THE CONTINUOUS MARKET CYCLE OF THE SHORT-TERM INSURANCE INDUSTRY

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Abstract

The short-term insurance industry is a cyclical type of business due to the impact of the continuous market cycle. This cycle has a growth phase, soft market phase, hard market phase and a break-even phase. The objective of the research paper focuses on the improvement of financial decision-making when executives of the short-term insurance industry are managing their business during the various phases of the continuous market cycle. Both a literature study and an empirical survey were necessary to achieve the research objective. The empirical survey included the contributions of the top nine commercial and corporate short-term insurers in South Africa. They represented more than 77% of the total gross written premiums in 2009 and can thus be considered as the leaders of the short-term insurance industry in this country. The conclusions of the study should be valuable to other developing countries with emerging market economies as South Africa is also classified as such. The study focused on the various factors which may cause the continuous market cycle, the problem areas which the executives experience concerning the continuous market cycle, and how often various factors are adjusted by the short-term insurers to account for changes in the continuous market cycle.

Keywords: Business Cycle, Competition, Continuous Market Cycle, Foreign Exchange Rates, Interest Rates, Investment Income, Phases, Reinsurance, Short-Term Insurers, Solvency

JEL code: M

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1. Introduction and Objective of Research

The short-term insurance industry is a cyclical business where the continuous market cycle plays a decisive role (Harris, 2009:28). According to McGillivray (2004:20) the continuous market cycle of the short-term insurance industry is a challenge which should be properly managed by the executives concerned to ensure the financial success of the business. As four phases can be identified from the continuous market cycle, this paper will address the characteristics of each phase, as well as the terms and conditions which usually prevail when the continuous market cycle enters a new phase.

The continuous market cycle is potentially caused by a number of determining factors, some of which may have more empirical value than others. This research will attempt to identify the most important determining factors in order to assist executives of the short-term insurance industry when managing their enterprises during the various phases of the continuous market cycle. Possible determining factors are, amongst others, the impact of interest rates and the earnings on investments, the effect of foreign exchanges rates and the business cycle, the influence of competition between the various role players in the short-term insurance industry, the solvency position of the short-term insurers, as well as the availability of reinsurance. Attention will also be paid to the main underwriting strategies which can be applied when the various phases of the continuous market cycle prevail.

The *objective* of this research thus embodies the improvement of financial decision-making when executives of the short-term insurance industry are managing their business during the various phases of the continuous market cycle. The aspects of this topic as mentioned in the preceding discussion will be addressed by means of a literature study, after which the results of an empirical survey will follow. The empirical survey will focus on the various factors which may cause the continuous market cycle as perceived by the respondents, the problem areas which the executives experience concerning the continuous market cycle, and how often various factors are adjusted by the short-term insurers to account for changes in the continuous market cycle.

2. Phases of the Continuous Market Cycle

Since 1991, the pattern of the continuous market cycle has been somewhat different (Rosenblatt, 2004:103). The continuous market cycle appears to be longer, while irregular periods of profits and losses may occur. Fewer severe fluctuations in profitability seems to take place (Grossman & Ginsburg, 2004:91). According to Rosenblatt (2004:103), changes in the continuous market cycle may not be as rigorous in the future as they were in the past.

Although the depth of each phase may vary, the continuous market cycle of the short-term insurance industry should be regarded as a given phenomenon (Pozzi, 2006:95). It is possible to identify four phases in the continuous market cycle, viz. the growth phase, the soft market phase, the hard market phase and the break-even phase. The characteristics of each phase, as well as the underwriting terms and conditions which usually prevail during each phase will be discussed in the following sections.

2.1 Growth phase

The growth phase of the continuous market cycle is driven by the profit motive of the short-term insurers. New insurance products are developed by the short-term insurers in order to attract new clients and to increase the coverage of existing clients. During this phase it is possible that new entrants into the short-term insurance market may arrive on the business scene by way of local or international insurers.

2.2 Soft market phase

Coverage is usually readily available during the soft market phase, while underwriting profits may deteriorate due to the greater competition in the short-term insurance market (Higgins & Thistle, 2000:442). Short-term insurers tend to expand their product range even further, while they are sometimes not exercising the due diligence required to ensure that all the relevant information of the clients are accurate and current. Thus the chance of experiencing a loss is greater for short-term insurers (Flanigan, 2007:3).

New entrants may be drawn to the market and due to the intense competition between insurers, the premiums may be lower than the administration and claims costs, which may lead to underwriting losses (Grossman & Ginsburg, 2004:91). As it is a buyer's market the terms and conditions of the insurance policies may be less rigid and the prices may be in favour of the clients (Croteau, 2009:25). It is possible that some short-term insurers may become insolvent during the soft market phase. According to Flanigan (2007:8), the soft market phase usually lasts longer than the hard market phase, and may continue as long as no major catastrophes occur.

2.3 Hard market phase

The hard market phase is characterised by escalating insurance premiums and more restrictive terms and conditions may be applied by the short-term insurers (Hyman, 2003:29). A phenomenon of this phase is that renewals of insurance policies may even be refused. The beginning of the hard market phase is usually brisk, while premium income may decrease during this period (Higgins & Thistle, 2000:442). The loss ratio of the short-term insurers may increase during the hard market phase and the insurers may try to accomplish greater returns without selling more business (Gambrill, 2009:78).

2.4 Break-even phase

Usually little or no underwriting profit is made during the break-even phase of the continuous market cycle. Insurance tariffs may increase as competition may decrease during this phase. Short-term insurers are usually looking for new business as long as it represents good risks. While the coverage of bad risks is not renewed, special insurance packages may be offered to attract excellent new clients.

3. Possible Causes of the Continuous Market Cycle

Possible causes of the continuous market cycle are discussed in the following sections of this paper and consist mainly of the impact of the interest rates, investment income, the foreign exchange rates, the business cycle, competition in the short-term insurance industry, the solvency of short-term insurers, and the availability of reinsurance.

3.1 Interest rates and investment income

A relationship may exist between the level of interest rates and the insurance rates according to Grace and Hotchkiss (1995:739). Variations in underwriting profits may sometimes be counteracted by higher or lower interest earnings (Doherty & Garven, 1995:401). It is believed that higher interest rates provide larger investment income which may lead to lower premiums, but sometimes with a time lag (Fung *et al*. 1998:542). Higher interest rates may therefore not be reflected immediately in the premium rates (Sandrock, 1996:125). There is however no evidence that variability of the interest rate is *solely* responsible for the continuous market cycle, although changes in the interest rates may be one of the causes of the continuous market cycle.

3.2 Foreign exchange rates

The potential impact of foreign exchange rates on the continuous market cycle is based on the following rationale, namely that when the purchasing power of a currency decreases, the cost of imported goods will increase and the claims cost of short-term insurers should also escalate. This may lead to higher premiums in the medium term to offset the higher claims cost (Vermaak, 2007:58). It was already mentioned that higher premium levels is a characteristic of a hard market phase as well as a break-even phase. When the continuous market cycle is in a soft market phase, the higher premiums may therefore introduce a subsequent phase of the continuous market cycle. However, if currency instability is properly managed, a short-term insurer may be able to recover from a hard market phase (Gunnion, 2004:11). It can be concluded that foreign exchange rates may be one of the contributing causes of the continuous market cycle.

3.3 Business cycle

During a downswing of the business cycle, enterprises and individuals may obtain less short-term insurance coverage, because they may find it difficult to pay the premiums while restricted financial conditions prevail. This will without any doubt impact on the premium earnings of the short-term insurers. Poor economic conditions may also put more pressure on the claims cost of short-term insurers, due to possible fraudulent activities of the insureds, higher unemployment levels in the economy and higher expected crime rates (Vermaak, 2007:58).

An increase in the economic activities of a country may lead to escalating consumer spending, including higher short-term insurance cover. The business cycle should therefore be one of the possible causes of the continuous market cycle, influencing the short-term insurance industry in a negative or positive manner.

3.4 Competition in the short-term insurance industry

When new short-term insurers enter the insurance industry, some of the premiums will flow to them and away from the current insurers. Especially during a soft market phase the greater competition should lead to lower insurance rates (Mastowski, 2007:13). Short-term insurers should become more competent to counteract the marketing strategy of competitors, to avoid that their market share and net profits may decline (Gilleland, Jones & Fennell, 1999:173). The competition between short-term insurers should be regarded as one of the possible causes of the continuous market cycle as it impacts on the level of the insurance rates, the stipulations of the policy contracts offered to the clients, and eventually also the net profit of the short-term insurers.

3.5 Solvency of short-term insurers

The solvency of a short-term insurer is often expressed by the solvency margin which is the ratio of the shareholders' interest divided by the net premium income. The ratio is vital as it indicates whether a short-term insurer has the financial capacity to meet the future claims of the risks which it underwrites. When the net premium income increases due to an aggressive marketing strategy during a soft market phase, without an appropriate increase in the shareholders' interest, the solvency position of a short-term insurer will deteriorate and this can eventually lead to insolvency. The bankruptcy of an insurer may have a detrimental influence on the entire short-term insurance industry, as the insurers and reinsurers are often interdependent on each other due to the reinsurance or coinsurance of the associated risks. The solvency of short-term insurers may therefore be regarded as a possible cause of the continuous market cycle as the insurers' solvency positions may impact positively or negatively on the entire insurance industry.

3.6 Availability of reinsurance

Reinsurance enables short-term insurers to cede a proportion of the risks which they underwrite to a reinsurer, while the last-mentioned receives a part of the insurance premium which the insurer obtained from the policyholder (Diacon & Carter, 1992:217). It is sometimes argued that the continuous market cycle may be caused by the reinsurers since they are in a position to adjust the reinsurance capacity and the reinsurance rates which eventually impact on the short-term insurance policies (McGillivray, 2004:20). When the reinsurance rates increase, short-term insurers are under pressure to increase their rates as well, to recoup the higher reinsurance rates from their policyholders.

4. Strategies in Response to the Continuous Market Cycle

According to Boor (2004:6), there are two main strategies which can be applied to counter the impact brought about by changes in the continuous market cycle, focusing on the maintenance of the market share, as well as conserving the capital of the short-term insurer. The strategy which focuses on *maintaining the market share* of the short-term insurer during all the phases of the continuous market cycle does not necessarily provide a solution as the emphasis is on the market share instead of the net profitability and net cash inflow of the insurer. Price wars between insurers may arise which may ultimately lead to insolvency of some insurers as well as losses to the entire insurance industry (Grossman & Ginsburg, 2004:95).

The strategy focusing on the *conservation of the short-term insurer's capital* puts the emphasis on underwriting not an extensive amount of coverage during the soft market phase, while the underwriting of good risks is increased when the hard market phase prevails. Insurers applying this strategy are able to obtain a large amount of profitable business when the continuous market cycle is heading for a hard market phase. This strategy provides a sound financial solution to the countering of the continuous market cycle as the solvency, profitability and net cash inflow of the insurers are prominent features of this strategy.

5. Research Methodology

The objective of this research paper was already formulated as the improvement of financial decision-making when executives of the short-term insurance industry are managing their business during the various phases of the continuous market cycle. The view of the market leaders in South Africa is therefore of prime importance to achieve the research objective and to serve as an example to the particular short-term insurance industry. South Africa is a developing country, has an emerging market economy en recently became a member of the BRICS countries (MSCI Barra, 2010; SouthAfrica.info, 2011). The empirical results should therefore also be valuable to short-term insurers in similar countries.

A questionnaire was constructed by applying the information obtained from the preceding literature study. The questionnaire was sent to the executive managers of the top 10 commercial and corporate short-term insurers in South Africa, along with a covering letter. One of the insurers however said that they are not influenced by the continuous market cycle as they only underwrite compulsory insurance for employees in the mining and manufacturing industries. After following up, the nine remaining short-term insurers completed the questionnaire. It should be emphasised that the nine short-term insurers represented more than 77% of the total gross written premiums of the commercial and corporate insurers in 2009 (Santam Limited, 2010:14). They can thus be considered as the leaders of the short-term insurance industry in South Africa.

6. Empirical Results

It was already stated that the empirical survey of this research paper focuses on the various factors which may cause the continuous market cycle according to the respondents, the problem areas which the executives experience concerning the continuous market cycle, and how often various factors are adjusted by the respondents to account for changes in the continuous market cycle. The empirical results of these aspects are addressed in the following sections.

6.1 The importance of various factors which may cause the continuous market cycle

The importance of various factors which may cause the continuous market cycle, according to the perception of the responding short-term insurers, appears in Table 1. A five point Likert interval scale is used, ranging from 'extremely important' to 'not important'.

Table 1. The importance of the various factors which may cause the continuous market cycle, as perceived by the respondents

Factors	Extremely important	Highly important	Mode-rately important	Little important	Not important
Fluctuation of the interest rates		6	2		1
Impact of foreign exchange *control*	1			6	2
Impact of foreign exchange *rates*	1	3	2	3	
Business cycle of the economy	4	4	1		
Fluctuations in consumer spending	2	4	3		
Competition between insurers	8		1		
Impact of the solvency margins of insurers	3	2	4		
Inaccurate premium rating by insurers and/or insurance intermediaries	4	5			
Inaccurate risk selection by insurers and/or insurance intermediaries	5	4			
Impact of large claims	2	3	3		1
Inability to predict future claims accurately	2	6		1	
Liquidity of insurers	3	3	2		1
Availability of under-writing capacity of insurers	3	4	2		
Availability of reinsu-rance	3	2	4		

The results of the preceding table indicate that it is the opinion of the majority of respondents that competition between short-term insurers as well as inaccurate risk selection by insurers and/or insurance intermediaries are extremely important as possible causes of the continuous market cycle.

Weights were assigned to the various factors which appear in the preceding table, to obtain a clear depiction of the empirical results. The various factors can consequently be ranked in a declining order of importance based on their total weighted score calculated. It was possible to apply weights as it was explicitly mentioned on the questionnaire that the five point Likert interval scale forms a continuum when it was employed (Albright, Winston & Zappe, 2002:224-229 & 245). The following weights were allocated to the responses obtained from the nine short-term insurers:

A weight of 5 was allocated for:	Extremely important	or	Always
A weight of 4 was allocated for:	Highly important	or	Very often
A weight of 3 was allocated for:	Moderately important	or	Sometimes
A weight of 2 was allocated for:	Little important	or	Seldom
A weight of 1 was allocated for:	Not important	or	Never

The weighted responses on the importance of various factors which may cause the continuous market cycle, based on the perceptions of the respondents, appear in the following table in a declining order of importance.

Table 2. The weighted responses on the importance of various factors which may cause the continuous market cycle as perceived by the respondents, in a declining order of importance

Total weighted score calculated	Declining order of importance	Factors
43	1	Competition between insurers
41	2	Inaccurate risk selection by insurers and/or insurance intermediaries
40	3	Inaccurate premium rating by insurers and/or insurance intermediaries
39	4	Business cycle of the economy
37	5	Availability of underwriting capacity of insurers
36	6	Inability to predict future claims accurately
35	7	Fluctuations in consumer spending
35	7	Impact of the solvency margins of insurers
35	7	Availability of reinsurance
34	10	Liquidity of insurers
32	11	Impact of large claims
31	12	Fluctuation of the interest rates
29	13	Impact of foreign exchange *rates*
19	14	Impact of foreign exchange *control*

The total weighted score calculated shows that the competition between short-term insurers is perceived by the respondents as the *most* important factor which may cause the continuous market cycle, while inaccurate risk selection by insurers and/or insurance intermediaries represents the *second* most important factor. The *third* and *fourth* most important factors are respectively inaccurate premium rating by insurers and/or insurance intermediaries, as well as the business cycle of the economy, while the *fifth* and *sixth* most important factors are respectively represented by the availability of underwriting capacity of the insurers and the inability to predict future claims accurately.

It should be emphasised that five of the six most important factors can be partially managed by the executives in the short-term insurance industry, namely the competition between insurers, the risk selection, the premium rating, the availability of underwriting capacity and the prediction of future claims. The fourth most important factor, viz. the business cycle of the economy, is often considered as an external and uncontrollable factor for the short-term insurers. Overall, it is an important conclusion that the decision-making process of the short-term insurers may be a possible cause of the continuous market cycle in the short-term insurance industry.

6.2 Problem areas which the executives experience concerning the continuous market cycle

The executives of the short-term insurance industry experience various problem areas relating to the continuous market cycle. The nine contributory short-term insurers were each asked to mention the three most important problem areas and their responses appear in Table 3.

Table 3. Problems areas which the executives experience concerning the continuous market cycle, as perceived by the respondents

Problem areas	Number of respondents who mentioned the problem area
Business cycle of the economy	7
The extent of the competition between insurers	6
Inaccurate premium rating by insurers and/or insurance intermediaries	4
Availability of reinsurance	3
Inaccurate risk selection by insurers and/or insurance intermediaries	2
Inability to predict future claims accurately	2
Liquidity of insurers	1
Profit management by insurers	1
Cost management	1

According to the preceding table, seven of the nine short-term insurers mentioned the business cycle of the economy as a problem area for their executives. As the business cycle of the economy is often regarded as a factor which short-term insurers cannot control directly, a possible solution is to focus on the management of the entire value chain. Counter-cyclical product offering by short-term insurers, proper risk rating and fraud risk management are other possible solutions to solve the problem area.

Six of the nine contributory insurers listed the competition between short-term insurers as a problem area for executives. Solutions to solve this problem focus on employing proper risk management, to stick to a stable and predictable profit margin, to apply product differentiation, while responsive strategies should also receive attention.

Inaccurate premium rating by insurers and/or insurance intermediaries was a problem area mentioned by four of the short-term insurers. Solutions to address this problem area include the proper training and development of employees, research into price determination, and to apply sound underwriting practices. Insurers should not compromise financial principles to achieve short-term benefits.

The availability of reinsurance was another problem area mentioned by three of the contributory short-term insurers. The problem area may be addressed by short-term insurers when they share detailed information with their reinsurers to support the relationship of trust between them. Short-term insurers should also protect their treaty reinsurance arrangements with their reinsurers to ensure that reinsurance cover is available in future.

6.3 How often various factors are adjusted to account for changes in the continuous market cycle

In order to account for changes in the continuous market cycle, short-term insurers should adjust various factors. The responses of the contributing short-term insurers are summarised in Table 4, showing how often these factors are adjusted by the insurers.

Table 4. How often various factors are adjusted to account for changes in the continuous market cycle, as perceived by the respondents

Factors	Always	Very often	Some-times	Seldom	Never
Adjust the level of the premium	2	4	3		
Require an excess (deducti-ble) to be paid when a claim is made	2	4	2		1
Strictness of risk selection	3	3	3		
Level of coverage provided	2	2	3	2	
Renewal of insurance policies	4	2	1	1	1
Development of insurance products		3	6		
Solvency margin of the short-term insurer		2	2	4	1

The information of the preceding table was weighted (as described in Section 6.1) to obtain a better depiction of the responses of the contributing insurers. The total weighted scores calculated are shown in the following table in a declining order of frequency.

Table 5. The weighted responses on how often various factors are adjusted to account for changes in the continuous market cycle, in a declining order of importance

Total weighted score calculated	Declining order of frequency	Factors
36	1	Strictness of risk selection
35	2	Adjust the level of the premium
34	3	Renewal of insurance policies
33	4	Require an excess (deductible) to be paid when a claim is made
31	5	Level of coverage provided
30	6	Development of insurance products
23	7	Solvency margin of the short-term insurer

According to the total weighted score calculated, the strictness of risk selection is *most* often adjusted by the short-term insurers, followed by the adjustment of the level of the premiums which takes the *second* place. It therefore emerges that the short-term insurers do not always apply an enduring underwriting strategy with established requirements and a stable profit margin, but may tend to choose a more responsive and dynamic strategy.

This conclusion is further supported by the factors which are adjusted respectively *third* and *fourth* most frequently according to Table 5, namely the renewal of insurance policies and the requirement of an excess when a claim is made. It is not clear from the results whether the short-term insurers are amplifying the impact of the continuous market cycle or whether they are trying to act counter-cyclically. It is however clear that the short-term insurers do not always employ a long-term underwriting strategy with set requirements and a stable profit margin.

7. Conclusions

The improvement of financial decision-making when executives of the short-term insurance industry are managing their enterprises during the various phases of the continuous market cycle, embodies the objective of this research paper. The findings of this research paper should also be valuable to short-term insurance industries in emerging market economies of developing countries. The following conclusions came to light from the empirical survey, which was based on the literature study:

(1) It is significant that five of the six most important factors which may cause the continuous market cycle, can be partially managed by the executives in the short-term insurance industry. These factors are the competition between insurers, the risk selection, the premium rating, the availability of underwriting capacity and the prediction of future claims. The fourth most important factor, viz. the business cycle of the economy, is often considered as an external and uncontrollable factor for the short-term insurers. It is therefore concluded that the decision-making process of the short-term insurers may be a possible cause of the continuous market cycle in the short-term insurance industry.

(2) The problem areas which the executives experience concerning the continuous cycle and which were mentioned most frequently, focus on the business cycle of the economy, the competition between insurers, the inaccurate premium rating by insurers and/or insurance intermediaries, as well as the availability of reinsurance. A number of possible solutions are provided to assist the solving of the problem areas.

(3) The various factors which are most often adjusted by the short-term insurers to account for changes in the continuous market cycle, include the strictness of risk selection, the level of the premiums, the renewal of insurance policies and the requirement of an excess when a claim is made. Although it is not clear whether the short-term insurers are amplifying the impact of the continuous market cycle or whether they are trying to act counter-cyclically, it is obvious that the short-term insurers do not always employ a long-term underwriting strategy with set requirements and a stable profit margin.

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