

Study Guide  
to accompany

# Fundamentals of Insurance

Robert I. Mehr

Manual prepared by  
Sanford B. Halperin

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Manual prepared by  
**Sanford B. Halperin**  
*Northeast Louisiana University*

**1983**



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# PREFACE

This Study Guide was written to help you, the student. If you use it, it will help you. It is an adjunct to the text, not a substitute for it.

Each chapter in this Study Guide has a prefatory statement, followed by a chapter outline. The questions for each chapter are of four different kinds: (1) true or false, (2) multiple choice, (3) completion, and (4) short answer (essay) questions or problems. The answers to all but the short answer format are given in the key at the back of the Study Guide.

Questions were generally not taken directly from the innerscript material. One notable exception, however, is in Chapter 2, "Risk and Insurance." A student should know, for example, the difference between chance of loss and the degree of risk (uncertainty).

You will find deliberate repetition used as a learning technique. The answers to some of the true/false questions might, for example, help you to answer some of the multiple-choice questions.

A comment on terminology. I have for the sake of uniformity used the text author's wording *property-liability* rather than the broader *property-casualty*. But to avoid a possible error between *insured* and *insurer*, I have referred to *insurance company* rather than *insurer* (even though not all insurers may be companies).

Each student has his or her system for maximizing use of a supplementary aid such as this Study Guide. I shall not presume to tell you how to use it. May I caution you, however, against seeking the answers provided at the back of this Study Guide before attempting to answer the questions yourself.

If you have a question or comment about this Study Guide, please write to me.

Good luck and best wishes.

**S.B.H.**

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# Chapter 1

## A Prelude to the Study of Insurance

A prelude is an introductory event. In music, it is a movement introducing the main theme. Chapter 1 sets the stage for what follows. It introduces the insurance business, the fields of insurance, and the social aspects.

### Chapter Outline

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- I. How to Proceed
    - A. The burden of financial loss
    - B. Shifting the burden by law
    - C. Insurance and the burden of loss
  - II. The Insurance Business
    - A. The Insurer
    - B. The Insured
    - C. The Contract
    - D. Underwriting and rating
    - E. Finance
    - F. Public control
  - III. Fields of insurance
    - A. Private
    - B. Government
  - IV. Insurance and Society
    - A. Social values of insurance
    - B. Social costs of insurance
    - C. Social responsibility
  - V. Summary
-

## Objective Questions

### *True or False*

- |   |   |     |   |
|---|---|-----|---|
| T | F | 1.  | Only a few people are affected by insurance unless it is compulsory.  |
| T | F | 2.  | Insurance decreases the quality of life because premium payments are an expense.  |
| T | F | 3.  | In insurance, what you don't know can't hurt you.   |
| T | F | 4.  | Many mistakes would be avoided if buyers could rely on the expertise of insurance personnel.  |
| T | F | 5.  | Lax enforcement of required auto liability laws could allow a person to drive unprotected against liability claims.   |
| T | F | 6.  | "Other insurance clauses" are provided for the purpose of allowing an insured to collect from each company the full amount of the loss in fire insurance, even though he may profit from the fire loss. |
| T | F | 7.  | The text author recognizes that a text cannot have a purpose of helping insurance buyers to deal effectively with insurance companies and agents.   |
| T | F | 8.  | Social security could be considered redistribution of income losses.  |
| T | F | 9.  | An insurance policy is a loss-sharing arrangement.  |
| T | F | 10. | In fire insurance, a person's interest can be insured even if he is not the owner of the building insured.  |
| T | F | 11. | Liability policies are called "third party coverages" because they are bought and paid for by the injured third party.  |
| T | F | 12. | Bankruptcy or insolvency of the insured relieves the insurance company from paying a liability claim on behalf of the insured.  |
| T | F | 13. | Promises of insurers are described in contracts.  |
| T | F | 14. | Employment by an insurance company includes persons skilled in investment analysis.   |
| T | F | 15. | Insurance companies are subject to a lesser degree of public control than are most other businesses.  |
| T | F | 16. | The extent of insurance regulation varies from state to state.  |
| T | F | 17. | Automobile insurance was formerly split between fire insurers and casualty insurers.  |
| T | F | 18. | Multiple-line underwriting refers in most states to fire and casualty insurance.  |
| T | F | 19. | Life insurance companies write life and health insurance but not annuities.   |
| T | F | 20. | Health insurance may not be written by property and liability insurers.   |
| T | F | 21. | Liability coverage cannot be used to protect against claims for negligence.   |
| T | F | 22. | Suretyship includes bonds to guarantee performance.   |
| T | F | 23. | Because workers' compensation insurance is required in most states, it cannot be written by private insurers.   |
| T | F | 24. | In those states where automobile liability insurance is required of car owners, it cannot be written by private insurers.   |
| T | F | 25. | Loss prevention activities are generally not of concern to insurers because insureds won't buy insurance if the chance of loss is small.  |
| T | F | 26. | Indemnity can offset a loss in full or in part through insurance.   |
| T | F | 27. | Insurance is of primary importance as the basis of the credit system.   |
| T | F | 28. | Financial responsibility laws do not apply in automobile accident cases.  |
| T | F | 29. | A social cost of insurance is that of fraudulent claims.  |
| T | F | 30. | Insurance may reduce the incentive to protect property against loss.  |

*Multiple Choice*

1. In order to shift the burden successfully to the wrong doer because of negligence, the injured person must:
  - I. not have been convicted of negligence within three years.
  - II. be the owner or driver of a vehicle himself
  - III. prove fault.
  - IV. be able to collect from the wrongdoer or his insurer.
  - A. I and II only
  - B. III and IV only
  - C. I, II, and III only
  - D. II, III, and IV only
  - E. I, II, III, and IV
2. Insurers may be:
  - I. corporations.
  - II. partnerships.
  - III. individuals.
  - A. I only
  - B. II only
  - C. I and III only
  - D. II and III only
  - E. I, II, and III only
3. Sales management includes which of the following tasks with respect to its field force?
  - I. Acquisition
  - II. Training
  - III. Supervising
  - IV. Compensating
  - A. I and II only
  - B. III and IV only
  - C. I, II, and III only
  - D. II, III, and IV only
  - E. I, II, III, and IV
4. The broadest division of insurance is between:
  - A. private and government.
  - B. life and fire.
  - C. fire and marine.
  - D. casualty and surety.
  - E. life and surety.
5. Two major branches of private insurance are:
  - A. health and life.
  - B. life and property.
  - C. property and health.
  - D. health and annuities.
  - E. property and annuities.
6. Government insurance may be:
  - I. written by federal agencies.
  - II. written by state agencies.
  - III. voluntary.
  - IV. compulsory.



- A. I and II only
  - B. III and IV only
  - C. I, II, and III only
  - D. II, III, and IV only
  - E. I, II, III, and IV
7. In insurance, the acronym FAIR stands for:
- A. Final Arrangements in Insurance Reorganization.
  - B. Finishing Arguments of Insurers' Regulations.
  - C. Fair Access to Insurance Requirements.
  - D. Fundamental Approach to Insurance Regulation.
  - E. Fund Analysis in Insurance Regions.
8. Life insurance companies:
- I. retain at least 75 percent of annual income instead of paying it out in claims.
  - II. have a lower percentage of operating expense to income than do property insurers.
  - III. have a higher investment income than do property insurers.
  - IV. function as savings intermediaries.
- A. I and II only
  - B. III and IV only
  - C. I, II, and III only
  - D. II, III, and IV only
  - E. I, II, III, and IV
9. Sources of insurance figures include:
- A. *Life Insurance Fact Book*.
  - B. *Insurance Facts*.
  - C. Choices A and B.
  - D. *Facts on Insurance*.
  - E. Choices A, B, and D.
10. The term "affected with a public interest":
- A. does not apply to life insurance.
  - B. does not apply to fire insurance.
  - C. choices A and B.
  - D. is not clear.
  - E. choices A, B, and D.

### Completion

1. The modern theory of probability was founded by \_\_\_\_\_.
2. In addition to loss by fire the owners of a residence are subject to loss while the house is undergoing repairs and they are forced to live in \_\_\_\_\_.
3. The bank that finances an automobile purchase will insist that the borrower carry insurance against \_\_\_\_\_ to the car.
4. Examples of laws passed to redistribute loss where society believes that the common-law allocation of loss is not in the public interest are \_\_\_\_\_ and \_\_\_\_\_ laws.
5. Sales representatives can be either \_\_\_\_\_ or independent \_\_\_\_\_.
6. An insured is anyone protected by a policy from financial \_\_\_\_\_.

7. The premium charged is a function of probability of the \_\_\_\_\_ of the loss and its probability of \_\_\_\_\_.
8. Safe operation of an insurance plan requires skill in the \_\_\_\_\_ of applicants.
9. Reasons for refusal to accept an application can include the \_\_\_\_\_ nature of the property or the \_\_\_\_\_ character of its owner.
10. Policies exemplifying multiple line underwriting include \_\_\_\_\_ and \_\_\_\_\_.

*Short Answer Questions*

1. A bank lends money to an automobile buyer to finance the automobile purchase. What is commonly pledged as security for the loan?
2. No-fault automobile laws provide that injured persons must look to whom for payment?
3. What is a chief difference between the negligence system and the no-fault laws?
4. What is generally meant by multiple-line underwriting?
5. What does the Inner-City Capital Investment Program (I-CAP) do?
6. What legal forms of business organizations may insurers take?
7. How does insurance eliminate worry?

8. What are some of the social costs of insurance?
9. "Insurance employs substantial amounts of labor, capital, and land." Explain.
10. How far do you think that the social responsibility of insurers should extend?

# Chapter 2

## Risk and Insurance

Definitions are important in general because they make us sharpen our thinking and be more precise. In insurance, definitions of contractual terms can make the difference between payment and nonpayment. After giving us basic definitions, this chapter explains methods of handling economic risk (including insurance as a method of shifting risk). The chapter concludes with criteria of an insurable exposure.

### Chapter Outline

---

#### I. Basic Definitions

- A. Chance of loss
- B. Definition of risk
- C. Peril
- D. Hazard
- E. Loss

#### II. Risk and Risk Bearing

- A. Social cost of risk
- B. Methods of handling risk

#### III. Insurance as a Device for Handling Risk

- A. Definition of insurance
- B. Indemnity
- C. Law of large numbers
- D. Criteria of an insurable exposure

#### IV. Summary

---

## Objective Questions

### *True or False*

- |   |   |     |   |
|---|---|-----|---|
| T | F | 1.  | The chance of getting a "head" on a single toss of a coin is $\frac{1}{2}$ .  |
| T | F | 2.  | Actual losses cannot be predicted with 100 percent accuracy by the insurance company.   |
| T | F | 3.  | Pure risk can produce loss or gain.   |
| T | F | 4.  | Speculative risk can produce loss or gain.  |
| T | F | 5.  | Buying stock is an example of pure risk.  |
| T | F | 6.  | There is speculative risk for the insurance company.  |
| T | F | 7.  | Ownership of a chain of stores can reduce risk as compared with the risk if only one store was owned.   |
| T | F | 8.  | Percentage variation decreases as exposure increases.   |
| T | F | 9.  | If you increased exposure 50 percent, you would automatically be decreasing your risk by 50 percent.  |
| T | F | 10. | If the future course of events is perfectly predictable, the risk is measured as 100 percent.   |
| T | F | 11. | If it is impossible for an event to happen, the risk is measured as 100 percent.  |
| T | F | 12. | Insurance is sold primarily in those cases where there is zero risk.  |
| T | F | 13. | Chance of loss is another name for degree of risk.  |
| T | F | 14. | Indifference to loss or carelessness is sometimes known as morale (as opposed to moral) hazard.   |
| T | F | 15. | Faking a claim is an example of moral hazard.   |
| T | F | 16. | Risk may discourage investors.  |
| T | F | 17. | The effect of risk on the economy is the same as that of socially undesirable monopolies.   |
| T | F | 18. | A specific risk cannot be avoided if an alternate choice exists.  |
| T | F | 19. | Retention of risk cannot result from unawareness but has to be by deliberate choice.  |
| T | F | 20. | Risks may be retained if there is no way to meet them.  |
| T | F | 21. | Underwriters' Laboratories, Inc. originally was established by fire insurers to test for fire hazards.  |
| T | F | 22. | Automatic sprinklers are primarily designed to prevent loss rather than reduce its severity.  |
| T | F | 23. | Hedging is often used in grain "futures" but cannot be used in betting.   |
| T | F | 24. | Subcontracting relieves the general contractor of residual liability for the entire job.  |
| T | F | 25. | A hold harmless agreement can shift a legal obligation.   |
| T | F | 26. | A surety bond is a three-party agreement wherein the surety agrees to answer to the obligee for the default of the principal.                           |
| T | F | 27. | Insurance is a method of shifting risk and of reducing risk.  |
| T | F | 28. | We do not have insurance if we combine similar exposure units.  |
| T | F | 29. | The law of large numbers is not applicable to insurance because the former is based on regularity of events while the latter deals with irregularities. |
| T | F | 30. | An essential criterion of an insurable exposure is that there be the sale of a policy by a commission agent.  |

### *Multiple Choice*

1. Chance of loss:
  - I. is the long-run relative frequency of a loss.
  - II. may be expressed by a fraction.
  - III. may be expressed by a percentage.
  - IV. is better known as hazard.

- A. I and II only
  - B. III and II only
  - C. I, II, and III only
  - D. II, III, and IV only
  - E. I, II, III, and IV
2. A person tosses a six-sided die (one of a pair of dice). The probability of tossing a 4-spot on any single toss is:
- A.  $1/6$ .
  - B.  $1/4$ .
  - C.  $4/6$ .
  - D.  $1/2$ .
  - E. none of the above.
3. Rates should be:
- I. adequate.
  - II. equitable.
  - III. nonexcessive.
  - IV. permanent.
- A. I and II only
  - B. III and IV only
  - C. I, II, and III only
  - D. II, III, and IV only
  - E. I, II, III, and IV
4. If chance of loss is "relatively high," the most efficient method of dealing with risk is:
- A. risk avoidance or risk assumption.
  - B. use of a major loss prevention effort.
  - C. self-insurance.
  - D. A and B.
  - E. A, B, and C.
5. Concerning risk:
- I. Behavioral scientists have the most precise definition of risk.
  - II. Behavioral scientists treat risk as related to human behavior.
  - III. Mathematicians define it as the degree of dispersion of values around the mean.
  - IV. The larger the degree of dispersion the greater the risk.
- A. I and II only
  - B. III and IV only
  - C. I, II, and III only
  - D. II, III, and IV only
  - E. I, II, III, and IV
6. The technical definition of risk is best described as:
- A. uncertainty.
  - B. loss itself.
  - C. cause of loss.
  - D. chance of loss.
  - E. gambling.
7. Which letter best describes the truth?
- I. Fire is a peril.
  - II. The pile of oily rags that may cause spontaneous combustion is a hazard.
  - III. Gunpowder in a building is a physical hazard.
  - IV. Arson is the result of moral hazard.

- A. I and II only
  - B. III and IV only
  - C. I, II, and III only
  - D. II, III, and IV only
  - E. I, II, III, and IV
8. Actions that may be taken by an underwriter include:
- I. rejection of application.
  - II. restriction on coverage.
  - III. increasing the premium.
- A. III only
  - B. I and II only
  - C. I and III only
  - D. II and III only
  - E. I, II, and III
9. A loss includes which of the following characteristics?
- I. Unintentional
  - II. Decline or disappearance of value
  - III. Must be a physical article
- A. I only
  - B. I and II only
  - C. I and II only
  - D. II and III only
  - E. I, II, and III
10. Losses resulting from destruction of property may be of what types?
- I. Loss of the article
  - II. Loss of income or use
  - III. Extra expense
- A. I only
  - B. I and II only
  - C. I and III only
  - D. II and III only
  - E. I, II, and III

#### *Completion*

1. Insurance is purchased to offset the \_\_\_\_\_ resulting from perils.
2. In insurance, chance of loss is important because it is the basis upon which \_\_\_\_\_ are established.
3. If the chance of loss is infinitesimal, \_\_\_\_\_ the risk.
4. In our text risk is defined as \_\_\_\_\_ concerning loss.
5. The accuracy with which losses can be predicted is called \_\_\_\_\_ of risk.
6. Degree of risk is measured by probable variation of actual experience from \_\_\_\_\_ experience.
7. The lower the probable percentage of variation, the \_\_\_\_\_ the risk.
8. People prefer a \_\_\_\_\_ certain budgetable cost than an uncertain but potentially \_\_\_\_\_ loss that is nonbudgetable.
9. The more predictable the loss, the \_\_\_\_\_ is the degree of risk.
10. The \_\_\_\_\_ Act limits the aggregate liability from a nuclear accident.

### *Short Answer Questions*

1. Differentiate between loss frequency and loss severity.
2. What are the general methods of dealing with economic risks?
3. Differentiate between reducing the hazard and reducing the loss.
4. Explain the difference in the liability of a partner and of a stockholder.
5. How is insurance the opposite of gambling with respect to risk?
6. What is indemnity?
7. What criteria are considered for an insurable exposure?
8. Compare death and sickness with respect to determination of definite loss.
9. How do fire insurers attempt to guard against catastrophic losses? Hint: Refer to criterion “unlikely to produce loss to a great many at the same time.”



10. Why do the criteria of an insurable exposure apply mostly to private insurance rather than to social insurance?