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Government could force bank CEO heads to roll

Firing a chief executive would be tricky politically

By Ronald D. Orol, MarketWatch

WASHINGTON (MarketWatch) -- U.S. banking regulators have the authority to oust executives and directors of institutions receiving federal bailout dollars, leaving many analysts and academics to wonder whether government officials will move to shake up the corporate leadership at reeling banks.

"There will be some [government] pressure for certain executives to step down. Citigroup will be first, other than GMAC, but there will be more resignations," said Christopher Whalen, managing director of Institutional Risk Analytics, in Torrance, Calif. "With Citi, we taxpayers are effectively guaranteeing their debt, they are effectively nationalized already, so bank regulators definitely have the power to force bank CEOs to resign."

At issue are a group of 10 troubled mega-banks, including Bank of America Corp. (BAC **11.44**, +0.19, +1.69%) and Citigroup Inc. (C **3.67**, -0.10, -2.65%), which were ordered by regulators on May 7 to collectively raise $74.6 billion in capital by November. They must provide plans for how they will raise the capital by June 8.

All of the banks are considered well-capitalized currently, the government said.

Federal Deposit Insurance Corp. Chairwoman Sheila Bair indicated recently that management changes could happen based, in part, on these capital plans the banks are submitting to the government.

Already, the Obama administration has pressed some institutions receiving government funds from the bank bailout fund, known as the Troubled Asset Relief Program, to change CEOs and boards. The Treasury Department announced seven weeks ago that it was ousting Richard Wagoner Jr., the chief executive of federal bailout recipient General Motors. Corp. (GM **1.43**, +0.16, +12.60%).

Three government-appointed trustees for American International Group Inc. (AIG **1.79**, -0.02, -1.10%) are also seeking new board members for the embattled mega-insurer. AIG has received more than $180 billion in taxpayer-funded bailout dollars, giving the government an 80% stake in the company.

Other financial institutions receiving federal bailout dollars have become subject to restrictions on CEO pay practices, leading some regulatory observers to believe more restrictions are on the way.

Tools to oust CEOs

The Federal Reserve and other bank regulators could use their authority to liquidate a bank as a means of forcing its executives and directors to step down. 'The Fed only has to threaten to resolve the subsidiary bank, which is enough to force the CEO out," Whalen said.

However, there is a question about whether bank regulators have the political backing to pull the lever and press banks to replace CEOs and directors.

Columbia Law School Professor John Coffee agrees that government will use its power over bank resources to extort some concessions. However, he argues that it would be difficult to oust a major bank CEO, in part, because of the potential political fallout.

"By forcing out a CEO, they might pick someone worse, pushing the bank into an even more troubled situation and then hurting the Obama administration even more," Coffee said. "The GOP wouldn't mind criticizing Democrats for being too interventionist."

Nevertheless, government regulators are, at the very least, pressing banks to find more people with banking expertise for board positions. Coffee contended that too many banks install directors with limited experience in the banking sector, in part, because they like to have directors who are less likely to challenge the CEO's strategy. However, he pointed out that banks are subject to the Clayton Antitrust Act of 1914, which prohibits an executive of one bank from serving on the board of another bank.

Behind the scenes punches

However, many experts believe bank regulators are pressing financial institutions to change boards and executives by employing behind-the-scene incentives. William Poole, former head of the Federal Reserve Bank of St. Louis, argued that regulators may employ a number of mechanisms to exert leverage on bank CEOs. However, he insisted that the government should steer clear of influencing bank management or board policies.

Poole, a Cato Institute senior fellow, said he was disturbed to see the Treasury Department publicly disclose details of bank stress tests it completed earlier this month.

"Regulators can threaten to publicly disclose adverse regulatory judgments, which have the power to kill a bank, in exchange for having CEOs resign," Poole said. "Disclosing this information damaged the long-standing understanding that regulatory judgment on banks would be confidential."

Toxic incentive?

However, Poole argued that another Treasury program that would have banks sell toxic mortgage securities shouldn't be used as leverage for CEO succession or other concessions.

The Treasury Department is in the final stages of identifying five or six private funds that together with government guarantees and taxpayer-backed capital would buy illiquid mortgage securities from financial institutions.

"If you look at the stress test paper, the anticipated losses from toxic assets are small," Poole said. "The toxic asset program is apparently going away and it shouldn't be used as leverage for CEO plans."

Lawsuits on the way?

Nancy Bush, president of NAB Research LLC in Annandale, N.J., said she bank CEOs may strike back at government restrictions by filing lawsuits against the government, arguing that it is overstepping its authority over banks. A CEO that is forced out may do so as well, she said.

"Sooner or later we will see a company or board take the government to court arguing it overstepped its authority," said Bush.