IASB issues revised exposure draft on insurance contracts

Overview

On 20 June 2013, the International Accounting Standards Board (IASB or the Board) issued a revised exposure draft Insurance Contracts (the revised ED) as part of its ongoing insurance contracts project. This is a major milestone in the IASB’s efforts to eliminate the current diversity that exists in insurance contract accounting. The revised ED takes into account the re-deliberations by the IASB since its July 2010 exposure draft Insurance Contracts (2010 ED). The IASB held the majority of those meetings jointly with the Financial Accounting Standards Board (FASB). In turn, the FASB issued a discussion paper, Preliminary Views on Insurance Contracts in September 2010.

Over the past few years, the IASB and FASB worked towards the objective of a joint insurance contracts standard as part of their overall convergence effort. Whilst the Boards agree on many aspects of insurance contract accounting, there are a few areas where they have been unable to find common ground.

The insurance contract measurement principles that are set out in the IASB’s revised ED are similar to those in the 2010 ED: a current measurement model comprising of the expected present value of future cash flows, a risk adjustment and a contractual service margin (referred to as residual margin in the 2010 ED). The revised ED permits the use of a simplified model for certain types of contracts.

Whilst many aspects of the revised measurement model may seem similar to the guidance in the 2010 ED, the Board made several key changes in response to comments received. Some of the most prominent changes relate to addressing the concerns for earnings volatility, for example, how to present the effect of changes in discount rates and the treatment of contracts with participating features. The revised proposals also represent a major change for the presentation of the statement of comprehensive income. The transitional provisions have been amended to include a contractual service margin for existing business when implementing the future insurance standard.

The IASB’s aim in issuing the revised ED is to develop a model that will bring overall consistency and understandability to how entities account for insurance contracts. However, the Board has acknowledged that, because insurance contracts themselves can be fairly complex, the revised ED also has some complexities.

The revised ED does not propose an effective date, but instead, states the effective date will be around three years after the issuance of the final standard.

This publication provides a summary of the main areas of the revised ED and the changes to the 2010 ED.

What you should know

- The IASB has asked for comments on five key areas of the proposed measurement model to be submitted by 25 October 2013
- The proposals retain many of the characteristics of the 2010 exposure draft, but a number of important changes have been made
- The IASB introduces the use of other comprehensive income for presenting the effects of changes in discount rates
- Specific guidance on measurement and presentation for certain types of insurance contracts with participating features is introduced
- Certain changes in the expected present value of future cash flows are adjusted against the contractual service margin
- The statement of comprehensive income will include premium revenue for all insurance contracts
- The measurement on transition will include a contractual service margin
The journey so far

The IASB’s predecessor, the International Accounting Standards Committee, started work on a new accounting standard for insurance contracts in 1997. Since then, the road towards a finalised model has been one with many obstacles. In July 2010, the Board published a set of proposals built around a current measurement model with all of the effects of measurement changes recorded in profit or loss. Although not the same as fair value in all respects, the insurance model proposed in the 2010 ED represented a value that reflects current economic circumstances at the reporting date.

One of the main criticisms of the 2010 ED was that the proposed model, especially for long-duration contracts, would, in effect, force insurers to measure both assets and liabilities on a current basis (i.e., a current balance sheet measurement approach) with the effects of re-measurements reported in profit or loss. Although not the same as fair value in all respects, the insurance model proposed in the 2010 ED represented a value that reflects current economic circumstances at the reporting date.

Another key concern was the presentation model for the statement of comprehensive income, in particular, the removal of volume information such as premiums and claims caused by the Board’s decision to focus on summarised margin information. The comment letters in response to the 2010 ED also raised many other issues such as: which cash flows and acquisition expenses to include; unbundling (i.e., identifying individual components of an insurance contract and treat those components as if they were separate contracts); the application of the simplified model; and the treatment for reinsurance.

The Board took on the challenges raised in the comment letters as part of its re-deliberations and made changes to many areas of the proposal. Nevertheless, it remains committed to a current measurement model with a simplification for certain types of contracts.

Although the Board decided that re-exposure is necessary, it wants to avoid re-opening areas that, in its view, have already been deliberated sufficiently during past discussions. As a result, the Board selected the following five key areas for comments only:

- Adjusting the contractual service margin
- Treatment of certain types of contracts with participating features
- Presentation of premiums and claims in the statement of comprehensive income
- Determining the interest expense in profit or loss, including the use of other comprehensive income (OCI) for presenting the effect of changes in discount rates
- Approach to transition

How we see it

With its decision to re-expose in a targeted way, the IASB seeks to balance two important factors:

1) The need to seek feedback on key aspects of the model, particularly where those key aspects differ from the 2010 ED

2) Avoiding unnecessary delay by re-opening aspects where it believes its deliberations have been sufficient

Whilst the IASB aims to limit the re-deliberations following re-exposure, the decision to re-expose will inevitably have an impact on the timing of completion of the final standard.
Building block measurement model
The revised ED has maintained the basic components of the measurement model comprising the fulfilment cash flows and the contractual service margin. The fulfilment cash flows are determined by adjusting the estimates of future cash flows for the time value of money using discount rates that reflect the characteristics of those cash flows and applying a risk adjustment. The risk adjustment reflects the level of compensation that the insurer demands to accept the uncertainty that the future cash outflows could be more than expected. The contractual service margin represents expected contract profit in an insurance contract.

Cash flows
The starting point of the building block model is the unbiased, probability-weighted estimate of future cash flows, representing the net of future cash outflows and future cash inflows from insurance contracts. The cash flows included in the model should reflect how the insurer expects to fulfil the contract. The objective of the measurement is to estimate the expected value (i.e., the statistical mean) of the cash flows, with the revised ED clarifying that this objective does not necessarily require every possible scenario to be identified but, rather, it incorporates all available information in the estimation process. Available information includes, but is not limited to, industry data, historical data of an entity’s expenses, and market inputs when those inputs are relevant to the fulfilment of the contract. The revised ED also requires that, similar to the 2010 ED, the cash flows (or any other component of the model) do not reflect the insurers’ own credit standing.

A noticeable change to the 2010 ED is the definition for determining which cash flows are included in the model. The 2010 ED made reference to the cash flows that are incremental at the portfolio level. The revised ED includes all cash flows that relate directly to the fulfilment of a portfolio of contracts, including an allocation of fixed and variable overheads that are directly attributable to fulfilling that portfolio. Another difference exists for acquisition costs (the costs of selling, underwriting and initiating insurance contracts). The 2010 ED uses acquisition costs that are incremental at the individual contract level. The revised ED determines the acquisition costs at the portfolio level, for both successful and unsuccessful efforts.

Time value of money
The proposed model requires that, in determining the fulfilment cash flows, an insurer should discount the estimates of future cash flows to reflect the characteristics of those cash flows. This principle for determining the discount rate in the revised ED is fundamentally similar to the 2010 ED. The methodology for determining the discount rate is based on the following principles:

- For liability measurement purposes, discount rates should be updated each reporting period (i.e., a current rate)
- Discount rates should be consistent with observable current market inputs for instruments with similar cash flow characteristics as the insurance contract liability
- Rates should exclude factors that are not relevant to the insurance contract liability
- To the extent that the amount, timing or uncertainty of the cash flows arising from an insurance contract depend wholly or partly on the returns from underlying items (e.g., financial instruments), the discount rate should reflect that dependency

The Board clarifies, in the revised ED, two approaches that could be used to establish discount rates: a ‘top-down’ approach and a ‘bottom-up’ approach. The top-down approach starts at an expected rate of return on assets adjusted for items included in that rate that are not part of the characteristics of the liability (e.g., expected and unexpected defaults). The bottom-up approach starts by determining a risk-free rate and then adjusts that rate to reflect the characteristics of the insurance liability, which may include an illiquidity component.
The Board had concluded that an exact determination of a discount rate that reflects the characteristics of insurance liabilities may not be directly attainable from available market information. Therefore, the revised ED includes guidance that requires an insurer to estimate the inputs necessary to determine the relevant rates to the extent observable market information is not available, implying significant judgments are necessary to apply either the bottom-up or top-down method.

Although the model uses a current-market interest rate for measurement of the liability, the Board decided to move towards the use of OCI for presenting the effects of changes in discount rates. In addition, the revised ED introduces specific guidance, including changes in discount rates, for certain types of contracts with participating features. These items are discussed below.

**Risk adjustment**

The risk adjustment captures the effects of uncertainty about the amount and timing of the cash flows arising from the contract. In the Board’s view, the risk adjustment represents the compensation the insurer would require for bearing such uncertainty and reflects the point at which the insurer would be indifferent between fulfilling a liability with a range of possible outcomes and a liability with fixed cash flows only. The Board does not prescribe the unit of account for setting the risk adjustment. Considering when and how to incorporate the effects of diversification of risks into the measurement is, in the Board’s view, implicit in the objective of the risk adjustment. The Board acknowledged that, as a result, insurers will be able to consider cross-portfolio effects and use pricing practices as an input to estimating the risk adjustment.

In the spirit of having a principles-based accounting model, the Board decided to eliminate the guidance included in the 2010 ED that only permitted three methods for estimating the risk adjustment. Instead, the application guidance now focuses on setting out the characteristics that the risk adjustment should meet (e.g., the risk adjustment is measured in an explicit way and risks should not be double-counted).

**Contractual service margin**

The contractual service margin is recorded when the contracts are initially recognised and eliminates any day-one gains in an insurance contract, thereby representing unearned expected profit in the contract. The contractual service margin is determined at the portfolio level, as the excess, if any, of the expected present value of the cash inflows over the expected present value of future cash outflows plus the risk adjustment.

The contractual service margin cannot be negative. At initial recognition, if the sum of the fulfilment cash outflows plus risk adjustment exceeds the cash inflows (i.e., an onerous contract), the excess amount over the cash inflows should be recognised in profit or loss as an expense.

The revised ED notes that, over the coverage period, the contractual service margin should be recognised systematically in profit or loss in a way that best reflects the transfer of services under the contract (e.g., insurance coverage).

In line with using updated estimates for the fulfilment cash flows and risk adjustment, the revised ED provides that the contractual service margin should not be ‘locked in’ at inception. Instead, the margin should be adjusted (‘updated’) for subsequent changes in future cash flows to the extent that:

- Those changes reflect differences between current and previous estimates of future cash flows that relate to future coverage
- The contractual service margin is sufficient to absorb any unfavourable changes
This is a significant change from the 2010 ED, which applied a locked-in margin determined at initial recognition, with no subsequent changes other than for amounts recognised in profit or loss for services provided during the period.

**Presentation**

The Board revisited the following key aspects of the presentation model:

- Inclusion of earned premiums in the statement of comprehensive income for all insurance contracts
- Presentation of the effect of changes in discount rates

**Presentation of earned premiums in the statement of comprehensive income**

The 2010 ED proposed a statement of comprehensive income with a focus on summarised (i.e., net) margins, and did not allow premiums to be reported when applying the building block model.

The revised ED proposes that an insurer should present premium revenue in profit or loss. The IASB discussed alternative premium measures and agreed that an earned premium approach would best align the recognition of revenue for insurance contracts with the proposals from the IASB and FASB’s joint revenue recognition project. The insurance contract’s earned premium for a period represents the sum of the latest estimate of the expected claims and expenses for the period (excluding those recognised in profit or loss), the change in the risk adjustment, the amount of contractual service margin released, and an allocated portion of the premium for the recovery of acquisition costs.

Existing models for non-life (short-duration) contracts already apply earned premiums to allocate the contract premium as revenue, and will continue to do so under the proposals for the simplified model. However, the Board’s proposal on the presentation of insurance contract revenue will significantly impact life business as the earned premium approach is a fundamentally different concept compared with the premiums due approach used in many existing accounting models.

Although the newly proposed presentation model focuses on volume measures like premiums, claims and expenses, insurers would still need to provide margin information as part of the disclosures.
Presentation of the effect of changes in the discount rates

The other significant change in presentation in the revised ED is the use of OCI to recognise some of the changes in the insurance contract liability. The revised ED requires that an insurer would recognise and present in OCI the difference between:

i) Discounting the cash flows arising from the insurance contract using a current discount rate

ii) Discounting the cash flows using the rate when the insurance contract was initially recognised (the locked-in rate)

For cash flows of a contract that are expected to vary directly (i.e., in all scenarios) with returns on underlying items, the discount rate for determining the interest expense under (ii) above should be updated when the expected future cash flows change as a result of a change in the expected returns from the underlying items.

The Board introduced the OCI treatment in conjunction with its proposal to create a fair value through other comprehensive income category for certain debt instruments, thereby seeking better alignment between measurement and presentation of Insurance liabilities and the assets backing those liabilities.

The next section discusses specific guidance, including the effect of changes in the discount rate, applied to contracts that specify a link to the returns on underlying items the insurer is required to hold.

How we see it

We encourage insurers to consider the proposed insurance contracts measurement model alongside the Board’s classification and measurement model for financial instruments to ensure that the intended objective of eliminating accounting mismatches is achieved.

The impact of these new standards on the financial performance will be fundamental to an insurer’s key performance measures. Assessing this impact by considering IFRS 4 Phase II and IFRS 9 Financial Instruments jointly is also critical for participating in the forthcoming debate.

Contracts that specify a link to the returns on underlying items required to be held

The 2010 ED proposed that, when the amount, timing or uncertainty of cash flows arising from an insurance contract depend wholly or partly on the returns from specific assets, an insurer should reflect that dependency in the discount rate used to measure the insurance contract. The revised ED retained this principle, but introduces specific measurement and presentation guidance for contracts that require the entity to hold underlying items and specify a link to returns on those underlying items, implying two criteria need to be met:

- The insurer is required to actually hold the underlying items, such as specific assets, an underlying pool of insurance contracts, or the assets and liabilities of an insurer as a whole
- The contractual terms need to include a link between the payments to the policyholder and those underlying items.
The revised ED distinguishes three types of cash flows within such an insurance contract, which are:

1) Those that vary directly with underlying items, i.e., the cash flows change consistently with the underlying items in all scenarios

2) Those that vary indirectly with underlying items, i.e., there will be scenarios in which the cash flows do not vary with the underlying items (options and guarantees)

3) Those that do not vary with underlying items (e.g., fixed cash flows)

The components of the fulfilment cash flows that are expected to vary directly with the returns on underlying items are measured by reference to the carrying value of the underlying items using a consistent presentation of measurement changes in the statement of comprehensive income. This means the insurer does not apply the building block model to these cash flows, but, instead, uses the underlying items for measuring this component of the insurance liability. If, for example, the underlying items are financial instruments measured at fair value through profit or loss, the measurement of the insurance liability would reflect those fair values and the corresponding changes in the measurement of the liability would also be presented in profit or loss. This measurement and presentation exception seeks to reflect situations in which there is no economic mismatch between the insurance contracts and the assets backing them.

The components of the fulfilment cash flows that are not expected to vary directly with the returns on underlying items are measured in accordance with the building block model. Changes in the measurement are presented in either profit or loss or OCI, according to the general presentation requirements of the revised ED, and changes in the current value of options and guarantees are recognised in profit or loss. As a result of this guidance, some of the effects of discount rate changes for a contract with cash flows that vary with underlying items would be reported in OCI and other effects in profit or loss.

How we see it

The IASB's guidance on contracts with participating features aims to reduce the accounting mismatch between the measurement of assets and liabilities. Given the broad spectrum of participating contracts globally, it is key that insurers perform detailed analyses to determine how specific types of contracts fit into the guidance of the revised ED. The need to untangle cash flows is likely to present operational issues. We expect the specific guidance for contracts with participating features to elicit many comments from constituents, many of whom are also seeking further clarification from the Board on how to interpret and apply this guidance in practice.
Simplified approach for a liability for remaining coverage

The simplified approach incorporates two elements of an insurance contract liability:

- A liability for the remaining coverage, which measures the insurer’s obligation to provide coverage to the policyholder during the coverage period.
- A liability for incurred claims which measures the insurer’s present value obligation to investigate and pay claims that have already occurred, whether reported or not.

The proposed model permits a simplified approach for measuring the liability for remaining coverage for insurance where, based on certain criteria, the simplified approach approximates the building block measurement model. As a practical expedient, an insurer will be able to use the simplified approach for contracts with coverage periods of one year or less. The simplified approach measures the liability for remaining coverage by allocating the contract premiums over the coverage period and is similar to many existing accounting models for non-life insurance.

In contrast to existing models, the simplified approach in the revised ED requires that an insurer accrete interest on the liability for remaining coverage if the contract premium contains a significant financing component and the expected time between receipt of the premium and the provision of coverage is more than a year. The insurer accretes interest at the rate determined at initial recognition.

An insurer recognises the contract premium as revenue over the coverage period in a systematic way that best reflects the transfer of services provided under the contract. An onerous contract test applies both at the point the contract is written (i.e., when the insurer is bound by the contract) and subsequently.

How we see it

As a result of the application of the simplified model, non-life insurers may generally feel that the impact of the new proposals is less far-reaching for them than for the life business. However, non-life insurers should be aware that the measurement of the claims liability uses many of the components of the building block model, including discounting and the use of OCI. Presenting the effects of changes arising from current interest rate movements in OCI means the interest expense on the claims liability would be the original locked-in rate. Consequently, insurers would have to track the discount rate and the relating claim amounts on an underwriting basis.

Diagram 1: Components of the building block model and the simplified approach
Reinsurance

The revised ED requires that a cedant measures the reinsurance contract it holds at the present value of the fulfillment cash flows, including the risk of non-performance by the reinsurer, and a contractual service margin. The cedant should estimate the present value of the fulfillment cash flows for the reinsurance contract in the same manner as the corresponding part of the present value of the fulfillment cash flows for the underlying insurance contract. The decision to present the effect of changes in discount rates in OCI also applies to reinsurance assets.

In a change to the 2010 ED, a cedant records any difference between the future cash inflows plus the risk adjustment and the future cash outflows as a contractual service margin. This means that, in contrast to the model for underlying direct contracts, the contractual service margin can be both positive and negative. However, if a reinsurance contract reimburses a cedant for liabilities incurred as a result of past events (retroactive reinsurance), a negative contractual service margin (i.e., the cost to purchase insurance, which the Board referred to as a loss) would be recognised in profit or loss immediately. The Board noted the cost of purchasing reinsurance should be recognised immediately because the underlying reinsured claims have already been incurred.

Other requirements of the revised ED relating to reinsurance include:

- Ceded premiums should be presented net of ceding commissions.
- Cash flows that affect either the amount of ceded premiums or ceding commissions that are contingent on claims or benefits experience, i.e., loss sensitive features, should be recognised as claims or benefits cash flows rather than premiums.
- For retroactive reinsurance contracts, the contractual service margin included in the cedant’s recoverable and the reinsurer’s insurance contract liability should be amortised over time.
- A cedant evaluates whether it would be permitted to use the simplified model for its reinsurance contracts based on the same criteria as a direct insurer, but this evaluation is made independently of the underlying direct contracts.

How we see it

Insurers will need to understand how key performance indicators, e.g., loss and expense ratios, may be affected by the proposed guidance for contingent features in reinsurance contracts. While net underwriting margin would not be affected by these decisions, volume information could be affected significantly depending on the extent of adjustable features.

The approach to transition

The 2010 ED required prospective application, measuring contracts under the new model from the moment of transition. At that time, the Board believed this would relieve insurers of the burdensome impact of a retrospective application of the model. However, it received negative feedback in the comment letters as the measurement on transition would not carry forward an unearned profit amount.

In its re-deliberations, the Board aimed to balance complexity, comparability and usefulness, and decided on a modified retrospective approach. This approach means insurers would need to retrospectively apply the new standard to all prior periods unless it is impracticable to do so. If it is impracticable, then insurers would need to estimate the contractual service margin using as much objective information as possible with some relief through certain practical expedients.

The Board decided that the effective date of the standard would be around three years after the issuance of the final standard, rather than selecting a very specific transition period at this stage. The Board acknowledged that this could lead to a mandatory effective date that will be after the mandatory effective date for IFRS 9. To deal with the resulting complexities, the Board retained the possibility that, on transition, an insurer will be able to re-designate its financial instruments where new insurance contract accounting creates accounting mismatches.

How we see it

Whilst the proposed transition approach aims to reduce the difficulty that was inherent to a full retrospective approach, we expect the efforts to meet the transition requirements for long-duration contracts to be significant. Insurers may lack data to estimate the contractual service margin fully retrospectively for many reasons, including system constraints, acquisitions and divestitures.

By allowing re-designation of financial instruments upon transition to the future insurance standard, the Board signals the mandatory the effective dates of the financial instrument standard and insurance standard may not be aligned for insurers.
Other topics

Some of the key aspects of the revised proposals, including those on which the Board is seeking input from the forthcoming responses have already been outlined earlier in this publication. The table below summarises other noticeable changes made in the revised ED (not comprehensive):

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<thead>
<tr>
<th>Topic</th>
<th>Changes in the revised ED</th>
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<tbody>
<tr>
<td>Definition and scope</td>
<td>The revised ED retains the 2010 ED's definition of an insurance contract, which is also similar to the existing definition in IFRS 4 <strong>Insurance Contracts</strong>, but adds that a reinsurance contract is deemed to transfer significant insurance risk if substantially all of the insurance risk is assumed by the reinsurer.</td>
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<td>The revised ED includes additional criteria for scope exclusions regarding fixed-fee service contracts, but brings back the existing scoping for financial guarantee contracts from IFRS 4 by excluding those contracts from the future insurance standard unless previously regarded as insurance contracts by the issuer.</td>
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<td>Contracts with participating features</td>
<td>The revised ED clarifies that the insurance standard would apply to financial instruments with discretionary participation features if these are issued by an entity that also issues insurance contracts, dropping the additional requirement from the 2010 ED that such contracts participate in the same pool of assets as insurance contracts.</td>
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<td>Portfolio</td>
<td>The revised ED changes the definition of a portfolio compared with the 2010 ED (and IFRS 4) by adding to the definition the requirement that a portfolio of insurance contracts is priced similarly relative to the risk taken.</td>
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<td>Separation and disaggregation</td>
<td>The term ‘unbundling’ is no longer used; instead, the revised ED refers to ‘separating components from an insurance contract’. The revised ED requires an insurer to separate from an insurance contract: (i) embedded derivatives, if they meet certain specified criteria; (ii) distinct investments components; and (iii) performance obligations to provide goods and services.</td>
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<td>The revised ED introduces the notion of disaggregation by requiring an insurer to exclude from the statement of comprehensive income insurance contract revenue (i.e., not to be reported as premium revenue, but as a deposit item) and incurred claims in respect of investments components that have not been separated. Investment components that have not been separated would include amounts which are payable to the policyholder regardless of whether an insured event occurs.</td>
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<td>Contract boundary</td>
<td>Whilst the 2010 ED provided that an insurer should recognise an insurance contract when it becomes party to an insurance contract, the revised ED clarifies the recognition point of an insurance contract as the earliest of: the beginning of the coverage period; the date when payments from the policyholder become due; or when there is evidence that a portfolio of insurance contracts is onerous.</td>
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<td>In addition, the revised ED introduces guidance on how to treat modifications to insurance contracts.</td>
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### Changes in the revised ED

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<td>Portfolio transfers and business combinations</td>
<td>The revised ED retains the proposals from the 2010 ED on how to account for insurance contracts under a portfolio transfer and business combinations. The revised ED clarifies that the date of recognition for contracts acquired in a portfolio transfer or a business combination is the date of the transfer or the business combination. This means that the contractual service margin for acquired contracts will be determined based on the date of acquisition, rather than on the date the contracts were originally entered into with policyholders.</td>
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<td>Disclosures</td>
<td>The revised ED requires extensive disclosures in respect of reconciliations from the opening to the closing balance of the aggregate carrying amounts of insurance contract liabilities and insurance contract assets. The reconciliations required seek to show the linkage between the movements on the statement of financial position and the amounts recognised in the statement of comprehensive income, and include summarised margin information.</td>
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### The road ahead

The upcoming months will be crucial for the future of insurance accounting. With a 120-day comment period, the IASB plans to start re-deliberations later this year, and is expected to continue discussions into 2014. Based on this time line, the earliest possible date for a finalised standard would be well into 2014.

The Board may feel it has undertaken significant efforts to address, and resolve, concerns around the 2010 ED proposals, and will presumably look ahead with this mindset to the forthcoming responses to the revised ED. The Board appears to be determined to complete the new standard as it believes today’s economic environment is putting an increasing number of challenges to financial reporting under the existing IFRS 4 standard.

While the revisions to the model may reduce the potential for earnings volatility, they come with a potential for increased operational complexity. Preparers and users will therefore need to carefully understand and evaluate the potential impact of the proposals in the revised ED, in order to provide effective feedback in their comment letters and help the Board shaping a well-balanced future IFRS for insurance contracts.
## Area IFRS insurance contacts

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