

## Comments

of the Association of German Banks on  
the consultation by the European Commission on a  
possible recovery and resolution framework for  
financial institutions other than banks

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## **Consultation by the European Commission on a possible recovery and resolution framework for financial institutions other than banks**

Thank you for the opportunity to respond to your consultation document on a possible recovery and resolution framework for financial institutions other than banks.

Our members welcome and support the idea of regulating the recovery and resolution of systemically important institutions which are not banks. Financial market infrastructures provide key services needed to execute transactions in financial instruments and thus act as cornerstones of smoothly functioning financial markets. As a result of their status as deposit-taking banks, some financial market infrastructures, such as the German central securities depository (CSD) and the central counterparty (CCP) fall or may fall within the scope of the planned Directive establishing a framework for the recovery and resolution of credit institutions and investment firms (Crisis Management Directive). Nevertheless, as providers of systemically important services of a very specific kind, CSDs and CCPs should rather be subject to separate, more specialist rules.

Our comments will consequently focus on the financial market infrastructures (FMIs) addressed in section 3 of the consultation document. We are well aware that we are not among the primary addressees of this consultation. As participants in, and users of, these FMIs, however, we are directly affected by the effects of any regulation on them. With this in mind, we would like to contribute our perspective to this aspect of the consultation.

### **1. General remarks**

We warmly welcome the objective of ensuring the continuity of the services provided by systemically important FMIs, especially in a crisis which would otherwise normally result in their insolvency, and of separating them if necessary from an ailing FMI and transferring them to viable institutions. Divisions and services not considered systemically important should then be wound down in an orderly manner and terminated. Moreover, when approving and monitoring interconnected FMIs, especially those with interoperable links, care should already be taken to ensure that these links can swiftly and easily be unpicked and ended. Steps should also be taken to avoid the creation of FMI oligopolies or monopolies so that sufficient alternatives will exist if critical services need to be transferred. FMIs that operate across borders, thus potentially developing Europe-wide or even global systemic importance, cannot be wound down by one national supervisory body alone. We would like to see special attention paid to ensuring coordination between the authorities whose markets are affected in such cases.

Regarding the management of a default situation, however, we believe it is of utmost importance to clearly distinguish between the different stages – ordinary course of business, recovery and resolution – and, in order to avoid any uncertainty over the responsibility and consequences, to

provide for precise and predictable arrangements and procedures that take these aspects into account.

We also consider it essential that FMIs follow the Principles for Financial Market Infrastructures drawn up by CPSS and IOSCO and published in April 2012. Compliance with these principles will minimise the risk of an FMI getting into financial difficulties. We would therefore recommend incorporating the principles into the planned recovery and resolution framework.

Before taking any further concrete steps towards establishing the framework, we believe the Commission should not only evaluate the responses to its own consultation, but also consider the findings of the recently completed consultation by CPSS and IOSCO on the recovery and resolution of FMIs.

It would also be desirable, in our view, for the European Commission to take account in their plans for a recovery and resolution framework of other ongoing and upcoming legislative projects concerning CCPs and CSDs and to consider their findings as well as any problems addressed in related discussions. Such projects include the Regulation on OTC derivatives, central counterparties and trade repositories (EMIR) – now already in force –, especially its requirements for CCPs; the planned Regulation on CSDs and securities settlement (CSDR); and the Securities Law Legislation, which addresses questions relating to custody and the transfer of securities.

We would like to point out in addition that many of the solutions referred to in the consultation paper, especially the **loss allocation models**, are the subject of controversial discussion not only among our members. Further models also exist whose implications cannot be entirely grasped at this stage and which should therefore be **considered only with the greatest caution**. With this in mind, we would recommend more in-depth discussion and careful evaluation and analysis of the likely impact of the solutions proposed here and elsewhere in order to avoid undesired and irreversible legal consequences. This discussion and analysis should take place with the involvement of experts representing all affected parties including but not limited to FMIs, direct and indirect users, clearing and non-clearing members, supervisors and insolvency administrators.

## 2. Replies to the questions

Our replies to the questions raised in section 3 of the consultative document are as follows:

**1. Do you think that a framework of measures and powers for authorities to resolve CCPs and CSDs is needed at EU level or do you consider that ordinary insolvency law is sufficient?**

No. Given the crucial importance of CCPs and CSDs to the stability and smooth functioning of the financial markets, we take the view that existing **insolvency law is not** sufficient to resolve a failure at either national or cross-border level, let alone a situation with global dimensions. In the interests of avoiding further financial crises and enhancing the resilience these FMIs demonstrated in the last crisis, we welcome plans to set up a dedicated framework for FMI recovery and resolution which takes account of both the special role played by CCPs and CSDs and the special features of their structures and tasks. In the event of a crisis, ordinary insolvency law would in many member states inevitably bring about the suspension of clearing and settlement services, generate uncertainty or at least lengthy delays in releasing assets to creditors with a legitimate claim and thus carry a contagion risk which would be anything but conducive to financial stability.

In view of the differences between national insolvency rules, we particularly welcome harmonisation in the context of the recovery and resolution of systemically important FMIs operating across borders. It will be vital to draw a **clean line of demarcation** between the recovery and resolution framework and national insolvency regimes.

**2. In your view, which scenarios/events might lead to the need to resolve respectively a CCP and a CSD? Which types of scenarios CCPs/CSDs and authorities need to be prepared for which may imply the need for recovery actions if not yet resolution?**

The question asks about scenarios leading to recovery and resolution. Critical scenarios can arise in three different categories, which need to be considered separately.

1. **Ordinary course of business**, in which supervisors have a monitoring role to play.
2. **Recovery**, meaning that the FMI is in difficulties but can still return to orderly operations without outside intervention. Supervisors will intervene only in exceptional cases and in a supportive capacity.
3. **Resolution**, since recovery no longer seems feasible. Supervisors will play a proactive role.

**CCPs:** The default of a member generally occurs during normal business operations. For this reason, arrangements exist under EMIR to offer the CCP financial protection in such

cases (e.g. rules in connection with the so-called default waterfall). The CPSS/IOSCO Principles are also designed to effectively cushion against risks arising in the course of normal business operations.

Nevertheless, the simultaneous default of several members or, in the event of interoperability, of other CCPs could exhaust the waterfall and push a CCP into financial difficulties. As well as losses arising in the course of the CCP performing its functions, financial distress could also be caused by various forms of legitimate or illegitimate conduct (e.g. bad investments, operational losses, mismanagement, competitive pressure, fraud or unusual financial or political developments). Supervisors should keep an eye on events of this kind and be prepared for any recovery measures that might subsequently become necessary. The CCP itself should be responsible for such measures. Should these recovery measures fail or should the CCP fail to take recovery measures despite their necessity, action by supervisors may be required. In this case, supervisors will need to determine whether a resolution phase has already been entered (meaning that recovery measures have little chance of success) or whether recovery is still feasible without external assistance and, if so, what measures the CCP should be instructed to take.

**CSD:** Since a CSD is not itself a party to a contract, but executes transactions concluded under bilateral agreements between its participants, the CSD will not normally be affected by a participant's default. If a CSD takes on credit risk, however, there is a chance that this risk will materialise. This may occur within the parameters of normal business operations or may push the CSD into crisis. On top of this, CSDs can also get into financial difficulties as a result of misconduct (e.g. bad investments, operational losses, mismanagement, competitive pressure, fraud or unusual financial or political developments).

Arrangements already exist (EMIR) or are under development (CSDR) to cope with problems arising in the course of normal business operations. For the other two categories, appropriate recovery and resolution measures and plans should be drawn up for implementation in the event that ailing FMIs themselves have no such plans or only inadequate plans in place. These recovery and resolution plans should take adequate account of individual causes and effects and set out what will happen in a way that is clear and predictable.

**3. Do you think that existing rules which may impact CCPs/CSDs resolution (such as provisions on collateral or settlement finality) should be amended to facilitate the implementation of a resolution regime for CCPs/CSDs?**

**No.** In our view, the primary objective of the above rules (e.g. in the Financial Collateral Directive and Settlement Finality Directive) is to establish legal certainty, to determine the time at which a transaction may be deemed effectively settled for third parties and to protect the property or legal title to property of an FMI's members or clients. Though

these provisions address the possible insolvency of an FMI's member or client, they are not concerned with the insolvency of the FMI itself as the supplier of the platform. A future recovery and resolution framework for FMIs should therefore take account of these provisions and not modify or, even worse, override them.

As we understand it, the resolution of an FMI under the planned framework would avoid the consequences of insolvency under ordinary insolvency law. Instead, a special legal mechanism would be applied to wind down the FMI in an orderly manner under the supervision of the FMI's competent authority. Core services (such as the clearing and settlement of securities) would not be suspended in this case, but could initially continue. The provisions of the Financial Collateral Directive and Settlement Finality Directive should continue to apply to these services in the same way as before. Modifications in the event of the FMI's resolution would probably lead to legal uncertainty concerning their application, which would fly in the face of the objective of the recovery and resolution framework (namely to ensure financial stability).

As to the existing exposure management and collateral mechanisms under EMIR (initial and variation margin, default fund, dedicated fund), we firmly believe that these need to remain untouched as well, so as to avoid the risk of contagion spreading among an ailing FMI's users, members and clients.

We also consider it important to take account of the CPSS/IOSCO Principles when drawing up the recovery and resolution framework. Adequate account should be taken, too, of the provisions currently under discussion for the future CSDR and possible upcoming requirements in the area of securities (Securities Law Legislation).

**4. Do you consider that a common resolution framework applicable to CCPs and CSDs is desirable or do you favour specific regimes by type of FMIs?**

Given the differences between CCPs and CSDs both in their type of business, risks and membership structures, we do **not** consider a common recovery and resolution framework to be an appropriate solution. Instead, we favour a **separate, specific regime for each type of FMI**. It should, in addition, be borne in mind that FMIs which are also deposit-taking institutions will be covered by the future Crisis Management Directive. For these institutions, the FMI regime should be the more specific, with the Crisis Management Directive applying in a subsidiary capacity to their bank-specific responsibilities and risks only.

5. **Do you consider that it should only apply to those FMIs which attain specific thresholds in terms of size, level of interconnectedness and /or degree of substitutability, or to those FMIs that incur particular risks, such as credit and liquidity risks, or that it should apply to all? If the former, what are suitable thresholds in one or more of these respects beyond which FMIs are relevant from a resolution point of view? What would be an appropriate treatment of CSDs that do not incur credit and liquidity risks and those that incur such risks?**

**No.** Since it is planned that only systemically important institutions will be covered by the recovery and resolution framework, it would at first sight seem logical to let criteria such as size, interconnectedness and substitutability determine whether or not an institution falls within its scope. As we see it, however, CSDs – unlike banks – are all systemically important by virtue of their monopolistic structure. The same applies to CCPs owing to the particularly high risk of contagion underlying their business model. The recovery and resolution framework should therefore apply to **all FMIs** (CCPs and CSDs) irrespective of thresholds relating to size, interconnectedness, substitutability or credit and liquidity risk, etc.

An FMI's size, interconnectedness and substitutability, and the level of credit and liquidity risk they carry are nevertheless important factors. They should be used to determine the timeframe within which a recovery plan should be submitted and in the selection of suitable recovery and resolution tools.

6. **Regarding FMIs (some CSDs and some CCPs) that are also credit institutions, is the proposed bank recovery and resolution framework sufficient or should something in addition be considered? If so, what should the FMI-specific framework add to the bank recovery and resolution framework? How do you see the interaction between the resolution regime for banks and a specific regime for CCPs / CSDs?**

Recovery and resolution measures should depend primarily on the FMI's function. This determines its systemic importance and the need to avoid ordinary insolvency proceedings. In order to maintain the special, systemically important services provided by CCPs and CSDs, the **FMI-specific framework** should apply to an ailing FMI regardless of whether or not it is also a deposit-taking institution. The Crisis Management Directive should apply only in a subsidiary capacity and only to banking functions unrelated to its systemically important services.

In our view, an FMI-specific recovery and resolution framework should not “add to” the Crisis Management Directive but should be a self-contained instrument, setting out special, detailed requirements for CCPs and CSDs. The provisions of the Crisis Management Directive should then apply in a subsidiary capacity if bank-specific functions of an ailing

FMI have also been affected. It will be essential, in any event, to ensure proper **coordination** both between the supervisory and resolution authorities involved and of the measures they apply so as to avoid undesirable inconsistency.

**7. Do you agree that the general objective for the resolution of CCPs/CSDs should be continuity of critical services?**

**Yes.** But the continuity of ancillary services needed to support these critical services should also be ensured. This should only apply, however, if the services of the FMI in question can **really be deemed systemically important**. It should be possible to split off and terminate all other services.

Furthermore, even systemically important services should **not** be continued at any price. Each individual case needs to be carefully weighed on its own merits.

**8. Do you agree with the above objectives for the resolution of CCPs/CSDs?**

Yes, though the list should not be regarded as exhaustive.

**9. Which ones are, according to you, the ones that should be prioritized?**

Next to all the high-level objectives mentioned we would prioritise the “more operational objectives” as follows:

- legal certainty and predictability about the events and timings triggering recovery or resolution and about the associated measures and consequences,
- coordination mechanisms between different jurisdictions and authorities,
- adequate resolution powers and tools,
- adequate preparation for the failure of a CCP or CSD.

**10. What other objectives are important for CCP/CSD resolution?**

- The smooth functioning of markets should be ensured;
- there should be clarity and predictability about the **consequences** of measures;
- the interests of all those affected by the measures should be adequately weighed;
- losses should be divided among those responsible for causing them (taking due account of user and ownership structures); and
- it should be possible to terminate or close all functions which are not systemically important.

**11. What should be the respective roles of FMIs and authorities in the development and execution of recovery plans and resolution plans? Should resolution authorities have the power to request changes in the operation of FMIs in order to ensure resolvability?**

- Role of FMIs

FMIs should **develop recovery plans** with due regard for the interests of direct and indirect users and should support supervisors in the development of resolution plans. In addition, they should be open to **cooperation with users and supervisors** both when developing and when implementing their recovery and resolution plans.

- Role of authorities

Competent authorities should **monitor** the development and feasibility of recovery plans and assist FMIs if necessary. They should **involve** the relevant FMI and its users in the development and implementation of resolution plans.

- Authorities' powers of intervention

We are not completely clear about the second question. We firmly reject the idea of supervisors intervening in an FMI's business operations before recovery measures become necessary. If the FMI is in the recovery phase, supervisors should have the power to intervene in exceptional circumstances to support the recovery. This applies particularly if the FMI's management fails to implement the recovery plan or fails to implement it adequately. It might be worth considering establishing thresholds or milestones regarding the urgency of implementation. It should be possible for supervisors to break up an FMI in the resolution phase (cf. our reply to question 15).

**12. To what extent do you think that CCPs/CSDs in cooperation with their users would be able to define efficient recovery and resolution plans on the basis of amendments to their contractual laws?**

Cooperation with users on recovery and resolution plans is absolutely **essential**. Users of FMIs naturally have a vital interest in the existence of effective recovery and resolution planning, so their involvement will ensure that the plans developed will be practicable to implement and function smoothly.

Recovery plans should, in addition, take account of what caused the losses incurred. Various measures could be undertaken to eliminate these causes. These measures would need to be discussed and agreed with users to ensure the greatest possible acceptance of their inclusion in business terms and conditions or contracts. Mechanisms that result in

obligations to pay additional fees, replenishments, the waiving of claims or the conversion of claims into equity holdings in the FMI must be **transparent, clear and predictable**. Any liability or obligation to make payments must be strictly **limited**. To be properly effective, moreover, they need the **express consent** of each individual user.

Recovery and resolution plans should take account of existing rules and regulations (EMIR and CSDR) and not undermine the exposure management and collateral mechanisms already in place to deal with stress situations (e.g. waterfall).

**13. Should resolution be triggered when an FMI has reached a point of distress such that there are no realistic prospects of recovery over an appropriate timeframe, when all other intervention measures have been exhausted, and when winding up the institution under normal insolvency proceedings would risk causing financial instability?**

Basically, **yes**. Where a cross-border dimension is involved, however, the question arises as to whether the prerequisites for normal insolvency proceedings would be the same. Harmonisation in this area is to be very welcomed.

It is essential that the trigger for the resolution of an FMI can be determined on the basis of **objective criteria** and is **clearly defined**.

**14. Should these conditions be refined for FMIs? For example, what would be suitable indicators that could be used for triggering resolution of different FMIs? How would these differ between FMIs?**

The indicators of the point at which an FMI is no longer a viable concern should be the **same** for both types of FMI. This is also in the interests of harmonisation. There will nevertheless be differences in what happens once this point has been reached. Subsequent resolution measures (e.g. transfer of essential functions) and the speed of their implementation will naturally differ according to the type of FMI.

**15. Should there be a framework for authorities to intervene before an FMI meets the conditions for resolution when they could for example amend contractual arrangements and impose additional steps, for example require unactivated parts of recovery plans or contractual loss sharing arrangements to be put into action?**

We would generally support intervention by supervisors in cases where the ailing FMI has refrained from implementing appropriate measures or is no longer in a position or reluctant to initiate them. In a pre-resolution phase, the FMI's normal supervisory authority

should be responsible for taking remedial action. It should be borne in mind that this authority may not be the same as the authority responsible for resolution. Coordination with the resolution authority would be useful in such case.

A prerequisite for intervention, however, is that the measures taken by supervisors are set out in the FMI's recovery plan ("unactivated") and that the FMI has been negligent in failing to execute these measures itself. Supervisors should **not** be permitted to take measures which are not included in the FMI's recovery plan; nor should they be permitted to change existing contractual arrangements unilaterally.

It should also be ensured that recovery plans are wherever possible implemented by the FMI itself and that supervisors intervene only in **exceptional** circumstances. Furthermore, a legal basis for such action by supervisors is essential.

**16. Should resolution authorities of FMIs have the above powers? Should they have further powers to successfully carry out resolution in relation to FMIs? Which ones?**

Yes. The resolution authority should generally have all the options and powers mentioned when dealing with both CSDs and CCPs.

**17. Should they be further adapted or specified to the needs of FMI resolution?**

Yes, they should be tailored to the specific characteristics of either CSDs or CCPs.

**18. Do you consider that temporary stay on the exercise of early termination rights could be a relevant tool for FMIs? Under what conditions? How should it apply between interoperated FMIs? How should it be articulated with similar powers to impose temporary stays in the bank resolution framework?**

We have **serious reservations** about the idea of imposing a stay.

On the one hand, a stay may represent a sensible measure which will allow the FMI to be stabilised and transactions to be transferred elsewhere. But it is critically important to time such a measure correctly and to ensure that circumvention is not possible.

In any event, an approach along the lines of that taken for the Crisis Management Directive should apply:

- the stay should be applied within very narrow parameters,
- it should be imposed for a limited period of time (at most 48 hours) and the beginning and end should be clearly defined,

- there should be adequate safeguards: in the case of a netting arrangement, for example – no cherrypicking; transactions should be transferred and terminated in their entirety,
- termination rights should be reactivated after the stay (the remaining parties should be able to exercise their contractual rights in full).

**19. Do you consider that moratorium on payments could be a relevant tool for all FMIs or only some of them? If so, under what conditions?**

CSDs: we do not consider a moratorium on payments a suitable tool since CSDs always execute payments for third parties.

CCPs: we also have **serious reservations** about a moratorium, especially one imposed on payments in the context of exposure management and collateral mechanisms (e.g. margin). At most, the use of a moratorium might be considered in situations which could justify the imposition of a stay. It would therefore be essential to apply the same conditions as those listed in our reply to question 18.

**20. Which reorganisation tools could be appropriate for resolving different types and CSDs and CCPs? What would be their advantages and disadvantages?**

We agree that an FMI should be subject to resolution regimes tailored to FMIs and “their critical role in financial markets”. We also agree with the considerations regarding transfer of all or part of operations, establishment of a bridge institution and transfer of certain “bad” assets.

This is also the reason for why we call for care when approving and monitoring interconnected FMIs and for steps to be taken to avoid the creation of FMI oligopolies or monopolies so that sufficient alternatives will exist if critical services need to be transferred. The mentioned reorganisation tools also need to be coordinated between all authorities whose markets are affected.

Furthermore, a mechanism for the **analysis of the actually critical services** could be useful in order to determine which parts of operations are to be transferred (only) and which parts are to be closed. In every case, the termination of services, disposal of assets and closure of business units which are considered to be not systemically important, must be possible.

The establishment of **valuation principles** for CCPs in crisis would also be useful.

**21. Which loss allocation and recapitalisation tools could be appropriate for resolving different types of CSDs and CCPs? Would this vary according to different types of possible failures (e.g. those caused by defaulting members, or those caused by operational risks)? What would be their advantages and disadvantages?**

First of all, we see a need to clarify that the tools mentioned in the consultative document and other models for loss allocation and funding obligations are intended only as a last resort and may under no circumstances be used by the authorities until the resolution phase has been reached. In addition, loss allocation tools need to take adequate account of the affected FMI's function and business model.

What is more, we firmly believe this issue requires further discussion. We have **extremely grave concerns** about these tools because they not only raise very serious questions about proportionality but may also have unforeseeable consequences for those involved (risk of contagion). First, they may place creditors in a significantly worse position than that which would have existed in an insolvency situation. Second, they may transfer the FMI's crisis to its users and exacerbate it. We consider it essential to clearly define the **boundaries** of all these tools and **not** to permit **unlimited** funding obligations to arise. It would also be desirable to ensure a proportionate involvement of all creditors (not just direct and indirect users).

Whenever funding obligations do arise, they should be **linked** to specific rescue measures. Furthermore, it should be possible for the affected parties to **withdraw** from their contractual agreement after losses have been allocated or funding payments have been made.

We would be happy to participate in discussions of the tools mentioned in (i) to (v) and of other models.

**22. What other tools would be effective in a CCP/CSD resolution?**

Other tools and loss allocation models may well prove useful in combination with those discussed above, which should in no case be considered exhaustive. This is a matter requiring **further in-depth analysis**.

**23. Can resolution tools based on contractual arrangements be effective and compatible with existing national insolvency laws?**

That depends on the national insolvency law involved. Harmonisation is therefore highly desirable (cf. our reply to question 1).

**24. Do you consider that a resolution regime for FMIs should be applicable to the whole group the FMI is a part of? What specific tools or powers for the resolution authorities should be designed?**

a) The question of whether the resolution regime for an ailing FMI should also be applicable to the whole group will depend on the FMI's structure, functions and individual situation. This is a matter that needs to be examined on a **case-by-case basis**, both at the level of the individual **company and at group level**. The key point, as we see it, is to confine the risk which has materialised in the FMI and avoid it spreading to other entities within the group. The risk of contagion should be kept to an absolute minimum.

b) Loss allocation and recapitalisation measures could be distributed within the group. The parent company or a fellow subsidiary could provide a guarantee, for instance. Here too, the situation needs to be examined on a case-by-case basis at FMI and group level. If, however, other members of the group also provide systemically important services, authorities should refrain from involving them in the resolution of the affected FMI if at all possible.

**25. In your view, what are the key elements and main challenges to take into account for the smooth resolution of an FMI operating cross-border? What aspects and effects of any divergent insolvency and resolution laws applicable to FMIs and their members are relevant here? Are particular measures needed in the case of interoperable CCPs or CSDs?**

It is key, in our view, that rules and regulations are harmonised and that supervisors coordinate their actions. Interoperability should be suspended as quickly as possible. It should be ensured in the course of day-to-day supervision that interoperability can be swiftly terminated in the event of a crisis and that the linked FMI will not receive preferential treatment over all other participants.

**26. Do you agree that, within the EU, resolution colleges should be involved in resolution issues of cross border FMIs?**

There should definitely be cooperation and cooperation; they will prove key to success. A point which remains to be considered, however, is whether this cooperation should take place within fixed colleges or whether it might be more effective to establish cooperation on an ad-hoc basis.

**27. How should the decision-making process be organized to make sure that swift decisions can be taken? Alternatively, do you think that responsibility for resolving FMIs should be centralised at EU-level?**

Decisions should initially be taken by the collaborating national authorities or by the colleges of these authorities. Only if agreement cannot be reached should an EU authority (such as ESMA) become involved to help achieve a consensus.

**28. Do you agree that a recognition regime should be defined to enable mutual enforceability of resolution measures?**

Yes.

**29. Do you agree that bilateral cooperation agreements should be signed with third countries?**

Yes, though it will be important to ensure reciprocity.

**30. Do you agree that the resolution of FMIs should observe the hierarchy of claims in insolvency to the extent possible and respect the principle that creditors should not be worse off than in insolvency?**

Yes. This principle should offer guidance in the event of resolution. Creditors can only be permitted to be worse off in exceptional cases if overriding interests are involved and with due regard for the principle of proportionality. The limits of such divergence need to be clearly defined, however.