



RISK MANAGEMENT & INSURANCE

9TH EDITION

TRIESCHMANN GUSTAVSON

JAMES S. TRIESCHMAI
University of Georgia

SANDRA G. GUSTAVSON
University of Georgia

RISK MANAGEMENT & INSURANCE

9TH EDITION



SOUTH-WESTERN College Publishing

An International Thomson Publishing Company

Sponsoring Editor: Christopher Will
Production Editor: Rebecca Roby
Production House: Impressions, a Division of Edwards Brothers, Inc.
Cover and Internal Design: Lotus Wittkopf
Cover Photographer: National Oceanic and Atmospheric Administration
Marketing Manager: Denise Carlson

FF65IA
Copyright © 1995
by South-Western College Publishing
Cincinnati, Ohio

All Rights Reserved

The text of this publication, or any part thereof, may not be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, storage in an information retrieval system, or otherwise, without the prior written permission of the publisher.

Library of Congress Cataloging-in-Publication Data

Gustavson, Sandra G.

Risk management and insurance / Sandra G. Gustavson, James S.
Treischmann. -- 9th ed.
p. cm.

Rev. ed. of: Risk & insurance / Mark R. Greene, James S.
Trieschmann, Sandra G. Gustavson. 8th ed. c1992.

Includes bibliographical references and index.

ISBN 0-538-83920-1

1. Insurance--United States. 2. Risk management--United States.
I. Treischmann, James S. II. Greene, Mark Richard, 1923-- Risk &
insurance. III. Title.

HG8051.T73 1995

368--dc20

94-15758

CIP

ISBN: 0-538-83920-1

1 2 3 4 5 6 7 8 9 0 D1 3 2 1 0 9 8 7 6 5 4

Printed in the United States of America



This book is printed on acid-free paper that meets Environmental Protection Agency standards for recycled paper.

I(T)P

International Thomson Publishing

South-Western College Publishing is an ITP Company. The ITP trademark is used under license.

PREFACE

As their fields of expertise evolve over time, successful professionals seek to keep pace with the changes taking place in their disciplines. In recent years, this necessity for growth has been particularly true for those concerned with risk and the ways to deal with it. In 1962, when the first edition of this text was published under the title *Risk and Insurance*, there was little debate about the proper tool for managing risks—it was simply insurance. That simplicity no longer exists in the complex world of the 1990s.

In today's competitive, innovative environment, there is a variety of solutions for almost all problems. Consequently, when faced with any of a myriad of risks, businesses are no longer restricted to purchasing insurance. Many approaches for managing those risks can be considered, and insurance may or may not be a part of the optimal solution for a particular firm. Similarly, individuals also have alternatives for dealing with risks affecting them. The ninth edition of this text reflects this fundamental change in society, that insurance is only one of many tools that may be used to manage risk. Accordingly, the book's title has been changed to *Risk Management and Insurance*.

In this revised edition, risk management is the transcending concept within which insurance finds its place. Thus, the word *insurance* appears only minimally until Chapter 4—after the more general risk management process is thoroughly discussed and many alternative risk management tools are presented. Similarly, Chapters 7 and 14 highlight various exposures to risk completely apart from potential insurance tools for dealing with those exposures. The overall understanding throughout this edition is that risks can be managed if they are identified prior to a loss, and insurance is an important—but not the only—tool available for that purpose.

The ninth edition has been significantly reorganized to reflect this emphasis on risk management. The book begins with an exploration of the nature of risk in Part 1, leading naturally into a detailed treatment of the risk management process in Part 2. Three of the five chapters in Part 2 contain primarily new material: Chapter 2 (Risk Identification and Evaluation), Chapter 3 (Risk Management Techniques: Noninsurance Methods), and Chapter 6 (Selecting Risk Management Techniques). In response to reader comments regarding the eighth edition, the material on statistical analysis and capital budgeting also has been integrated into Part 2, rather than appearing separately in the appendices. Business students will find this treatment of the material compatible

with their studies in other courses. Of course, the important elements of insurance theory that formed a central part of the eighth and earlier editions have not been expunged. The principles and policy provisions common to many forms of insurance are included in Part 2 as part of the discussion of insurance as a risk management technique. More detailed treatments of specific types of insurance are provided later in the text.

The next two sections of the text continue the risk management orientation, and the various forms of insurance are presented as major risk treatment possibilities. For example, Part 3 includes an introductory chapter on exposures to property and liability risks, followed by several chapters on property and liability insurance. As in prior editions, specific details regarding commonly used policy forms are included. Part 3 includes new material on safety issues, such as motorcycle helmet requirements and legal blood alcohol limits by state. In the discussion of the homeowners' policy, there is a detailed analysis of an additional living expense case. Large deductible workers' compensation programs are also introduced.

Part 4 is organized in a similar manner for presentation of the exposures related to the potential loss of life, health, and income, with an emphasis on the ways insurance contracts can be used to deal with these exposures. The most significant new material in Part 4 involves the increasingly important role of managed health care and the continuing debate over health care reform. And in keeping with the text's risk management orientation, relevant material on social security and other government insurance programs is integrated into appropriate chapters, rather than being segregated into a "social insurance" chapter as is often done in textbooks devoted primarily to insurance.

Part 5, entitled "The Risk Management Environment," includes four chapters on institutional aspects of risk management and insurance. The administrative aspects involved with implementing risk management decisions are addressed, as well as the government regulations that impact this industry. A new chapter, entitled "Implementing Risk Management Decisions," appears at the end of Part 5. It presents a personal risk management case and an in-depth analysis of that case. It then describes alternative ways to finance workers' compensation losses and examines the use of captives, self-insurance, retro-rated insurance, and large deductible insurance plans.

From a pedagogical perspective, the ninth edition retains many of the features included in the eighth. Learning objectives are stated for each chapter, and the key terms now list the page number where each term is first introduced. The separation of "Questions for Review" and "Questions for Discussion" at the end of each chapter is also continued. An opening vignette for each chapter is a new feature in the ninth edition. These vignettes whet the reader's appetite for the material presented in the chapter. In some cases the vignette is drawn from current events; in others the vignette is a short hypothetical situation.

Each chapter also contains boxed material taken from current literature to further illustrate concepts discussed within the main body of the chapter. There are three series of boxes, each identified by distinctive icons. The “International Perspectives” boxes illustrate the application of risk management considerations on a global basis. This approach is more effective in expanding global awareness than a separate international chapter would be. The second series of boxes, “Ethical Perspectives,” presents ethical dilemmas common in the field of risk management. Finally, the “Professional Perspectives” boxes illustrate practical applications of text material, many of which are based on recent interviews with practicing risk management professionals.

The materials in the appendices supplement and complement the text material. Once again, the glossary has been expanded and improved. Present value and annuity tables are included, as are sample policy forms for automobile, homeowners’, life, and disability income insurance. Appendix C provides a sample risk management checklist that can assist in the risk identification phase of the risk management process. The specific example used involves commercial automobile exposures.

The new emphasis on risk management does not change the basic strengths inherent in earlier editions of this text: (1) Basic ideas and principles associated with various types of risks and methods of risk treatment are covered. (2) A broad range of risk management concepts and problems is covered in recognition that one course on this topic is often the most that many college students take. (3) Further thought about the problems of risk management and insurance is stimulated through questions that often cannot be answered by short, factual statements taken directly from text material.

Supplements

An exciting new supplement for the ninth edition of *Risk Management and Insurance* is a videotape of several CNBC clips that illustrate recent news stories related to each chapter in the text. These video cases help students visualize the relevancy of the material and are available upon adoption of the text by contacting South-Western College Publishing.

A more traditional instructor’s manual is also available. It contains additional discussion questions and objective questions to provide instructors with more choices in composing tests. Exam questions are also available in an easy-to-use computerized test bank. Included at the end of the instructor’s manual are several cases that can be used for class discussion, as well as numerous overhead masters to aid instructors in class presentations.

Acknowledgments There are many we would like to thank for their kind assistance in preparing the ninth edition. Much of the material builds on prior editions, for which University of Georgia Professor Emeritus Mark Greene was the senior author. We thank Mark for his excellent work and acknowledge our reliance

on work that he first formulated. In addition, we are especially grateful to the following persons for their thorough review and suggested changes:

Julie Cagle
Xavier University
Varadarajan V. Chari
Northwestern University
R.B. Drennan
Temple University
Stephen Elliott
Northwestern State University
Karen L. Hamilton
American Institute for Property and Liability Underwriters
Carol A.B. Jordan
Eastern Kentucky University
Roger Severns,
Mankato State University
Thomas G. Smith
Fort Valley State College
Joe Stanford
Bridgewater State College
William J. Warfel
Indiana State University

Finally, we extend our special thanks to Kelly Chitwood, who generously contributed her time and effort for proofreading and other assistance. We also thank Bill Fleming, Sheila King, and Cindy Owensby, who helped with the instructor's manual and with other manuscript preparation tasks.

James S. Trieschmann
Sandra G. Gustavson

BRIEF CONTENTS

Part 1	What Is Risk?	1
1	Introduction to Risk	3
Part 2	The Risk Management Process	19
2	Risk Identification and Evaluation	21
3	Risk Management Techniques: Noninsurance Methods	43
4	Insurance as a Risk Management Technique: Principles	59
5	Insurance as a Risk Management Tool: Policy Provisions	89
6	Selecting Risk Management Techniques	117
Part 3	Risk Management—Property and Liability Exposures	135
7	Exposures to Property and Liability Losses	137
8	Personal Automobile Policy—Part I	167
9	Personal Automobile Policy—Part II	199
10	Risk Management for Homeowners	219
11	Business Liability and Workers' Compensation Insurance	267
12	Business Property Insurance—Part I	303
13	Business Property Insurance—Part II	325
Part 4	Risk Management—Life, Health, and Income Exposures	357
14	Life, Health, and Loss-of-Income Exposures	359
15	Life Insurance	389
16	Health Insurance	421
17	Annuities	451
18	Employee Benefits: Life and Health Benefits	469
19	Employee Benefits: Retirement Plans	499
20	Financial and Estate Planning	527
Part 5	The Risk Management Environment	559
21	The Insurance Industry	561
22	Functions and Organization of Insurers and Risk Managers	585
23	Government Regulation of Insurance	619
24	Implementing Risk Management Decisions	643
Appendices		
A	Glossary	A-1
B	Present Value and Annuity Tables	B-1
C	Risk Management Checklist	C-1
D	Personal Automobile Policy	D-1

E	Homeowners-3 Policy	E-1
F	Disability Income Insurance Policy	F-1
G	Whole Life Insurance Policy	G-1
Index		I-1

CONTENTS

Part 1	What Is Risk?	1
1	Introduction to Risk	3
	The Burden of Risk	5
	Definitions of Risk	5
	Sources of Pure Risk	8
	Measurement of Risk	11
	Management of Risk	14
Part 2	The Risk Management Process	19
2	Risk Identification and Evaluation	21
	Risk Identification	22
	Risk Evaluation	27
	Accuracy of Predictions	35
3	Risk Management Techniques: Noninsurance Methods	43
	Risk Avoidance	44
	Loss Control	45
	Risk Retention	49
	Risk Transfer	54
4	Insurance as a Risk Management Technique: Principles	59
	The Nature of Insurance	60
	Principle of Indemnity	61
	Principle of Insurable Interest	62
	Principle of Subrogation	64
	Principle of Utmost Good Faith	67
	Requisites of Insurable Risks	70
	Requirements of an Insurance Contract	74
	Distinguishing Characteristics of Insurance Contracts	76
	Role of Agents and Brokers	77
	Principles of Social Insurance	78
	Social and Economic Values and Costs of Insurance	81
5	Insurance as a Risk Management Tool: Policy Provisions	89
	Declarations	91
	The Insuring Agreement	91
	Exclusions	92
	Common Policy Conditions	95
	Definitions	101

	Basis of Recovery	101
	Clauses Limiting Amounts Payable	103
6	Selecting Risk Management Techniques	117
	Avoid Risks If Possible	119
	Implement Appropriate Loss Control Measures	119
	Select the Optimal Mix of Risk Retention and Risk Transfer	124
	Subjective Risk Management	131
Part 3	Risk Management—Property and Liability Exposures	135
7	Exposures to Property and Liability Losses	137
	Property Loss Exposures	138
	Liability Exposures	140
	Types of Liability Damages	141
	Criminal and Civil Law	143
	Torts	143
	Basic Law of Negligence	143
	The Negligent Act	144
	Defenses to Negligence Claims	145
	Factors Leading to Higher Standards of Care	146
	Types of Liability Exposures	150
	Miscellaneous Liability	161
8	Personal Automobile Policy—Part I	167
	The High Cost of Automobile Losses	168
	Insurance Claims	169
	The Need for Insurance	171
	Personal Automobile Policy	171
	Personal Automobile Policy Components	173
	Automobile Insurance and the Law	185
	Risk Management and Personal Automobile Rating	189
9	Personal Automobile Policy—Part II	199
	Recent Trends Affecting Automobile Insurance	201
	Cost Containment	207
	No-Fault	209
	Alcohol and Driving	213
	Advances in Driver and Auto Safety	214
10	Risk Management for Homeowners	219
	Homeowners' Program: Development	220
	Outline of Homeowners' Coverages	221
	Analysis of Homeowners' Policy	224
	Perils Covered In Homeowners' Insurance	232
	Optional Property Endorsements to Home-Owners' Policies	240
	Flood Insurance	244
	Personal Articles Floater (PAF)	245
	Mobile Home Endorsement to Homeowners' Policy	245

	Comprehensive Personal Liability and Medical Payments Insurance	247
	Dwelling Program (Not Homeowners')	255
	Farmowners'-Ranchowners' Policy	257
	Risk Management—Personal Lines	258
11	Business Liability and Workers' Compensation Insurance	267
	Common Liability Contract Provisions	268
	Commercial Liability Insurance	276
	Commercial General Liability (CGL)	276
	Business Auto Coverage	280
	Professional Liability Insurance	281
	Workers' Compensation Insurance	287
	Risk Management and Workers' Compensation	296
12	Business Property Insurance—Part I	303
	The Simplified Commercial Lines Portfolio (SCLP) Policy	305
	Boiler and Machinery Insurance	309
	Business Owners' Program	311
	Other Commercial Property Forms	312
	Reporting Forms	312
	Consequential Loss Coverage	313
	Time-Element Contracts	314
	Contracts Without Time Element	321
13	Business Property Insurance—Part II	325
	Transportation Insurance	327
	Ocean Transportation Insurance	329
	Land Transportation Insurance	336
	Floater Contracts	337
	Credit Insurance	340
	Title Insurance	341
	Plate Glass Insurance	343
	Crime	343
	Loss Due to Stealing	343
	Crime Insurance and Bonds	344
	Burglary, Robbery, and Theft Insurance	348
	Risk Management of the Crime Peril	350
Part 4	Risk Management—Life, Health, and Income Exposures	357
14	Life, Health, and Loss-of-Income Exposures	359
	Exposures Due to Premature Death	361
	Exposures Due to Loss of Health	372
	Other Income Loss Exposures	382
15	Life Insurance	389
	Types of Life insurance	391

	Income Tax Treatment of Life Insurance	402
	Life Insurance Contract Provisions	403
16	Health Insurance	421
	Health Insurance Providers	423
	Mechanics of Cost Sharing	426
	Health Expense Insurance	429
	Disability Income Insurance	436
	Health Insurance Policy Provisions	439
	Health Care Reform	443
17	Annuities	451
	Structure of Annuities	453
	Annuity Characteristics	454
	Annuity Taxation	459
18	Employee Benefits: Life and Health Benefits	469
	Reasons for Employee Benefits	470
	Premature Death Benefits	473
	Health Expense Benefits	480
	Disability Income Benefits	491
19	Employee Benefits: Retirement Plans	499
	Social Security Retirement Benefits	501
	Pension Plans	505
	Deferred Profit-Sharing Plans	516
	Employee Savings Plans	517
	Individual Retirement Accounts	519
	Keogh Plans	521
	Section 403(b) Plans	522
20	Financial and Estate Planning	527
	Financial Planning	528
	Estate Planning	529
	A Case Study: The Johnson Family	538
	Considerations in Buying Life and Health Insurance	550
Part 5	The Risk Management Environment	559
21	The Insurance Industry	561
	The Field of Insurance	563
	Types of Insurers	565
	Channels of Distribution in Insurance	573
22	Functions and Organization of Insurers and Risk Managers	585
	Functions of Insurers	586
	Reinsurance	605
	Administration for Risk Management	611
23	Government Regulation of Insurance	619
	Why Insurance Is Regulated	620

	The Legal Background of Regulation	622
	The McCarran-Ferguson Act	623
	Federal Versus State Regulation	625
	Responsibilities of the State Insurance Department	628
	Miscellaneous Insurance Laws	635
	Tort Reform	637
	Taxation of Insurance	638
24	Implementing Risk Management Decisions	643
	Personal Risk Management	644
	Commercial Risk Management	650
	Conclusions	661
Appendices		
	A Glossary	A-1
	B Present Value and Annuity Tables	B-1
	C Risk Management Checklist	C-1
	D Personal Automobile Policy	D-1
	E Homeowners-3 Policy	E-1
	F Disability Income Insurance Policy	F-1
	G Whole Life Insurance Policy	G-1
	Index	I-1

PART ONE

What Is Risk?

1 Introduction to Risk

1

Introduction to Risk

CHAPTER OBJECTIVES

After studying this chapter, you should be able to

1. Explain three ways to categorize risk.
2. List the components of an entity's cost of risk.
3. Give several examples of pure risks involving property, liability, life, health, and loss of income risks.
4. Distinguish between chance of loss and degree of risk.
5. Give examples of three types of hazards.
6. Identify the difference between hazards and perils.
7. Explain the four steps in the risk management process.