

## ch03

Student: \_\_\_\_\_

1. In recent years, the total assets of insurance companies in the U.S. have been decreasing.  
True False
2. Due to a recent increase in demand for new insurance products, the number of life insurance companies as been increasing in the United States.  
True False
3. The process of life insurance uses risk pooling to transfer income-related uncertainties from a group of individuals to an insured individual.  
True False
4. Adverse selection is a situation where customers who most need insurance are more likely to apply for insurance.  
True False
5. In 2008, ordinary life accounted for over 80% of policies in force.  
True False
6. Term life insurance includes a savings element as well as the pure insurance element.  
True False
7. A term life policy allows the policyholder to vary the maturity of the policy.  
True False
8. The policy that will pay a specific dollar benefit to beneficiaries and remains in effect as long as premiums are paid is called whole life.  
True False
9. The policyholder can vary the premium payments on an endowment life policy.  
True False
10. In group life insurance, lower rates on policies can be offered because of cost economies as a result of mass administration of plans and reduced selling and commission costs.  
True False
11. Employers that sponsor non-contributory group life insurance require the employee to pay the insurance premiums.  
True False
12. Annuities are the reverse of life insurance in that they are different means of liquidating a fund.  
True False
13. The payments from an annuity offered by a life insurance company can either begin immediately or may be deferred to start at some future date.  
True False
14. Annuities are popular retirement savings products because investment returns on contributions are tax-deferred.  
True False
15. By regulation, the payments on an annuity contract must stop when the annuity holder dies.  
True False

16. The rate of growth in the annuities market is increasing primarily because of the recent changes in the capital gains tax rates.  
True False
17. Life insurance companies also manage private pension plans that may include guaranteed investment contracts (GICs).  
True False
18. Pension fund management is a relatively small portion of the life insurance industry.  
True False
19. By 2009, life insurance companies were managing over 40% of all private pension plans.  
True False
20. Loss exposures faced by insurers in accident and health lines are more similar to those faced by traditional life insurance than by property-casualty insurance.  
True False
21. Although life insurance companies also provide health and accident insurance, they underwrite less than 35% of all health insurance policies.  
True False
22. The cash surrender value of a life insurance policy represents the payment to the insured's beneficiaries at the time of death.  
True False
23. The policy reserves on the liability side of the balance sheet of a life insurance company are estimated based on actuarial assumptions of expected future liability commitments on currently existing contracts.  
True False
24. Because of the large amounts of policy reserves that life insurance companies carry as liabilities, they are rarely surprised by unexpected fluctuations in expected future payouts.  
True False
25. As of 2009, chartering of life insurance companies can be done only at the state level.  
True False
26. Insurance guaranty funds involve a permanent fund similar to the FDIC for the purpose of compensating the policyholders of failed insurers.  
True False
27. State-sponsored insurance guarantee funds are run and administered by private insurance companies operating in the state.  
True False
28. Insurance guarantee funds are administered by federal insurance regulators.  
True False
29. A permanent guarantee fund for the insurance industry does not exist.  
True False
30. As currently structured, contributions to a state-sponsored guarantee fund are collected only after the actual failure of an insurance company.  
True False
31. As currently structured, state guarantee funds will continue to collect premium payments and honor life policies and annuity obligations of a failed insurance company.  
True False

32. In the case of an insurance company failure, policyholders immediately receive a payout of the cash surrender value of their policies.  
True False
33. During the most recent financial crisis, life insurance companies with large proportions of separate accounts business were well-protected from the decline in the debt and equity markets.  
True False
34. The growth of HMOs has increased the amount of health insurance premiums collected by life insurance companies.  
True False
35. Property insurance involves coverage against the loss of personal property as well as protection against legal liability claims.  
True False
36. PC underwriting risk only exists when the premiums generated on a given insurance line are less than the claims (losses) on the line.  
True False
37. The largest property-casualty (PC) insurance companies have become less influential over the past decade.  
True False
38. In general, maximum levels of losses are more predictable for liability lines than for property lines.  
True False
39. The expected loss potential is more difficult to determine with low-severity, high-frequency events.  
True False
40. Automobile liability insurance provides protection against theft or damage to the vehicle.  
True False
41. Unexpected increases in inflation cause loss rates to increase more for long-tail risk than for short-tail risks.  
True False
42. Loss adjustment expenses refer to the costs surrounding the loss settlement process.  
True False
43. Property-casualty insurers tend to have a higher level of liquidity risk than life insurers.  
True False
44. One reason for the recent decline in the expense ratio for PC insurers is an increase dependence on independent brokers to sell and distribute insurance policies.  
True False
45. Insurance companies have resisted the investment in technology that banks and other financial service firms have pursued.  
True False
46. The Insurance Regulatory Information System (IRIS) is a standardized exam to measure the profitability of insurance companies.  
True False
47. Unlike the banking industry, globalization of financial services is having little or no effect on the insurance industry.  
True False

48. The primary function of insurance companies is to
- A. generate fees for the banks that sell insurance products.
  - B. sell a variety of consumer investment products.
  - C. protect policyholders from adverse events.
  - D. assist in the transfer of wealth into the future.
  - E. provide contracts that encourage policyholders to save current income.
49. The largest line of life insurance in terms of total contract value in the U.S. is
- A. ordinary life.
  - B. group life.
  - C. industrial life.
  - D. credit life.
  - E. noncontributory life.
50. The problem of adverse selection
- A. implies that many people who do not need insurance coverage have it through group plans.
  - B. means that those people who apply for insurance are the least likely to need insurance coverage.
  - C. causes insurance underwriters to alter the health statistics of the general population when determining appropriate premiums.
  - D. creates a savings element along with the insurance component of the premium and policy.
  - E. does not exist in the insurance industry.
51. Insurance policy benefits are classified on an insurance company's balance sheet as
- A. liabilities, because the insurance company may have to pay out the benefits.
  - B. assets, because policy benefits are valuable to the company.
  - C. liabilities, because customers may fall behind on their premium payments.
  - D. assets, because policy benefits are fully covered by premium payments.
  - E. liabilities, because insurance companies must maintain a capital base to cover the payments of benefits.
52. Which of the following is pure life insurance with a savings element built in
- A. term life.
  - B. universal life.
  - C. whole life.
  - D. variable universal life.
  - E. variable life.
53. An insurance policy that protects an individual over an entire lifetime is called
- A. term life.
  - B. universal life.
  - C. whole life.
  - D. endowment life.
  - E. variable life.
54. An insurance policy in which fixed premium payments are invested in mutual funds of stocks, bonds, and money market instruments is called
- A. term life.
  - B. universal life.
  - C. whole life.
  - D. endowment life.
  - E. variable life.
55. Which of the following involves fixed premium payments and a benefit payout at the time of death that will depend on investment returns over the life of the policy?
- A. Term life.
  - B. Variable life.
  - C. Whole life.
  - D. Endowment life.
  - E. Universal life.

56. An insurance policy that often is the least expensive to the insured because of the policy does not include a savings plan is called
- A. term life.
  - B. universal life.
  - C. whole life.
  - D. endowment life.
  - E. variable life.
57. An insurance policy that allows both the premium amount and the maturity of the life contract to be changed by the insured is called
- A. term life.
  - B. universal life.
  - C. whole life.
  - D. endowment life.
  - E. variable life.
58. Which of the following insurance products protects a lender against a borrower's death prior to repayment of the debt?
- A. Credit life.
  - B. Universal life.
  - C. Whole life.
  - D. Endowment life.
  - E. Variable life.
59. An annuity is a financial contract that
- A. is used to build up a fund.
  - B. pays only fixed returns to groups of employees.
  - C. is used to liquidate a fund.
  - D. pays only variable returns to individuals.
  - E. None of the above are correct.
60. Variable universal life insurance policies
- A. have fixed premiums and a fixed benefit payout.
  - B. have fixed premiums, but allow the benefit payout to vary with investment returns.
  - C. have a fixed benefit payout, but allow the premium to vary with investment returns.
  - D. allow both the premium and benefit payout to vary with investment returns.
  - E. allow both the premium and benefit payout to vary with investment returns, but have a fixed maturity date.
61. The largest asset category on the balance sheet of U.S. life insurance companies as of year-end 2009 was
- A. government securities.
  - B. corporate bonds.
  - C. corporate stock.
  - D. cash.
  - E. mortgages.
62. The largest liability category on the balance sheet of U.S. life insurance companies as of year-end 2009 was
- A. net policy reserves.
  - B. policy claims.
  - C. premium and deposit funds.
  - D. commission, taxes and expenses.
  - E. capital surplus.

63. Guaranteed investment contracts (GICs) offered by a life insurance company
- A. are endowment life policies marketed to group insurance policyholders.
  - B. are short- and medium-term debt instruments sold to fund their pension plan business.
  - C. can only be purchased by a group life insurance plan.
  - D. earn a return based on the consumer price index (CPI).
  - E. Short- and medium-term investments in venture capital firms.
64. The surrender value of an insurance policy is
- A. the expected payment commitment on existing policy contracts.
  - B. a fund established and held separately from the company's other assets.
  - C. the cash value paid to the policyholder if the policy is terminated before it matures.
  - D. the same as the endowment payout.
  - E. the price at which the company may repurchase the policy.
65. Which of the following did NOT occur in the life insurance industry during the most recent financial crisis?
- A. Low equity values reduced asset-based fees on separate account assets.
  - B. Losses were incurred on holding of commercial mortgage-backed securities and commercial loans.
  - C. Asset-based fees declined on products such as variable annuities and pension fund assets that were tied to equity returns.
  - D. Low interest rates and harsh economic conditions caused many policyholders to terminate or surrender their policies.
  - E. Policy premium increased as more households and small businesses attempted to transfer risk to insurance companies.
66. The McCarran-Ferguson Act of 1945
- A. separated commercial banking from insurance activities.
  - B. mandated federal insurance company charters.
  - C. stipulated that insurance companies are to be regulated at the state level.
  - D. initiated a national insurance guaranty fund.
  - E. limited insurance company assets to low risk government securities.
67. As of 2009, the primary regulator of both the life and property-casualty insurance industry is/are the
- A. state insurance commissions.
  - B. NAIC.
  - C. Federal Reserve.
  - D. IRIS.
  - E. new federal oversight commission yet to be named.
68. The insurance company that was the largest beneficiary of federal bailout funds during the most recent financial crisis was
- A. Globe Life.
  - B. UBS.
  - C. State Farm.
  - D. AIG.
  - E. New York Life.
69. Underwriting risk faced by property-casualty insurance companies may result from unexpected
- A. increases in loss rates.
  - B. decreases in loss adjustment expenses.
  - C. increases in investment yields.
  - D. cancellations of policies by customers.
  - E. increases in policy premiums.

70. Life insurance guaranty funds
- A. are sponsored by state insurance regulators.
  - B. involve a permanent reserve fund similar to the FDIC's bank deposit reserve.
  - C. require uniform contributions from each state when there is a failure of an insurance company.
  - D. make policyholder payments immediately in the event of an insurance company failure.
  - E. are regulated by the Federal Reserve Bank.
71. Property-casualty insurance involves
- A. insurance coverage related to the loss of real and personal property.
  - B. insurance protection against legal liability exposure.
  - C. insurance protection against injuries in employment related work.
  - D. Answers A and B only.
  - E. Answers A and C only.
72. As of year-end 2009, asset of property-casualty insurers totaled approximately \_\_\_\_\_, which was \_\_\_\_\_ of the assets of the life insurance industry.
- A. \$900 billion; 20 percent
  - B. \$1,500 billion; 33 percent
  - C. \$4,250 billion; 90 percent
  - D. \$5,750 billion; 105 percent
  - E. \$7,700 billion; 120 percent
73. The two policy categories offered by property-casualty insurers that are most likely to be subject to rate regulation are
- A. auto insurance and worker's compensation.
  - B. homeowner multiple peril and commercial multiple peril.
  - C. earthquake and flood.
  - D. surety bonds and financial guaranty.
  - E. product liability and farm owner multiple peril.
74. If losses on a particular line of medical malpractice insurance were \$650 million and premiums earned were \$575 million, the loss ratio would be
- A. 1.13 implying that this line of insurance is profitable.
  - B. 1.13 implying that this line of insurance is unprofitable.
  - C. 0.88 implying that this line of insurance is profitable.
  - D. 0.88 implying that this line of insurance is unprofitable.
  - E. -\$75 million implying that this line of insurance is unprofitable.
75. If losses on a particular line of fire insurance were \$430 million, premiums earned were \$595 million, and loss adjustment expenses were \$95 million, the combined ratio would be
- A. 0.88 implying that this line of insurance is profitable.
  - B. 0.88 implying that this line of insurance is unprofitable.
  - C. 1.13 implying that this line of insurance is profitable.
  - D. 1.13 implying that this line of insurance is unprofitable.
  - E. 0.22 implying that this line of insurance is profitable.
76. For property-casualty insurers, loss rates are more predictable for
- A. low-severity high-frequency events.
  - B. low-severity low-frequency events.
  - C. high-severity high-frequency events.
  - D. high severity low-frequency events.
  - E. low severity medium-frequency events.
77. Higher uncertainty of losses forces property-casualty firms to
- A. invest in more short-term assets than life insurance firms.
  - B. invest in more long-term assets than life insurance firms.
  - C. hold a lower percentage of capital and reserves than life insurance firms.
  - D. invest in riskier equity securities than life insurance firms.
  - E. conduct more separate accounts business than life insurance firms.

78. For property-casualty insurers, losses are higher for lines that are exposed to
- A. long tails and low inflation.
  - B. long tails and high inflation.
  - C. short tails and low inflation.
  - D. short tails and high inflation.
  - E. short tails and no inflation.
79. Factors that affect the predictability of claims loss exposure include
- A. unexpected increases in inflation.
  - B. the frequency and severity of loss.
  - C. the concept of long-tail risk.
  - D. property versus liability coverage.
  - E. All of the above.
80. If the loss ratio on a line of insurance is 70 percent and loss adjustment expenses are 33 percent, then the line is profitable before dividends if the ratio of
- A. commissions and other expenses are 15 percent and investment yields are 10 percent.
  - B. commissions and other expenses are 5 percent and investment yields are 6 percent.
  - C. commissions and other expenses are 16 percent and investment yields are 20 percent.
  - D. commissions and other expenses are 15 percent and investment yields are 12 percent.
  - E. commissions and other expenses are 6 percent and investment yields are 4 percent.
81. An insurance company collected \$31.0 million in premiums and disbursed \$28 million in losses. Loss adjustment expenses amounted to \$5.0 million. The firm is profitable
- A. if dividends paid to policyholders is \$4 million and income generated on investments is \$4 million.
  - B. if dividends paid to policyholders is \$10 million and income generated on investments is \$14 million.
  - C. if dividends paid to policyholders is \$6 million and income generated on investments is \$2 million.
  - D. if dividends paid to policyholders is \$10 million and income generated on investments is \$4 million.
  - E. if dividends paid to policyholders is \$4 million and income generated on investments is \$2 million.
82. You start an annuity with \$1million and expect to receive 12 equal payments beginning at the end of the first year. The guaranteed annual interest rate is 6 percent. The annual payments that you expect to collect are
- A. \$88,333.33.
  - B. \$119,277.03.
  - C. \$59,638.51.
  - D. \$56,262.75.
  - E. \$112,525.50.
83. Calculate the annual cash flows of a \$2 million, 10-year fixed-payment annuity earning a guaranteed 8 percent annually if the payments are to begin at the end of the year.
- A. \$137,990.27.
  - B. \$275,980.53.
  - C. \$298,058.98.
  - D. \$149,029.49.
  - E. \$220,000.00.
84. What explains the recent increase in many large insurance companies conversion to stockholder controlled companies?
- A. Pressure from policyholders.
  - B. Additional premiums.
  - C. Access to equity markets.
  - D. Tax concerns.
  - E. Regulatory requirement.

85. Which of the following is an advantage of converting from a mutual insurance company to a stockholder-controlled company?
- A. Publicly held companies have access to equity markets for additional capital for future business expansion.
  - B. Mutual organizations are subject to higher regulatory standards than public companies.
  - C. Ability to offer more insurance products than those allowed under mutual ownership.
  - D. Publicly held insurance companies can convert to federal charters but mutual organizations cannot.
  - E. Mutual organizations can only underwrite policies in the state in which they are chartered while publicly held organizations can expand nationwide.
86. Which of the following is NOT a possible result when a property-liability company purchases reinsurance?
- A. Improved capital position.
  - B. Limits on losses on reinsured policies.
  - C. Stabilized cash flows.
  - D. Dilution of earnings per share.
  - E. All of the above are possible results of purchasing reinsurance.
87. Which account refers to the reserve set-aside that contains the portion of a premium that has been paid before insurance coverage has been provided?
- A. Unearned premiums.
  - B. Prepaid premiums.
  - C. Premium reserves.
  - D. Policy reserves.
  - E. Outstanding premiums.
88. The largest asset on property-casualty insurers' balance sheet as of year-end 2009 was
- A. cash.
  - B. bonds.
  - C. common stock.
  - D. short-term securities.
  - E. mortgages and mortgage-backed investments.
89. The largest liability on property-casualty insurers' balance sheet as of year-end 2009 was
- A. loss reserve and loss adjustment expenses.
  - B. unearned premiums.
  - C. cash.
  - D. policyholder surplus.
  - E. conditional reserve funds.
90. The decline in premium income from 2007-2009 in the property-casualty industry can be explained by the
- A. failure of a large number of PC companies.
  - B. federal government gradually increasing compensation and reconstruction assistance following natural disasters.
  - C. merger of several of the largest U.S. property-casualty companies.
  - D. increased availability of catastrophe bonds.
  - E. less stringent oversight of the industry by state insurance commissioners.
91. Which of the following arises in policies in which the insured event occurs during a coverage period but a claim is not filed or reported until many years later?
- A. Short-tail losses.
  - B. Adverse selection.
  - C. Moral hazard.
  - D. Long-tail losses.
  - E. Social inflation.

92. What does the loss ratio measure in any particular year?
- A. Payouts on policies to premiums earned.
  - B. Amount of premiums earned relative to the payout on policies.
  - C. Overall underwriting profitability of a line.
  - D. Loss adjustment expenses to premiums earned.
  - E. Commission and other acquisition costs to premiums written.
93. Which of the following is used as collateral when an insurance company issues policy loans?
- A. Expected premium payments.
  - B. Existing policies.
  - C. Unearned premiums.
  - D. Guarantee funds.
  - E. U.S. Treasury Bills.
94. What is essentially understood to be insurance for property-casualty insurance companies?
- A. Policy reserves.
  - B. Conditional reserve funds.
  - C. Reinsurance.
  - D. Unearned premiums.
  - E. Surplus notes.
95. Which of the following observations concerning reinsurance is FALSE?
- A. It is an alternative to managing risk on a PC insurer's balance sheet.
  - B. Non-U.S. reinsurers are majority players in U.S. reinsurance business.
  - C. It does not enable the insurer to improve its capital position.
  - D. It can be used to limit losses and stabilize cash flows.
  - E. It represented 2.7 percent of total PC industry assets in 2009.
96. The operating ratio for a PC insurer equals
- A. loss ratio plus the ratios of loss adjustment expenses to premiums earned.
  - B. loss ratio plus expense ratio plus dividend ratio.
  - C. combined ratio minus dividends paid to policyholders.
  - D. acquisition costs plus dividends paid as a proportion of premiums earned.
  - E. combined ratio after dividends minus the investment yield.
97. Calculate the annual cash flows of a \$2 million, 10-year fixed-payment annuity earning a guaranteed 8 percent per annum if annual payments are to begin at the end of year 6.
- A. \$218,973.21.
  - B. \$202,752.97.
  - C. \$343,321.86.
  - D. \$405,505.95.
  - E. \$437,946.42.
98. Calculate the annual cash flows of a \$500,000, 12-year fixed-payment annuity earning a guaranteed 6 percent per annum if annual payments are to begin at the end of the year.
- A. \$59,638.51.
  - B. \$56,262.75.
  - C. \$29,819.26.
  - D. \$83,841.52.
  - E. \$28,131.37.
99. Calculate the annual cash flows of a \$500,000, 12-year fixed-payment annuity earning a guaranteed 5 percent per annum if annual payments are to begin at the end of year 4.
- A. \$32,652.38.
  - B. \$79,018.76.
  - C. \$62,195.01.
  - D. \$65,304.76.
  - E. \$31,097.50.



## ch03 Key

1. FALSE
2. FALSE
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36. FALSE

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- 38. FALSE
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- 40. FALSE
- 41. TRUE
- 42. TRUE
- 43. TRUE
- 44. FALSE
- 45. FALSE
- 46. FALSE
- 47. FALSE
- 48. C
- 49. A
- 50. C
- 51. A
- 52. C
- 53. C
- 54. E
- 55. B
- 56. A
- 57. B
- 58. A
- 59. C
- 60. D
- 61. B
- 62. A
- 63. B
- 64. C
- 65. E
- 66. C
- 67. A
- 68. D
- 69. A
- 70. A
- 71. D
- 72. C
- 73. A
- 74. B

75. A  
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91. D  
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93. B  
94. C  
95. C  
96. E  
97. E  
98. A  
99. D

# ch03 Summary

<u>Category</u>	<u># of Questions</u>
Saunders - Chapter 03	99