PRINCIPLES OF
RISK MANAGEMENT AND INSURANCE
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Principles of
RISK MANAGEMENT AND
INSURANCE

GEORGE E. REJDA
MICHAEL J. MCNAMARA
WILLIAM H. RABEL

Pearson
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The first edition of this text appeared 37 years ago in 1982. The basic objective was to write an intellectually stimulating and visually attractive text from which students can learn and professors can teach. The fundamental objective for this edition remains the same. This edition provides students with an in-depth treatment of major risk management and insurance topics in a visually attractive and user-friendly product with no prerequisites. The 14th edition is unique in this respect. Students can immediately apply the basic principles in this text to their own personal risk management and insurance programs to deal with major risks that create great economic insecurity.

CONTENT CHANGES IN THE 14TH EDITION

Thoroughly revised and updated, the 14th edition provides a comprehensive analysis of major life and health insurance contracts and property and liability insurance coverages, which readers have come to expect from Principles of Risk Management and Insurance. Key content changes in this edition include the following:

- **Enterprise risk management.** Chapter 4 provides a revised and expanded treatment of enterprise risk management.
- **Changes in marketing practices.** Chapter 5 covers significant changes in marketing practices. In particular, the fields of wholesale insurance and surplus lines insurance have been evolving rapidly, which has led to a new classification system for intermediaries in those areas. Wholesale insurance refers to property/casualty intermediaries who obtain business only from “retail” agents and brokers and do not deal with the public. The Wholesale and Specialty Insurance Association has been formed to provide a single voice for intermediaries in the field. In addition, Chapter 5 deals with shifts in consumer preferences that have produced changes in life insurance marketing and financial planning.
- **Government regulation.** Chapter 8 adds new material to enhance the understanding of state insurance regulation. Additional insights have been added dealing with insurance regulation following the severe 2008 debacle and economic downswing.
- **Estate tax law.** Policyholders with large taxable estates often purchase life insurance for federal estate tax purposes. Chapter 13 deals with important considerations in purchasing life insurance for federal estate tax purposes. Updates have been added to reflect recent changes in the federal estate tax law.
- **Poor performance of health care delivery system.** When compared to advanced foreign nations, the United States scores last or low on most measurements of health care delivery systems and health insurance. Chapter 15 provides an updated analysis of the broken and flawed health care delivery system in the United States.
- **Evaluation of the Affordable Care Act.** Chapters 15 and 16 provide a current analysis of the Affordable Care Act (ACA) and an evaluation of its effectiveness in reducing the number of uninsured individuals and family members. The 14th edition analyzes the most egregious defects now found in the current ACA program.
- **Update on developments in employer-sponsored group health insurance plans.** Employers continue to struggle with the rapid increase in group health insurance premiums and continue to seek new solutions for holding down costs. Chapter 16 is an update on current trends in group health insurance and proposals to slow health care cost increases.
- **Changes in group life and health insurance.** Chapter 16 also deals with changes in group life
and health insurance and the market for group health insurance. For example, high-deductible health insurance plans combined with health savings accounts are making substantial gains in the preferred provider organization (PPO) market.

- **Obsolescence in certain retirement plans.** Chapter 16 recognizes that certain older retirement plans such as money purchase retirement plans and Keogh plans for the self-employed have become obsolete and are being replaced by other options.

- **Coverage of new Personal Auto Policy (PAP).** The Insurance Services Office (ISO) has released a new version of the Personal Auto Policy. The 2018 PAP is discussed in Chapter 20. The policy was revised to address car sharing and ride sharing (for example, Uber and Lyft) problems. Additional changes in the 2018 PAP are also discussed.

- **Cyber insurance.** Computer hackers have been successful in accessing the credit card records and other personal information of millions of individuals. Cyber security remains an important financial concern for business firms and public entities because of data breaches and malware. Chapter 25 provides an updated treatment of cyber property insurance. Chapter 26 provides an updated treatment of cyber liability insurance.

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**IDENTIFICATION AND TREATMENT OF MAJOR RISKS**

A primary objective of the text is to identify major risks in our economy and the various techniques for treating risk. Since the last edition of the text appeared, several tragedies have occurred that vividly show the deadly presence of risk in our society. In August 2017, Hurricane Harvey caused $125 billion in damage, record rainfall and catastrophic flooding in Texas and Louisiana, and 107 confirmed deaths. Harvey was the second most-costly hurricane in the United States since 1900. Shortly thereafter, in October 2017, a deranged gunman rained gunfire on people attending an outdoor concert across the street from the Mandalay Bay Resort and Casino in Las Vegas, Nevada, killing 58 people (including the gunman) and wounding and injuring more than 800 people from gunfire and panic.

In addition to catastrophic tragedies at the national level, the media routinely report events that clearly show the destructive presence of risk at the local level. Examples abound. An employee in a liquor store is shot and killed by a customer seeking cash and alcohol; a house fire leaves a family homeless; a tornado destroys a large part of a small town; a fire leaves a family homeless; a tornado destroys a large part of a small town; a drunk driver fails to stop at a red light and smashes into another motorist; a plant explosion kills two people and injures several employees; and a blinding snowstorm and ice-packed interstate highway cause a chain-like accident and collision damage to 10 cars. As a result, victims and families experience catastrophic financial losses, intense emotional pain and suffering, serious physical and mental injuries, and often death. To say that we live in a risky and very dangerous environment is an enormous understatement.

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**OVERVIEW OF THE 14TH EDITION**

The 14th edition of this text discusses the aforementioned risks and other insurance issues, as well. The text is designed for a beginning undergraduate course in risk management and insurance with no prerequisites. Topics discussed include basic principles in risk management and insurance, introductory and advanced topics in traditional risk management, newer enterprise risk management concepts, functional and financial operations of insurers, legal principles, life and health insurance, property and liability insurance, employee benefits, Social Security, and social insurance programs. In addition, the 14th edition is a user-friendly text for students who can apply basic concepts immediately to their own personal risk management and insurance programs.

---

**SOLVING TEACHING AND LEARNING CHALLENGES**

By its very nature, the introductory course in risk management and insurance involves the teaching of highly complex technical concepts that can present certain teaching and learning challenges to both professors and students. To deal with technical problems and complexity, the authors have designed the text to reflect a basic principle in education—**repetition is the**
mother of learning. The 14th edition reflects this important principle in the following ways:

- **Learning objectives.** Each chapter has specific learning objectives, which give students an overview of the subject matter and list the important concepts students are expected to know.
- **Chapter discussion.** Each chapter presents text material designed to give students the knowledge needed to attain the learning objectives specified at the beginning of the chapter. Important material is often presented in italics for emphasis.

Katerina, age 24, is a finance major at a large university. The placement director for the university has an annual job fair where recruiters from different business firms interview students for possible employment. Katerina signed up for an interview with a large multi-line insurance company to learn about job opportunities. The recruiter explained that job openings exist in several areas, and that the company hires new employees with a wide variety of educational backgrounds. Katerina is surprised to learn of the wide range of jobs in the insurance industry. The company has career openings in underwriting, sales, claims, actuarial, finance, information systems, accounting, legal, engineering, medicine, and in other areas as well.

- **Chapter summary.** Each chapter ends with a summary of the major concepts students should know so that the learning objectives listed at the beginning of the chapter can be attained.

**SUMMARY**

- There are several basic types of insurers:
  - Stock insurers
  - Mutual insurers
  - Lloyd’s
  - Reciprocal exchange
  - Blue Cross and Blue Shield Plans
  - Health maintenance organizations (HMOs)
  - Captive insurers
  - Savings bank life insurance

- An **agent** is someone who legally represents the insurer and has the authority to act on the insurer’s behalf. In contrast, a **broker** is someone who legally represents the insured.

- **Key concepts and terms.** Risk management and insurance has its own unique vocabulary and set of key concepts and terms. Instructors should inform students that these terms are clearly defined and easily accessible in the Glossary at the end of the text. If students do not understand the basic vocabulary, they will perform poorly.

**KEY CONCEPTS AND TERMS**

Advance premium mutual (97)
Agent (102)
Assessment mutual (97)
Broker (102)
Captive agent (105)
Captive insurer (101)
Career agents (105)
Demutualization (98)
Direct response system (108)
Direct writer (107)
Exclusive agency system (107)
Fraternal insurers (97)
Holding company (99)
Independent agency system (107)
Interinsurance exchange (100)
Lloyd’s (99)
Managed care plans (101)
Managing general agent (MGA) (104)
Mass merchandising (108)
Multiple distribution systems (108)

- **Review questions.** The answers to review questions at the end of each chapter enable students to answer the learning objectives listed at the beginning of each chapter.

**REVIEW QUESTIONS**

1. Explain each of the following characteristics of a typical insurance plan.
   a. Pooling of losses
   b. Payment of fortuitous losses
   c. Risk transfer
   d. Indemnification
2. Explain the law of large numbers.
3. Pure risks ideally should have certain characteristics to be insurable by private insurers. List the six characteristics of an ideally insurable risk.
4. Identify the approaches that insurers can use to deal with the problem of catastrophic loss exposures.
5. Why are most market risks, financial risks, production risks, and political risks considered difficult to insure by private insurers?

- **Application questions.** These questions are a continuation of the review questions but at a higher level. The application questions enable students
to develop their analytical skills by having them apply the principles and concepts discussed in the chapter to specific risk management and insurance problems.

APPLICATION QUESTIONS

1. A group of investors are discussing the formation of a new property and liability insurer. The proposed company would market new homeowners policies that combine traditional homeowner coverage with unemployment benefits if the policyholder becomes involuntarily unemployed. Each investor would contribute at least $100,000 and would receive a proportionate interest in the company. In addition, the company would raise additional capital by selling ownership rights to other investors. Management wants to avoid the expense of hiring and training agents to sell the new policy and wants to sell the insurance directly to the public by selective advertising in personal finance magazines.
   a. Identify the type of insurance company that best fits the preceding description.

   • Insights. Each chapter has one or more Insights, which are short articles designed to give a practical application of the principle or concept discussed in the chapter.

   INSTRUCTOR RESOURCES

Several supplements are available to help busy instructors with a limited amount of time to prepare for class more efficiently and to have access to high-quality multiple choice questions for examinations. The available supplements are listed in the following table.

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<td>Solutions to all questions and problems in the book</td>
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STUDENT SUPPLEMENTS AVAILABLE

To enhance student performance and higher class achievement levels, the text also makes available several supplements that can upgrade the overall learning experience of students. The following supplements enable students to understand more easily some difficult technical concepts in risk management and insurance.

Supplements Available to Students at www.pearsonhighered.com/author

Features of the Supplement

1350 multiple choice questions with these annotations:
- Difficulty level (1 for straight recall, 2 for some analysis, 3 for complex analysis)
- Learning Objective
- AACSB learning standard
- Written and Oral Communication; Ethical Understanding and Reasoning; Analytical Thinking; Information Technology; Interpersonal Relations and Teamwork; Diverse and Multicultural Work; Reflective Thinking; Application of Knowledge)

Test Bank

Computerized Test Gen

TestGen allows instructors to:
- Customize, save, and generate classroom tests
- Edit, add, or delete questions from the Test Item Files
- Analyze test results
- Organize a database of tests and student results

PowerPoints

Slides include all the tables and equations in the textbook. PowerPoints meet accessibility standards for students with disabilities. Features include, but are not limited to:
- Keyboard and screen reader access
- Alternative text for images
- High color contrast between background and foreground colors

EMPLOYABILITY

INSIGHT 1.2

Careers in Risk Management and Insurance

Insurance is one crucial for insurers, considering the large volume of data that insurers must manage. All of these functional areas must work together for an insurer to be successful. These areas are discussed in greater detail in Chapter 6.

Importance of Risk Management and Insurance. Whatever your specialty is and whenever you plan to work, experts agree that understanding the principles of risk management and insurance is important. Insurance is a challenging field, and considerable technical knowledge is expected of employees who want to rise to top levels. To be effective in risk management and insurance, you must be able to think logically and apply important principles. Farm (2002). As a result, insurance companies today require ongoing professional development for their employees as they enter the company and move up through the ranks. Most insurers today encourage their employees to participate in industry-specific education programs such as Chartered Life Underwriter (CLU), Chartered Property Casualty Underwriter (CPCU), Fellow, Life Management Institute (FMI), and Certified Financial Planner (CFP).

(Continued)
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The views expressed in the text are those solely of the authors and do not necessarily reflect the viewpoints or positions of the reviewers whose assistance we gratefully acknowledge.

Finally, the fundamental objective underlying the 14th edition remains the same as in the first edition: We have attempted to write an intellectually stimulating and visually attractive textbook from which students can learn and professors can teach.

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