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Legal Update
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German Legislator decides to cap bonuses for bank staff – CRD IV Implementation Act adopted

On July 5, 2013, the German Federal Council *(Bundesrat)* decided to raise no objection against the CRD IV Implementation Act passed by the German Federal Parliament *(Bundestag)* on June 27, 2013. The legislative procedure for this Act, which implements Directive 2013/36/EU *(Capital Requirements Directive IV,* "**CRD IV**"*)* into German law, is thus completed.

Together with Regulation (EU) No. 575/2013 (Capital Requirements Regulation, "**CRR**"), the CRD IV is part of the so-called "Single Rule Book". The Single Rule Book enhances the capital adequacy of credit institutions and other institutions regulated by the German Banking Act ("**Institutions**"), provides for liquidity requirements harmonised throughout the EU, and harmonises the European banking supervisory legislation. Unlike the CRD IV, the CRR does not require implementation; it has a direct and immediate effect on the Institutions.

The Act implementing the requirements of CRD IV will enter into force on January 1, 2014. The German Banking Act *(Kreditwesengesetz,* "**KWG**"*)* will be changed, and a revision of the German Remuneration Regulation for Institutions *(Instituts-Vergütungsverordnung,* "**InstitutsVergV**"*)* is expected. Under employment law aspects, the new regulations on bonus caps are of particular importance. This Legal Update outlines the main new regulations and their employment law implications.

New regulations

Cap on the variable remuneration

Principle: Maximum 100 per cent of the fixed remuneration

According to the revised Section 25a para. 5 KWG, the variable remuneration of employees or managers of Institutions must generally not exceed 100 per cent of the fixed remuneration.

Exceptions

In exceptional cases, a variable remuneration of up to 200 per cent of the fixed remuneration may be granted by resolution of the shareholders, the owners, the members or the governing bodies of the Institution. The resolution requires a majority of at least 66 per cent of the votes cast provided that at least 50 per cent of the voting rights are represented in the vote, or of at least 75 per cent of the votes cast. Compliance with these requirements has to be ascertained by the auditor in the audit of the financial statements and interim financial statements.

According to Section 25a para. 1 (1) KWG, each Institution must have a proper business organisation. This must in particular include an adequate and effective risk management which again shall ensure that Institutions have in place an appropriate, transparent and sustainable, development-oriented remuneration system for managers and employees, subject to the stipulated principles. This, however, shall according to the wording of the new law not apply *"insofar as the remuneration has been agreed under a collective bargaining agreement or within its scope of application by agreement between the contracting parties on the application of the collectively agreed regulations,*

or in a works council agreement based on a collective bargaining agreement."

Comments: The wording of this regulation suggests the possibility of deviations from the statutory caps through or based on a collective bargaining agreement. In practice, this could give plenty of interesting scope for structural discretion. However, the systematic position of this exception in Sec. 25a para. 1 (3) no. 6 KWG rev., instead of in the following Sec. 25a para. 5 KWG rev. which exclusively deals with capping the variable remuneration, militates against the intention of the legislator to permit such scope of structural discretion. Hopefully, the revised version of the InstitutsVergV will provide further insights.

Whistleblowing

Proper business organisation furthermore requires a process enabling employees to report to suitable bodies any violations of the CRR or the KWG or any legal regulations adopted on the basis of the KWG and any criminal offences within the Institution while keeping their identity secret.

Comments: Thus, as from January 1, 2014 KWG-regulated Institutions will be obliged to set up whistleblower contacts or appoint internal ombudsmen. A whole range of employment law (especially co-determination) and data protection law requirements needs to be observed upon implementation of such obligation. Always another challenge is the question of the internal response to a corresponding report through the whistleblower system. A one-fits-all solution will not work in this respect.

Amendment of the InstitutsVergV

The revised version of Sec. 25a para. 6 KWG forms the statutory basis for the amendment of the InstitutsVergV by the Federal Ministry of Finance.

It is to be expected that at the same time as the CRD IV Implementation Act a substantially revised version of the InstitutsVergV will enter into force, which may well especially include more detailed provisions on the following:

- cap on the variable remuneration, including the requirements and parameters for full loss or partial reduction of the variable remuneration; and
- monitoring of adequacy and transparency of the remuneration systems by the Institution, and
- disclosure of the structure of remuneration systems and the composition of the remuneration.

Consequences of non-compliance

The Federal Financial Supervisory Authority ("**BaFin**") can issue orders that are suitable and necessary to ensure the proper business organisation of an Institution. This also includes adequate, transparent and sustainable, development-oriented remuneration systems for managers and employees (i.e. also a cap on the variable remuneration). When the Institution violates such orders, the BaFin can impose fines of up to EUR 5 million. Other conceivable orders might be to reduce risks or not to engage in certain types of business transactions at all or only to a limited extent.

For example, if the capital endowment of an Institution is inadequate, it could also be ordered that the total annual amount of the variable remuneration of all managers and employees of such Institution is to be capped at a particular portion of the annual results. Also, the payment of variable remuneration components could be entirely prohibited.

Likewise, the BaFin could under certain circumstances request the full or partial extinction of claims for variable remuneration in Institutions obtaining governmental support, unless the claims for variable remuneration arose before January 1, 2011, or before January 1, 2012 for members of corporate bodies and managers.

Comments: Institutions are obliged to consider the regulatory authority of the BaFin in corresponding contractual agreements with their members of corporate bodies, managers and employees. This is necessary because the orders of the BaFin are addressed to the Institution itself. Thus, a corresponding reservation of amendment needs to be included in the contractual agreements. As a result of the new regulations and extended powers of intervention, existing reservations should be reviewed and adjusted if necessary. Regarding the validity of such reservations, the Federal Labour Court developed a mandatory casuistry strongly depending on each individual case.

No rights may be derived from contractual agreements on the granting of a variable remuneration that conflict with any order issued by the BaFin.

Implementation of the new regulations under employment law

The CRD IV Implementation Act enters into force on January 1, 2014, i.e. the new regulations will apply as of that date and Institutions must from then on implement the contents set out above. Therefore, it should already now be considered in the future conclusion of employment contracts and service agreements that the required cap on special payments is correspondingly reflected.

However, the situation is problematic with regard to old contracts which of course fail to contractually implement the corresponding new regulations or even contain conflicting provisions. In our opinion, the following applies in this regard:

Consensual amendment

Employment contracts or service agreements may be amended at any time by common consent. The Institutions concerned can thus offer their employees to amend existing contracts to create compliance with the regulatory requirements.

Comments: In the given constellation we believe it is likely that in the individual case employees or members of management boards of Institutions are obliged to agree to an amendment of their working conditions due to their contractual fiduciary duty. This might especially be the case when the Institution offers a compensation equivalent to the loss of bonus chances.

Variable remuneration at the discretion of the Institutions

If the employment contract or service agreement or a works council agreement only generally provides for a variable remuneration which in terms of amount is at the discretion of the Institution, then the Institution must upon exercising its discretion consider the new requirements for the remuneration system, and must against this background determine a bonus not exceeding the threshold applicable as from 2014.

Comments: In its case law, the Federal Labour Court established very stringent requirements regarding a variable remuneration that is entirely at the discretion of the employer or principal. In particular in general terms and conditions, such regulations can easily be invalid and grant the employee an unintended claim.

Reservation of revocation and a voluntary status

If existing bonus agreements conflict with the new regulations, Institutions might be able to use reservations of revocation and a voluntary status for the adjustment of the agreements, insofar as such reservations were validly agreed in connection with the bonus agreements.

Comments: Such reservations frequently fail to comply with the stringent judicial requirements, and are consequently invalid. This needs to be examined on a case-to-case basis.

Dismissal with the option of continued employment on different terms

The traditional means for unilateral amendment of working conditions is a so-called *"Änderungskündigung"*, i.e. a dismissal with the option of continued employment on different terms. However, for lack of a reason for dismissal recognised under the Protection against Unfair Dismissal Act, such dismissal for the amendment of existing bonus agreements should not be validly possible.

Frustration of contract (*Störung der Geschäftsgrundlage*)

According to the principle of frustration of contract, a party may request the adjustment of a contract if the circumstances on which the contract was based materially changed after conclusion of the contract, and the party cannot be reasonably expected to continue the unchanged contract.

Comments: Frustration of contract can be a valuable tool in the given constellation. Due to numerous interpretation issues that need to be clarified for determining a frustration of contract, this also needs to be evaluated for each individual case.

Members of corporate bodies

Employment protection legislation does generally not apply to members of corporate bodies, i.e. in particular managing directors of a company with limited liability *(GmbH-Geschäftsführer)* or members of the board of directors of German stock corporations *(AG-Vorstände)*, so that an adjustment of existing service agreements should be less problematic.

Comments: It would particularly be an option in respect of members of corporate bodies to invoke the general contractual fiduciary duty in connection with the new regulatory standards. Against this background, it should always be attempted to achieve an adjustment of the contract in mutual agreement with the member of the corporate body. For lack of applicability of the employment protection legislation, the service contract could be terminated with an option of continuation on different terms if a "negotiated solution" fails. As a rule, the agreed or statutory notice periods have to be observed. In individual cases, e.g. for lack of a possibility of ordinary termination or the agreement of a very long notice period, a termination with an option of continuation on different terms can also be possible as an extraordinary dismissal with such option, i.e. with immediate effect.

Employees of branches abroad

The KWG - and thus the strict remuneration provisions - also applies to branch offices of German Institutions in other European countries.

Comments: The remuneration regulations anchored in the KWG might in such cases have to be implemented according to the laws of the state in which the branch is seated. The law applicable to the respective employment depends on the content of the employment contract and the place of work performance.

Regulations of the directly applicable CRR

The CRR, which will also take immediate effect as of January 1, 2014, is less significant with a view to the regulation of remuneration. However, the comprehensive obligations to disclose the remuneration policy and practice as standardised in Art. 450 need to be mentioned, as they are more comprehensive than the disclosure obligations so far contained in the InstitutsVergV.

Sometimes, the Institutions will now also have to disclose the number of persons whose remuneration for the business year amounts to or exceeds EUR 1 million. These statements are to be broken down into remuneration levels of EUR 500,000 for remunerations between EUR 1 million and EUR 5 million, and into remuneration levels of EUR 1 million for remunerations of EUR 5 million and more.

Conclusion

The new regulations of the KWG entering into force on January 1, 2014, the regulations of the CRR and the expected amended version of the InstitutsVergV create challenges for Institutions and their employees. The clean legal implementation of the regulatory requirements against the competing interests of employment law and data protection law is a challenging task without ready-made solutions. However, for each individual case there is a suitable solution that will also in the future enable the relevant Institutions to offer their employees attractive remuneration packages in compliance with the regulatory conditions.

Based on the intervention possibilities provided to the BaFin and the announced additional staffing of the competent BaFin departments it can be expected that the compliance with the statutory requirements will be more strictly monitored as from 2014, and that non-compliance will be more immediately sanctioned. Not only can this tarnish the image of the Institutions concerned, there is also the threat of fines and not least the possible irritation of high potentials who will not receive the expected bonus payments. In view of an increasingly tough war for talent, this aspect should not be ignored.

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