an example of
A) moral hazard.
B) fundamental risk.
C) attitudinal hazard.
D) adverse selection.
Answer: D
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

17) Which of the following statements regarding insurance and gambling is (are) true?
I. Insurance is used to handle existing pure risks, while gambling creates a new speculative risk.
II. Insurance usually involves risk avoidance, while gambling typically involves only risk reduction.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: A
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

18) In addition to marketing life insurance, life insurers typically sell which of the following products?
I. Retirement annuities
II. Disability income insurance
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: C
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

19) Inland marine insurance provides coverage for
A) goods being shipped on land.
B) premature death of members of the armed forces.
C) goods being shipped on ocean-going vessels.
D) liability exposures of nonprofit organizations.
Answer: A
Diff: 1
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20) Which of the following is classified as casualty insurance?
A) workers compensation insurance
B) fire insurance
C) marine insurance
D) life insurance
Answer: A
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

21) Which of the following is a form of casualty insurance?
A) fire insurance
B) general liability insurance
C) inland marine insurance
D) ocean marine insurance
Answer: B
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

22) Which of the following statements regarding private insurance and government insurance is (are) true?
I. Private insurance programs include life and health insurance and property and liability insurance.
II. Social insurance programs are government insurance programs that are voluntary and financed entirely by contributions from covered employers
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: A
Diff: 1
Question Status: New
AACSB: Application of Knowledge

23) All of the following are benefits to society that result from insurance EXCEPT
A) less worry and fear.
B) elimination of moral hazard.
C) indemnification for loss.
D) loss prevention.
Answer: B
Diff: 1
Question Status: Previous Edition
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24) Which of the following statements about the insurance industry as a source of investment funds is (are) true?
I. These funds result in a lower cost of capital than would exist in the absence of insurance.
II. These funds tend to promote economic growth and full employment.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: C
Diff: 1
Question Status: New
AACSB: Application of Knowledge

25) All of the following are social costs associated with insurance EXCEPT
A) insurance company operating expenses.
B) fraudulent claims.
C) inflated claims.
D) increased cost of capital.
Answer: D
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

26) A group of farmers agreed that if any farmer suffered a property loss, the loss would be spread over the entire group. In this way, each farmer is responsible for the average loss of the group rather than the actual loss that each farmer sustained. Which characteristic of insurance is embodied in this agreement?
A) pooling of losses
B) fortuitous losses
C) risk avoidance
D) indemnification
Answer: A
Diff: 2
Question Status: Previous Edition
AACSB: Reflective Thinking

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27) XYZ Insurance Company writes coverage for most perils which can damage property. XYZ, however, does not write flood insurance on property located in flood plains. Which requirement of an ideally insurable risk might be violated if XYZ wrote flood insurance on property located in flood plains?
A) There must be a large number of similar exposure units.
B) The loss should not be catastrophic.
C) The chance of loss must be calculable.
D) The losses must be determinable and measurable.
Answer: B
Diff: 2
Question Status: Previous Edition
AACSB: Reflective Thinking

28) ABC Appliance offers a warranty requiring an annual fee. The warranty may be purchased at the time of sale or at any time within the first year after the appliance was purchased. The warranty fee after the date of purchase is twice the time-of-purchase fee. When asked why the fee was higher after the date of purchase, ABC's president said, "Buying a warranty is voluntary. We've noted that those who buy the warranty after the purchase date have a greater need for service." Charging the same rate or a lower rate after the date of purchase would expose ABC to what problem that also impacts private insurers?
A) excessive premiums
B) reduced claims
C) bad investments
D) adverse selection
Answer: D
Diff: 2
Question Status: Previous Edition
AACSB: Reflective Thinking

29) Insurance companies collect premiums in advance. Since the premiums collected are not needed to pay losses and expenses immediately, the funds can be loaned to business firms. Because of this fact, insurance benefits society by
A) enhancing credit.
B) providing a source of investment funds.
C) indemnifying losses.
D) providing an incentive for loss prevention.
Answer: B
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

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30) LMN Insurance sells homeowners insurance. The LMN homeowners policy combines property and casualty insurance in the same contract. Insurance policies combining property and casualty coverage in the same contract are called
A) mono-line policies.
B) multi-year policies.
C) multiple-line policies.
D) manuscript policies.
Answer: C
Diff: 2
Question Status: Previous Edition
AACSB: Reflective Thinking

31) One branch of government insurance programs has a number of distinguishing characteristics. These programs are compulsory, they are financed by mandatory contributions rather than general tax revenues, and benefits are weighted in favor of low-income groups. These government insurance programs are called
A) welfare programs.
B) social insurance programs.
C) casualty insurance programs.
D) private insurance programs.
Answer: B
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

32) Gina would like to buy a house. She will pay 10 percent of the cost of the house as a down payment and borrow the other 90 percent from a mortgage lender. The home will serve as collateral for the loan. The lender will not make the loan to Gina unless the home is insured. Using insurance to secure the collateral for a loan illustrates which of the following benefits of insurance to society?
A) enhancement of credit
B) reduction of fear and worry
C) source of investment funds
D) incentives for loss prevention
Answer: A
Diff: 2
Question Status: Previous Edition
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33) ABC Insurance Company calculated the amount that it expected to pay in claims for each policy sold. Rather than selling the insurance for the amount it expected to pay in claims, ABC added an allowance to cover the cost of doing business, including commissions, taxes, and acquisition expenses. This allowance is called a(n)
A) policyowner dividend.
B) premium.
C) expense loading.
D) rate credit.
Answer: C
Diff: 2
Question Status: Previous Edition
AACSB: Reflective Thinking

34) JKL Insurance Company estimates that 14 out of every 100 homeowners it insures will file a claim each year. Last year, JKL insured 200 homeowners. According to the law of large numbers, what should happen if JKL insures 2,000 homeowners this year?
A) The total number of claims filed by JKL policyowners should decrease.
B) The total dollar value of claims will decrease.
C) The average size of loss will decline in value.
D) The actual results will more closely approach the expected results.
Answer: D
Diff: 2
Question Status: Previous Edition
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35) Apex Insurance Company wrote a large number of property insurance policies in an area where earthquake losses could occur. When the president of Apex was asked if she feared that a severe earthquake might put the company out of business, she responded, "Not a chance. We transferred most of that risk to other insurance companies." An arrangement by which an insurer that initially writes insurance transfers to another insurer part or all of the potential losses associated with such insurance is called
A) hedging.
B) speculating.
C) reinsurance.
D) loss avoidance.
Answer: C
Diff: 2
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36) According to the law of large numbers, what should happen as an insurance company increases the number of loss exposures that it insures?
A) Fewer losses should be expected to occur.
B) The amount of premiums needed to cover losses should decrease.
C) The volatility of the insurance company's underwriting results should increase.
D) The difference between actual and expected results should decrease.
Answer: D
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

37) Which of the following statements regarding insurance and hedging is (are) true?
I. Insurance involves the transfer of an insurable risk while hedging handles risk that is typically uninsurable.
II. Insurance transactions can reduce objective risk, while hedging typically involves only risk transfer and not risk reduction.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: C
Diff: 2
Question Status: Previous Edition
AACSB: Application of Knowledge

38) Ashley opened an all-you-can-eat buffet restaurant. The price per-person was based on what Ashley believed an average restaurant patron would consume. The restaurant began to lose money. Ashley concluded that her patrons had "above average" appetites, and were attracted to her restaurant because they could eat as much as they wanted while being charged an average price. A similar phenomenon exists in insurance markets. This problem is called
A) legal hazard.
B) adverse selection.
C) attitudinal hazard.
D) nondiversifiable risk.
Answer: B
Diff: 2
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39) Which of the following statements concerning social insurance benefits is (are) correct?
I. Social insurance benefits are heavily weighted in favor of upper-income groups because of their higher earnings.
II. Social insurance benefits are financed entirely or in part by mandatory contributions by covered employers and employees, and not by general revenues of the government.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: B
Diff: 1
Question Status: New
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40) Adverse selection occurs
A) when an insurance company loses money on its investments.
B) when insurance purchasers buy insurance but do not have a loss.
C) when catastrophic losses occur as a result of a natural disaster.
D) when applicants with a higher-than-average chance of loss seek insurance at standard rates.
Answer: D
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

41) Which of the following statements regarding insurance and hedging is true?
A) Both insurance and hedging deal only with pure risks.
B) Insurance reduces objective risk while hedging involves only risk transfer and not risk reduction.
C) Hedging reduces objective risk while insurance involves only risk reduction and not risk transfer.
D) Both insurance and hedging reduce objective risk but do not involve the transfer of risk.
Answer: B
Diff: 2
Question Status: Previous Edition
AACSB: Application of Knowledge

42) Which of the following is an example of private insurance?
A) unemployment insurance
B) Social Security
C) life insurance
D) federal deposit insurance
Answer: C
Diff: 1
Question Status: Previous Edition
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43) If insurers were to provide indemnification for losses that were deliberately caused, which characteristic of ideally insurable risks would not be met?
A) The loss must be accidental and unintentional.
B) The loss must be determinable and measurable.
C) The loss should not be catastrophic.
D) There must be a large number of similar exposure units.
Answer: A
Diff: 1
Question Status: Previous Edition
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44) An insurance company that sells earthquake insurance in an area where earthquakes are possible has subjected itself to the risk of insolvency if a severe earthquake occurs. An insurer can safely sell earthquake insurance in this area if it shifts the risk of catastrophic loss to another insurer. The shifting of insured risk from one insurer to another insurer is called
A) underwriting.
B) casualty insurance.
C) coinsurance.
D) reinsurance.
Answer: D
Diff: 1
Question Status: Previous Edition
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45) The premium that insurance companies charge does not cover the cost of expected losses only. The premium must also cover the cost of compensating agents and other costs of doing business. The amount added to the pure premium to cover these costs is called the
A) expense loading.
B) deductible.
C) dividend.
D) loss reserve.
Answer: A
Diff: 1
Question Status: Previous Edition
AACSB: Application of Knowledge

46) A discount store chain is concerned that cashiers might steal money from cash registers. To provide protection against theft by the cashiers, the discount store chain can purchase a
A) fidelity bond.
B) liability insurance policy.
C) surety bond.
D) business income insurance policy.
Answer: A
Diff: 1
Question Status: Previous Edition
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47) BBB Auto Club provides emergency road service and other services to its members. BBB Auto Club charges a higher membership fee to new members than it charges to members who are renewing their membership. When asked to explain this pricing policy, the auto club president noted, "New members often sign-up prior to taking a long road trip, so we have to charge more as first-year members have higher service utilization rates." A similar phenomenon observed in insurance markets is called
A) attitudinal hazard.
B) adverse selection.
C) risk aversion.
D) moral hazard.
Answer: B
Diff: 2
Question Status: New
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