

Exercise 1.A

Match the method of managing risk on the left with its correct description on the right.

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| ___ 1. Avoid risk | A. George always wears his seat belt in the car. |
| ___ 2. Control risk | B. Terry's car is not insured. |
| ___ 3. Retain risk | C. Gretchen doesn't own a car because she doesn't know how to drive. |

Exercise answers can be found at the end of the Unit 1 answers and rationales.

1.5. INSURANCE

You learned that one way of managing risk is to transfer it. This is what insurance does. The purpose of insurance is not to avoid or eliminate risk but to transfer risk. To see how it works, let's look at the hypothetical town of Middlefield.

Middlefield has 200 homes, each worth \$100,000. Usually, one home in Middlefield burns to the ground each year. If the homeowner has to pay for the house, the owner will suffer a \$100,000 loss. However, if that loss were divided among each of Middlefield's homeowners, it would be only \$500. Wouldn't you agree to pay \$500 knowing that if your house burned down, you would receive \$100,000?

This is basically how insurance works. Instead of paying each other, people pay insurance companies, thus transferring the risk and responsibility for paying for any losses that occur to the company in exchange for a premium. The insurance company accumulates these premiums to provide the funds to pay for losses. This means that even though people don't pay each other directly, they still share in the cost of each other's losses.

