

# Swiss Financial Services Newsletter

September 2006

## Editorial

Dear Reader,

Auditing and advisory have traditionally played a major role in the banking, insurance and corporate enterprise industries. Nowadays, the financial service industry operates in an ever changing environment, facing numerous challenges in keeping up with the latest technological developments, globalization tendencies and changes to supervisory regulations and commercial law.

With this newsletter we hope to share with you our professional experience in these and a variety of other business sectors.

Quality is our focus. We express this through a profound knowledge of the business and structure of our clients, the work of our qualified professionals and through our determination to anticipate new developments and their consequences. Quality also means listening to our clients, understanding them and taking their problems seriously.

In this issue we detail how we met quality requirements during a due diligence

task and in the realm of a restructuring process.

By introducing practice relevant topics, like "2005 IFRS Impact on Swiss Banks" or the "Outsourcing Assurance Standards" we aim to provide insight into relevant themes and approaches that will aid you in structuring your financial pattern.

Besides continuously developing legislation, the many risks and potentials of our economic environment have to be considered at all times. Through the written summaries in this issue we hope to best master this decision making process.

We wish you an inspired reading!



Alexander Gut  
Member of the Executive Board

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# M&A in Private Banking

## Due Diligence Success Factors in a Private Banking Transaction

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### Background

In the M&A process, the value of a private bank is frequently assessed on the basis of its assets under management. One stage in the process is to conduct an in-depth analysis of the private bank's profitability using internal evaluation models. In addition to any risks that may be identified, transaction quality is one of the key parameters governing M&A transactions.

### Due diligence: access to information

A due diligence procedure often begins with discussions on the nature and the scope of the information to which access is required. These discussions usually center on the need to preserve client confidentiality. If the data provided is incomplete, a number of the buyer's questions will remain unanswered. Hence buyers usually put themselves at greater risk than the vendor.

Therefore the preferred option is to recommend that the buyer seek guarantees in the purchase agreement to back up management's assurances about the

completeness of the information furnished. In addition, the buyer must seek to ensure that liabilities regarding (hidden) risks, which subsequently manifest themselves, will be assumed by the vendor. Contractual amendment clauses determining the price reductions that apply in such eventualities are an indispensable means of protecting the buyer. Without such clauses, the only recourse left would be the rocky road of litigation.

### Due diligence: no skeletons in the closet

Assuming that buyer and vendor have agreed on the price in advance, due diligence can focus on the following areas:

- sustainability of earnings and the business model
- cost structure and cost control
- filtering out risks in connection with the annual financial statement, regulatory risks and tax risks
- transfer pricing, VAT as well as risks for currently pending tax assessments
- integration risks
- pension liability risks

The sustainability of earnings depends primarily on the volatility of assets under management and on the fee structure. However, it is almost impossible to gauge the stability of assets under management. Ideally, the buyer will impose a clause which stipulates that the definitive purchase price is based only on those assets which remain under management after the grace period following the purchase agreement end date.

The various revenue streams of the acquisition target must be analyzed in detail. The following questions need to be addressed: How much commission income is generated by managing client assets? How much income is derived from securities and currency trading for the client's account? What are the margins on collateral loans and other forms of credit to private banking clients?

## Conclusions

The analysis listed here are central to the correct evaluation of net worth. With the distinct disadvantage that a great deal of time is needed along with very close contact to the target for information, input from the management team and so on.

For these reasons M&A transactions in which the client is guaranteed exclusivity, require preferred auctions where the seller determines when and what will be shown to the potential buyer. Buyers can steer this process by actively seeking targets or have them researched.

The most recent KPMG survey "Hungry for More III" clearly indicates that over a third of all buyers lose 10% of their clients and client assets within one year. The reason often is ill prepared target integration. Recognizing integration risks during the due diligence and the analysis process is therefore of central importance.

# IAS 39: Fair Value Option

## A valid alternative to hedge accounting

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### **New regulation on the fair value option**

Due to the fair value option, the consideration of the IAS 39 2003 for revision into EU law was placed at risk. In order to still obtain EU endorsement, the International Accounting Standards Board (IASB) restricted the subscription rights option in its 2005 publication "Amendment to IAS 39: The Fair Value Option." In the future, only certain select financial assets and financial liabilities will be allowed the balance sheet category assignment "at fair value through profit or loss." Once a fair value can reliably be determined, one of the conditions listed in Table 1, below, must then apply. Moreover, in case of financial liability, fair value fluctuations caused by one's own credit risk changes must be disclosed (see Table 2).

### **Practical implications**

Adopting the fair value option, whenever permissible, can simplify company accounting considerably. Not only does it allow financial instruments to be presented more representively, but it also offers an elegant way to circumvent the otherwise exacting requirements that arise from embedded derivatives and hedge accounting (especially documentation and monitoring of hedge effec-

tiveness). On the other hand, it should be noted that the fair value option does not permit individualized accounting of value fluctuations, since the following rules apply:

- The financial instrument must always be rated at its fair value and booked to the income statement.
- The fair value option cannot be applied to just a part or component of the financial instrument, it has to be practised throughout (e.g. not just 25% of what has been issued).
- The risk of the other party must be considered in the valuation, which can have a direct impact on the company earnings.

Hence a company has to actively decide if and when it wishes to make use of the fair value option, or whether it prefers to apply the relatively complicated hedge accounting rules, for selected transactions, for example. Additionally, for fiscal years beginning on or after January 1, 2006 some questions concerning the implementation of the amendment need to be answered:

- May all financial instruments, following the fair value option, continue to be assigned to the category "at fair value through profit or loss?"

## Conditions for adopting the fair value option

Fair value accounting prevents or reduces discrepancies arising from differing valuation and/or profit realisation principles for linked assets and debt capital positions ("accounting mismatches").	A group of financial assets and/or liabilities are managed on a fair value basis on which performance is gauged (risk management or investment strategy must be based on fair values and reported accordingly).	Where a contract has one or more embedded derivatives, the entire hybrid instrument may be designated "at fair value through profit or loss" (unless the embedded derivative is insignificant or separation is not permitted).
<i>Allows for a "natural hedge" or a simple alternative to the fair value hedge.</i>	<i>Accommodates the already established practices in a number of industries, such as investment companies.</i>	<i>Avoids the potential compulsion for separation of a derivative from the host contract.</i>

Table 1

- What concrete changes need to be made to the accounts from prior years when the amendment is adopted for the first time?
- When IFRS is applied for the first time how can the fair value option be practised most sensibly?

Answers to these questions are complex and require careful analysis, not only of the available options, but also in regards to the publicity strategy of the company in question.

### A practical example

A company enters into a fixed-interest financial liability of CHF 1,000 on January 5, 2006. The interest rate risk has been hedged using an interest rate swap.

For this hedging the company can either apply hedge accounting (fair value hedge) or exercise the fair value option.

Under the IASB amendment to the fair value option, the company opts for the fair value option. The following implications apply:

- Initial reporting of the financial liability and the interest rate swap at fair value
- Income statement reporting on the fluctuations in fair value of the financial liability and the interest rate swap (based on the principle of always reporting the gross figures when exercising the fair value option rather than reporting the net figures for hedge accounting)

- As opposed to hedge accounting, a fair value option that has been exercised at the onset must be maintained until the financial liability is eliminated.

Without the fair value option, the financial liability would be valued at amortised cost, although the fair value continues to apply for the interest rate swap. Leading to an "accounting mismatch," which can be eliminated by taking up the fair value option, while at the same time allowing for the disregard of the extensive hedge accounting rules.

## Disclosure Obligations (IAS 32 / IFRS 7)

Appendant requirements follow general guidelines. When practising the fair value option, the following disclosure rules apply:

- Applied criteria for practising the fair value option
- Reasons for practising the fair value option
- Type of financial instruments designated for fair value
- Effects on the financial statement and P/L account through the fair value option:
  - Disclosure of the book value of financial instruments in the category "at fair value through profit or loss"
  - Net gains and losses on these financial instruments
  - Differences between the book value and the amount payable upon expiration of a financial liability
  - Information on changes to credit risk for financial liabilities, over time and accumulated
  - Disclosure of any changes to the calculation methods used to determine credit risk. An application guidance gives instructions on how changes in credit risk are to be calculated.

Table 2

# IFRS

## IFRS 2005 Impact on Swiss Banks

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### **IFRS in Europe**

The European Union decided in 2002 that all listed companies must publish their consolidated financial statements under the guidelines of the IFRS (International Financial Reporting Standards) starting in 2005. However, a number of European countries, including France and Germany, decided not to adopt the IFRS guidelines in their entirety, limiting the assessment capabilities of financial statements issued by European banks.

### **IFRS in Switzerland**

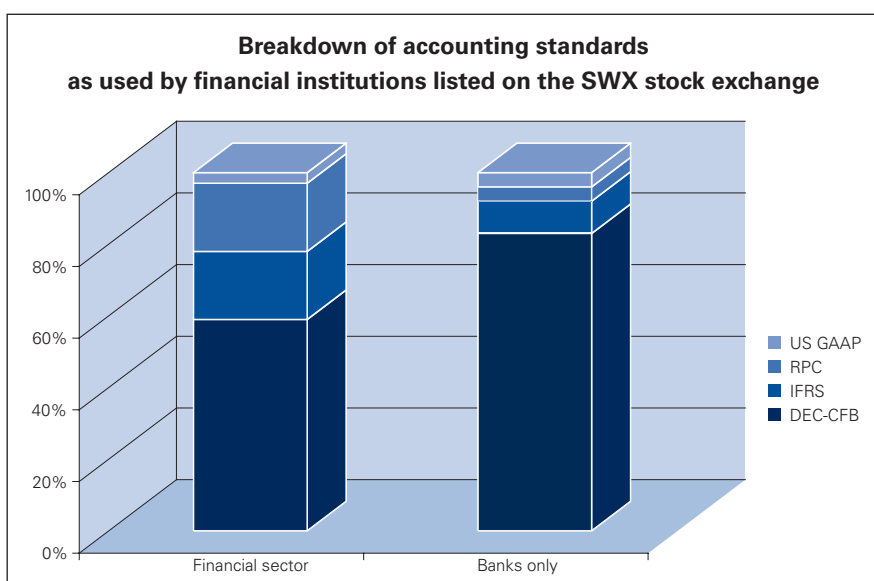
In Switzerland, under Article 68 of the regulations governing Swiss stock market listings, banks and securities brokers can opt to report either according to an international standard, IFRS or US GAAP (United States Generally Accepted Accounting Principles) or according to the Bank Accounting Guidelines of the Swiss Federal Banking Commission (BAG-SFBC).

### **Impact on Swiss banks**

The BAG-SFBC were updated in 2002 to bring Swiss standards more in line with IFRS. While international standards aim for a "true and fair" presentation of all financial statements, the BAG-SFBC require a true and fair view of the consolidated accounts only. This principle is set out in Article 25d of the Implementing Ordinance on Banks and Savings Banks

(BO) which states that group accounts must give a true and fair view of the banking group's net assets, financial situation and profitability. The BAG-SFBC set out detailed provisions for complying with this article and incorporate many of the Swiss accounting reporting recommendations (Swiss GAAP-ARR), which also follow the "true and fair" principle. Although the 2002 version of the BAG-SFBC allows consolidated financial statements to be prepared under IFRS, most of the Swiss and foreign banks established in Switzerland continue to apply the SFBC standards to comply with their legal obligations. The breakdown of listed financial institutions opting for each of the permitted standards for their consolidated financial statements, as of December 31, 2004, is detailed in the chart below.

The financial sector comprises not only banks but securities dealers, bank holding companies and other financial groups as well. BAG-SFBC seems to remain the overwhelming choice for preparing consolidated financial statements in the Swiss banking sector. Credit Suisse is the only bank group to use US GAAP. Of the cantonal banks, which make up the most numerous subset of listed companies, none prepare their accounts in IFRS.



Source: SWX

The statutory single-company accounts used to calculate regulatory capital requirements are still prepared using BAG-SFBC. Since March 31, 2004, the SFBC has accepted consolidated accounts prepared under IFRS or US GAAP for the calculation of consolidated capital requirements. Nonetheless the SFBC requires that capital as stated in international accounts should be restated to bring it fully into compliance with the demanding qualitative requirements for items included in the core capital. For instance, the SFBC Newsletter #32 requires the

elimination of any unrealised gains not related to trading that have been recorded in the income statement or directly to equity under international standards. The SFBC then accepts IFRS consolidated accounts for prudential purposes but requires a reconciliation between:

- capital as established under international standards and
- adjusted capital, following the restatement of particular positions in the international financial statements, which serves as the base for assessing capital adequacy under BO.

### Group financial reporting for consolidation purposes (the consolidation reporting package)

Foreign-owned Swiss banks generally draw up a consolidation reporting package for their parent company, using the accounting principles of the foreign group. One indirect consequence of this is that, since 2005, some of these reporting packages have had to comply with IFRS. Depending on the group's size and home country, accounting instructions for 2005 were more or less extensive and detailed. Disclosures are often limited to the information required by the group's preset forms, without going into the depth of detail required by IFRS. Also note that the materiality threshold of the reporting package is often set quite high which can sometimes limit the number of adjustments (e.g. amending the application of the effective interest rate method to loan arrangement fees). In practice, some adjustments are managed centrally at the banking group's head office abroad, such as goodwill, scope of consolidation for special purpose entities (SPE), actuarial commitments or impairment of assets. In these cases the Swiss institution need only provide the raw figures which the group then uses to measure and record the items in its consolidated accounts.

### Main divergences from IFRS

In practice, accounting systems are generally based on Swiss standards. The impact of IFRS is often limited to off-balance sheet restatements in the reporting pack prepared according to the accounting principles in use by the group. The main adjustments often concern the following items:

- restatement of hidden reserves
- valuation of nostro securities
- hedge accounting
- pension commitments
- goodwill
- valuation of investment property (e.g. held-for-sale buildings)
- scope of consolidation
- deferred tax

Since the impact of IFRS may be limited to off-balance sheet accounting restatements in drawing up a reporting package, general management often has little to do with the process. In smaller companies, the responsibility for these off-balance sheet restatements is often largely left to the chief accountant. Banks whose performance is assessed using group standards naturally tend to place more

emphasis on identifying and measuring IFRS adjustments.

### Accounts published under IFRS

Real change will come when Swiss banks start publishing their full set of financial statements under IFRS. Once this happens, it will become increasingly difficult to prepare IFRS financial statements based on accounts kept using Swiss standards (statutory BAG-SFBC accounts) and merely restated at the end of each year.

#### *IFRS accounting*

IFRS uses an approach based on the balance sheet where an increasing number of items are recorded at fair value. The accounting process largely consists of applying criteria for the recognition, measurement (often at fair value) and derecognition of balance sheet items.

Booked income is increasingly linked to changes in fair value of balance sheet assets and liabilities. Entries arising from balance sheet adjustments tend to dominate over the real flows of income and expense on the income statement. The

principles of historical cost or accruals are abandoned. In some cases the requirement for an annual impairment test replaces the gradual amortisation of intangible assets over time. Periodic recognition of income requires an analysis of the underlying activities so that revenues can be booked when and if a significant act occurs. For instance, fees for setting up a structured product cannot, in principle, be booked over the lifetime of the product.

For bank balance sheets, where most of the assets and liabilities are financial instruments as defined by IAS 39, the fair value approach could result in a considerable impact for IFRS revenues in connection with the tax balance sheet (usually very similar to the statutory balance sheet). The fair value principle also means greater volatility in results which will be influenced by a larger number of underlying factors (e.g. interest rates, market capitalisation, actuarial valuations). As a result, accounting entries can potentially be triggered by more people in the organisation, exercising multi-disciplinary skills and having less to do with the timing of cash inflows and outflows.

### *Transparency*

The third pillar of Basel II seeks to improve the transparency of financial statements so that market rules can function better. The new IFRS 7 standard solidifies this approach with various detailed information. This climate of transparency will inevitably help shape regulators' thinking on future changes.

### **Conclusion**

The conversion to IFRS will radically transform the type of events that can give rise to an accounting entry. Measures of performance and value creation will also need to be rethought in the light of fair value changes. Also, this new accounting approach, which brings with it a revised financial vocabulary, will require cutting-edge expertise. The scale and significance of these changes is, as yet, neither known or understood.

For small or medium-sized institutions in the Swiss banking world, 2005 has not brought an accounting revolution. But change is stirring on numerous fronts and seems inevitable. IFRS is gaining ground, convergence with US GAAP is advancing

and the resulting need for consolidated oversight will become increasingly urgent, making the case for a common accounting framework ever more certain. Meanwhile, the capital markets are demanding greater transparency and comparability between institutions.

The ARR, on which BAG-SFBC rely for the preparation of consolidated accounts, are undergoing a thorough overhaul, now in its consultation phase. The new ARR, renamed Swiss GAAP ARR, should be in place by January 1, 2007. We can then expect the SFBC to examine the rules and decide on their applicability to banks. Furthermore, the SFBC has a working group in place to reexamine the issue of preparation and publication of Swiss banks' financial statements. That said, in its 2004 annual report, the SFBC stated that it would take some time to complete the grand project of a single overarching framework for rules governing the preparation of accounts.

Ultimately, the issue is not whether or not to adopt IFRS, but to be prepared when IFRS becomes inevitable and to

use the transition to create competitive advantage. KPMG's professionals stand ready to help you meet this challenge, and are in an ideal position to advise you on the changes in the pipeline. For further information please visit [www.kpmg.ch](http://www.kpmg.ch) or contact the author:

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# Compliance

## Groups and conglomerates Oversight

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### Supervision of financial and insurance groups and conglomerates

#### 1. Background

On 1 January 2006, the completely revised provisions of the Swiss Federal Insurance Supervision Law (VAG) and its implementing ordinances (AVO and AVO-BPV), plus the amended provisions of the Federal Banking Law (BankG) and the Federal Stock Exchange Law (BEHG), went into effect. This means that the new rules on financial and insurance groups and conglomerates must comply.

#### 2. Definitions

In Art. 62 et seq. VAG and Art. 3c et seq. BankG the terms **financial** and/or **insurance group** and **financial** and/or **insurance conglomerate** are defined as follows:

##### Insurance group

(Art. 62-69 VAG; Art. 191-203 AVO)

Two or more insurance companies where

- at least one is an insurance company;
- overall, primarily active in the insurance sector;
- forms an economic unit or are connected in other ways through manners of influence or control.

##### Financial group

(Art. 3c para. 1; Art 3d-h; Art. 3bis para. 1bis BankG)

Two or more companies where

- at least one is active as a bank or securities trader;
- primary activity in the finance sector;
- forms an economic unit or a unit where, on the basis of other circumstances, it can be assumed that one or more of the companies under individual supervision are obliged economically or by law to provide assistance to the group companies.

##### Insurance conglomerate

(Art. 70-77 VAG; Art. 204-206 AVO)

Two or more companies form an insurance conglomerate where

- at least one is an insurance company;
- at least one is a bank or securities trader of considerable significance;
- overall, they are primarily active in the insurance sector;
- forms an economic unit or are connected in other ways through manners of influence or control.

### Financial conglomerate

(Art. 3c para. 2; Art 3d-h; Art. 3bis para. 1bis BankG)

Two or more companies which

- form a financial services group dominated by bank or securities traders;
- primary activity in banking or securities trading;
- include at least one insurance company of considerable economic significance.

A comparison of these pairs of terms shows that they are **largely the same**. However, there is some room for interpretation by the competent regulatory authorities, the Federal Insurance Office (FIO) and the Federal Banking Commission (FBC).

### 3. Purpose and scope of the regulations

The new rules on supervision of groups and conglomerates are intended primarily to **protect policy holders** and **depositors**. The solvency and equity capital of groups/conglomerates shall not be affected by dependencies and liabilities towards other companies.

The FIO and FBC can place groups/conglomerates under their supervision if they are **actually managed from within Switzerland** or if they are directed from a foreign country but are not subject to any equivalent supervision there (Art. 3d BankG; Art. 65 and 73 VAG). In case both Swiss and foreign authorities claim full or partial rights of supervision, the authorities must come to a bilateral arrangement, whereas the Swiss authority will always consult groups/conglomerates incorporated in Switzerland in advance. The group/conglomerate supervision is **in addition to** individual supervision (Art. 66 and 74 VAG; Art. 3e BankG). As with other corporate structures, the people entrusted with executive and overall management, supervision and control must **have a good reputation** and **clean conduct of business affairs** (Art. 67 and 75; Art. 3f para. 1 BankG). Irrespective of the type of group or conglomerate involved, the regulations state that they must have an **external auditor** (Art. 70 and 78 VAG; Art. 3h para. 2 BankG) and that they are **fully liable to disclose information** to their supervising authority (Art. 71 and 79 VAG; Art. 3h para. 3 BankG).

### 4. Monitoring risk /equity capital

Banking and/or insurance groups and conglomerates must, as a **precondition for obtaining a licence**, be organised in such a manner that they are able to **identify, limit and monitor all significant risks** (Art. 4 para. 2 item q; Art. 3f para. 2 BankG).

### Insurance groups / insurance conglomerates

The FIO is also entitled to issue rules and regulations with regard to monitoring **group-internal processes** and group-wide concentrations of risk. Last but not least, because of the principle of proportionality, the supervisory authority will concentrate on the group-internal procedures (Art. 68 and 76 VAG). The allowable shareholders' equity is set by a federal council ordinance, but because of its greater expertise in this field, the FIO will then set the actual capital adequacy limits (Art. 69 and 77 VAG). In general, the consolidated balance sheet of the group or conglomerate serves as the basis for allowable shareholders' equity. Capital adequacy, in turn, is based on the solvency regulations applicable to the individual companies (Art. 67 and 75 VAG).

### **Financial groups / financial conglomerates**

According to Art. 3g BankG, the FBC is authorised to issue regulations governing shareholders' equity, **liquidity, risk distribution, group-internal risk positions and accounting** for financial groups and financial conglomerates. In cases where financial conglomerates are dominated by banking or securities trading they may even do so on an individual **case-by-case** basis (Art. 3g BankG).

It remains to be seen whether risk management and capital adequacy regulations still to be decreed by the supervisory authorities, will impose as additional requirements on groups and/or conglomerates.

### **5. Temporary arrangements and forecasts**

Any company actually operating a financial or insurance group or a financial or insurance conglomerate from within Switzerland, that does not direct a bank or insurance company in Switzerland, must have notified the FBC or the FIO by March 31, 2006. Existing groups and conglomerates must conform to the new rules within two years. It seems safe to assume that, given how broadly

the terms "financial/insurance group" and "financial/insurance conglomerate" are defined, a large number of existing insurance and banking groups will now fall under the new guidelines for the first time. To make sure all companies offering combined financial services can meet the statutory period, they should check whether they are included under the new regulations.

# Retail Banking

## Trends in Retail Banking

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Retail banking in Switzerland has developed over the years from being rather neglected becoming an important and consistent profit maker for major banks as well as for cantonal and regional banks.

Over the last two years a shift of market shares from the major banks to the cantonal and regional banks was monitored. In these cases, proximity and customer service played a key role.

Even if market saturation tendencies are sensed, one can definitely say the mortgaging business has been rediscovered. The latest published bank closings only reinforce this impression. Sure enough, the strong economy as well as historically low interest rates are responsible for expansion in this segment. Despite all these positive developments, a limited increase is to be expected.

Retail clients have specific requirements for the investment of their assets. They will not put their savings into a savings account or invest them in the finance market, preferring instead the structured products, which were especially made for the retail banking segment. However, such investments are supplied with capital protection, because the retail clients have not forgotten their losses in the stock market.

In the market, the importance of branch offices is consistently being emphasised. More and more the retail client wants personal advisory service at the bank. The practice of closing branches for economic reasons, as has been the tendency in the past few years, should not be continued. The branch manager needs to return to representing the position of the entrepreneur, he or she must act independently and speak competently about standardised mortgage products. Advisory service is key.

Among the providers of mortgage products a true price war and struggle for survival has arisen, leading to another margin erosion that is only likely to intensify. The client is very sensitive towards prices, even if in many cases the loyalty to "my bank" is strong, the price needs to be appropriate.

What does that mean for banks? In order to still be profitable in the future under the given premises, new cost-efficient business models are needed, i.e. the costs of production (mainly back-office) are to be reduced. The technical development of the past years also requires updated IT infrastructures. In the future, retail banks can hardly afford to cover all elements in the chain of integrated added value, the volumes are too small and the costs are too high. One possible solution could be to outsource back-office tasks, allowing smaller banks to maintain their autonomy while cutting costs. Some bigger banks are already offering their "insourcing" services.

The development in the European market is showing similar tendencies. Products have to be simple and transparent. The quality of advisory service in so-called advisory locations, in supermarkets for example, has gained importance.

In conclusion more direct contact with the client will be a factor of increasing importance; a product range with simple and clear choices is required and back-office tasks should be taken over by an outside agency.

# IRM – Information Risk Management

## Managing the risks of a banking platform migration

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In consideration of such aspects as efficient service provision, reduction of IT-costs and support of individual business models, many banks are moving from their current IT-platform to a new banking system.

The evaluation of the most eligible product requires a rating of the scalability, integration-capability and the openness of the interfaces. Benchmark comparisons could serve as important sources of information. The evaluation process also has to consider whether a company should develop the system internally or commission an outside source. The IT system provider as well as the service provider should be examined regarding their economical stability to insure the sustainability of the new IT solution.

Once a new banking system is evaluated and the service provision is arranged, the planning process has to guarantee that the migration from the current IT-platform to the new banking system can be performed without any interruption of service and within an appropriate timeframe and cost structure. This includes the coordination of activities with the relevant third party providers, such as Telekurs or

SIS SegalInterSettle, to insure that their services can be used seamlessly during the whole migration process. This is particularly crucial if there will be a change of service providers. It is very important that the tasks of the two providers are well coordinated and carefully detailed in respects to services rendered and the conclusion of the contract.

For this reason, proper management of the migration project is key to avoid the inherent risks of this process. The migration project plan needs to contain all relevant tasks within a feasible timeframe with consideration of the allocated resources and the third-party deliverables, as mentioned above. It is important that the tasks are monitored, quality controlled and reported so that subsequent errors can be prevented and counteractive measures can be taken as necessary, such as reallocating resources.

The data-conversion rules have to be defined clearly and without ambiguity to insure that the information from the current IT platform can be attuned to the new banking system format. Within the data-conversion, reconciliation also has to be defined. The most important part of the information-transfer reconciliation

concerns the balance sheets of the old and the new system. Since it is important to set up the reconciliation based on a realistic amount of information to recognize and address differences, using only the balance-sheets of the two systems is not enough. Based on the analysis of the data-conversion the reconciliation rules (group-totals, sub-group totals) should also be defined in the conversion programs and implemented based on an appropriate percentage so that any apparent difference can be analyzed with minimal effort. These reconciliation rules are also very helpful in the debugging and quality control process of the data-conversion-software.

There should be adequate tests set up for the data-conversion and the start-up of the new banking system with the converted information from the current banking system. The reconciliation, based on the different control values reported by the conversion programs (related to the old system) and the concerning values of the new system should be compared. The tests should include the processing of all business-critical banking transaction types.

The project plan should include a backup plan that becomes effective if the tests do not show the expected results within the defined timeframe. This backup plan should consider an ongoing usage of the old system if the migration cannot be set up in time and it should also contain – as a worst case scenario – the necessary steps to return from the new banking system to the old one. The defined tasks must be coordinated with the service providers.

An appropriate risk management based on a properly set up project plan saves money and insures a successful system migration.

# IRM – Information Risk Management

## Assurance Standards on Outsourcing SAS70 – ISA402 – SFBC Circ. 99/2

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Many financial institutions have chosen to outsource parts of their operational processes to third party service providers (e.g. application hosting, IT operations, back-office operations). Whilst most of these outsourcing initiatives are aiming to fulfil various business objectives, very few will find their foundation in an internal controls initiative. Nevertheless, outsourcing initiatives have to be evaluated for their adequacy of internal controls from a financial reporting and a SFBC compliance perspective.

The main standards and regulations that are relevant in this context are the SAS70, the ISA402 and the SFBC circular 99/2 on outsourcing. While the SFBC circular 99/2 requires a specific report stating the compliance with 9 principles related to specific regulatory requirements; both SAS70 and ISA402 are standards intended to give assurance on controls over financial reporting.

Which standards are to be used depends on the regulations the company has to comply with and the relevance the outsourced services have for the financial reporting. A bank being supervised by the SFBC has to comply with the outsourcing circular 99/2 and the bank's auditor will have to conclude on the compliance with the aforementioned nine principles. The standard to be used for the controls over financial reporting depend on whether the company has to comply with the Sarbanes Oxley Act, Section 404. If SOX-compliance is not required the company's report. Otherwise the auditor will need to rely on a SAS70 report. There are two types of SAS 70 reports: Type I and Type II, whereas only a Type II report provides sufficient assurance for an auditor to rely on.

- A Type I report describes the service provider's description of controls at a specific point in time (e.g. March 31, 2006).
- A Type II report not only includes the service provider's description of controls, but also includes detailed testing of the service provider's controls and an assessment of their operating effectiveness over a period of time, which should be a minimum of six months (e.g. January 1, 2006 to 30 June, 2006).

Although the standards address two different scope objectives (i.e. SFBC requirements, controls over financial reporting), some of the controls required for SFBC compliance may also be necessary for controls over financial reporting (e.g. access controls).

Because the standards do not present the flexibility to allow a single report to address all of the other standard's requirements, two independent opinions have to be produced by the service company's auditor: one on SFBC regulatory compliance and a second on the controls over financial reporting.

However, to avoid overhead in building two distinct control environments, the service company can design and implement an integrated control system that addresses both requirements. Following the same reasoning the service company's auditor may also audit the control system in an integrated fashion but finally documenting the work and reporting the conclusion as set forth in the different standards.

# Interview

with Adrian Gerber, expert on the Luzerner Kantonalbank Special Financing Team and Giulio De Lucia, Head of Corporate Restructuring at KPMG Switzerland

Daniel Häring  
Ivo Cathomen  
KPMG, Zurich

## **“Nowadays, we take action sooner.”**

Identifying potential restructuring candidates in the credit business at an early stage gives Luzerner Kantonalbank the leeway it requires to provide support for corporate clients. One way of doing this is to engage external consultants such as KPMG’s restructuring professionals. We discussed the issue with Adrian Gerber, expert from the Luzerner Kantonalbank Special Financing Team, and Giulio De Lucia, Head of Corporate Restructuring at KPMG Switzerland.

### *Adrian Gerber, in your view, how are the restructuring cases developing in your bank’s area?*

Adrian Gerber: Luzerner Kantonalbank has registered a 40% reduction in the number of cases we have analysed since 2000. Given the size of our market share in the whole canton, this development is considered representative throughout the area. At the same time, the amount of restructuring cases among large companies has dropped as much or even more. In 2005, the eight largest cases took up around 20% of our capacity.

### *What other changes have you witnessed?*

Adrian Gerber: Because of the larger number of cases we used to deal with, we had no choice in the past, but to react to the situations around us. Now we have the opportunity to step in and help borrowers at an earlier stage, which also give us more time to react.

### *How does Switzerland present itself within the country and from an international point of view?*

Giulio De Lucia: The decrease is noticeable throughout Switzerland. Internationally, the situation varies from country to country. One interesting trend witnessed among foreign banks is that they have stopped dealing with restructuring cases themselves and instead have started selling them as an entire portfolio to institutional investors. This trend is especially noticeable in Germany and eastern Europe. The potential buyers are mainly investors from the Anglo-Saxon countries.

### *Are there clear sector trends?*

Giulio De Lucia: Companies in sectors undergoing structural change, such as the motor industry or tourism tend to be affected most often.



Adrian Gerber

"KPMG has a reputation for professionalism. I was especially impressed by how quickly they came up with initial proposals for solutions."

*Adrian Gerber*

Adrian Gerber: This also coincides with our experience. Around 50% of all the companies on our watchlist belong to the construction, automotive, real estate and food service industries. Having said that, this also reflects the make-up of industry in central Switzerland, with only a small share of high-tech companies.

#### *How much influence does the bank's credit policy have on the number of restructuring cases?*

Adrian Gerber: There is a timely delayed link between the two. If lending policies are too aggressive, recovery cases are sure to follow. By the same token, a restrictive credit policy can drag existing clients into a liquidity squeeze caused by overdemanding repayments and high interest. But to only lay the blame on credit policy would be too simple. Besides individual management mistakes, the main cause is the overall state of the economy.

#### *What action should the Luzerner Kantonalbank follow?*

Adrian Gerber: As a cantonal bank we try to avoid a stop-start policy and instead follow a steady course; we even communicate unpleasant facts openly and clearly, we act reliably and honestly.

#### *How has the role of banks been changing?*

Giulio De Lucia: Nowadays banks monitor risk trends more attentively and are acting more quickly. The risk management systems available for this purpose have been refined and enhanced.

Adrian Gerber: I consider the early identification of risks as our core task. Our aim is to spot cases as early as possible, support client advisors in the front office and draw their attention to delicate issues. Doing that, we also take a close look at companies that are far from being actual restructuring cases. A good example of this is the unsettled follow-up regulation. If we have enough available time, we can point out different possibilities to the entrepreneur. One of the challenges we face, is to get people working at the front to call us for our services. Another challenge is the process of gaining acceptance among clients. This requires a high degree of sensitivity on our part.

#### *What reactions do you get from companies?*

Adrian Gerber: Reactions vary. Sometimes our visit inspires the entrepreneur to be more ambitious, sometimes it provokes resistance. In any case, we look for collaboration via personal communi-

cation, not via confrontation. Terminating a credit facility is used as a last resort only.

Giulio De Lucia: Because of the selective view managers sometimes have, they often fail to realise or do not realise fast enough, that development is moving in the wrong direction. In this context, the indicator given by the bank can have a very positive effect.

#### *What contribution can KPMG professionals make?*

Adrian Gerber: The golden rule is that the bank does not intervene in business operations. We would not have the capacity to manage individual cases with the required level of intensity, but we can offer incentives.

#### *As a professional, what might be your contribution?*

Giulio De Lucia: We provide a neutral base for decision-making within a very short time and we have the expertise and the quantitative capabilities which a bank often lacks. Compared to lenders, we take a much closer look at business operations and if needed, we can also assist the company implementing the necessary measures, which is something that banks are not able to do.



Giulio De Lucia

*What contractual relationship do you, as a consultant have with the respective company and the bank?*

Giulio De Lucia: The company is our client. Because of the agreements between the debtor and the bank, we have a reporting duty towards the institute. The relationship is based on neutrality. We are neither agents of the bank nor of the client. We perform well, if we can build our own opinion. Often we assume an intermediary role between creditor and debtor.

*Doesn't this result in conflicts of interest?*

Giulio De Lucia: It's possible, but we can only steer a safe course by acting professionally and neutrally.

*Is your role affected if an external consultant gets involved?*

Adrian Gerber: We remain involved in the project regardless. For instance, we agree to receive a monthly report which we use to assess whether the restructuring is going according to plan or whether we need to pull the emergency cord.

*How are cases triaged?*

Adrian Gerber: Business problems involving operational circumstances are cases for the consultants. Often we will then tie in the continuing business relationship by calling on the services of an additional consultant. Ultimately, though, the triage is dependant on our assessment of the entrepreneur.

*What cases do you deal with internally?*

Adrian Gerber: On the one hand, it is the smaller cases. On the other hand, it is situations, in which we have enough time to act and the entrepreneur is able to implement the required changes themselves, or when external factors temporarily create difficulties.

*What trend is the recovery taking for you as lender?*

Adrian Gerber: I hope we can keep focusing on early identification. Above all, we aim to avoid emergencies. For us this means we have to perceive companies as a unit rather than judging them solely by their bank balances. This also requires input from our client advisors on a daily business.

*What influence will Basel II have?*

Adrian Gerber: I don't expect the introduction of Basel II to have any impact, because we incorporated the pertinent factors into our credit policy years ago.

*What changes to your role do you see from the perspective of the external consultant?*

Giulio De Lucia: I think the main change in the future is that we will play a more active role in implementing measures that have already been identified. Clients are less interested in purely theoretical advice.

# Keeping you informed

## Audit / Tax / Advisory

This section of the newsletter highlights the very latest pamphlets, studies and journals. Of course, you can also download these publications as well as many others, free of charge at [www.kpmg.ch/library](http://www.kpmg.ch/library).

Also featured here are national and international events in the Financial Services field. Further information about all KPMG Switzerland events can be found at: [www.kpmg.ch/about\\_kpmg/events/11804.htm](http://www.kpmg.ch/about_kpmg/events/11804.htm)

### Publications

#### **Hungry for more**

##### *Executive Summary*

Stuart Robertson  
Partner, Head Financial Advisory Services  
KPMG, Zurich

In June 2006, KPMG will publish the third annual update of its "Hungry for More?" global survey on the M&A appetite of private banks. The objective of this publication is to gauge acquisition appetite and strategy in the global private banking and wealth management industry, based on interviews with private banks around the world.

This survey concept has been developed and led by KPMG Switzerland, and because of the importance of private banking, the publication has particular relevance in the Swiss market. Last year's survey showed that Swiss respondents had both a higher incidence of past acquisitions and a greater propensity to future acquisitions than the global average.

Last year's publication pointed to acceleration in M&A activity in the global private banking and wealth management industries, with global M&A levels increasing 26 percent in 2004 from the previous year. In the last two years, Asia-Pacific was identified as the region with the most growth potential, and also saw

the most transactions during the year. This level of M&A growth is likely to be sustained as the survey noted a significant increase in planned acquisition activity in all regions over the next three years. Stay tuned for the results of this year's survey. Source: [www.kpmg.ch/library/publikationen\\_studien/en/11985\\_12213.htm](http://www.kpmg.ch/library/publikationen_studien/en/11985_12213.htm)

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### **Corporate Financing in Switzerland**

#### *Unused optimization potential*

Claudio Steffenoni  
Partner, Corporate Finance  
KPMG, Zurich

Almost 70% of small and medium-sized companies in Switzerland recognize the potential to optimize corporate financing, but only 8% actively take advantage of the competition between banks. Corporate financing is always an issue of great interest. In addition to structures, the discussion also focuses on negotiated terms and costs of financing.

In the summer of 2005, KPMG Switzerland surveyed 270 medium-sized businesses in Switzerland on corporate financing. This study summarizes the analysis of 75 returned questionnaires.

69% of the surveyed companies stated that they could lower their financing costs

and achieve better terms by more actively controlling the financing process or by taking advantage of the competition between banks. However, only 8% are willing or able to pursue a so-called auction process with financial institutions at the end of the proposal phase. For the other 92%, the bank selection process apparently is completed once they have obtained proposals.

#### **Time pressure and limited human resources**

According to the respondents, the reasons are time pressure to finalize the financing process (33%) and preference for a certain provider (also 33%), specifically the key relationship bank. 24% lack the necessary human resources for an auction process. At the same time, a mere 12% of businesses are willing to consult an external financing specialist. 31% are of the opinion that there is no potential for optimization. 80% of the surveyed companies contact domestic banks for financing proposals, while 55% also consider foreign institutions.

The banks have no particular interest in additionally fueling competition. Due to average long-term associations exceeding 10 years and a strong commitment to their products, relationship banks in particular are able to ensure that their corporate clients remain loyal. However, the results of the survey indicate that there is no significant difference in the

customer service activities of relationship banks and foreign competitors.

Claudio Steffenoni, Head Financing of KPMG Switzerland comments as follows: "Based on KPMG's experience in supporting businesses in the financing process, we know that there is considerable potential for optimization. Medium-sized companies could easily use the competition between banks to their advantage, meaning they could negotiate the terms of external financing. Especially in view of the revised international capital framework "Basel II" and due to the very strong market position of a handful of banks in Switzerland, it is imperative for finance managers to take action."

This study can be downloaded at:  
[www.kpmg.ch/library/pdf/20051128\\_Financing\\_Survey\\_2005.pdf](http://www.kpmg.ch/library/pdf/20051128_Financing_Survey_2005.pdf)

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#### **frontiers in finance: New markets, new risks, new challenges**

Companies today are having to assess the many risks and uncertainties the environment poses against a continually evolving regulatory background. This edition explores how financial services companies are facing up to these challenges.

The *frontiers in finance* series assembles the comments of KPMG's member firm

professionals from around the globe, providing you with informed perspectives on current and future industry trends and developments. The series is designed to stimulate your thinking by highlighting specific practice oriented issues at both the strategic and tactical level.

[www.kpmg.ch/library/pdf/20060320\\_Frontiers\\_in\\_Finance\\_March\\_2006.pdf](http://www.kpmg.ch/library/pdf/20060320_Frontiers_in_Finance_March_2006.pdf)

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#### **New version of the Swiss Right of Review (OR) and the new Audit Supervision Statute (RAG).**

The Swiss right of review is currently being completely revised. From now on revisionary rights will not be determined by the legal form of a company but instead by its size and relevance. Variances between proper and limited revisions will be set, which involve numerous requirements relating to articles of review, autonomy and reporting. New aspects of the revisionary standards make it especially advantageous for companies to familiarize themselves early with the new regulations, for example in consideration of internal monitoring in the area of auditing inspection reporting and guidelines for executing a risk evaluation in the annual financial statement addendum.

Through the "Audit Update" we aim to keep our clients and partners up to date on the latest changes. In the first edition

of the "Audit Update" we summarize the most relevant points. The second edition exams more closely the recent changes requiring auditors to deliver an audit option for internal monitoring during a proper revision. On this topic Treuhand-Kammer compiled a position paper, which we reprint in its entirety.

The "Audit Update" is published in German, French and English. The first edition from February 2006 is also available in Italian. The German version of the second edition is now available with the English and French versions soon to follow.

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### **Investment Fund Regulations in Switzerland**

KPMG Switzerland has updated the pamphlet, "Investment Fund Regulations in Switzerland" with unofficial translations of the relevant rules and self-regulation guidelines in the investment fund sector.

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Available under: [www.kpmg.ch/library/pdf/20060411\\_Investment\\_Fund\\_Regulations\\_in\\_Switzerland.pdf](http://www.kpmg.ch/library/pdf/20060411_Investment_Fund_Regulations_in_Switzerland.pdf)

### **Events**

#### **KPMG's Fokus Session "new markets, new risks, new challenges", Finance Forum 06, Kongresshaus, Zurich on November 7, 2006**

Under the motto "Financial Centre Switzerland – road to success – strategies for a lasting growth" the leading meeting of the financial sector will be held for the 16<sup>th</sup> time on 7 & 8 November 2006 in the "Kongresshaus" in Zürich. Leading representatives of the financial industry will provide information concerning the latest business models, strategies and products at the exhibition. The features of the Finance Forum will comprise a clear focus on current banking subjects as well as the high quality of the speeches and panel discussions.

The focus session is the 1-day-symposium to meet the frequently expressed wish of participants, namely that of a current subject being treated in depth and throughout an entire day. *KPMG* will run the *focus session* on 7 November 2006 under the title: "new markets, new risks, new challenges". We have managed to sign up very interesting speakers for this subject.

Trough out the day our professionals will be ready to assist you in the **KPMG lounge** on the 2nd floor. They will be glad to answer questions or advise you at length on a specific topic. Reserva-

tions for individual meetings may be booked in advance.

Please contact Carmen Borges, Marketing Manager Financial Services, KPMG Zurich, via telephone: +41 44 249 20 51 or e-mail: [carmenborges@kpmg.com](mailto:carmenborges@kpmg.com).

The complete program as well as the registration form for the Focus Session can be found at: [www.finance-forum.ch](http://www.finance-forum.ch). This session is free for the participants.

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This newsletter is available in German, French and English. Additional copies can be ordered or downloaded under [www.kpmg.ch](http://www.kpmg.ch).