Circular 2015/3 Leverage Ratio – Banks

Calculating the unweighted capital ratio (leverage ratio) at banks

KPMG

FINANCIAL SERVICES

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KPMG

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Calculating the unweighted capital ratio (leverage ratio) at banks

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Annex	Derivatives using the SA-CCR

Addressees

BA			ISA			SESTA	FMIA						CISA									AMLA			OTHERS	
Banks	Financial groups and congl.	Other intermediaries	Insurance companies	Ins. groups and congl.	Distributors	Securities dealers	Trading Venues	Central Counterparties	Central depositories	Trade repositories	Payment systems	Participants	Fund management companies	SICAV	Limited partnerships for CIS	SICAF	Custodian banks	Managers domestic CIS	Distributors	Representatives of foreign CISs	Other intermediaries	SROs	DSFIs	SRO Supervised	Audit firms	Rating Agencies
X	X					X																				

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I. Subject matter

This circular shall provide more detail on Articles 46 of the Capital Adequacy Ordinance (CAO; SR. 952.03). Specifically, it shall define the calculation of the leverage ratio as per the guidelines issued by the Basel Minimum Standards (Basel III Leverage Ratio). The relevant duties regarding disclosures shall be regulated in FINMA circ. 16/1 "Disclosure – Banks". For instance, there are items which must be disclosed despite the fact that they do not influence the leverage ratio in the final result (e.g. items mentioned in margin nos. 7, 16-17, 36, 39, 51, 56). 1

II. Basel Minimum Standards

These regulations shall be based on the revised agreement of the Basel Committee on Banking Supervision (the Basel Minimum Standards). The Basel Minimum Requirements regarding leverage ratio shall be defined in the document "Basel III leverage ratio framework and disclosure requirements", dated January 2014. Where underlying text passages which this circulars refers to are relevant, reference shall be made to them in square brackets in the following explanations. 2

III. Definition of leverage ratio

[§6] The Basel III leverage ratio shall be an unweighted capital ratio. It shall be defined as the eligible core capital (the numerator) divided by the total exposure (the denominator), with this ratio expressed as a percentage: 3

Leverage ratio = Core capital / total exposure 4

[§10] The capital measure for the Basel III leverage ratio shall be the Tier 1 capital of the risk-based capital framework as defined in Article 18(2) CAO, taking into account the transitional provisions as per Article 137 et seqq. CAO. In other words, the capital measure used for the leverage ratio at any particular point in time shall be the Tier 1 capital measure applied at that time under the risk-based framework. 5

IV. Consolidation

[§8] The Basel III leverage ratio framework shall follow the same scope of regulatory consolidation as is used for the risk-based capital adequacy provisions as per Articles 7-13 CAO. Special purpose entities' assets reported in the balance sheet which are excluded from risk-weighted positions due to specific provisions as per Articles 48-88 CAO should be considered as part of the regulatory consolidation and must be included in the total exposure. Therefore, assets of special purpose entities may only be excluded from the total exposure if they have been excluded from both the risk-weighted positions as well as from the balance sheet (as required by the accounting standards). 6

[§9] Where a banking, financial, insurance or commercial entity is outside the scope of regulatory consolidation, only the investment in the capital of such entities (i.e. only the carrying value of the investment, as opposed to the underlying assets and other engagements related to such entity) is to be included in the total exposure in the leverage ratio. However, investments in the capital of such entities that are deducted from Tier 1 capital may be excluded from the total exposure in the leverage ratio. 7

V. Total exposure

[§12] The total exposure for calculating the leverage ratio shall generally follow accounting values (book values), whereby the following applies: 8

- on-balance sheet, non-derivative exposures are included in the total exposure net of provisions for default risks and similar asset provisions.[1] 9*

- Netting of loans and deposits is not permitted. The specific rules of this circular shall apply to the netting of derivatives with securities financing transactions (SFT). If using trade date accounting, netting other receivables with payables may be called for by the applicable accounting rules; this shall only be permitted if this is not done to mitigate risks, especially if such netting of receivables with payables takes place with trades that have not been settled. 10

Banks that calculate the eligible and required capital at single-entity level according to a FINMA-approved international accounting standard (cf. margin no. 156 of FINMA circ. 13/1 "Eligible equity capital – banks"), shall also use this same standard to calculate their leverage ratio as per margin no. 8 (i.e. subject to taking into consideration margin nos. 9-10 as well as the remaining provisions in this circular). 11

[§13] Unless specified differently below, banks must not take into account physical or financial collateral, guarantees or other credit risk mitigation techniques listed in Article 61 CAO. Hence, they do not reduce the total exposure. 12

[§14] A bank's total exposure shall be the sum of on-balance sheet exposures, derivative exposures, securities financing transaction (SFT) exposures and off-balance sheet (OBS) items. The specific treatments for these four main exposure types are defined below. 13

A. On-balance-sheet exposures

[§15] All balance sheet assets must be included in the total exposure at book value, taking into consideration margin nos. 9-11. With the exception of the cases stipulated in margin nos. 21-73, this shall also include collateral carried on the balance sheet for derivatives or SFTs but not the receivables and positive replacement values for derivatives and SFTs themselves, which are accounted for in margin nos. 21-73. 14

[§15] Banks using accounting standards other than the Swiss accounting guidelines for banks or IFRS and that recognize fiduciary assets in their balance sheets may exclude these when calculating the total exposure, provided that they meet the IAS 39 criteria for de-recognition and, if applicable, the IFRS 10 criteria for de-consolidation. 15

[§16] However, to ensure consistency, balance sheet assets deducted from Tier 1 capital (as set out in Articles 32 et seq. CAO or according to FINMA Circ. 13/1) may be deducted from the total exposure. 16

[1] The value adjustments offset in CET1 in accordance with margin nos. 144.1 et seq. of FINMA Circ. 2013/1 "Eligible equity capital – banks" may not be deducted from the corresponding items.

For banks using the internal ratings-based (IRB) approach Article 32(e) CAO requires any shortfall in the stock of eligible provisions relative to expected losses to be deducted from CET1 capital. This same amount may also be deducted from the total exposure. 17

[§17] Liabilities may not be deducted from the exposure measure, including the following measures: 18

- Unrealized gains from the revaluation of liabilities. 19
- Valuation adjustments for negative replacement values for derivatives due to changes in the bank's own credit risk. 20

B. Derivative exposures

[§18] Derivatives shall create two types of exposures: (a) an exposure arising from the underlying of the derivative contract; and (b) a counterparty credit risk (CCR) exposure. The Basel III leverage ratio framework as defined below aims to cover both types of exposures simultaneously. 21

[§19] Banks must calculate their derivative exposures as the replacement cost (RC) for the current exposure plus an add-on according to the mark-to-market method (current exposure method, CEM) (cf. Article 57 CAO in the version dated 1 July 2016 and FINMA Circ. 08/19 "Credit risks - banks" margin nos. 16-63), subject to margin no. 24. 22

[§12] Current replacement values shall take into consideration value adjustments (e.g. value adjustments due to counterparty credit risk). 23

[§19] Where a bank acts as a protection seller for a credit derivative, it must add the amount resulting from the special treatment as described in margin nos. 42–51 to the credit equivalent as per margin no. 22. 24

a) Netting

[§21] The netting of positive and negative replacement values from derivative contracts with the same counterparty (thus arriving at a net replacement value as well as the relevant individual add-ons to a net add-on) shall take place under the same conditions and is done in the same manner as the mark-to-market method (CEM) (cf. FINMA circ. 08/19 "Credit risks - banks" margin no. 54-63). 25

b) Treatment of posted collateral

[§23] Unless margin nos. 34 and 35 apply, collateral received by the bank must not be netted with derivative exposures, even if netting were to be permitted under the bank's operative accounting or its risk-based capital adequacy provisions. Hence, when calculating the exposure amount, a bank must not reduce the total exposure by any collateral received from the counterparty. 26

[§24] The same shall apply to collateral posted by the bank. If the bank has assigned collateral in connection with derivatives and if this has led to a reduction in the value of its balance sheet items under the applicable accounting standard, the bank must, subject to margin no. 36, add the amount of this assigned collateral to the total exposure again. 27

[§25] When determining the derivative exposures for the Basel III leverage ratio, the cash portion of the variation margin exchanged between counterparties may be treated as a pre-settlement payment (cf. margin nos. 35-36) if the following criteria are met: 28

- The cash received is not to be segregated from the receiving party's own assets. Contracts cleared through a qualifying central counterparty (QCCP) are exempted from this criterion (cf. margin no. 40). 29

- The variation margin is calculated and exchanged on a daily basis based on mark-to-market valuation of derivative positions. 30

- The variation margin includes the full market value of the derivative contracts, subject to any thresholds and minimum transfer amounts. 31

- Derivatives transactions and variation margins shall be subject to a netting agreement between the two counterparties. This netting agreement must explicitly stipulate that the counterparties agree to settle net any payment obligations covered by such a netting agreement, taking into account any variation margin received or provided, if one of the two parties is affected by a credit event. The netting agreement must be legally enforceable and effective in all relevant jurisdictions, including in the event of default, bankruptcy or insolvency. 32

- The cash portion of the variation margin shall be received in a currency listed as settlement currency in either the derivative contract, in the netting agreement or in the credit support annex of the netting agreement. 33

[§26] If the conditions in margin nos. 29-33 are met, the following netting arrangements shall be permitted: 34

- The cash variation margins received may be netted with the positive replacement cost portion. 35

- In the case of cash variation margin provided to a counterparty, the posting bank may deduct the resulting receivable from its total exposure, where the cash variation margin has been recognized as an asset under the bank's operative accounting framework. 36

[§26] Cash variation margins may not be used to reduce the add-on. Therefore, collateral must not be included when calculating the add-on. Specifically, the replacement values used to calculate the net add-on must not include received or posted collateral. 37

c) Treatment of clearing services

[§27] Where a bank acting as clearing member (CM) offers clearing services to its customers and guarantees the fulfilment of the CCP's obligations towards its customers, then this bank must, in addition to the derivative exposures towards the customers, also record the derivative exposures towards the CCP. The latter shall be calculated according to the same rules as all other derivative exposures. 38

[§27] However, if the bank acting as clearing member of a QCCP does not guarantee the fulfillment of the QCCP's obligations towards their customers, then the bank does not have to include its derivative exposures to the QCCP as well as the claims of collateral posted to the QCCP in connection with these customer transactions in the calculation of the total exposure. 39

The term "qualified central counterparty" (QCCP) shall be defined margin no. 521 FINMA circ. 17/7 "Credit risks – banks". 40*

[§28] Where a client enters directly into a derivatives transaction with the CCP and the bank as clearing member (CM) guarantees the performance of its clients' derivative trade exposures to the CCP, the bank must calculate its derivative exposure as if it had entered directly into the transaction with the client (i.e. as set out in margin nos. 22-37). This shall also apply to collateral received or posted. 41

d) Special treatment for credit derivatives with the bank as protection provider (written credit derivatives)

Credit derivatives in which the bank is involved as collateral provider (hereinafter referred to as "written credit derivatives") shall result in an exposure to the referenced credit in addition to the exposure to the counterparty. This circumstance shall be taken into account in the calculation of the total exposure as follows. 42

[§30] In addition to the above treatment for derivatives and related collateral, the effective notional amount referenced by a written credit derivative shall be included in the total exposure. The effective notional value is arrived at by correcting the notional value so that it reflects the actual risks of contracts which may have a leveraging effect or another reinforcing effect on a transaction. The effective notional value may be reduced by any negative replacement value of a credit derivative if this negative replacement value leads to a reduction of the Tier 1 capital. 43

[§30] The amount resulting from margin no. 43 may be reduced by the effective notional amount of offsetting credit derivatives (i.e. those where the bank acts as protection buyer), provided that the following conditions are met: 44

- Reference names. Credit derivatives must be written to the same reference name. Two reference names shall only be considered identical if they refer to the same legal entity. 45

- Pools of reference names. Protection purchased on a pool of reference entities may offset protection sold on individual reference names if the protection purchased is economically equivalent to buying protection separately on each of the individual names in the pool (this would, for example, be the case if a bank were to purchase protection on an entire securitization structure). If a bank purchases protection on a pool of reference names, but the credit protection does not cover the entire pool (i.e. the protection covers only a subset of the pool, as in the case of an nth-to-default credit derivative or a securitization tranche), netting is not permitted for the protection sold on individual reference names. However, such purchased protections may offset sold protections on a pool, provided the purchased protection covers the entire subset of the pool on which protection has been sold. In other words, offsetting may only be recognized if the pool of reference entities and the level of subordination in both transactions are identical. 46

- Pari passu or junior ranking. Credit protection purchased for a single reference name must refer to a reference obligation which ranks pari passu with or is junior to the underlying reference obligation of the written credit derivative so that a credit event in a written credit derivative shall inevitably lead to a credit event for the credit protection purchased. For tranched products, the purchased credit protection must be on a reference obligation with the same level of seniority. 47

- Residual maturity. The residual maturity of the credit protection must be equal to or longer than that of the written credit derivative. 48

- Notional value. If the effective notional amount of a written credit derivative has been reduced by a negative replacement value as per margin no. 43, the effective notional amount of the offsetting purchased credit protection must be reduced by any resulting positive replacement value reflected in Tier 1 capital. 49

- Total Return Swaps. If a bank acquires credit protection through a total return swap, recognizing the received net payments as net income but without recognizing the relevant replacement value variations affecting Tier 1 capital, the credit protection shall not be taken into account when netting the effective nominal value for the written credit derivative. 50

[§31] When calculating the credit equivalent as per margin nos. 22 and 25, the individual add-on for all of the written credit derivatives whose full effective notional value was included when calculating the total exposure as per margin no. 43 (without having been reduced as per margin no. 44) may be set to zero. This is to avoid double-counting such positions. 51

e) Optional application of the SA-CCR

Instead of the mark-to-market method, banks may also apply the standard approach (SA-CCR, cf. Article 57 CAO and margin nos. 32-122 FINMA Circ. 17/7 "Credit Risks - Banks") in accordance with the provisions of the Annex, which replace margin nos. 21-25. Banks in categories 1-3 must inform FINMA of this, stating the effects on the leverage ratio at the time of conversion. Banks in categories 4 and 5 do not need to inform FINMA. 51.1*

Banks making use of the option to use the SA-CCR shall indicate this when disclosing the leverage ratio in accordance with FINMA Circ. 16/1 "Disclosure – Banks". 51.2*

C. Securities financing transactions

The following shall be considered to be securities financing transactions (SFT) as per this Circular: repos and reverse repos, securities lending and borrowing and margin lending where the value of the transactions depends on market valuations and the transactions are often subject to margin or variation agreements. 52

[§32] SFTs shall be included in the total exposure according to the treatment described below. The treatment shall recognize that secured lending and borrowing in the form of SFTs is an important source of leverage and ensure consistent international implementation by providing a common measure that takes into account the main differences in the accounting standards. 53

a) General treatment: bank acting as principal

[§33] In the general treatment (i.e. with the exception of margin nos. 70-73), the sum of gross SFT assets as per margin nos. 55-62 and the exposure to the SFT counterparty as per margin nos. 63-67 shall be recognized in the total exposure for the leverage ratio. 54

[§33i] Cash payables may not be netted with cash receivables in the balance sheet in gross SFT assets recognized for accounting purposes (as is currently permitted according to the accounting standards), thus avoiding differences in netting possibilities which could arise due to the use of different accounting standards. 55

[§33i] Gross SFT assets recognized for accounting purposes (i.e. with no recognition of netting permitted by accounting standards), shall be adjusted as follows: 56

- For SFT assets subject to novation and cleared through a QCCP, "gross SFT assets recognized for accounting purposes" shall be replaced by the final contractual exposure, since pre-existing contracts have been replaced by new legal obligations through the novation process. 57
- If a bank has recognized the securities received under an SFT as an asset on its balance sheet, it may exclude the value of these from the total exposure. 58
- Cash payables and cash receivables in SFTs with the same counterparty may be measured net if all the following criteria are met: 59
  a. transactions have the same explicit final settlement date. 60
  b. the right to offset the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable both in the normal course of business and in the event of default, insolvency and bankruptcy. 61
  c. the counterparties intend to settle net or simultaneously, or the transactions are subject to a settlement mechanism that, from a functional point of view, is equivalent to a net settlement, i.e., factually, the cash flows of the transactions are equivalent to a single net amount on the settlement date. To achieve such equivalence, both transactions shall be settled through the same settlement system and the settlement arrangements shall be supported by cash and/or intraday credit facilities intended to ensure that both transactions will be settled by the end of the business day. In this kind of unwinding/settlement system, any failed settlement of a single security shall only delay the settlement of the cash amount linked to this particular settlement or generate an obligation to the settlement system. SFTs where a settlement failed at the time they should have been settled shall be excluded from the net treatment and must be recognized as a gross amount in the total exposure. 62

[§33(ii)] The exposure to the SFT counterparty shall be calculated using the current replacement value without any haircuts. This means: 63

- If the conditions for the contractual netting as stipulated in FINMA Circ. 17/7 "Credit risks – banks" margin nos 137–144 have been fulfilled, exposure (E^*) shall be the larger amount of zero or the total fair value of securities and cash lent to a counterparty for all transactions included in the netting agreement ($\sum E_i$) less the total fair value of cash and securities received from the counterparty for those transactions ($\sum C_i$). This is illustrated in the following formula: 64

$$E^* = \max\{0, [\sum E_i - \sum C_i]\},$$ 65

where index "i" covers all of the transactions in the netting agreement. 66

- If the conditions for contractual offsetting are not met, the current exposure for transactions with a counterparty must be calculated on a transaction by transaction basis: that is, each transaction i is treated as its own netting set, as shown in the following formula: 67

$$E_i^* = \max\{0, [E_i - C_i]\}$$ 68

[§34] Sale accounting transactions: if an SFT is recognized as a sale due to the bank's accounting standards, the bank must reverse all accounting entries related to this sale, and then calculate its total exposure as if the SFT had been treated as a financing transaction under its accounting standards (i.e. in accordance with margin no. 54). 69

b) Bank acting as agent

[§35] A bank acting as agent in an SFT shall generally provide an indemnity or guarantee to only one of the two parties involved, and only for the difference between the value of the security or cash its customer has lent and the value of collateral the borrower has provided. In this situation, the bank shall be exposed to the counterparty of its customer for the difference in values rather than to the full exposure to the underlying security or cash of the transaction. Where the bank does not own/control the underlying cash or security resource, that resource cannot be leveraged by the bank. These circumstances shall be taken into consideration in margin nos. 71-73. 70

[§36] Where a bank acting as agent in an SFT provides an indemnity or guarantee to a customer or counterparty for any difference between the value of the security or cash the customer has lent and the value of collateral the borrower has provided, the bank shall calculate its total exposure by applying only margin nos. 63-68. 71

[§37] A bank acting as agent in an SFT and providing an indemnity or guarantee to a customer or counterparty shall only be eligible for the exceptional treatment set out in margin no. 71 if the bank's exposure to the transaction is limited to the guaranteed difference between the value of the security or cash its customer has lent and the value of the collateral the borrower has provided. In situations where the bank is further economically exposed (i.e. beyond the guarantee for the difference) to the underlying security or cash in the transaction, a further exposure equal to the full amount of the security or cash must be included in the calculation of the total exposure. This shall especially be the case where the bank manages the collateral received in its own name or for own account instead of the account of the client or the debtor or lends it to others. 72

[§36] If a bank acts as an agent in an SFT and, in addition to meeting the conditions stipulated in margin nos. 70-72, does not provide an indemnity or guarantee to any of the parties involved, it is not exposed to this SFT and therefore does not need to include it when calculating its total exposure. 73

D. Off-balance-sheet (OBS) items

[§38] This section shall explain how to incorporate OBS items into the total exposure relevant to the leverage ratio. OBS items shall include all types of contingent liabilities and commitments, whether or not unconditionally cancelable. Specifically, they shall include transactions described in Articles 53-54 CAO and in Annex 1 to the CAO, including liquidity facilities, direct credit substitutes, acceptances, standby letters of credit and trade letters of credit. 74

[§39] With the exception of margin no. 76, the credit conversion factors (CCFs) stipulated in Annex 1 to the CAO shall be applied to the notional value or the cash value of each transaction to calculate the exposure arising from OBS items for the leverage ratio. 75

[§39] For the purpose of calculating the leverage ratio, a floor of 10% shall apply to the CCFs. The OBS items for which a credit conversion factor of 0% is foreseen in the risk-based capital adequacy provisions (Annex 1 to the CAO) must also take a CCF of 10% for the purpose of calculating the leverage ratio. This shall be applicable to credit commitments which the bank could cancel anytime without prior notice or which expire automatically if a borrower's credit rating worsens. 76

VI. Transitional provisions

Banks making use of the transitional provision for the SA-CH approach as defined in Article 137 CAO must use the mark-to-market method (CEM) as per SA-CH approach when calculating the credit equivalent as per margin no. 22 (margin nos. 16-48 of FINMA Circ. 08/19 "Credit risk - banks", margin nos. 16-48, in the version of 31.12.2012). For the calculation of the total exposure, the credit equivalents thus calculated shall be multiplied by a factor of 1.5. 77

Repealed 78*

Annex

Derivatives using SA-CCR

If the SA-CCR is used optionally, the following margin nos. of the Annex replace margin nos. 21-25 of the Circular. The figures in square brackets shall refer to the chapter "Leverage Ratio" of the document "Basel III: Finalising post-crisis reforms" of December 2017.

[§33-34] The exposure to derivative positions shall be calculated as the sum from the regulatory replacement costs (RC) in accordance with margin no. 2 of the Annex and the collateral add-on in accordance with the standardized approach for the credit equivalents of derivatives (SA-CCR, cf. margin nos.32-33 and 49-105 of FINMA Circular 2017/7 "Credit Risks - Banks") multiplied by the alpha factor of 1.4, subject to margin nos. 3-6 of the Annex or margin nos. 26-41 of the Circular. 1

§33-34 and §2 Annex] The regulatory replacement costs shall be calculated as RC = max(0 ; V - CVMr + CVMp), with V the current positive or negative net market value of the derivative contracts that can be offset in accordance with margin no. 5 of the Annex after taking into account value adjustments (e.g. value adjustments due to counterparty credit risk). CVMr shall be the cash part of the margin payments received from the bank which meet the conditions of margin nos. 28-33 and which is not already included in the net market value (V). CVMp shall be the cash part of the margin payments made by the bank under the conditions set out in margin nos. 29-33 of the Circular. 2

[§33] Where a bank acts as a protection seller for a credit derivative, it must add the amount resulting from the special treatment as described in margin nos. 42-51 to the credit equivalent as per margin no. 1 of the Annex. 3

[§3 Annex] The exception in margin no. 36 FINMA-RS 2017/7 "Credit Risks - Banks" is not applicable when calculating the leverage ratio. This means that contracts whose replacement value cannot be positive must still be included. 4

[§34-35] Netting positive and negative replacement values from derivatives with the same counterparty, thus arriving at a net replacement value as well as aggregating add-ons within a netting set take place under the same conditions and in the same manner as the SA-CCR (cf. circ. margin nos. 73 – 104 and 145 – 155 of FINMA Circ. 2017/7). 5

In the case of derivatives with margin calls, the maturity factor as per margin no. 64 of FINMA Circ. 2017/7 may be taken into account. This maturity factor may be capped by the maturity factor for derivatives without margin calls pursuant to margin no. 63 of FINMA Circ. 2017/7. For the sake of simplicity, the maturity factor according to margin no. 63 of FINMA Circ. 2017/7 may also be used for all derivatives. 6

List of amendments

The Circular has been amended as follows:

These amendments were passed on 20 June 2018 and shall enter into force on 30 June 2018.

Newly inserted margin nos.	51.1 51.2
Amended margin nos.	1, 9, 22, 40, 64
Repealed margin nos.	78
Other amendments	New title before margin no. 51.1

The annexes to the circular were amended as follows:

These amendments have been passed on 20 June 2018 and shall enter into force on 30 June 2018.

New	Annex on derivatives using the SA-CCR

Contacts

Philipp Rickert
Partner, Head of Financial Services,
Member of the Executive Committee
Zurich
Tel. +41 58 249 42 13
prickert@kpmg.com

Helen Campbell
Partner, FS Transformation
Tel. +41 58 249 35 01
hcampbell@kpmg.com

Thomas Dorst
Partner, Assurance & Regulation
Tel. + 41 58 249 54 44
tdorst@kpmg.com

Nicolas Moser
Partner, Geneva Office
Tel. +41 58 249 37 87
nmoser@kpmg.com

www.kpmg.ch

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