

Credit and risk Management (FIN625)

Assignment No.2

Marks: 15

Solution:

A)

The conditions that must exist before a pure risk is considered to be an insurable one are following:

Large number of exposure units

To predict average loss

Accidental and unintentional loss

To control moral hazard

To assure randomness

Determinable and measurable loss

To facilitate loss adjustment

Insurer must be able to determine if the loss is covered and if so, how much should be paid.

No catastrophic loss

To allow the pooling technique to work

Exposures to catastrophic loss can be managed by:

- i Dispersing coverage over a large geographic area
- ii Using reinsurance
- iii Catastrophe bonds

Calculable chance of loss

To establish an adequate premium

Economically feasible premium

So people can afford to buy

Premium must be substantially less than the face value of the policy

Insurance allows the insured to transfer a risk to the insurer, whereas gambling creates a risk where none previously existed.

B)

The following are the risk handling methods used by an investor:

Risk Avoidance

Avoidance means a certain loss exposure is never acquired, or an existing loss exposure is abandoned

- ✓ The chance of loss is reduced to zero
- ✓ It is not always possible, or practical, to avoid all losses

Loss Control/Risk Reduction

Loss prevention refers to activities to reduce the frequency of losses

Loss reduction refers to activities to reduce the severity of losses

Risk Retention/Assumption

Retention means that the firm retains part or all of the losses that can result from a given loss. Retention is effectively used when:

- ✓ No other method of treatment is available
- ✓ The worst possible loss is not serious
- ✓ Losses are highly predictable

Risk Transference

A risk may be transferred to another party through contracts, hedging, or incorporation

Insurance transfers the risk of loss to the insurer who is, a financial intermediary that specializes in assuming risk. The insured pays a premium to agree that if certain events (losses) occur, money will be provided to the insured to pay for the consequences of those losses.