

Principles of Risk Management and Insurance, 14e (Rejda)
Chapter 1 Risk and Its Treatment

- 1) Traditionally, risk has been defined as
- A) any situation in which the probability of loss is one.
 - B) any situation in which the probability of loss is zero.
 - C) uncertainty concerning the occurrence of loss.
 - D) the probability of a loss occurring.

Answer: C

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

- 2) Objective risk is defined as
- A) the probability of loss.
 - B) the relative variation of actual loss from expected loss.
 - C) uncertainty based on a person's mental condition or state of mind.
 - D) the cause of loss.

Answer: B

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

- 3) An insurance company estimates its objective risk for 10,000 exposures to be 10 percent. Assuming the probability of loss remains the same, what would happen to the objective risk if the number of exposures were to increase to 1 million?
- A) It would decrease to 1 percent.
 - B) It would decrease to 5 percent.
 - C) It would remain the same.
 - D) It would increase to 20 percent.

Answer: A

Diff: 3

Question Status: Previous Edition

AACSB: Analytical Thinking

- 4) Uncertainty based on a person's mental condition or state of mind is known as
- A) objective risk.
 - B) subjective risk.
 - C) objective probability.
 - D) subjective probability.

Answer: B

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

5) The long-run relative frequency of an event based on the assumption of an infinite number of observations with no change in the underlying conditions is called

- A) objective probability.
- B) objective risk.
- C) subjective probability.
- D) subjective risk.

Answer: A

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

6) Which of the following statements about *a priori* probabilities is correct?

- A) They are subjective probabilities based on ambiguity in the way probability is perceived.
- B) They are subjective probabilities that may vary among individuals because of factors such as age, gender, education, and the use of alcohol.
- C) They are objective probabilities that can be determined by deductive reasoning.
- D) They are objective probabilities that can be determined by subjective reasoning.

Answer: C

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

7) An individual's personal estimate of the chance of loss is a(n)

- A) objective probability.
- B) objective risk.
- C) subjective probability.
- D) *a priori* probability.

Answer: C

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

8) A peril is

- A) a moral hazard.
- B) the cause of a loss.
- C) a condition that increases the chance of a loss.
- D) the probability that a loss will occur.

Answer: B

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

9) An earthquake is an example of a(n)

- A) moral hazard.
- B) peril.
- C) physical hazard.
- D) objective risk.

Answer: B

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

10) Dense fog that increases the chance of an automobile accident is an example of a

- A) speculative risk.
- B) peril.
- C) physical hazard.
- D) moral hazard.

Answer: C

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

11) Faking an accident to collect insurance proceeds is an example of

- A) physical hazard.
- B) objective risk.
- C) moral hazard.
- D) attitudinal hazard.

Answer: C

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

12) Carelessness or indifference to a loss is an example of

- A) physical hazard.
- B) objective probability.
- C) moral hazard.
- D) attitudinal hazard.

Answer: D

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

13) Some characteristics of the judicial system and regulatory environment increase the frequency and severity of loss. This hazard is called

- A) moral hazard.
- B) physical hazard.
- C) attitudinal hazard.
- D) legal hazard.

Answer: D

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

14) Taylor Tobacco Company is concerned that the company may be held liable in a court of law and ordered to pay a large damage award to a smoker harmed by the company's cigarettes. The characteristics of the judicial system that increase the frequency and severity of loss are known as

- A) moral hazard.
- B) particular risk.
- C) speculative risk.
- D) legal hazard.

Answer: D

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

15) A name that encompasses all of the major risks faced by a business firm is

- A) financial risk.
- B) speculative risk.
- C) enterprise risk.
- D) pure risk.

Answer: C

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

16) Which of the following statements about financial risk is (are) true?

- I. Enterprise risk does not include financial risk.
- II. Financial risk is easily addressed through the purchase of insurance.

- A) I only
- B) II only
- C) both I and II
- D) neither I nor II

Answer: D

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

17) One of the speculative financial risks considered in an enterprise risk management program is the risk of loss because of adverse changes in commodity prices, interest rates, foreign exchange rates, and the value of money. This risk is called

- A) property risk.
- B) financial risk.
- C) strategic risk.
- D) operational risk.

Answer: B

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

18) Katelyn was just named Risk Manager of ABC Company. She has decided to create a risk management program which considers all of the risks faced by ABC—pure, speculative, operational, and strategic—in a single risk management program. Such a program is called a(n)

- A) financial risk management program.
- B) enterprise risk management program.
- C) fundamental risk management program.
- D) consequential risk management program.

Answer: B

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

19) A pure risk is defined as a situation in which there is

- A) only the possibility of loss or no loss.
- B) only the possibility of profit.
- C) a possibility of neither profit nor loss.
- D) a possibility of either profit or loss.

Answer: A

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

20) The premature death of an individual is an example of a

- A) pure risk.
- B) speculative risk.
- C) nondiversifiable risk.
- D) physical hazard.

Answer: A

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

21) Which of the following statements about speculative risks is true?

- A) They are almost always insurable by private insurers.
- B) They are more easily predictable than pure risks.
- C) They may benefit society even though a loss occurs.
- D) They involve only a chance of loss.

Answer: C

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

22) A family's automobile that is a total loss as a result of a collision is an example of which of the following types of risk?

- I. Speculative risk
 - II. Diversifiable risk
- A) I only
 - B) II only
 - C) both I and II
 - D) neither I nor II

Answer: B

Diff: 1

Question Status: Revised

AACSB: Reflective Thinking

23) All of the following are programs to insure nondiversifiable risks EXCEPT

- A) federal flood insurance.
- B) auto physical damage insurance.
- C) Social Security.
- D) unemployment insurance.

Answer: B

Diff: 1

Question Status: Revised

AACSB: Application of Knowledge

24) All of the following are examples of personal risks EXCEPT

- A) poor health.
- B) unemployment.
- C) premature death.
- D) loss of business income.

Answer: D

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

25) Which of the following is a reason why premature death may result in economic insecurity?

- I. Additional expenses associated with death may be incurred.
- II. The income of the deceased person's family may be inadequate to meet its basic needs.

- 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

26) Which of the following is (are) often consequences of long-term disability?

- I. Continuing medical expenses
- II. Loss or reduction of employee benefits

- 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

27) Which of the following is an example of consequential (indirect) loss?

- A) the theft of a person's jewelry
- B) the destruction of a firm's manufacturing plant by an earthquake
- C) the cost of renting a substitute vehicle while a collision-damaged car is being repaired
- D) the vandalism of a person's automobile

Answer: C

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

28) The extra expense incurred by a business to stay in operation following a fire is an example of a(n)

- A) fundamental risk.
- B) speculative risk.
- C) direct loss.
- D) indirect loss.

Answer: D

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

29) Which of the following statements about liability risks is (are) true?

- I. Future income and assets can be attached to pay judgments if inadequate insurance is carried.
- II. There is an upper limit on the amount of loss.

- 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

30) All of the following are burdens to society because of the presence of risk EXCEPT

- A) The size of an emergency fund must be increased.
- B) Risk provides an incentive for people to engage in risk control.
- C) Society is deprived of certain goods and services.
- D) Mental fear and worry are present.

Answer: B

Diff: 1

Question Status: Revised

AACSB: Application of Knowledge

31) Loss control includes which of the following?

- I. Loss reduction
- II. Loss prevention

- 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

32) Following good health habits can be categorized as

- A) loss prevention.
- B) risk retention.
- C) noninsurance transfer.
- D) personal insurance.

Answer: A

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

- 33) From the insured's perspective, the use of deductibles in insurance contracts is an example of
- A) risk transfer.
 - B) risk control.
 - C) risk avoidance.
 - D) risk retention.

Answer: D

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

- 34) The use of fire-resistive materials when constructing a building is an example of
- A) risk transfer.
 - B) risk control.
 - C) risk avoidance.
 - D) risk retention.

Answer: B

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

- 35) All of the following statements about risk retention are true EXCEPT
- A) It may be used intentionally if commercial insurance is unavailable.
 - B) It may be used passively because of ignorance.
 - C) Its use is most appropriate for low-frequency, high-severity types of risks.
 - D) Its use results in cost savings if losses are less than the cost of insurance.

Answer: C

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

- 36) Which of the following is an example of a noninsurance risk transfer?
- A) not engaging in dangerous activities
 - B) entering into a hold-harmless agreement
 - C) installing smoke detectors in your home
 - D) using nonflammable building material when constructing a house

Answer: B

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

37) Curt borrowed money from a bank to purchase a fishing boat. He purchased property insurance on the boat. Curt had difficulty making loan payments because he did not catch many fish, and fish prices were low. Curt intentionally sunk the boat, collected from his insurer, and paid off the loan balance. This scenario illustrates the problem of

- A) adverse selection.
- B) moral hazard.
- C) nondiversifiable risk.
- D) attitudinal hazard.

Answer: B

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

38) Jenna opened a successful restaurant. One night, after the restaurant had closed, a fire started when the electrical system malfunctioned. In addition to the physical damage to the restaurant, Jenna lost profits that could have been earned while the restaurant was closed for repairs. The lost profits are an example of

- A) direct loss.
- B) nondiversifiable risk.
- C) speculative risk.
- D) indirect loss.

Answer: D

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

39) Brad started a pest control business. To protect his personal assets against liability arising out of the business, Brad incorporated the business. Brad's use of the corporate form of organization to shield against personal liability claims illustrates

- A) fundamental risk.
- B) noninsurance transfer.
- C) risk retention.
- D) objective risk.

Answer: B

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

40) ABC Insurance Company plans to sell homeowners insurance in five Western states. ABC expects that 8 homeowners out of every 100, on average, will report claims each year. The variation between the rate of loss that ABC expects to occur and the rate of loss that actually occurs is called

- A) objective probability.
- B) subjective probability.
- C) objective risk.
- D) subjective risk.

Answer: C

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

41) Williams Company installed smoke detectors, a sprinkler system, and fire extinguishers in its new manufacturing facility. These devices are all examples of

- A) risk control.
- B) noninsurance transfer.
- C) risk avoidance.
- D) risk retention.

Answer: A

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

42) Which of the following statements about hedging is (are) true?

- I. Hedging is a form of risk transfer.
- II. Hedging is used to address the risk of unfavorable price fluctuations.

- 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

43) Cathy's car hit a patch of ice on the road. The car skidded off the road and hit a tree. The presence of ice on the road is best described as a(n)

- A) peril.
- B) subjective risk.
- C) physical hazard.
- D) indirect loss.

Answer: C

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

44) Jim and Paula Franklin started a dry cleaning business. The business may be successful or it may fail. The type of risk that is present when either a profit or loss could occur is called

- A) pure risk.
- B) subjective risk.
- C) nondiversifiable risk.
- D) speculative risk.

Answer: D

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

45) Ben is concerned that if he injures someone or damages someone's property he could be held legally responsible and required to pay damages. This type of risk is called a

- A) speculative risk.
- B) liability risk.
- C) nondiversifiable risk.
- D) property risk.

Answer: B

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

46) MLX Drug Company would like to market a new hypertension drug. While the Food and Drug Administration (FDA) was testing the drug, it discovered that the drug produced a harmful side effect. When MLX learned of the FDA's test result, MLX abandoned its plan to produce and distribute the drug. MLX's reaction illustrates

- A) risk avoidance.
- B) hedging.
- C) risk transfer.
- D) risk retention.

Answer: A

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

47) ABC Insurance Company sells auto insurance in one state. Recently, the state legislature passed a law that limits the use of an individual's credit history by insurers when selecting applicants to insure. This change in law will increase the possibility of unprofitable results for ABC. This type of hazard is an example of

- A) physical hazard.
- B) legal hazard.
- C) moral hazard.
- D) attitudinal hazard.

Answer: B

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

- 48) All of the following are characteristics of the liability risk that most people face EXCEPT
- A) a lien may be placed on your income and assets to satisfy a legal judgment.
 - B) substantial legal expenses may be incurred defending the claim.
 - C) there is no upper limit on the amount of the loss.
 - D) owning liability insurance eliminates the possibility of being held legally liable.

Answer: D

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

- 49) Which of the following statements about chance of loss and risk is (are) true?
- I. If the chance of loss is identical for two groups, the objective risk must be the same.
 - II. Two individuals may perceive differently the risk inherent in a given activity.

- A) I only
- B) II only
- C) both I and II
- D) neither I nor II

Answer: B

Diff: 2

Question Status: Previous Edition

AACSB: Application of Knowledge

- 50) A risk that affects only individuals or small groups and not the entire economy is called a
- A) diversifiable risk.
 - B) pure risk.
 - C) speculative risk.
 - D) nondiversifiable risk.

Answer: A

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

- 51) Which of the following is an example of a commercial risk?
- A) the risk of insufficient retirement income
 - B) the loss of business income
 - C) the risk of premature death
 - D) the risk of being unemployed

Answer: B

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

52) A special form of planned retention by which part or all of a give loss exposure is retained by the firm is called

- A) hedging.
- B) self-insurance.
- C) passive retention.
- D) noninsurance transfer.

Answer: B

Diff: 1

Question Status: Previous Edition

AACSB: Application of Knowledge

53) The production facility for ABC Manufacturing is located in a flood plain. Although the risk of flood is low, ABC's risk manager is concerned that a flood could damage the plant and equipment. He received bids on flood insurance from two insurance agents, but decided the cost of coverage was too high relative to the risk. So he did not purchase flood insurance. Which risk management technique is ABC using with respect to the risk of flood?

- A) active retention
- B) noninsurance transfer
- C) passive retention
- D) avoidance

Answer: A

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

54) A student who has skipped many classes and not studied the course material was surprised to learn there was a test when he showed-up for class. The student's mental uncertainty about whether or not he will pass the test is called

- A) objective risk.
- B) objective probability.
- C) subjective probability.
- D) subjective risk.

Answer: D

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

55) Rapid inflation, cyclical unemployment, war, hurricanes, and floods are all examples of

- A) diversifiable risks.
- B) physical hazards.
- C) nondiversifiable risks.
- D) speculative risks.

Answer: C

Diff: 1

Question Status: Previous Edition

AACSB: Reflective Thinking

56) Five years ago, Shannon decided to start investing monthly in the common stock of ABC Telecom Company. Her financial well-being will be harmed if the price of ABC Telecom stock drops significantly. The risk of investment loss can be reduced if she invests in other companies and other types of financial assets. The risk Shannon faces with regard to her investments is a(n)

- A) enterprise risk.
- B) diversifiable risk.
- C) pure risk.
- D) nondiversifiable risk.

Answer: B

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

57) Frazier Electric keeps a paper copy of business records at the company's headquarters. The company also has two back-up copies of business records stored in electronic files. The electronic files are kept in the event the paper records are damaged or destroyed. The back-up files illustrate which of the following risk control techniques?

- A) loss prevention
- B) loss reduction
- C) diversification
- D) duplication

Answer: D

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

58) Rather than storing all of its finished goods in a single location, Davis Company divides the finished goods between two warehouses. This simple risk control technique which is designed to limit losses should a warehouse fire occur is called

- A) duplication.
- B) risk transfer.
- C) separation.
- D) loss prevention.

Answer: C

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

59) Some members of Congress are concerned that if one or two large U.S. banks fail, it could lead to the collapse of the entire U.S. financial sector. This risk is called

- A) objective risk.
- B) systemic risk.
- C) enterprise risk.
- D) subjective risk.

Answer: B

Diff: 2

Question Status: Previous Edition

AACSB: Reflective Thinking

60) Which of the following are personal risks that can cause great economic insecurity?

- I. Alcohol and drug addiction
- II. Inadequate retirement income

- 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

61) Which of the following statements is true regarding careers in risk management and insurance going forward?

- A) Employment opportunities in insurance will be limited to sales and claims.
- B) Reduced consumer demand for insurance products will create significant job losses in the industry.
- C) Many job opportunities will be available requiring a wide range of knowledge and skills.
- D) A government takeover of the insurance industry is predicted, reducing the number of private sector jobs.

Answer: C

Diff: 1

Question Status: New

AACSB: Application of Knowledge

62) Janice mistakenly thought that Medicare covers the cost of a long-term care in a nursing home. So she did not purchase long-term care insurance or save in case she needed a long stay in a nursing home. Janice's treatment of the risk of a long-term stay in a nursing home is best described as

- A) planned retention.
- B) unplanned retention.
- C) risk transfer.
- D) risk control.

Answer: B

Diff: 2

Question Status: New

AACSB: Reflective Thinking