## AINS 21

### ANSWERS TO THE QUESTIONS IN THE COURSE GUIDE

6th Edition

Property and Liability Insurance Principles 2015-2016

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Assignment 1

Understanding Insurance

Educational Objective 1

The whole concept of insurance is a broad one – What is it? How does it function? What does it do? Viewing insurance through four dimensions can help clarify what it is and does:

A Risk Management Technique – people, businesses, and other organizations face the risk of financial loss arising from a wide range of types of property they own or activities in which they engage. Other types of risk management techniques exist by which these risks of financial loss can be avoided, reduced, or prevented. The purchase of insurance can be a useful method of dealing with the potential financial consequences of the risks which the insured chooses to retain.

A Risk Transfer System – the vehicle of insurance operates in such a way as to: (1) transfer the potential financial consequences of a loss away from the insured and onto the insurer, and (2) spread the costs of those losses among all of the insureds covered by the insurer. Insurers use mathematical models and loss costs to calculate how much premium should be charged to each insured in order to equitably cover these loss costs (and other expenses of the insurer).

A Business – insurers have many functions to perform in order to be financially strong enough to pay present and future claims, meet operating expenses, and produce a profit for the stockholders. State governments closely monitor the operations of both property/casualty and life/health insurers to ensure that they are financially sound enough to meet the needs of their insureds.

A Contract – Since insurance works to transfer the potential risk of financial loss away from the insured and onto the insurer, close attention needs to be given to the nature of the document between insured and insurer which accomplishes this.

It is a contract of **utmost good faith** wherein both parties are bound to complete honesty and disclosure.

It is a **contract of adhesion** wherein the insured is accepting the document produced by the insurer all-or-nothing. Because of the unequal position of the insured, any ambiguity of wording is interpreted in the insured’s favor if a dispute arises.

It is a **contract of indemnity** where the insurer pays the insured an amount directly related to the actual amount of loss incurred by the insured. Part of the reasoning of this is so that the insured cannot profit from being paid for a loss.

**Key Words and Phrases**

1-1. A **loss exposure (exposure)** is a circumstance or a condition of the environment that presents the possibility of a financial loss.

1-2. **Risk management** is the practice of taking steps to minimize or eliminate the effects of losses incurred by an organization.

1-3. **Loss prevention** is a risk management technique that attempts to reduce the frequency of a loss exposure.

1-4. **Loss reduction** is a risk management technique that attempts to reduce the severity of a loss exposure (in dollars).

1-5. **Exposure unit** is a basic measuring segment of exposure to loss. Exposure units can be individual cars, homes, measurements of $100 of payroll, and other types of things counted and grouped together for purposes of loss experience analysis of the whole group.

1-6. **Property-casualty insurance** is a group of coverages which deal with exposure to financial loss arising from ownership of property or legal liability to others.

1-7. **Life-health insurance** is a group of coverages which deal with exposure to financial loss arising from death, injury, or sickness.
1-8. **Utmost good faith** is a relationship between parties in a contract where both are obligated to full and honest disclosure of all pertinent facts.

1-9. **Contract of adhesion** is a contract in which one party must adhere to the contract exactly as it is written by the other party.

1-10. **Contract of indemnity** is a contract in which the insurer agrees to pay an amount directly related to the amount of loss if a covered loss occurs.

1-11. A **self-contained policy** is a complete policy in a single document which contains all the agreements between the insurer and the insured.

1-12. A **modular policy** is a policy built of several different documents, none of which could be a complete policy by itself.

**Review Questions**

1-1. Risk management techniques can be categorized into four types:

   **Avoidance** is the practice of taking steps to avoid even the possibility of loss. Not owning a car is an example of avoidance of the chance of incurring any type of financial loss associated with car ownership.

   **Loss prevention** is the technique of taking steps to reduce the possibility of the occurrence of loss, e.g., requiring employees to wear steel-toed shoes in work areas.

   **Loss reduction** is the practice where steps are taken to reduce the severity of losses when they do occur. Firewalls at regular intervals in commercial structures are an example.

   **Transfer** is the technique where the financial consequences of loss are transferred by contract to a party willing to bear the chance of loss. The purchase of insurance is an example of transfer (from the insured to the insurer).

1-2. Insurance is a transfer system because the insured/policyholder transfers the chance (or risk) of loss to another party, the insurer/insurance company. It is a loss sharing mechanism because many insureds transfer their chances of loss to the insurer, who pools their premiums so that payment of losses incurred by insureds can be shared by all. The pooling of exposure units also occurs, enabling the forecast of future loss experience.

1-3. This mechanism is the insurance policy by which the insured transfers financial responsibility for losses to the insurer. Because the premiums of many insureds are pooled, each insured need only pay a small periodic payment instead of bearing the potential of a large loss occurring without the presence of insurance.

1-4. The law of large numbers describes how the future experience exhibited by a group of exposure units is predictable based upon analysis of past experience and other factors. As the number of exposure units increases, the prediction of that future experience (e.g., losses) becomes more reliable.

1-5. Examples of property-casualty insurance would include auto insurance (personal or commercial), property insurance (personal homeowners or commercial structures), and liability coverages such as commercial general liability.

1-6. The two primary sources of income for insurers are the premiums paid by insureds and the investment income earned by those premiums before they are needed to pay claims.
# MULTIPLE CHOICE QUESTIONS WORKBOOK

**AINS 21**

**6th Edition**

**2015-2016**

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Assignment 1

Understanding Insurance

1. All individuals and organizations are faced with conditions/situations presenting the possibility of loss. These are known as:
   (A) Perils
   (B) Adverse selection
   (C) Loss exposures
   (D) Net income losses
   (Text 1.3)

2. The use of insurance as a risk management method falls under which technique?
   (A) Transfer
   (B) Loss prevention
   (C) Retention
   (D) Avoidance
   (Text 1.4)

3. Which of the following statements best explains how loss control may help to reduce claim payments?
   (A) Loss control assures the insured that the peril insured against will not occur.
   (B) Loss control helps to prevent losses from occurring.
   (C) Loss control reduces frequency of losses, but has little effect on severity of losses.
   (D) All of the above.
   (Text 1.4)

4. Loss prevention measures strive to reduce:
   (A) How often a loss might occur
   (B) How costly a loss will be
   (C) The insurance premiums of an organization
   (D) The likelihood the policy will be cancelled
   (Text 1.4)

5. When an insured purchases insurance to transfer risk, he or she is transferring:
   (A) Temporary ownership of the property insured to the insurer
   (B) Premium to the insurer only if a loss occurs
   (C) Responsibility to reimburse the insured for premium payment if no loss occurs
   (D) Financial responsibility for possible insured losses to the insurer
   (Text 1.4)

6. Insurers are able to bear the cost of paying losses for insureds because:
   (A) Insurers make such high returns on investment income
   (B) Insurers pool the premiums of many insureds and share the costs of losses among all insureds
   (C) Insurers try to get out of paying some claims
   (D) None of the above
   (Text 1.5)

7. The entire insurance industry can be defined by two main types of insurance. These are:
   (A) Property/Casualty, and Life/Health
   (B) Auto (personal and business) and Property
   (C) Liability and Property
   (D) Property and Life/Health
   (Text 1.5)

8. The two main revenue sources for insurers are:
   (A) Loss control services and premium income
   (B) Investment income and rental of office space
   (C) Claim adjustment services and premium income
   (D) Premium income and investment income
   (Text 1.6)
1. C is the answer. The wording of the question is the definition of a loss exposure.

2. A is the answer. Insurance transfers financial responsibility for loss from the insured to the insurer.

3. B is the answer. Loss control does not guarantee that the perils insured against will not occur. Loss control helps to reduce both the frequency and the severity of losses.

4. A is the answer. Loss prevention measures address frequency (how often if at all a loss may occur from a given cause).

5. D is the answer.

6. B is the answer. The basic reason that insurance works is that insurers can pool the premiums of the many to pay the losses of the few – the law of large numbers enables insurers to predict the loss experience of the many.

7. A is the answer. These categories encompass all of the types of coverage provided, and each address a different concept of insurance need.

8. D is the answer. The combination of the two enables insurers to operate profitably and still keep premium charges reasonable.