

THINK CRITICALLY

Handwrite your responses in the space below; 2 sentences each.

1. What is the difference between a risk and an opportunity?

2. What are the four methods a business can use to deal with risks that it faces?

3. A _____ risk has the possibility of either a financial loss or a gain.
 - a. pure
 - b. speculative
 - c. natural
 - d. human

4. Which of the following is not one of the primary sources of risk faced by companies? _____
 - a. property
 - b. personnel
 - c. liability
 - d. financial

5. Using a financial services company to offer customer credit is an example of _____ the risk.
 - a. avoiding
 - b. transferring
 - c. insuring
 - d. transferring

6. True or False? _____ Controllable risks can be reduced or avoided by thoughtful actions.

7. True or False? _____ Risk management deals with both pure and speculative risks.

8. A word that is used as a substitute for risk is _____
 - a. peril
 - b. insurance
 - c. uncertainty
 - d. opportunity

9. Purchasing insurance trades a potentially large but uncertain loss for a smaller but certain _____.
 - a. gain
 - b. risk
 - c. result
 - d. payment

TEAMWORK

Discuss in pairs or small groups and then write your conclusions below.

10. With your team brainstorm a list of risks team members and their families face on a regular basis. Classify them as natural, human, controllable, and uncontrollable. Discuss what can be done to reduce the losses that could result from each risk.

THINK CRITICALLY

Handwrite your responses in the space below; 2 sentences each.

1. List the conditions that must exist in order for a risk to be insurable.
2. What is the difference between rate making and underwriting?
3. Describe the four common parts of an insurance policy.
4. A(n) _____ means that the insured will suffer a financial loss if the insured event occurs.
 - a. peril
 - b. insurable interest
 - c. risk
 - d. none of the above
5. The business activity in which each insurance application is carefully reviewed to make sure all information needed to make a decision is available and accurate is known as _____.
 - a. rate making
 - b. claims processing
 - c. investing
 - d. underwriting
6. With _____ the insured and insurer share the risk by paying a defined amount of the costs.
 - a. dividends
 - b. deductibles
 - c. coinsurance
 - d. premiums
7. True or False? _____ Insurance transfers some risk faced by an individual or organization to others.
8. True or False? _____ An insurance salesperson can actually represent several insurance companies rather than just one.
9. Which of the following must exist for a risk to be insurable? _____.
 - a. only a small number of individuals or businesses can face the risk
 - b. losses from the risk must be both accidental and uncertain
 - c. the cost of the losses cannot be estimated
 - d. all of the above must exist

10. The part of the insurance policy that forms the basis of the contract between the insured and the insurer is the _____
- a. exclusions
 - b. conditions
 - c. insuring agreement
 - d. declarations
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TEAMWORK

Discuss in pairs or small groups and then write your conclusions below.

11. Discuss with team members how you would make the decision whether to accept a higher deductible to an insurance policy in return for a lower annual premium. How does the decision provide an example of risk management?

Risky Business

Read each of the 7 business cases below. Think about what your business risks might be in each situation. Identify the possible financial losses and explain how you could manage these risks (review information in CFIN 10.1, if needed). Responses should be 20 words minimum per question.



1. You own a local fast food restaurant, Quik N Greasy. While watching the news one evening, you see that more and more obese people are suing restaurants – accusing them of making them fat.
2. Sleep Ezzzz is a successful pharmaceutical company which sells a pill designed to help people with insomnia. You work in the research department of Sleep Ezzzz and discover that some patients are dying suddenly in the middle of the night.
3. You own the Columbus Cutters, a professional hockey team.

4. Cups & Helmets, Inc. is the manufacturer of sports equipment used by many high school sports teams. An 11-year old boy receives brain injuries from a hockey puck that manages to break through the helmet.
5. You are a plastic surgeon with Snip/Cut. You have never had any lawsuits due to malpractice, but you know many other doctors who have lost everything.
6. Cheap-Way is grocery store in South Carolina. Hurricane season is coming up soon and you're worried about what might happen to your store.
7. You operate Big Tent Circus, which involves many acrobatic stunts and animal acts in the show.

Why It Matters: The Tyranny of the Average

“Average” is all around us: your GPA, the unemployment rate, Joey Votto’s batting performance. Using averages can help us make sense of a large amount of data. But it can also lead us to incorrect assumptions. For example, if one of your projects for math class were to calculate the average wealth of all your classmates’ families, you’d probably come up with a number that fairly accurately reflects the economic circumstances of most of those in your class. But what if one of your classmates were Bill Gates’ child? With his current wealth sitting at \$72.9 billion, your average calculation will suddenly give the appearance that everyone in your class lives in a billionaire family.

While this example of a misleading average is more amusing than substantive, there are plenty of examples that hit much closer to home. Let’s talk about car insurance. If you are a male driver under the age of 25, your car insurance premium is probably higher than that of a comparable young woman. In fact, if a female version of yourself existed, equal in all respects (same driving record, grades, car model, residence), odds are you will pay about \$676 more in premiums than your she-clone. But wait, you exclaim, insurance companies aren’t being fair! Enter the tyranny of the average.

Car insurance premiums for young males are generally higher than young women’s because, on average, young men are worse drivers. Men are more likely to be in a crash than women, especially fatal crashes. Women wear seatbelts 27% more often than men do. Men have twice as many DUI citations as women do. Men also drive more than women do—1.5 times more. So, men--especially young men--are on the road more than women, and once there, take greater risks--on average.

The problem in the insurance market is called adverse selection. In this case, adverse selection simply means that you have more information about your driving habits than the insurance company does. But the insurance company has to somehow determine an appropriate premium to charge you. What to do? The company relies, to some extent, on those averages. If a certain category of driver is, on average, involved in more crashes and engages in more risky behavior than other categories, and you fit into that category, you’re likely to pay higher premiums. Your individual behavior can certainly mitigate the effect of belonging to that risky category, such as getting better grades or taking driver training classes, but if you’re a young man, your premium is still likely to be more than that of a similar young woman.

This may not seem fair, but it is legal in the U.S. because insurance companies are not charging different premiums simply on the basis of gender. They are using gender as an indicator of risk because—on average—gender is associated with the greater likelihood of an accident on the part of young men. Gender is not the major factor in setting premiums, and the difference in premiums is becoming smaller as the driving habits of young men and women become more alike. This doesn’t mean that the tyranny of the average no longer exists; it simply means that the averages are more equal. If you’re a young male driver, don’t take your higher premium personally. Your insurance company doesn’t have anything against you, it’s just playing the averages.