Objective Risk - relative variation of actual from expected loss

Subjective Risk - uncertainty based on a person's mental condition or state of mind.

Objective probability - Long run relative frequency of an event based on the assumption of an infinite # of observations, no change in underlying conditions

Subjective probability - personal estimate of the chance of loss.

Fundamentals & Terminology in Risk and Insurance

Definition of <u>Insurance</u>

A financial mechanism whereby an individual or entity pays a small certain amount (i.e. premium) in exchange for being indemnified (i.e. reimbursed for covered losses) for large uncertain loss (i.e. the Contingency insured against).

Key Elements: Financial Arrangement
                loss Redistribution
                Dealing with Unexpected
                        Loss

Insurance Illustration

500 Homes Each Insured for $600 premium This year, with a Coverage of $100,000.

Total Premium Income:

$$500 \times \$600 = \$300,000$$

Out of the 500 insured homes

Homes 1, 100 : 500 are destroyed

$$Total \ loss = 3 \times \$100,000 = \$300,000$$
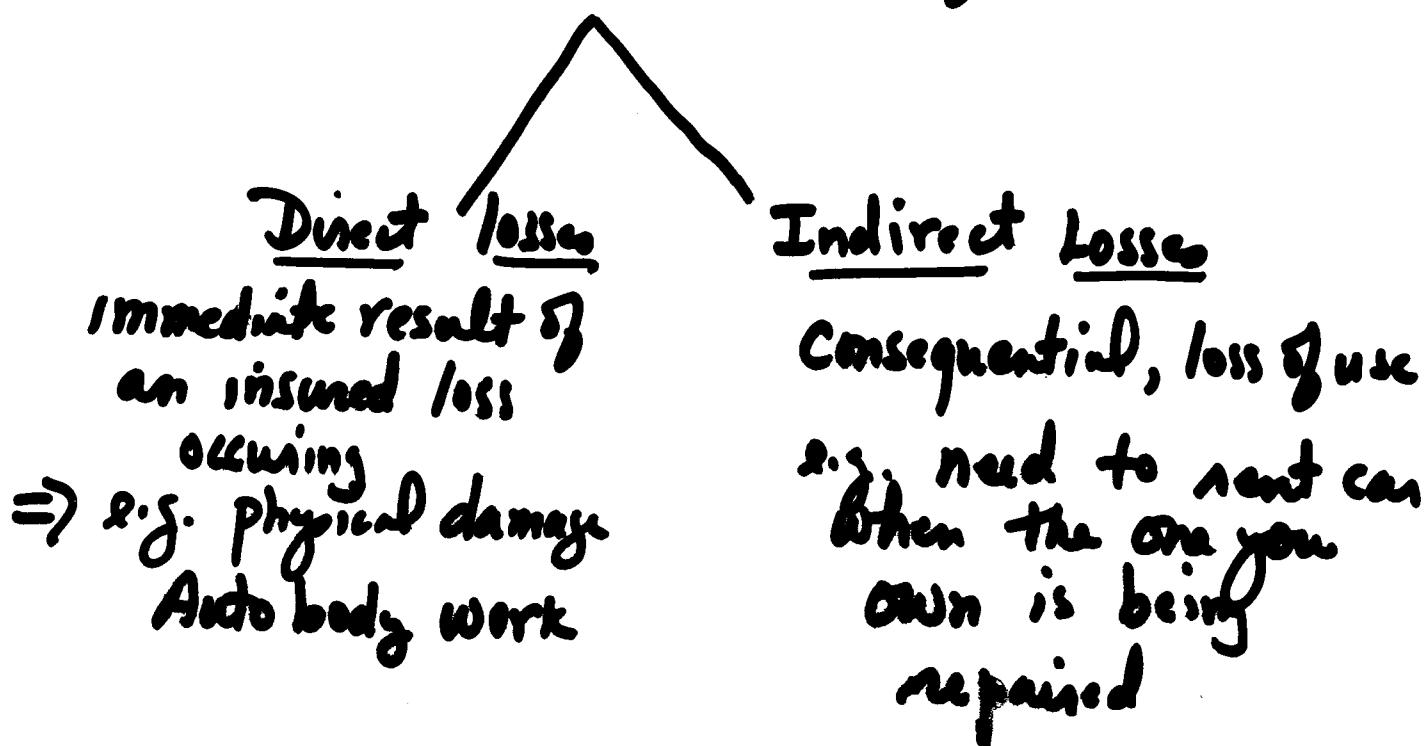
$$Premium \ Income - Insured \ loss = \$0$$

Each homeowner Shared in paying for the loss with the 500 homes that were insured.

Legal <u>Definition</u> of Insurance

A contractual arrangement whereby one party agrees to compensate another party for losses.

Loss - An undesired, unplanned reduction in economic value arising from chance.

Direct losses
Immediate result of an insured loss occuring
⇒ e.g. physical damage Auto body work

Indirect Losses
Consequential, loss of use
e.g. need to rent car when the one you own is being repaired

Chance of loss:

$$= \frac{\text{Actual \# expected losses}}{\text{\# exposed to loss}}$$

Difference Between __Hazard__ vs. __Peril__

__Peril__ __is__ __the__ __Cause__ of __loss__. (e.g. fires, tornados, heart disease)

Insurance will sometimes list specific perils covered under the Contract.

Hazards — Conditions that increase either the frequency or severity of loss.

3 Types — (1) Physical (2) Moral (3) Morale

Proximate Cause:

the first peril in a chain of events resulting in loss.

e.g.   Deer → Car → Ditch → telephone pole
→ Smashed in front end
+
Deer meat

Risk: Variation in possible outcomes of
an event based on chance.

⇒ Adverse Deviation away from expected
results.

Degree of Risk:

   A measure of the accuracy with which
the outcome of an event based on chance.

Higher the accuracy of prediction
   $\Rightarrow$ lower the degree of risk

Risk Classifications:

<u>Pure</u> vs. Speculative

Fundamental vs. <u>Particular</u>

<u>Static</u>   vs.   Dynamic

Which

Risk Management: is the logical process
Used by businesses and/or individuals
to deal with exposure to loss.

<u>Risk</u> <u>Mgt</u> <u>Encompasse</u> <u>more</u> <u>techniques</u>
<u>Than</u> just <u>Insurance</u>:
- ① Risk Avoidance
- ② Risk Assumption
- ③ Loss Control / Prevention
- ④ Loss Transfer / Sharing