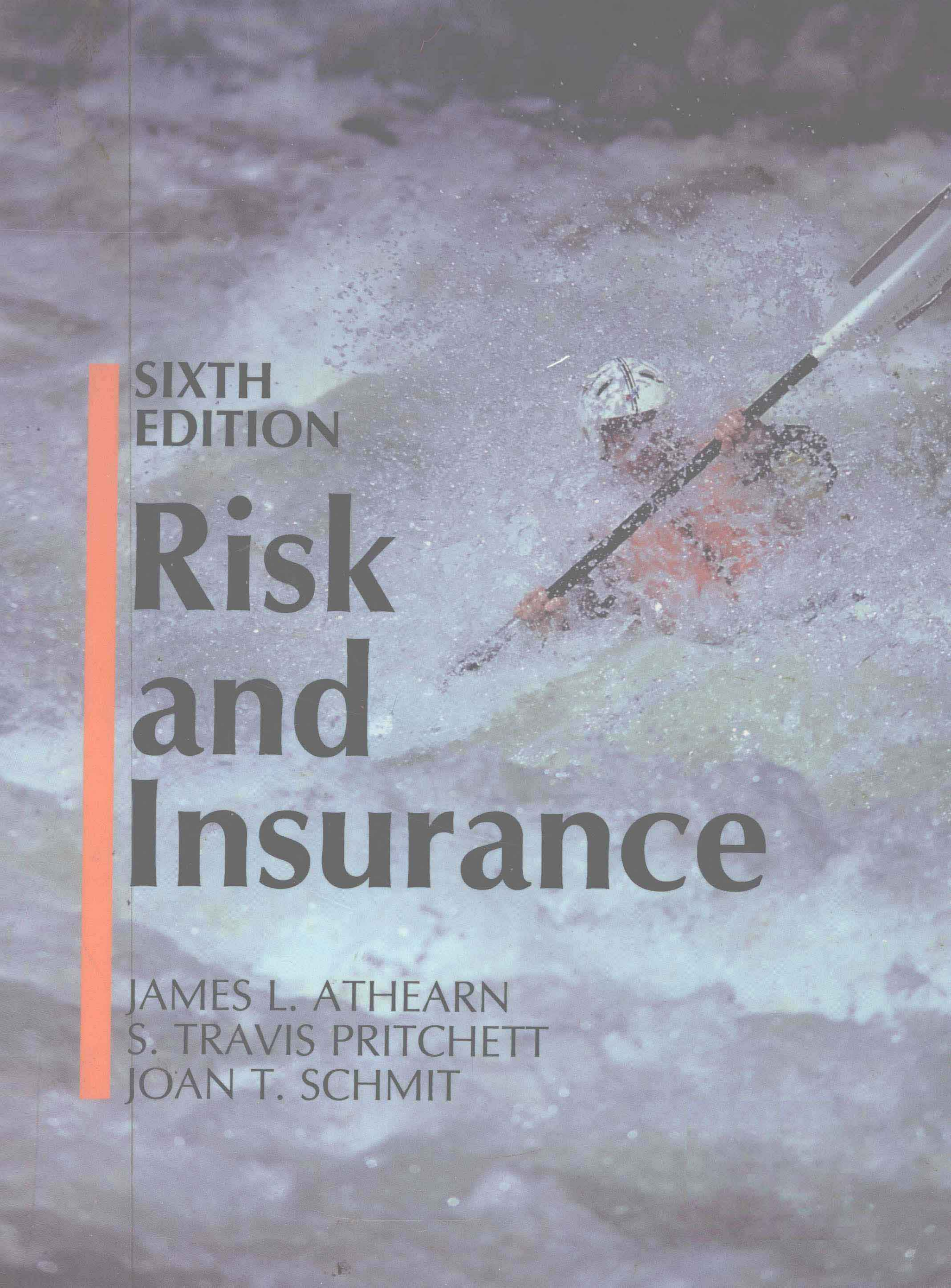

SIXTH EDITION

Risk and Insurance

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S. TRAVIS PRITCHETT
JOAN T. SCHMIT

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Risk and Insurance

To

Mary B. Pritchett and
the memory of Harvey E. Pritchett
and
Geraldine C. Schmit and
the memory of Harry J. Schmit

Preface

As the most recent fire, flood, earthquake or automobile crash demonstrates, individuals and organizations live in a risky world. Your financial security depends to a considerable extent on your ability to handle risk. This book can help you begin to acquire the knowledge and skill you need.

The book is operational. It is concerned with what you need to know and what you need to do. As you proceed chapter by chapter, you learn how to manage risk and make the best use of insurance and other risk handling techniques. Both insurance and your risk situation are complex; therefore, we discuss fundamental principles first and then apply them to real-world situations. To keep the book a reasonable length for an introductory course, only topics that meet one or both of the following tests are included:

1. Is this essential for the reader's understanding?
2. Will this help him or her as a risk manager and consumer of insurance products?

Because the field of risk and insurance is broad and dynamic, you won't know all there is to know about it when you finish this book. You will, however, have a great deal of knowledge and skill that will help you as a consumer and provide a foundation for further study.

Key Terms at the beginning of each chapter indicate some of the vocabulary that will be developed during the chapter. A review of these terms after you have studied a chapter is a test of whether you understand the material. If you can recall the meaning of the terms you probably have a good start on mastering the material.

Consumer Applications at the end of each chapter demonstrate how to use what you learned from it. For example, after the chapter on buying insurance, we discuss how to find a superior agent and settle a claim. After the chapter on managing home risks, we discuss how to shop for home insurance and how to reduce your home insurance costs.

Discussion Questions for each chapter provide the basis for class discussion that at times ranges beyond material included in the text. Short Cases offer an opportunity to practice using what you have learned from the chapter.

Specimen insurance policies are included in Appendixes A through

D for reference as you read about them in the text. Addresses and telephone numbers of state insurance departments are listed in Appendix F so you can call or write for help when you have an insurance problem. The Glossary provides a handy reference for insurance terms you need to know.

This book lists three authors, but it is the product of countless suggestions and a great deal of help from many people. Important suggestions were made by: Larry Cox, University of Georgia; Mark Cross, Louisiana Technical University; William O. Cummings, Virginia Polytechnic Institute and State University; Albert A. Freeman, Asheville-Buncombe Technical Institute; Larry Gaunt, Georgia State University; J. Smith Harrison, Jr., The Seibels Bruce Companies; Robert A. Hedges, Temple University; Thomas L. Heflin, California State University-Sacramento; Frank Hodges, Georgia Southern College; Thomas Luck, Mississippi State University; Angela M. McLain, University of Mississippi; Mary Q. Milling, Colonial Life and Accident Insurance Company; Phyllis Schiller Myers, Virginia Commonwealth University; M. Moshe Porat, Temple University; Clarence C. Rose, Radford University; and Allan Paul Waters, University of South Florida. Some reviewed the entire fifth edition; others commented on drafts of the sixth edition.

Many of the chapter cases contributed to the fourth edition by Professors John H. Thornton of North Texas State University and Terrence E. Williamson of the University of South Dakota appear in this edition, some in modified form. Frederick W. Schroath contributed a chapter on international insurance to the fifth edition. Some of this material has been integrated into the current edition. Ms. Kay Dillard, Lisa M. Fairchild, L. Paige Fields, Betty C. McLees, Katherine L. Phelps, Ellen Roueche, and Vicki R. Shealy of the University of South Carolina were immensely helpful in manuscript typing, index revision and administrative tasks.

This edition continues to reflect our belief that knowledge and skill are most readily acquired when complex matters—such as risk and insurance—are presented in an uncomplicated format. We have endeavored to keep up with what is most important for the beginning student in a constantly changing field, provide the amount of material that can be dealt with effectively in one term, add depth and discuss each topic in terms that are relevant for the reader.

JLA
STP
JTS

Risk and Insurance

Contents

Risk

1

INTRODUCTION

Risk is a *state* in which *losses* are *possible*. You are surrounded by innumerable risks from birth to death. They are as pervasive as the air you breathe. Air itself even involves risk because its pollutants can cause somewhat unpredictable illnesses that in turn can cause loss to both your ability to earn income by working and your ability to enjoy life in its fullest. Risk also exists when part of your family or business income can be wiped out by death or disability. Likewise, assets can be destroyed by earthquake, flood, fire, tornado, being held legally liable for damage to someone else, and a host of other causes of loss. Risk and methods of managing risk are of major importance in both your personal and professional lives. Although you are aware of much of the risk in your environment, all too often its more crucial aspects escape your attention or you fail to appreciate its significance. As background for later discussion, and to help you become risk conscious and develop a risk point of view, we discuss the following in this chapter:

1. The nature of risk
2. Characteristics of pure risk
3. Reactions to pure-risk awareness
4. Methods of handling pure risk

KEY TERMS

Risk
Loss
Pure risk
Speculative risk
Exposure
Peril
Hazard
Uncertainty
Risk averse
Avoidance
Loss prevention
Loss reduction
Retention
Transfer

NATURE OF RISK

The concept of risk becomes clear as you understand the way in which we are using each of the key terms in the definition. When we say "risk is a state," we mean it as a *state of the world*. Risk exists irrespective of awareness. We now are well aware, for example, that exposure to asbestos creates risks of ill health and an associated loss of earning power. Yet, when a typical person worked with asbestos in shipyards and other locations forty or fifty years ago, he or she had essentially no awareness that this hazardous material was increasing the chances of developing asbestosis. Asbestosis was then an unidentified disease, which we now know results in reduced breathing capacity and susceptibility to other cancers. Employers, insurers of their workers' compensation benefits, and even the manufacturers of asbestos knew little about the ultimate financial liability associated with this substance. Their lack of knowledge, however, did not influence the dimensions of risk associated with asbestosis even from the inception of its use.[1] The risk was as great or greater during the days of its first use (before 1930) as it is today. Thus, risk is an objective matter.

Risk has no meaning without **loss** being the outcome of concern. Loss consists of a disappearance or reduction in value.[2] Most of the discussion in this book will be about situations that involve potential for economic loss. Consequently, there is an implication that loss must be capable of being expressed in an easily measurable economic unit, such as dollars. Many losses, however, cannot be measured or described in economic terms.[3] For example, the death of a family pet may be felt as a great loss but not be measurable totally in economic terms. We may know what the cost would be to buy another pet of the same breed, but this is not the only diminution in value. Throughout your life, you will need to cope with situations that concern the potential loss of friendship, love, and other noneconomic matters. Although we concentrate on economic loss, you will find some of the risk management techniques introduced in this chapter (and developed in Chapter 2) to be equally useful in managing risk of noneconomic losses.

For risk to exist, it must be *possible* for loss to occur. Loss may or may not occur under risk, but no risk exists when the probability of loss is zero or one because the outcome is certain. When losses are possible,

1. The dimensions of risk include the uncertainty and risk aversion that accompany awareness. We will discuss these concepts later in this chapter. Mathematical dimensions of risk such as the probability of loss and its standard deviation will be discussed in Chapters 2 and 3.

2. This usage probably evolved from the insurance practice of paying funds upon the occurrence of a specified event. In most cases, the obligation of the insurer is stated in dollars, and you are presumed to have suffered a loss equal to or greater than the dollars received from the insurer under the terms of the insurance contract. From the insurance point of view, defining loss as a reduction or disappearance of value is understandable.

3. Risk theorists are also interested in the effect of risk on our utility. Utility involves both economic factors and emotional reaction to risk.