Principles of Risk Management and Insurance, 12e **(Rejda/McNamara)**
Chapter 3 Introduction to Risk Management

1) Risk management is concerned with
A) the identification and treatment of loss exposures.
B) the management of speculative risks only.
C) the management of pure risks that are uninsurable.
D) the purchase of insurance only.
Answer: A
Question Status: Previous Edition

2) A situation or circumstance in which a loss is possible, regardless of whether a loss occurs, is called a
A) deductible.
B) loss exposure.
C) loss avoidance.
D) peril.
Answer: B
Question Status: Previous Edition

3) Which of the following is a post-loss risk management objective?
A) treating loss exposures in the most economical way
B) continuing operations
C) reduction of anxiety
D) meeting externally imposed legal obligations
Answer: B
Question Status: Previous Edition

4) Preloss objectives of risk management include which of the following?
I. Preparing for potential losses in the most economical way
II. Reduction of anxiety
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: C
Question Status: Previous Edition

5) A risk manager is concerned with which of the following?
I. Identifying potential losses
II. Selecting the appropriate techniques for treating loss exposures
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: C
Question Status: Previous Edition

6) Which of the following is a source of information a risk manager could use to help identify pure loss exposures?
A) commodity prices
B) physical inspections
C) currency exchange rates
D) interest rate movements
Answer: B
Question Status: Previous Edition

7) Loss severity is defined as the
A) probable size of the losses which may occur during some period.
B) probable number of losses which may occur during some period.
C) probability that any particular piece of property may be totally destroyed.
D) probability that a liability judgment may exceed a firm's net worth.
Answer: A
Question Status: Previous Edition

8) Loss frequency is defined as the
A) probable size of the losses that may occur during some period.
B) probable number of losses that may occur during some period.
C) probability that any particular piece of property may be totally destroyed.
D) probability that a liability judgment may exceed a firm's net worth.
Answer: B
Question Status: Previous Edition

9) The worst loss that could ever happen to a firm is referred to as the
A) maximum possible loss.
B) probable maximum loss.
C) frequency of loss.
D) severity of loss.
Answer: A
Question Status: Previous Edition

10) The worst loss that is likely to happen is referred to as the
A) maximum possible loss.
B) probable maximum loss.
C) frequency of loss.
D) severity of loss.
Answer: B
Question Status: Previous Edition

11) All of the following statements about avoidance are true EXCEPT
A) Certain loss exposures are never acquired.
B) Certain loss exposures may be abandoned.
C) The chance of loss for certain loss exposures may be reduced to zero.
D) It can be used for any loss exposure facing a firm.
Answer: D
Question Status: Previous Edition

12) Abandoning an existing loss exposure is an example of
A) avoidance.
B) retention.
C) noninsurance transfer.
D) insurance transfer.
Answer: A
Question Status: Previous Edition

13) Which of the following conditions is (are) appropriate for using retention?
I. Losses are difficult to predict.
II. The worst possible loss is not serious.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: B
Question Status: Previous Edition

14) Which of the following statements regarding the use of retention is (are) true?
I. Retention is best used for loss exposures that have a low frequency and a high severity.
II. A financially strong firm can have a higher retention level than a firm whose financial position is weak.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: B
Question Status: Previous Edition

15) Which of the following statements about the use of a captive insurance company by a parent firm is true?
A) The captive may not write outside, non-parent company, business.
B) Captives are not permitted to use reinsurance, so any business insured by the captive stays with the captive.
C) The captive may be used to insure loss exposures that the parent firm finds it difficult to insure with private insurers.
D) Business placed with the captive is always considered retained risk and is never considered transferred risk.
Answer: C
Question Status: Previous Edition

16) Which of the following statements about self-insurance is (are) true?
I. It is a form of planned retention.
II. State law usually prohibits its use for workers compensation.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: A
Question Status: Previous Edition

17) All of the following are potential advantages of retention EXCEPT
A) lower expenses.
B) increased cash flow.
C) encouragement of loss prevention.
D) protection from catastrophic losses.
Answer: D
Question Status: Previous Edition

18) A restaurant owner leased a meeting room at the restaurant to a second party. The lease specified that the second party, not the restaurant owner, would be responsible for any liability arising out of the use of the meeting room, and that the restaurant owner would be "held harmless" for any damages. The restaurant owner's use of the hold-harmless agreement in the lease is an example of
A) retention.
B) self-insurance.
C) insurance.
D) noninsurance transfer.
Answer: D
Question Status: Previous Edition

19) All of the following are disadvantages of noninsurance transfers EXCEPT
A) The party to whom the potential loss is transferred may be unable to pay.
B) The transfer may fail because the contract language is ambiguous.
C) The only potential losses that can be transferred are those that are not commercially insurable.
D) The noninsurance transfer may be costly.
Answer: C
Question Status: Previous Edition

20) ABC Insurance retains the first $1 million of each property damage loss and purchases reinsurance for that part of any property loss that exceeds $1 million. The insurance for property losses above $1 million is called
A) excess insurance.
B) liability insurance.
C) coinsurance.
D) primary insurance.
Answer: A
Question Status: Previous Edition

21) Which of the following statements about the use of deductibles is (are) true?
I. They represent risk retention by insurance purchasers.
II. They tend to increase the cost of adjusting small claims.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: A
Question Status: Previous Edition

22) Which of the following statements about an excess insurance plan is true?
A) The insurer does not participate in a loss until the loss exceeds the amount the firm has decided to retain.
B) The insurer pays first up to some specified level; the insured then pays all losses exceeding the insurer's retention level.
C) Losses in excess of a specified amount are not covered.
D) The insured and insurer share equally in any loss that occurs.
Answer: A
Question Status: Previous Edition

23) Factors a risk manager must consider in selecting an insurer include which of the following?
I. The availability of risk management services
II. The financial strength of the insurer
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: C
Question Status: Previous Edition

24) An insurance policy specifically written and designed to meet the needs of an insurance purchaser is called a(n)
A) manuscript policy.
B) bureau policy.
C) standard policy.
D) excess policy.
Answer: A
Question Status: Previous Edition

25) All of the following are disadvantages of using insurance in a commercial risk management program EXCEPT
A) There is an opportunity cost because premiums must be paid in advance.
B) Considerable time and effort must be spent selecting and negotiating coverages.
C) It results in considerable fluctuations in earnings after losses occur.
D) Attitudes toward loss control may become lax when losses are insured.
Answer: C
Question Status: Previous Edition

26) Which of the following types of loss exposures may be appropriately handled through the purchase of insurance?
I. High-frequency, low-severity loss exposures
II. Low-frequency, high-severity loss exposures
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: B
Question Status: Previous Edition

27) Which of the following types of loss exposures are best handled by the use of avoidance?
A) low-frequency, low-severity loss exposures
B) low-frequency, high-severity loss exposures
C) high-frequency, low-severity loss exposures
D) high-frequency, high-severity loss exposures
Answer: D
Question Status: Previous Edition

28) Low-frequency, low-severity loss exposures are best handled by
A) avoidance.
B) retention.
C) insurance.
D) noninsurance transfer.
Answer: B
Question Status: Previous Edition

29) All of the following statements about the administration of a risk management program are true EXCEPT
A) The risk manager is an important part of a firm's management team.
B) A risk management policy statement can be used to educate top executives about the risk management process.
C) If a risk management program is properly designed, periodic review of the program is unnecessary.
D) In order to properly identify loss exposures, the risk manager needs the cooperation of other departments.
Answer: C
Question Status: Previous Edition

30) Cal was just hired as XYZ Company's first risk manager. Cal would like to employ the risk management process. The first step in the process Cal should follow is to
A) evaluate potential losses faced by XYZ Company.
B) formulate a treatment plan for XYZ Company's loss exposures.
C) identify potential losses faced by XYZ Company.
D) implement and administer a risk management plan for XYZ Company.
Answer: C
Question Status: Previous Edition

31) Members of Mid-South Petroleum Distributors, a trade group, had trouble obtaining affordable pollution liability insurance. The members formed a group captive that is exempt from many state laws that apply to other insurers. This group captive is called a(n)
A) reinsurance pool.
B) Lloyd's association.
C) alien insurer.
D) risk retention group.
Answer: D
Question Status: Previous Edition

32) Acme Company has three identical manufacturing plants, one on the Texas Gulf Coast, one in southern Alabama, and one in Florida. Each plant is valued at $200 million. Acme's risk manager is concerned about the damage which could be caused by a single hurricane. The risk manager believes there is an extremely low probability that a single hurricane could destroy two or all three plants because they are located so far apart. What is the probable maximum loss associated with a single hurricane?
A) $0 million
B) $200 million
C) $400 million
D) $600 million
Answer: B
Question Status: Previous Edition

33) Acme Company has three identical manufacturing plants, one on the Texas Gulf Coast, one in southern Alabama, and one in Florida. Each plant is valued at $200 million. Acme's risk manager is concerned about the damage which could be caused by a single hurricane. The risk manager believes there is an extremely low probability that a single hurricane could destroy two or all three plants because they are located so far apart. What is the maximum possible loss associated with a single hurricane?
A) $0 million
B) $200 million
C) $400 million
D) $600 million
Answer: D
Question Status: Previous Edition

34) Laura Evans is risk manager of LMN Company. Laura decided to retain certain property loss exposures. Which of the following is a method that Laura can use to fund the retained property losses?
A) current net income
B) private insurance
C) noninsurance transfer
D) high deductibles
Answer: A
Question Status: Previous Edition

35) Parker Department Stores has been hurt in recent months by a large increase in shoplifting losses. Parker's risk manager concluded that while the frequency of shoplifting losses was high, the severity is still relatively low. What is (are) the appropriate risk management technique(s) to apply to this problem?
A) retention
B) loss prevention
C) transfer through insurance
D) avoidance
Answer: B
Question Status: Revised

36) Barb, who is self-employed, is the main breadwinner for her family. Barb does not have disability income insurance because she has never stopped to consider the impact of a long-term disability upon her family. Barb's treatment of the risk of disability is best described as
A) risk transfer.
B) passive retention.
C) risk avoidance.
D) active retention.
Answer: B
Question Status: Previous Edition

37) Ryan decided to review his personal risk management program. His car is 10 years old, and he would receive little money from his insurer if the car was damaged or destroyed. Ryan decided to drop the physical damage insurance on the car. From a risk management perspective, dropping the physical damage insurance on the car is best described as
A) increasing the use of avoidance in the risk management program.
B) increasing the use of noninsurance transfer in the risk management program.
C) increasing the use of retention in the risk management program.
D) increasing the use of risk control in the risk management program.
Answer: C
Question Status: Previous Edition

38) To better understand her company's operations, a risk manager asked a production manager to draw a diagram tracing the steps in the production and distribution of the company's products. Such a diagram, which is useful in risk identification, is called a
A) financial statement.
B) risk management matrix.
C) flowchart.
D) risk management audit.
Answer: C
Question Status: Previous Edition

39) In reviewing his company's operations, a risk manager noticed that all of the company's finished goods were stored in a single warehouse. The risk manager recommended that the finished goods be divided among three warehouses to prevent all of the finished goods from being destroyed by the same peril. Dividing the finished goods among three warehouses illustrates
A) duplication.
B) separation.
C) insurance.
D) noninsurance transfer.
Answer: B
Question Status: Revised

40) Which of the following statements about a personal risk management program is (are) true?
I. Insurance and retention are the only techniques used to handle potential losses.
II. The steps in a personal risk management process are the same steps used by businesses.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: B
Question Status: Previous Edition

41) Bev lives in the suburbs and works downtown. She drives to work, and her most direct route to work would require her to pass through an area where carjackings and drive-by-shootings are common. Bev does not drive through this area. Instead, she uses a route which adds 10 minutes to her commute. Which risk management technique is Bev using with respect to the risk of injury while driving through the dangerous area?
A) noninsurance transfer
B) avoidance
C) passive retention
D) loss reduction
Answer: B
Question Status: Previous Edition

42) Brenda identified all of the pure loss exposures her family faces. Then she analyzed these loss exposures, developed a plan to treat these risks, and implemented the plan. The process Brenda conducted is called
A) personal insurance programming.
B) personal estate planning.
C) personal financial planning.
D) personal risk management.
Answer: D
Question Status: Previous Edition

43) Which statement about a company's cost of risk is (are) true?
I. Cost of risk includes insurance premiums and retained losses.
II. Reducing the cost of risk increases profitability.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: C
Question Status: Previous Edition

44) A useful measure for an organization to monitor is the total expenditures for treating loss exposures including retained losses, loss control expenses, insurance premiums, and other related expenses. This measure is called the organization's
A) cost of capital.
B) cost of goods sold.
C) cost of risk.
D) cost of equity.
Answer: C
Question Status: Previous Edition

45) Mark owns a 2006 sedan. The last time Mark renewed his auto insurance, he decided to drop the physical damage insurance on this vehicle. How is Mark dealing with the auto physical damage exposure in his personal risk management program?
A) risk transfer
B) passive retention
C) avoidance
D) active retention
Answer: D
Question Status: Previous Edition

46) Purchasing health insurance illustrates the use of which personal risk management technique?
A) avoidance
B) risk transfer
C) risk control
D) risk retention
Answer: B
Question Status: Previous Edition

47) Which of the following statements about captive insurance companies is (are) true?
I. A captive insurance company established by a U.S. company must be domiciled in the United States.
II. A captive insurance company may be owned by several parents.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: B
Question Status: Previous Edition

48) Which of the following is least likely to occur during a "hard" insurance market period?
A) difficulty in obtaining insurance
B) tightening underwriting standards
C) higher insurer profits
D) increasing premiums
Answer: C
Question Status: Previous Edition

49) Which of the following statements concerning the selection of risk management techniques and insurance market conditions is (are) true?
I. It's easier to purchase affordable insurance during a "soft " market than during a "hard" market.
II. Retention is used more during a "soft" market than during a "hard" market.
A) I only
B) II only
C) both I and II
D) neither I nor II
Answer: A
Question Status: Previous Edition

50) Discount Department Stores is a national retail chain. The company had one large, central warehouse. At the suggestion of the risk manager, the company decided to build four smaller regional warehouses so that a loss at the central warehouse would not be a catastrophic blow to the company's distribution system. Splitting the inventory between four regional warehouses illustrates which risk management technique?
A) duplication
B) risk transfer
C) separation
D) risk avoidance
Answer: C
Question Status: Revised

51) Each accounting period, Harris Company Department Store charges a bookkeeping account for its estimated shoplifting losses. The method that Harris Company Department Store uses to fund its retained shoplifting losses is a(n)
A) private insurance policy.
B) captive insurer.
C) credit line.
D) unfunded reserve.
Answer: D
Question Status: Previous Edition

52) Morris Company self-insures its workers compensation loss exposure. The risk manager of Morris Company is concerned about the possible impact of a single catastrophic claim. She decided to set a retention limit of $500,000 per-claim, and to purchase insurance that will be begin to pay once Morris Company has paid $500,000 on a single claim. The insurance the risk manager purchased is called
A) captive insurance.
B) excess insurance.
C) primary insurance.
D) umbrella insurance.
Answer: B
Question Status: Previous Edition

53) When Derrick became risk manager of Boller Company, he noticed that the company did not have a clear set of risk management objectives and a clearly-stated risk management philosophy. Derrick developed a written document stating the company's risk management objectives and risk management philosophy. This document is called a risk management
A) policy statement.
B) manuscript policy.
C) manual.
D) binder.
Answer: A
Question Status: Previous Edition

54) David never stopped to consider the possible consequences of a long-term, permanent, disability. So David did not include disability income insurance in his personal risk management program. David is dealing with the risk of disability through
A) passive retention.
B) active retention.
C) risk control.
D) risk avoidance.
Answer: A
Question Status: Previous Edition

55) The property and liability insurance industry fluctuates between periods of increasing insurance rates and tight underwriting standards, and decreasing insurance rates and loose underwriting standards. Profitability in the industry follows these cyclical movements. What is this pattern of fluctuations called?
A) the claims cycle
B) the underwriting cycle
C) the business cycle
D) the accounting cycle
Answer: B
Question Status: Previous Edition

56) The U.S. government is concerned that terrorists might try to crash a vehicle loaded with explosives into a U.S. embassy in a foreign country. Inside the gate to the embassy, they installed steel and cement posts in the road. These posts can be raised up from the ground to form a barrier against suicide bombers. The posts can be lowered back into the ground to allow safe vehicles to pass. This physical barrier system illustrates which risk management technique?
A) risk avoidance
B) insurance transfer
C) loss prevention
D) noninsurance transfer
Answer: C
Question Status: Previous Edition

57) A college professor stores class grading records on a spreadsheet on her office computer. Each time she updates a grading file she makes a printout and a backup copy of the grading file. The professor is using which risk management method to address the risk of losing her class grading records?
A) risk avoidance
B) duplication
C) separation
D) noninsurance transfer
Answer: B
Question Status: New

58) A risk manager was asked to review all the loss exposures his company faces. The risk manager noted that the company obtained over 90 percent of its raw materials from one supplier. He voiced concern about business interruption if that supplier was closed for some reason. Acting on his recommendation, the company began to purchase raw materials from two other suppliers. Using multiple suppliers illustrates which risk control technique?
A) risk avoidance
B) duplication
C) separation
D) diversification
Answer: D
Question Status: New

59) Melanie was just hired as the risk manager of JKL Company. The company president asked her to make a thorough review of all of the company's loss exposures. Melanie noted that many employees were too heavily invested in stock issued by the company in their 401-k plan. Melanie suggested that the employees change some of their investment holdings to mutual funds that invest in stock issued by different companies. The risk control method that Melanie suggested is
A) risk avoidance.
B) duplication.
C) diversification.
D) separation.
Answer: C
Question Status: New

60) A U.S. athletic equipment company has production plants in several Pacific Rim countries. Each plant is divided into separate production areas using six-foot thick concrete walls. The construction method is designed to prevent fire from spreading from one production area to another. Using thick concrete walls so that fire does not spread to another production area illustrates which risk control method?
A) separation
B) duplication
C) risk avoidance
D) diversification
Answer: A
Question Status: New