Introduction to Risk Management and MCQ

Chapter 1   Introduction to Enterprise Risk Management

1) A Pure Risk is defined as:

A) an event that offer no opportunity for financial gain

B) the chance a loss will occur

C) a diversifiable risk

D) a contingency that increases the chance of a loss

Answer: A

2) All the following are direct losses except:

A) a car is stolen

B) a house suffers flood damage

C) an apartment must be rented after a house is destroyed by fire

D) a business loses $100,000 in a law suit

Answer: C

3) All the following are direct losses except:

A) a house is burglarized

B) a store loses $200,000 in sales because a fire closes it down for two weeks

C) a corporation must pay $1 million in ransom when its CEO is kidnapped

D) an delivery truck needs $15,000 in repairs after a collision

Answer: B

4) Which of the following is not an example of a Catastrophic Loss Event?

A) Hurricane Katrina

B) Death of Michael Jackson

C) September 11, 2001 terror attacks

D) 2004 Tsunami in the Indian Ocean

Answer: B

5) Which of the following is not a method of protection of risk?

A) Group insurance plans

B) Employee benefits

C) Social insurance

D) Humanitarian aid   Answer: D

6) Defective electrical wiring that may lead to a fire is an example of a:

A) pure risk

B) non-diversifiable risk

C) speculative risk

D) physical hazard

Answer: D

7) Risk Pooling is an example of:

A) a Catastrophic Loss Event

B) diversifying risk

C) a speculate risk

D) applying the risk-return trade-off

Answer: B

8) Which of the following is a false statement?

A) Risk averse people will pay an insurance premium that is greater than the mathematically fair chance of loss in order to relieve themselves of uncertainty.

B) A risk seeker is willing to assume risk.

C) The mathematically fair price for insurance is the objective risk for the insurer multiplied by the maximum possible loss.

D) Insurance is never a mathematically fair trade because the insurer adds several operating and other costs to loss costs when it calculates the premium.

Answer: D

9) Which of the following is <u>not</u> a hazard?

A) Storing one ton of dynamite in a garage

B) Bad diet (eating lots of junk food)

C) Skating on thin ice

D) Getting shot accidentally while deer hunting

Answer: D

10) The correct order of the steps in the Risk Management Process is:

A) Establish Goals, Identify Potential Loss Exposure, Measure Potential Loss Exposure, Choose Risk Handling Techniques, Implement Techniques and Monitor Effectiveness

B) Establish Goals, Choose Risk Handling Techniques, Identify Potential Loss Exposure, Measure Potential Loss Exposure, Implement Techniques and Monitor Effectiveness

C) Establish Goals, Choose Risk Handling Techniques, Measure Potential Loss Exposure, Identify Potential Loss Exposure, Implement Techniques and Monitor Effectiveness

D) Establish Goals, Measure Potential Loss Exposure, Identify Potential Loss Exposure, Choose Risk Handling Techniques, Implement Techniques and Monitor Effectiveness

Answer: A

11) Assume that 1000 students, all healthy, all age 22, and all male, form a life insurance pool to pay $500 to the beneficiaries of any member who dies in the next 365 days. The chance of loss or probability of death for the members of this group is .002. To join the pool a member must pay: (Disregard interest earnings and reserves and assume expenses of operating the insurance pool are 30% of losses).

A) $1

B) $1.30

C) $3

D) $2.28

Answer: B

Diff: 3

12) Which of the following is <u>not</u> a type of risk when identifying a pure risk?

A) Retention Risk

B) Property Risk

C) Liability Risk

D) Human Resource Risk

Answer: A

13) Which of the following is a true statement?

A) Liability risks are risks associated with building calamities.

B) Theft is a diversifiable risk.

C) Most individuals in the industrialized countries carry no insurance.

D) The Law of Large Numbers is used in Risk Pooling.

Answer: D

14) Loss Transfer means:

A) shifting the financial consequences of a loss to a third party

B) shifting the financial consequences of a loss to a self-insurance program

C) shifting the financial consequences of a loss to a well-diversified portfolio

D) shifting the financial consequences of a loss to more wealthy group of people

Answer: A

Diff: 2

15) Which of the following is <u>not</u> a risk handling technique?

A) Loss control

B) Loss diversification

C) Loss transfer

D) Loss financing

Answer: B

16) Which of the following potential losses is <u>not</u> an example of a pure risk?
A) Loss of a home by fire
B) Theft of a car
C) Loss of $10,000 in the stock market
D) Theft of your wallet containing $100
Answer: C
Diff: 2

17) Enterprise Risk Management:
A) is only applicable to insurance firms
B) is an outdated method of dealing with risk
C) works best when evaluating risks is distinct company silos
D) is a process that examines all risks collectively
Answer: D
Diff: 2

18) Which of the following is <u>not</u> a direct social benefit of the insurance mechanism?
A) Increased business and social stability
B) Better allocation of society's resources
C) Better choice of optimum size of business operations
D) Lower federal and state income taxes
Answer: D
Diff: 2

19) The ideal insurance system:
A) reduces the probability of accidental and fortuitous losses due to increased predictability
B) requires the transfer of a large number of exposures to loss to a pool, where a fund exists in advance of losses having to be paid
C) works best when a large proportion of the participants in the pool submits a claim
D) eliminates all hazards
Answer: B
Diff: 2

20) Catastrophic losses are not insured by the private insurance industry because:

A) if a truly catastrophic loss occurs, it can threaten the solvency of the insurer

B) catastrophic losses can result from an individual's moral hazard

C) the federal government wants to insure catastrophic losses

D) the losses require foreign reinsurance companies to operate in the U.S.

Answer: A

Diff: 2

21) Which one of the following losses is an indirect loss?
A) Damage to a car when a tree falls on it
B) Loss caused by an arsonist who burns down a building to collect insurance proceeds
C) Monetary losses due to the inability to produce and sell goods when a machine is destroyed
D) Monetary losses due to a legal liability claim
Answer: C
Diff: 2

22) Diversifiable risk is defined as:
A) risk with two possible outcomes
B) risk with three possible outcomes
C) an individual's perception of risk
D) none of the above
Answer: D
Diff: 3

23) Why is a large number of exposure units generally required for a risk to be insurable?
A) It allows the insurer to accurately predict the aggregate dollar amount of loss.
B) It allows for at least some losses to occur.
C) It reduces speculative risk.
D) It reduces both the speculative risk and pure risk.
Answer: A
Diff: 2

24) Why is a large number of exposure units generally required for a risk to be insurable?
A) It prevents the insurer from losing money.
B) It guarantees that losses will be unintentional and measurable.
C) It enables the insurer to better predict the frequency and severity of losses (moderate).
D) It minimizes physical hazards.
Answer: C

Diff: 2

25) Examine the following list of "risks." Determine which of these are "pure risks."
I.   The risk that your antique Corvette will depreciate in market value
II. The risk that you will have a collision in your Corvette, thus causing you to spend thousands of dollars in repair costs
III. The risk that someone will steal your Corvette
IV. The risk that you will buy a house and lightning will strike your roof, thus causing you to have to purchase a new roof
V. The risk that you will invest your life savings in a business venture that fails, thus causing you to lose your entire investment
A) I, II, III, IV, and V
B) I, II, and IV
C) I, II, III, and IV
D) II, III, and IV
Answer: D
Diff: 3

26) The law of large numbers states that as the number of exposure units increases:
A) accuracy of predictions should improve
B) the chance of loss declines
C) Speculative risk increases
D) the number of accidents decreases
Answer: A
Diff: 3

27) Which of the following is an accurate definition of "insurance"?
A) A savings account designed to protect you in the event of a rainy day
B) A financial arrangement that redistributes the costs of unexpected losses among a pool of insureds
C) A communist plot to destroy capitalist enterprise
D) A contractual agreement in which the insurer agrees to pay the insured only if the insured requests the money
Answer: B
Diff: 2

28) An insurance applicant dying from cancer is not likely to be insured because:
A) the loss is not definite as to time and place
B) the probability of loss varies daily, ultimately reaching 1.0
C) the loss would be catastrophic for the insurer
D) the loss is certain to occur and the price for coverage would be uneconomical
Answer: D
Diff: 2

29) What is the fundamental function of the insurance company—in other words, what is it the insurance company does that makes the insurance mechanism work?
A) It pools those insureds having similar risks, and predicts the losses that those in the pool will suffer.
B) It pools any insureds who wish to purchase insurance, and attempts to predict the losses that those in the pool will suffer.
C) It redistributes government subsidies to those who have suffered catastrophes.
D) It eliminates the process of underwriting in order to sell insurance to as many people as possible, thus providing insureds with a huge quantity discount.
Answer: A
Diff: 2

30) There are four basic components of an insurance premium. Which of the following is not one of those components?
A) Losses suffered by the members of the insurance pool
B) Law of large numbers
C) An allowance for unexpected losses
D) Earnings on investments
Answer: B
Diff: 2

31) Enterprise Risk Management is typically described as having the following characteristics, except:
A) a top-down corporate focus
B) a broad scope of loss exposures
C) a portfolio perspective

D) a loose approach to risk identification, assessment, and treatment

Answer: D

Diff: 1

32) In the context of ERM, hazard risk is defined as:

A) being associated with the strategic direction of a firm

B) being associated with the operations of a firm

C) adverse financial losses associated with diversifiable risks.

D) adverse financial losses associated with pure risks.

Answer: D

Diff: 3

33) In the context of ERM, which of the following is an example of hazard risk?

A) Human Resource losses

B) Property losses

C) Liability losses

D) Supply Chain interruption losses

Answer: D

Diff: 3

34) Arthur is driving home from work when he runs off the road and hits a telephone pole. These are the losses he suffers: $12,000 to repair the damage to his car, and, $800 to rent a car while his car is being repaired. What is the correct name for each of these losses?

A) The $12,000 is an indirect loss, and the $800 is a direct loss.

B) The $12,000 is a direct loss, and the $800 is also a direct loss.

C) The $12,000 is a direct loss, and the $800 is an indirect loss.

D) The total loss of $12,800 is a direct loss.

Answer: C

Diff: 2

35) Which of the following is not an example of a speculative risk?

A) Purchase of an insurance policy

B) Investment in common stocks

C) Operating a business for profit

D) Investment in banana futures

Answer: A

Diff: 1

36) The most difficult and important step in the risk management process generally is:
A) evaluating risk
B) reviewing the program
C) selecting the best method(s) to handle the risk
D) identifying the risk
Answer: D
Diff: 1

37) A "pure risk" is defined as a situation where there is the possibility:
A) of loss or no change
B) of profit or no change
C) of profit or loss
D) that actual losses will deviate from expected losses
Answer: A
Diff: 2

38) Loss prevention and control:
A) eliminate risk
B) are an alternative to self insurance
C) reduce the probability and severity of loss
D) directly minimize the probability of a natural disaster occurring
Answer: C
Diff: 2

39) Loss prevention is the best risk management tool when the chance of loss is _____ and the potential loss severity is _____.
A) high, high
B) high, low
C) low, low
D) low, high
Answer: B
Diff: 2

40) Risk retention is not a good idea if:

A) the risk is unimportant

B) you did not identify the risk

C) the frequency is so low it almost will never happen

D) the exposure is potentially catastrophic

Answer: D

Diff: 2

41) Which of the following would <u>not</u> normally be identified in the risk management process?
A) Property exposures
B) Speculative exposures
C) Indirect loss exposures
D) Operations exposures
Answer: B
Diff: 2

42) The primary reason the insurance mechanism functions successfully is the:
A) existence of hazard risks
B) ease with which losses can be measured
C) predictability of losses via the law of large numbers
D) existence of many non-industrial nations
Answer: C
Diff: 2

43) If the chance of loss is high and loss severity is high, generally the most appropriate risk management tool is:
A) risk transfer
B) risk reduction
C) risk assumption
D) risk avoidance
Answer: D
Diff: 2

44) The Chief Risk Officer is concerned primarily with the management of:
A) operational risks
B) financial risks
C) strategic risks
D) all of the above
Answer: D
Diff: 1

45) Which of the following best describes a pure risk?

A) An uncontrollable risk that cannot be insured

B) The outcome will either be a loss or no change

C) The outcome will be either a loss or a gain

D) A risk with three possible outcomes

Answer: B

Diff: 2

46) When faced with a risk of loss that is low frequency-high severity in nature, a prudent risk manager would choose which of the following methods for handling the loss exposure?
A) self-insure
B) avoidance
C) transfer
D) mediate
Answer: C
Diff: 2

47) If you were the risk manager of the World Trade Center buildings, what loss prevention or reduction technique could you have implemented before the 9/11/01 tragedy that might have made a significant difference in the number of lives lost?
A) Guards on the roof of each building
B) Evacuation procedures that required everyone to leave after any sign of loss
C) Stronger exterior building materials
D) Better background screening of all who were allowed to work in the building
Answer: B
Diff: 3

48) Risk diversification is based on the principle that:
A) one should not be exposed to only one event
B) one should put all her "eggs in one basket"
C) risk can be measured subjectively
D) pure risk seldom happens
Answer: A
Diff: 1

49) Which of the following is <u>not</u> a goal of the government, employer or employee in providing employee benefits?
A) Raise tax revenue
B) Provide security for employees
C) Retain, attract and compensate employees
D) Encourage savings for retirement
Answer: A

Diff: 2

50) If a person installs an automatic sprinkler system to prevent serious fire damage, this action can be considered "insurance" as defined in the text.
Answer: FALSE
Diff: 2

51) Hazards may increase either the frequency or the severity of losses.
Answer: TRUE
Diff: 1

52) A flood is an example of a non-diversifiable risk.

Answer: TRUE

Diff: 2

53) In general, aggregate losses must be predictable in advance for an insurance system to work properly.

Answer: TRUE

Diff: 1

54) Risk averse people have a tendency to shy away from insurance.

Answer: FALSE

Diff: 3

55) "Loss" and "chance of loss" are terms with the same meaning.

Answer: FALSE

Diff: 2

56) Volcanoes have catastrophic loss potential because they are limited in geographic impact.

Answer: TRUE

Diff: 2

57) The law of large numbers allows the insurer to predict aggregate dollar losses in advance of their occurrence.

Answer: TRUE

Diff: 2

58) Insurance companies utilize the law of large numbers to reduce the chance of loss for their insureds.

Answer: FALSE

Diff: 3

59) Most speculative risks are insurable.

Answer: FALSE

Diff: 1

60) One reason catastrophes are difficult to insure is because the damage is so unpredictable.
Answer: TRUE
Diff: 2

61) Speculative risks refer to those events which can only result in loss.
Answer: FALSE
Diff: 2

62) Employee benefits have been strengthened in the last few years.
Answer: FALSE
Diff: 2

63) Enterprise Risk Management is a comprehensive approach to corporate risk.
Answer: TRUE
Diff: 1

64) The first step in the Risk Management Process is choosing appropriate risk handling techniques.
Answer: FALSE
Diff: 2

65) Enterprise Risk Management is the response of the accounting profession to corporate fraud.
Answer: TRUE
Diff: 2

66) Explain the financial definition and the legal definition of "insurance."
Answer: Financially, insurance is an arrangement which redistributes the cost of a few losses among many who contribute to a pool. Legally, insurance is a contractual arrangement where one party agrees to indemnify another if a loss occurs.
Diff: 2

67) Why is Enterprise Risk Management so important for firms?

Answer: There has been a clear breakdown in corporate governance and ERM provides a solution by examining all risks in the firm collectively and by elevating the analyses to the highest level in the corporation. This way the people in the corporate boardroom can no longer escape responsibility.
Diff: 2

68) Explain briefly the law of large numbers.
Answer: The law of large numbers is a mathematical rule that explains how insurance companies operate and are able to predict aggregate losses. The law says that the larger the sample size (the more exposures pooled together), the more closely the predicted result will equal the actual result.
Diff: 2

69) Describe the Risk Management Process.
Answer: The Risk Management Process is a systematic approach by which an organization can identify and manage its exposure to risk in ways that best fit its strategic goals. Most follow a set of five steps, namely: 1) Establish the Goals of the Risk Management Function, 2) Identify Potential Loss Exposures, 3) Measure Potential Loss Exposures, 4) Choose Risk Handling Techniques, and 5) Implement Techniques and Monitor Effectiveness.
Diff: 2

70) Discuss risk reduction through diversification.
Answer: Diversification reduces risk by not putting all of one's eggs in one basket, but instead spreading them across multiple baskets. By doing this, an unfavorable event, in this case dropping a basket, will not lead to all of the eggs being broken, but only one. Hence risk is being reduced since a large loss will be less likely to occur.
Diff: 2

71) What are the three basic methods of dealing with risk in the risk management process?
Answer: The only three alternatives to risk are to 1) avoid, 2) retain, or 3) transfer. All other methods are extensions or combinations of these three. Self-insurance is retention. Loss control (prevention and/or reduction) on the other hand is used to reduce the frequency and/or severity of losses, regardless of whether the exposure

has been retained or transferred. This decision is usually subject to a cost benefit analysis.

Diff: 2