MATERIAL LOSS REVIEW
OF
HAMILTON BANK, NA

OIG-03-032 December 17, 2002

Office of Inspector General

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The Department of the Treasury

Contents

Abbreviations

ALLL	Allowance for Loan and Lease Losses
ATRR	Allocated Transfer Risk Reserve
BIF	Bank Insurance Fund
BSA	Bank Secrecy Act
C&D	Cease and Desist
CEO	Chief Executive Officer
CMP	Civil Money Penalty
CRP	Capital Restoration Plan

Contents

DOF	Division of Finance
DOS	Division of Supervision
DRR	Division of Resolutions and Receiverships
EIC	Examiner-in-Charge
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
IPO	Initial Public Offering
LLR	Lessons Learned Review
OCC	Office of the Comptroller of the Currency
OECD	Organization for Economic Cooperation and Development
OIG	Office of Inspector General
OOI	Order of Investigations
PBSC	Problem Bank Subcommittee
PCA	Prompt Corrective Action
ROE	Report of Examination
SEC	Securities and Exchange Commission
SMS	Supervisory Monitoring System
SSN	Safety and Soundness Notice
SSP	Safety and Soundness Plan
TPS	Trust Preferred Stock
UBPR	Uniform Bank Performance Report

December 17, 2002

John D. Hawke, Jr.
Comptroller
Comptroller of the Currency

As mandated under section 38(k) of the Federal Deposit Insurance Act (FDIA), we reviewed the closure of Hamilton Bank, N.A. (Hamilton) of Miami, Florida. On January 11, 2002, the Office of the Comptroller of the Currency (OCC) closed Hamilton after finding that the bank was undercapitalized and suffered from deteriorating asset quality, poor earnings, a high level of non-performing loans, and sharply declining capital levels. As of March 31, 2002, the Federal Deposit Insurance Corporation (FDIC) estimated that Hamilton's closure would cost the Bank Insurance Fund (BIF) between $350 and $500 million. As of June 30, 2002, FDIC adjusted the estimated cost of Hamilton's closure to between $175 and $225 million, taking into account the recovery of international loans and asset sales.

An FDIA-mandated material loss review requires us to: (1) ascertain why the institution's problems resulted in a material loss to the insurance fund; (2) assess the regulator's supervision of the institution and (3) where applicable, recommend how such losses might be avoided in the future. We conducted fieldwork at OCC Headquarters in Washington, D.C.; the OCC District Office in Atlanta, Georgia; the FDIC Regional Office in Atlanta, Georgia; the OCC Field Office in Miami, Florida; the OCC Ombudsman Office in Houston, Texas; the FDIC Division of Supervision (DOS) in Plantation, Florida; and the FDIC Division of Resolutions and Receiverships (DRR) and Division of Finance (DOF) in Dallas, Texas.

We obtained information from the Federal Reserve Board Office of Inspector General in Washington, D.C., regarding Hamilton's holding company. We reviewed the supervisory files and interviewed key supervisory officials, such as examiners and others involved in regulatory enforcement matters. We also interviewed staff from the Securities and Exchange Commission (SEC). We did not review the independent public accountants' workpapers because the workpapers were under review by another agency. A detailed discussion of the review objectives, scope, and methodology is provided in Appendix 1.

During our review, Federal regulators and officials were investigating potential fraud activities at Hamilton. Until these investigations are completed, it is difficult to fully assess OCC's supervision of Hamilton and all of the underlying causes that led to its closure.

Results in Brief

Hamilton was initially chartered as Alliance National Bank (Alliance) on February 7, 1983. In 1988, a group of investors, which included Hamilton's Chairman of the Board (Chairman)/Chief Executive Officer (CEO), purchased through a holding company the failing Alliance, changing its name to Hamilton. Hamilton operated nine FDIC-insured branches, eight in Florida and one in San Juan, Puerto Rico. At the time of Hamilton's closing in January 2002, Hamilton had $1.3 billion in recorded assets.

Hamilton's initial core business was trade finance in emerging markets in the Caribbean Basin and in Central and Latin America. During the mid-1990s, senior management saw the potential for rapid growth and high earnings. To fund planned growth, the bank's parent holding company issued an initial public offering (IPO) in 1997. After the IPO, the holding company was required to make periodic public disclosures of financial results as required by SEC for publicly traded companies. To satisfy the demands of its shareholders, the bank was under pressure to show strong earnings. The IPO and resulting pressures led to a change in the bank's mission and credit philosophy for which the bank did not have the supporting expertise or infrastructure.

The bank grew significantly over the years from $22 million in assets in 1988 to $1.7 billion in 2000. The greatest asset growth occurred between 1996 and 1998, from $755 million to $1.7 billion.

Causes of Hamilton's Closure

Hamilton's closure in January 2002 occurred after the OCC found that Hamilton was undercapitalized and suffered from deteriorating asset quality, poor earnings, a high level of non-performing loans, and sharply declining capital levels. The board of directors (board) and management failed to adequately respond to OCC's supervisory and enforcement actions to rehabilitate the bank.

While the immediate cause of Hamilton's closure was due to unsafe and unsound practices, the root causes of the bank's closure can be attributed to the following: (1) aggressive growth and asset concentrations in foreign markets; (2) increased credit risk due to weak underwriting; (3) inadequate risk management systems and controls; and (4) an ineffective board and nonresponsive management.

OCC's Supervision of Hamilton

OCC's on-site examinations and resulting enforcement actions could have been more forceful between 1992 and 1997. OCC did not fully identify or address the bank's management weaknesses or unsafe lending practices until the bank had already established a base of problem loans. OCC's 1998 examination identified significant accounting issues but OCC did not follow-up on these matters until 10 months later. In addition, the OCC issued a Safety and Soundness Notice (SSN) following the 1998 examination. The OCC did not adhere to its policies regarding the follow-up procedures to determine compliance with the notice.

From September 1999 to the January 2002 closing, we concluded that OCC's supervision and enforcement actions of Hamilton were generally adequate, but by then it was too late given the issues identified in the earlier years, including the buildup of problem loans and a well-established pattern of nonresponsiveness by management. If these management and lending problems had been fully addressed sooner, OCC's ratings of Hamilton may have been different and may have resulted in earlier, more forceful supervision and enforcement actions.

Recommendations

OCC completed an internal quality assurance review, (Lessons Learned Review) of Hamilton prior to this report. We believe many of the review's recommendations for improvement address most of our findings. However, our report contains four recommendations aimed at enhancing the supervisory and examination process.

OCC Response and Office of Inspector General (OIG) Comments

In its December 17, 2002, written response to the OIG's draft report, OCC concurred with the reported findings and agreed to implement the recommendations. Over the next few weeks, OCC plans to formulate action plans detailing the steps it will take to implement the recommendations. The actions will be formally reported and monitored through the Department's Joint Audit Management Enterprise System.

We believe OCC's planned actions are responsive to the intent of the recommendations. The OIG will also continue to monitor OCC's progress in addressing the reported findings and recommendations. The full text of OCC's response is included in Appendix 5.

Background

The OCC fulfills its supervisory mission to promote and ensure the safety and soundness of the national banking system principally through its program of continual examination. Supervision involves on-site examinations that result in a Report of Examination (ROE) and monitoring and following up on bank problems. In large banks, examination activity can occur for much of the 12-month supervisory cycle. In smaller national bank affiliates and community banks, most examination activities take place during intervals of 12- or 18-month supervisory cycles. To assist monitoring, and in the planning and examination, examiners use information collected from the (1) Uniform Bank Performance Report (UBPR)[1] which highlights rapid changes in major categories during the previous quarter and provides annual comparisons, and (2) the Consolidated Reports of Condition and Income, also known as call reports.[2]

The OCC, like other bank regulatory agencies, uses the Uniform Financial Institutions Rating System, commonly called the CAMELS ratings.[3] The CAMELS rating system provides a general framework for assimilating and evaluating all significant financial, operational, and compliance factors inherent in a bank. It enables the regulator

[1] The Uniform Bank Performance Report is an analytical tool created for bank supervisory, examination, and management purposes. It shows the impact of management decisions and economic conditions on a bank's performance and balance sheet composition. The performance and composition data can be used in evaluating the adequacy of earnings, liquidity, capital, asset and liability management, and growth management. The source of the bank's financial data contained in the UBPR is the call report filed quarterly by each insured bank.

[2] The FDIC collects, corrects, updates and stores the call report submitted by banks on a quarterly basis. The call report collects basic financial data from commercial banks in the form of a balance sheet, an income statement, and supporting schedules. The Report of Condition schedules provide details on asset, liability, and capital accounts. The Report of Income schedules provide details on income and expenses. The call report is a primary source of financial data used for the supervision and regulation of banks, and is used as an editing benchmark for many other reports.

[3] Financial institution regulators use the Uniform Financial Institutions Rating System to evaluate an institution's performance. CAMELS is an acronym for the performance rating components: Capital adequacy, Asset quality, Management administration, Earnings, Liquidity, and Sensitivity to market risk. The Sensitivity component was added effective January 1997. Numerical values range from 1 to 5, with 1 being the highest rating and 5 representing the worst rated banks.

to assign each banking organization individual CAMELS component ratings and an overall composite rating that indicates the institution's overall condition.

Hamilton was initially chartered as Alliance on February 7, 1983. In 1988, a group of investors, which included Hamilton's Chairman/CEO, purchased through a holding company[4] the failing Alliance. Its name was changed to Hamilton on August 19, 1988. Hamilton operated nine FDIC-insured branches, eight in Florida and one in San Juan, Puerto Rico.

The bank's initial core business was trade finance[5] in emerging markets[6] in the Caribbean Basin, and in Central and Latin America. Historically, Hamilton's trade finance was low risk and focused in fee-based services. Trade finance was considered low risk due, in part, to the importance that countries assigned to maintaining access to trade credits. In a currency crisis, countries traditionally designated their trade liabilities for repayment before most other types of credits. According to 2000 ROE, during the mid-1990s, Hamilton's senior management saw the potential for rapid growth and high earnings. To fund planned growth, the bank's parent holding company issued an IPO in 1997.[7] To satisfy the demands of its shareholders, the bank was under pressure to show strong earnings. This resulted in the need to expand the asset base to generate new sources of revenue. The IPO and resulting pressures led to a change in the bank's mission and credit philosophy, for

[4] The holding company was Southern Bancorp (later renamed Hamilton Bancorp), which was regulated by the Federal Reserve Board.

[5] Trade finance consists of providing financial services related to the importation and exportation of goods. These services may include activities such as making loans during the pre-export period, issuing letters of credit, discounting checks or other financial instruments, and offering fee-based services such as providing credit or country information on purchasers of exported goods. Most trade financing involves short-term transactions of less than a year.

[6] Emerging markets are generally considered to be less developed countries that are not members of the Organization for Economic Cooperation and Development (OECD) or that have non-investment grade sovereign debt ratings. OECD primarily consists of European countries, Turkey, the United States, Canada, Japan, Australia, and New Zealand.

[7] After the IPO, the holding company was required to make periodic public disclosures of financial results as required by SEC for publicly traded companies.

which the bank did not have the supporting expertise or infrastructure.

While the bank did not formally develop a new strategy, it became much more aggressive in its risk selection. It concentrated on what it determined to be underserved markets, such as Panama, El Salvador, and Guatemala. The underserved countries had economies that were much less developed. In addition to lending for trade transactions, the bank began direct lending to marginally capitalized companies for working capital, and according to an OCC internal memorandum, in some cases, for "apparent venture capital." The bank often lent to the buyers, sellers, and intermediaries in trade transactions.

The bank also increased its lending to correspondent banks[8] in those countries. Very often, these correspondent banks also lent to Hamilton's customers. Not only did Hamilton create large concentrations[9] in these emerging markets, it also greatly increased concentration risk by lending to many of the parties taking part in the trade transactions. A large portion of the bank's domestic portfolio of loans was also considered as a risk concentration due to its connection with the bank's international lending. The loans were connected because many of the domestic borrowers were dependent on the economies in which the bank's international borrowers were located. The bank also expanded into areas of the world where it had no previous experience, such as Russia.

Additionally, the bank expanded its foreign correspondent banking relationship from facilitating trade finance to more risky wire and

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[8] Correspondent banking is an arrangement under which one bank provides payment and other services to another bank.

[9] A concentration is a significantly large volume of economically-related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. A concentration schedule may be included in the OCC Report of Examination. As a general rule, concentrations are listed by category according to their aggregate total and are reflected as a percentage of Tier 1 Capital plus Allowance for Loan and Lease Losses (ALLL). ALLL is a valuation reserve established and maintained by charges against a bank's operating income. As a valuation reserve, it is an estimate of uncollectible amounts that is used to reduce the book value of loans and leases to the amount that is expected to be collected.

"pouch"[10] activities. According to the 2000 ROE and OCC supervisory memorandum, pouch activity presents a significant potential risk for money laundering schemes, which, in turn, could subject a bank to additional risks, such as monetary losses, criminal prosecution, civil lawsuits, and reputation damage.

The bank grew significantly over the years, from $22 million in assets in 1988 to $1.7 billion in 2000. The greatest asset growth occurred between 1996 and 1998, when the asset base expanded from $755 million to $1.7 billion, an increase of 125 percent. At the time of its closing in January 2002, Hamilton had $1.3 billion in assets. According to an OCC internal supervisory memorandum, the significant growth in just 2 years increased the potential for additional adversely classified assets.[11] With the increase in asset size came a commensurate increase in adversely classified assets. For example, from the 1996 to the 1997 examinations, adversely classified assets increased approximately 139 percent. Between the 1997 and 1998 examinations, adversely classified assets increased approximately 98 percent.

Hamilton's country risk[12] exposure at the end of 2000 placed the bank in the top 10 financial institutions nationally both in terms of dollar volume of exposure and as a percentage of capital. Much of this exposure was highly concentrated in countries suffering economic instability and in emerging markets.

[10] Pouch activity refers to the practice of receiving pouches from various couriers containing deposits from bank customers outside the United States.

[11] Substandard, doubtful, and loss loans are collectively referred to as "adversely classified assets." "Substandard" loans have one or more well defined weaknesses that jeopardize full collection of that loan, and have a high probability of payment default. "Doubtful" loans have all weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. "Loss" loans are considered uncollectible and of such little value that their continuance as bank assets is not warranted. Any recovery is likely to occur only after lengthy recovery efforts such as litigation.

[12] Country risk is the risk that economic, social, and political conditions and events in foreign countries will adversely affect an institution's financial interests. Those effects are not limited to the impact on borrowers in that country, but also include the possibility of expropriation of assets, government repudiation of debt, exchange controls that limit the funds leaving a country, and fluctuations in the value of currency.

Hamilton was closed with $63 million in Tier 1 Capital,[13] representing 4.44 percent of total assets, and was not insolvent or "critically undercapitalized," as OCC acted to prevent further losses to the BIF. OCC appointed FDIC receiver on January 11, 2002, after OCC determined that the bank operated in an unsafe and unsound manner.

As of March 31, 2002, FDIC initially estimated Hamilton's closure would cost the BIF between $350 and $500 million. However, as of March 31, 2002, the FDIC lowered the estimated cost of Hamilton's closure to $175 to $225 million by factoring in the FDIC's recovery of international loans and asset sales.

Findings and Recommendations

Finding 1 Causes of Hamilton's Closure

Hamilton's rapid growth coupled with unsafe and unsound banking practices were the primary contributing factors that led to its closure. Hamilton's concentrated growth in emerging markets in the Caribbean Basin and in Central and Latin America and its change in business strategy from primarily trade financing to commercial lending after the holding company's IPO in 1997, occurred without adequate fundamental management oversight, systems and controls. Economic instability and the bank's poor underwriting practices in these emerging markets increased Hamilton's credit risk and eventual losses. Further, the board and management failed to adequately respond to OCC's supervisory and enforcement actions to rehabilitate the bank.

[13] Tier 1 Capital consists of common stockholders equity, noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries.

By 2001, Hamilton's capital levels were deficient given its poor asset quality[14] and earnings, as well as the high volume of non-performing loans. Because of the loan and operating losses, Hamilton depleted approximately 41 percent of its Tier 1 Capital between September 30, 2000, and September 30, 2001.

Capital Infusions Provided Funds for Hamilton's Growth

When the holding company formed the new institution, it inherited the numerous problems facing the former failing bank. Despite these problems, the holding company was able to generate capital funds from both internal and external sources to fund Hamilton's growth. The following table shows Hamilton's asset growth rates each year for the period 1991 to 2000.

Table 1: Asset Growth Rates

12/31/91	*12/31/92*	*12/31/93*	*12/31/94*	*12/31/95*	*12/31/96*	*12/31/97*	*12/31/98*	*12/31/99*	*12/31/00*
49.77	54.12	29.16	45.83	34.36	22.86	77.46	25.45	1.00	3.07

Source: Uniform Bank Performance Reports

In 1994, a private offering of $4.75 million in non-voting, non-cumulative, perpetual preferred stock was issued to the holding company shareholders. This additional capital infusion provided the support to enable Hamilton to expand its asset base by approximately 46 percent during that year. Management anticipated continuing this growing trend as evidenced by the 1995 board-approved capital plan, which addressed the major sources of capital needed to effectively manage growth. Based on this plan, management projected assets to increase to $1.3 billion by 1999. Between 1994 and the early part of 1997, the bank continued to expand; retained earnings primarily funded the growth.

In March 1997, the holding company completed an IPO raising a total of $38 million of which $30 million was injected into

[14] Asset Quality is the quantity of existing and potential credit risk assigned by OCC associated with a bank's loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. The evaluation of asset quality considers the adequacy of the ALLL and weighs the exposure to counter-party, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, are also considered.

Hamilton. The express purpose of the stock offering was to provide funds to support Hamilton's asset growth. The other $8 million in funds generated by the offering remained at the holding company to support its operations. The funds were available, if needed, to provide for additional expansion of the bank. The 1997 OCC examination report indicated that management developed a comprehensive capital plan that showed moderate growth for the institution at approximately 15 percent per year. The increase in assets during the first six months of 1997 was approximately 38 percent; assets increased by 52 percent for the nine month period ending September 30, 1997. Hamilton's December 31, 1997, UBPR reflected an asset growth rate of 77 percent during 1997. OCC's 1997 examination rated the institution a composite "1" with ratings of "1" for each CAMELS component.

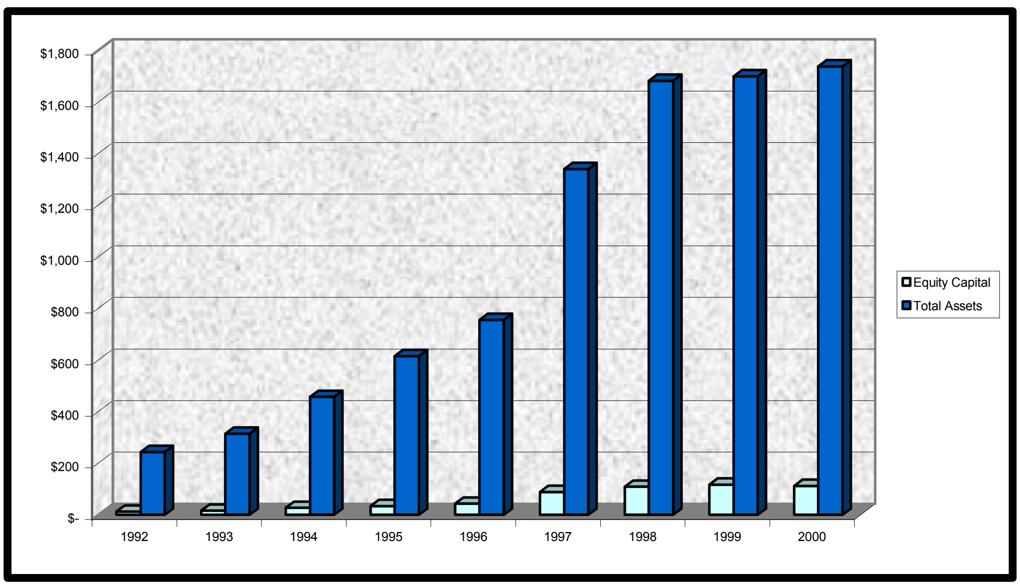
As a result of an off-site review of the institution, OCC notified the bank on March 3, 1998, of its downgrade to a CAMELS composite "2" due to its rapid growth, declining capital ratios, and substantial concentrations of risk in emerging markets. During OCC's next on-site examination of Hamilton, which began in June 1998 and was completed in November 1998, the examiners determined that the capital base was not sufficient to support Hamilton's level of growth. This report of examination noted that the asset size of the institution more than doubled since the IPO. The OCC lowered the capital component as well as the overall CAMELS composite rating to "3."

The holding company again demonstrated its ability to raise capital in the financial markets. A Trust Preferred Stock Offering[15] was issued in 1998 and raised approximately $12.6 million. As a result of this transaction, an additional $15 million was injected into the bank, and in 1999 the holding company provided another infusion of $8.6 million. These injections enabled the capital base to remain

[15] Trust Preferred Stock (TPS) is cumulative preferred stock issued by a business trust that is wholly owned by a bank holding company. It is a hybrid instrument that possesses characteristics typically associated with debt obligations. TPS can only be issued by holding companies; banks cannot issue TPS. In exchange for the stock that the trust sells to investors, the holding company issues a subordinated debenture to the trust in the same amount and with the same terms as the preferred stock. The company's payments on the debenture are used by the trust to pay dividends to the investors who purchased the preferred stock.

at a level where the OCC accorded a component rating of "3" for capital adequacy; however, the overall CAMELS composite was downgraded to a "4" as a result of the 1999 examination which began in August and was completed in December. In an attempt to abate the dissolution of capital due to excessive loan losses, the holding company injected another $5 million as of September 30, 2000. However, the capital injections were not sufficient to offset the deterioration in the bank's asset structure. The capital adequacy rating was lowered once again by OCC, this time to a "4" as a result of OCC's 2000 examination, which began in August 2000 and was completed in February 2001. Chart 1 shows the relationship between the equity growth and the corresponding increase in assets.

Chart 1: Equity Capital to Total Assets (in millions)



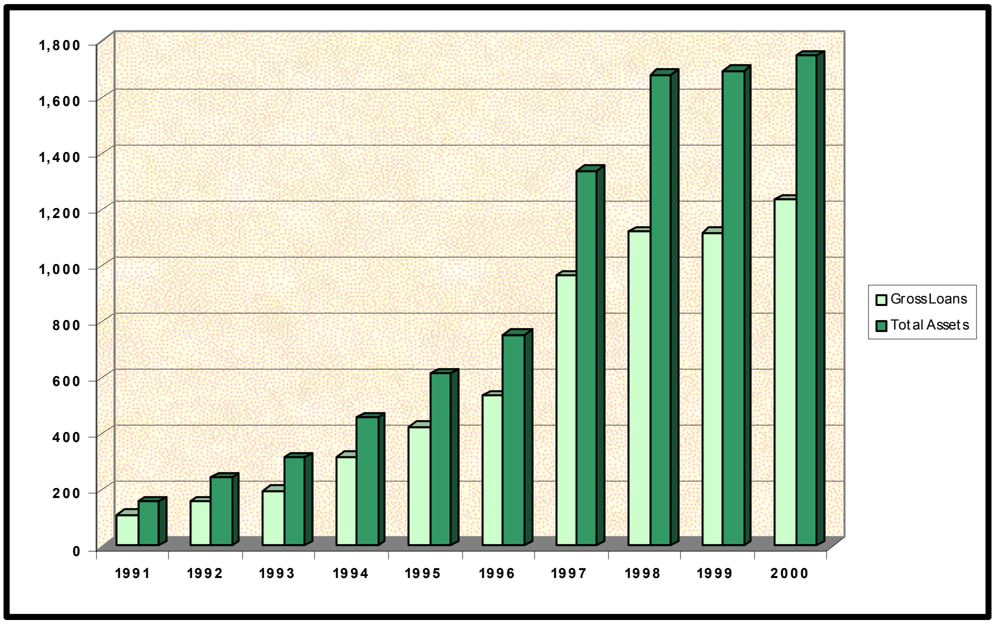
Source: OIG Analysis from FDIC's Institution Directory Internet Website

Even though the holding company was able to raise equity capital, it was never enough to provide sufficient capital support commensurate with its increasing growth and credit risk in its emerging markets loan portfolio.

Aggressive Growth and Asset Concentrations in Foreign Markets

Hamilton grew its assets throughout the 1990s. Total assets increased from $157 million to $1.3 billion in just six years—from the beginning of 1992 to the end of 1997. Growth rates during that time ranged from a low of 23 percent in 1996 to a high of 77 percent in 1997, the year of the bank's IPO. The rapid expansion of the loan portfolio in relation to the total assets is indicated in Chart 2.

Chart 2: Comparison of Hamilton's Gross Loans to Total Assets
(in millions)



Source: Hamilton's Uniform Bank Performance Reports

Asset growth rates were consistently high through 1998. Much of Hamilton's exposure was concentrated in countries suffering economic instability and also in emerging markets. Deterioration in the economies of Latin American, Central America, and Caribbean countries adversely impacted Hamilton. For example, in 1998 Ecuador suffered a deep recession, a large fiscal deficit, inflation, high unemployment and widespread bank insolvency. The high-risk profile and aggressive growth strategy pursued by Hamilton began to have an impact on the bank's profits in 1998.

Beginning in 1998, Hamilton's capital adequacy appeared strained by its on-going rapid growth, high levels of exposure to volatile emerging markets, and high concentrations of credit in emerging markets. According to the OCC, concentrations of credit in some emerging market countries were excessive in relation to the bank's capital structure. These concentrations as a percent of Hamilton's capital for the years 1997 through 2001 are shown in Appendix 2. The concentrations were a heightened concern to the OCC due to the economic conditions in many of the countries. Hamilton's risk in emerging markets, as a percent of capital, was among the highest of any U. S. chartered financial institution. As noted in the 1998 examination report and in the Lessons Learned Review (LLR), most banks were reducing their risk to emerging markets in light of market conditions at that time. According to our interviews, there were several Miami banks with high concentrations. OCC told them to reduce their concentrations, but Hamilton was the only one that did not reduce its concentration at the time. As of OCC's 1998 examination, Hamilton had not reduced the bank's risk. OCC recommended that management reduce the concentrations by providing more capital and/or by better diversifying the bank's assets. Hamilton began action to reduce concentrations by 1999. Reductions in concentrations from 1999 compared to 2001 totaled $266 million, which represented approximately a 38 percent decrease.

Increased Credit Risk Due to Weak Underwriting Practices

As early as 1991, OCC examiners reported deficiencies with Hamilton's underwriting practices and continued to report these weaknesses in subsequent examinations. Examiners reported, for example, that Hamilton lacked sufficient credit analysis, had credit administration weaknesses, and maintained inadequate file documentation.

In 1992, OCC reported that adherence to sound underwriting standards needed to be monitored by Hamilton to avoid loan quality problems. In 1995, the OCC reported that there were repeat instances of missing information in the credit files. The most prevalent deficiencies reported were missing copies of loan reviews and credit analyses/annual reviews.

Hamilton's weak credit administration led to the bank continuously having high numbers of poor quality loans and increasing losses. The bank had a record of making loans that quickly migrated to a "loss" category. Hamilton also had poor management, workout, and disposition strategies for chronic problem loans, according to an OCC internal memorandum.

During 1998, OCC noted that concentrations of credit to emerging markets, in relation to Hamilton's capital base, were significant and the credit risk was increasing in these loans. Latin America and other emerging markets had been exhibiting a greater degree of instability and turmoil as a result of the Asian and Russian economic problems.[16]

OCC examiners found that credit risk was not properly graded by Hamilton, and downgrades were not timely. In this regard, the most significant issues appeared in connection with a series of loans made to customers in Ecuador, primarily during the summer of 1999. In 1998, Ecuador's economy faltered and several Ecuadorian banks were intervened or taken over by the government. At that time Hamilton had one of the largest exposures to Ecuador of any national bank in the country.

In 2000, past due loans significantly increased and Hamilton loan officers failed to rate the credit risks of loans in a timely manner. Unlike the 1999 examination, where a large proportion of classified assets consisted of Ecuadorian credits subject to transfer risk as well as credit risk, the composition of problem assets noted by OCC in its 2000 examination was much more broadly based and was excessive from a pure credit risk perspective.

As shown in Table 2, adversely classified assets remained at a modest level compared to capital until 1999 when the adversely classified assets increased to 84 percent of capital and then to 120 percent in 2000 and to 187 percent in 2001. The 1999 ROE noted that the largest portion of adversely classified assets was comprised of Ecuadorian exposures subject to transfer risk and/or credit risk. In 2000, the composition of adversely classified assets

[16] In the fall of 1998, economic problems in Asia and Russia appeared to be spreading to Latin America (also known as "contagion risk").

was much broader-based including domestic credits, and the level included excessive risks based on credit considerations, according to OCC's 2000 examination report. The majority of the assets adversely classified in OCC's 2001 ROE were due to credit risk.

Table 2: OCC Adversely Classified Assets (in thousands)

Year	Adversely Classified Assets					Total *Capital
	Substandard	Doubtful	Loss	Total	Percent of Capital	
1992	$1,948	$23	$8	$1,979	21%	$9,425
1993	$2,338	$1,096	$87	$3,521	27%	$12,944
1994	$6,230	$447	$453	$7,130	37%	$19,362
1995	$4,951	$1,183	$100	$6,234	22%	$28,706
1996	$1,979	$2,355	$528	$4,862	12%	$41,292
1997	$8,629	$991	$1,996	$11,616	14%	$83,987
1998	$13,720	$2,897	$6,349	$22,966	21%	$108,879
1999	$56,023	$53,822	$28,922	$138,767	84%	$165,562
2000	$137,169	$25,831	$14,660	$177,660	120%	$147,824
2001	$138,351	$45,094	$37,041	$220,486	187%	$117,896

Source: OCC's Supervisory Monitoring System
* Tier 1 Capital Plus ALLL

Inadequate Risk Management Systems and Controls

Themes common to all OCC enforcement actions[17] taken against Hamilton were the absence of adequate risk management systems and controls. This was particularly evident in the lending-related function. As previously discussed, loan review and underwriting had chronic deficiencies throughout Hamilton's history. For example, credit risk was not properly graded and loan officers did not timely downgrade their loans. Due to the aforementioned deficiencies, Hamilton's internal grading process created inaccurate results.

[17] OCC uses a variety of enforcement actions to communicate problems or weaknesses, and to prompt or require corrective measures by banks. Enforcement actions fall into two broad categories, informal and formal and can include, for example, Commitment Letters, Memorandums of Understanding, Temporary Cease and Desist (C&D) Orders, and Safety and Soundness Orders.

Risk management systems vary from institution to institution depending on the nature of the business, the complexity of the transactions, and the overall asset size and exposures. However, all adequate risk management systems should be able to identify, measure, monitor, and control the risks. OCC continually reported that Hamilton's written policies and procedures were deficient. Additionally, Hamilton's internal controls were inadequate as demonstrated by the repeated criticisms in OCC's ROEs for errors pertaining to books, records, and call reports.

Ineffective Board of Directors and Nonresponsive Management

The decisions and practices of Hamilton's management and the board were, in our opinion, contributing factors to the bank's closure. For example, management and the board disregarded the risks associated with the emerging markets and failed to establish adequate methods to control those risks. Additionally, management and the board ignored or failed to recognize problems, losses, and supervisory recommendations including enforcement actions when they developed. According to an OCC supervisory memorandum, chronically inaccurate call reports demonstrated that the board and management either did not know or were attempting to conceal the true condition of the bank.

Despite the serious management deficiencies described above, the board did not hold senior management accountable. According to OCC examiners and officials, Hamilton's passive board allowed the Chairman/CEO to dominate the bank's activities. The Chairman/CEO had a history of exerting a strong influence on and exercising direct supervision over bank operations.

The bank filed numerous appeals with the OCC Ombudsman's office. During 2000, the bank appealed OCC's CAMELS composite rating of "4" and criticism of Hamilton's action regarding the Ecuadorian loans and investment practices cited in the 1999 examination report. The bank continued to challenge OCC's efforts to supervise Hamilton by filing additional appeals. For example, on June 30, 2000, Hamilton appealed examiner findings regarding the restructured Ecuadorian debt for Allocated Transfer Risk Reserve

(ATRR)[18] purposes. According to an OCC supervisory memorandum, Hamilton appeared to have attempted to manipulate the Ombudsman and the OCC supervisory office by providing them with inconsistent information regarding the restructured Ecuadorian debt. When the Ombudsman concluded that bank management was not truthful in the presentation of its appeals, the Ombudsman notified bank management that he would no longer entertain their requests for appeal.

Accounting Adjustments and Asset Write-downs

During the 1999 examination, examiners determined that the earnings level was deficient and did not support Hamilton's operations, capital, or allowance levels. According to the 1999 ROE, prior to this examination, earnings performance was good. However, the good earnings performance was attained by not providing for an adequate ALLL, ATRR, and by not recognizing losses from investment securities purchased in 1998 and 1999. During the 1999 examination, OCC identified high risk in the loan portfolio that required significant reserves and found that various investment securities were purchased and booked above fair value at the time of purchase. OCC required adjustments to earnings totaling $63 million. These adjustments included: (1) a $24 million write-down of investment securities; (2) a $32 million increase to the ATRR for the Ecuadorian loans;[19] (3) an additional $6 million provision to the ALLL; and (4) a $578,000 charge-off of accrued interest. As a result, in 1999, OCC downgraded Hamilton from "well capitalized" to "adequately capitalized" for purposes of

[18] Allocated Transfer Risk Reserve—under the International Lending Supervision Act of 1983, 12 U.S.C. § 3901 et seq., banks must, in certain circumstances, establish an allocated reserve for each asset subject to severe transfer risk. Transfer risk, in this context, means the possibility that the borrower will be unable to make payments in the appropriate currency because sufficient foreign exchange is not available in the home country of the borrower. The implementing regulations require that each affected bank charge off or maintain an ATRR for each asset with impaired value due to transfer risk. The ATRR is a specific reserve that is created by a charge to current income. The ATRR, which is not counted in the bank's capital, is separate from the ALLL and is deducted from gross loans and leases.

[19] The International Country Exposure Review Committee assigned a "value impaired" rating to Ecuador, and mandated a 90 percent ATRR for all non-performing (i.e. 30 days or more past due) Ecuadorian debts held by U.S. banks.

Prompt Corrective Action (PCA).[20] The combination of these adjustments caused the bank to have operating losses of approximately $50 million as of September 30, 1999.

- Investment Securities

  The investment securities adjustments of $24 million were necessary after the examiners found during the 1999 examination that the bank had engaged in unusual transactions[21] (referred to as Russian exposures in the 1999 ROE). The Russian exposures are discussed in the Supervisory section of this report. OCC examiners discovered that Hamilton had paid par value for investment securities when substantial market information indicated that the investments were actually worth much less than par. OCC learned that Hamilton had concurrently sold distressed assets at par at about the same time, and in some cases, to the same parties from which the bank had purchased assets. Furthermore, the counterparties in the transactions profited at Hamilton's expense because losses incurred in the assets they purchased from Hamilton were less than the losses in the assets they sold to Hamilton. According to OCC, in many cases, the counterparties had completely written off

[20] PCA is a framework of supervisory actions for insured banks, which are not adequately capitalized. These actions become increasingly severe as a bank falls into lower capital categories. The capital categories are: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, and Critically Undercapitalized (12 USC § 1831o). Actions can be taken under PCA for both quantitative and qualitative reasons. There are numerical parameters in the regulations governing the specific ratios of capital to total assets that a bank must maintain. The regulations also provide other measures by which banking agencies can determine an institution's compliance that do not include the use of ratios.

[21] The unusual transactions were considered as an unsafe and unsound banking practice because two parties sold assets with imbedded losses to each other without recognizing those losses. For instance, Party A sold assets to Party B at an artificially inflated price when the fair value of the assets sold for less than that inflated price. Simultaneously, Party B sold other assets to Party A at an artificially inflated price, similarly exceeding the fair value of those assets. Ordinarily, the two parties then carry the assets on their books at the purposefully inflated purchase price and do not record losses on the purchase or sale of the assets, even though the losses do exist. The OCC was able to determine through information obtained from banking regulators and the bank's counterparties that those counterparties did record losses on their end of the transaction. Thus, Hamilton was the only party, which did not record losses in these transactions.

the assets that they purchased. Hamilton management denied that the purchases and sales were related. Hamilton did not take the write-offs as directed in the 1999 ROE until OCC imposed an April 2000 Temporary Cease and Desist Order and required the bank to do so.

Also, in connection with the unusual transactions, OCC found that Hamilton prepaid for the investments it purchased which further exposed the bank to unnecessary risk and loss of income. In addition, Hamilton did not make timely general ledger entries, back-dated numerous entries, and booked a placement that never existed. The true condition of the bank was not accurately reflected and thus OCC required management to write down the securities by $24 million.

- ATRR Provisions

  During the 1999 examination, OCC reviewed Hamilton's credit exposure to several intervened Ecuadorian banks. Hamilton took actions, apparently to avoid establishing 90 percent ATRRs on loans to Ecuadorian banks. Hamilton's credit files indicated that some of its credit exposure to each of those banks had defaulted, and Hamilton had sold the credit exposure to other Ecuadorian banks. OCC found that the bank moved matured or past due Ecuadorian loans into accounts receivable to avoid showing the loans as past due and concluded the transactions constituted an unsafe and unsound practice. Hamilton failed to timely record the expense associated with the ATRRs, and as a result Hamilton was required by OCC to increase the ATRR for the Ecuadorian exposure by $32 million. In addition, in October 2000, during the on-site examination, the examiners discovered a $10 million Ecuadorian exposure that should have triggered ATRRs in the first and third quarters of 2000 as well. According to an OCC internal memorandum, Hamilton should have established ATRRs at that time.

- Allowance for Loan and Lease Losses

  During the 1999 examination, the examiners determined that the ALLL was inadequate because of insufficient credit risk grading and specific reserves for Watch List credits. Additionally, management established an inadequate and untimely ALLL provision for Ecuador given the economic difficulties Ecuador had been experiencing. During the examination, OCC performed an analysis, which required an additional $6 million in provisions to bring the ALLL to an adequate level.

Significant Events at the 2001 Examination

As a result of OCC's 2001 examination conducted between May and November, the bank received a composite CAMELS rating of "5" and also component ratings of "5" in the asset quality, management, and earnings components. The bank also received a rating of "4" in the capital and liquidity components. Major deficiencies noted by the examination included:

- Asset Quality remained poor and had deteriorated;
- The ALLL was inadequate;
- Earnings were severely deficient;
- Capital had been depleted by approximately 30 percent since the prior examination;
- The holding company was no longer a viable source of capital;
- Violation associated with a "golden parachute" payment was approved by the board; and
- The board and management failed to comply with OCC enforcement documents and failed to implement many of the corrective measures from prior reports of examination.

Management's unwillingness to recognize problems, patterns of resistance, and failure to comply with laws and regulations, or to take corrective action, contributed to Hamilton's losses and were significant factors in OCC's decision to place Hamilton in receivership.

Finding 2 OCC's Supervision of Hamilton

OCC conducted annual examinations of Hamilton Bank from 1991 until its closure.[22] In addition, OCC maintained surveillance of the institution through its off-site review process. Following Hamilton's closure, we conducted an independent review of the OCC's supervision as part of the material loss review process. The following section outlines the examination history of the bank and the results of our review.

Examination History

From inception of the institution through 1991, Hamilton's management was attempting to improve the loans inherited from Alliance. During this time, OCC continued to rate the institution a composite "3", which indicated that the institution was still experiencing problems.

The Early Years (1991-1996)

Even though management was able to rectify the deficiencies from the former problem loans, beginning with the 1991 OCC examination and continuing through the 1996 examination, other symptomatic conditions began to surface. Specific details pertaining to the examinations for this period, including the component and composite ratings and specific examination criticisms are detailed in Table 3. Also, see Appendix 3 for a detailed chronology of significant events regarding Hamilton.

[22] FDIC requested to join OCC in the 2000 examination because of (1) serious concerns with the bank's large concentrations in emerging markets, (2) certain unusual transactions, and (3) management's reluctance to acknowledge problems noted in the August 23, 1999 examination. FDIC participated in both the 2000 and 2001 examinations.

Table 3: OCC Safety and Soundness Examination and Enforcement Actions 1991-1996

Date Started	CAMELS Ratings	Assets In millions	Significant Safety and Soundness and Other Issues	Enforcement Actions
3/7/91	3/23232	$133	• Loan review function needed to be independent and adequately staffed • Ineffective officer loan grading system	NONE
1/6/92	2/22312	$157	• Risk management systems were deficient • Adherence to sound underwriting standards needed to be monitored • Loan administration needed improvement • ALLL process was incomplete • Country exposure management system was deficient	NONE
7/23/92			• Letter sent to Hamilton indicating OCC's consideration of Civil Money Penalties (CMPs) against the bank for violations of law	
10/14/92			• Letter sent to Hamilton waiving the imposition of CMPs providing the board instituted efforts to ensure non-recurrence of the violations	
1/4/93	2/22312	$243	• Inadequate recordkeeping and internal controls in loan operations • Violations of Law: legal lending limits;[23] insider transactions; and call reports • Material recordkeeping deficiencies, which required refiling of financial statements and the Country Exposure Report	NONE
2/14/94	2/22212	$314	• Internal problem loan identification system and loan administration needed improvement • Concentrations of credit over 25% of capital are significant and the bank should continue to track industry concentrations on an ongoing basis	NONE
1/30/95	2/22211	$457	• Inadequate credit files • Concentration of credit risk identification, tracking, and monitoring needed improvement. Risk grading had improved but was not consistently applied	NONE
4/15/96	2/21111	$635	• Internal Loan Review did not keep pace with bank growth • Asset Quality-the bank continued to experience relatively high loan losses • Large concentrations in volatile emerging markets • Weaknesses in supervision and analysis of correspondent banks • ALLL continued to have loan losses well above peer banks	NONE

Source: OCC Reports of Examination and OCC Correspondence

As detailed in the above table, problems involving loan underwriting, loan administration, material recordkeeping deficiencies, and concentrations of credit materialized in the early years.

OCC examiners repeatedly cited these deficiencies in their ROEs. Although management agreed to take corrective actions and implement corrective measures, subsequent examinations revealed a perpetuation of these deficiencies. Furthermore, even though the ROEs continued to criticize these areas in ensuing examinations, no sustained corrective measures, informal or formal enforcement actions, were implemented during the period of 1991 through 1996. Various options were available to the OCC, including

[23] Legal lending limits establish the maximum loan amount that an institution can extend to one person, or to related persons that are financially dependent.

downgrading the management component or initiating informal or formal actions against the institution.

The 1992 and 1993 ROEs rated the management component a “3” while the other components were rated “1” or “2.” The reports did not expressly state the reason(s) for the management component downgrade. Since the prior year, 1991, and the following three years, 1994–1996, reflected management component ratings of “2” or better, it is difficult to determine the exact cause for the “3” management ratings in 1992 and 1993. However, from the information in the reports, we surmise that the basis for the downgrade was associated with reported violations of laws and regulations.[24] The component ratings were not disclosed to the board at that time; therefore, it is questionable if the board was even aware of the root causes in the management rating downgrade since the overall composite rating remained a “2.”

Also, during this same period, 1991 through 1996, we were told and the LLR supports that the OCC’s supervisory structure and culture were undergoing a transformation. The demeanor of the OCC changed and the regulators focused their attention on establishing a good relationship with the banks and reducing the regulatory burden. It is not clear from the examination files why stronger action was not taken against Hamilton for repeat findings during this period.

The Later Years (1997-2002)

A pivotal mark for Hamilton was in 1997. Prior to the commencement of the 1997 OCC examination, the holding company obtained $38 million from an IPO and downstreamed $30 million to Hamilton. The additional capital cushion provided

[24]In 1992, the bank was in violation of the legal investment limit. In 1993, the violations of law included Corporate Powers of Association; Investment Security Regulation; Legal Lending Limits; Reports to the Comptroller of the Currency; Loans to Executive Officers of Banks including preferential treatment and current financial statements; Prohibitions Respecting Loans to Executive Officers and Directors of Banks; Rate of Interest Paid to Directors; Other Real Estate Owned; Security Procedures; Community Reinvestment Act (CRA) Public Notice; Information Required for Home Loan Applications; Additional Information Required in the Loan File; Equal Credit Opportunity Act (ECOA) Notice; Retention of Prohibited Information; and Regulation O- Reporting Requirements for Credit Secured by Certain Bank Stock.

the necessary funds for expansion. According to an OCC internal supervisory memorandum, since the holding company was now publicly traded, there were additional performance pressures. An example of an enhanced performance measure is achieving a high return on assets in order to satisfy a return to stockholders. In order to comply with market expectations and generate sizeable profits, Hamilton began branching into other business avenues. It ultimately expanded its lending activities to include commercial loans both domestically and in Central and South America.

From the onset of Hamilton Bank, management indicated its intention of increasing the institution's asset size. In 1989, the OCC was aware that management planned a rapid expansion of services and offices, both locally and in Latin America. The bank's capital plans indicated various target numbers that management hoped to attain by specific dates. The June 2, 1997, examination listed an asset growth rate from the capital plan of 15 percent a year. Information in the ROEs and SMS was limited to asset growth listed in dollar amounts covering a broad period rather than annual projections. Since asset growth rate percentages compared to projected growth objectives were not listed in the earlier reports, it is not possible to determine if the bank exceeded its goals. However, as noted in Table 1, the 1997 and 1998 asset growth rates far exceeded the rate projected in the capital plan.

Although the ROEs and SMS data elaborate on the growth of the institution, the increasing capital levels mitigated many concerns that the OCC had with the rapid expansion. We believe that the regulators should have taken a more aggressive stance concerning the rapid expansion, particularly since many of management's promises affecting correction of previous criticisms in ROEs never came to fruition. `

The 1997 OCC examination rated Hamilton a composite "1" based on the increased capitalization from the IPO as well as the OCC's perception that management "implemented good risk management processes that have resulted in high quality growth and effective supervision over bank operations." Despite the accolades contained in the 1997 ROE, Hamilton was still experiencing large concentrations in emerging markets, and weaknesses in loan grading, internal loan review, and the methodology for determining the adequacy of the ALLL.

As indicated in Table 1, Hamilton's asset growth rate exceeded 77 percent for 1997. As part of the supervisory process, the OCC conducted periodic reviews of Hamilton. Monthly monitoring and quarterly off-site analysis of the bank's performance was conducted between the 1997 and 1998 examinations. The March 1998 off-site review resulted in a downgrade to a composite "2" because of the rapid growth, the large concentrations of credit and the declining capital ratios. The next OCC on-site examination conducted between June and November 1998, specifically targeted foreign concentrations and exposures in new emerging markets. This examination resulted in a further downgrade to a composite "3" to "reflect the bank's vulnerability to economic conditions in emerging markets and weaknesses in management's supervision of this risk."

In addition to the overall weaknesses identified in the report, the bank was engaged in problematic Russian exposures. Information concerning specific transactions associated with the Russian exposures that occurred during 1998 is detailed in next section of this report titled, Delayed Supervisory Actions. At the conclusion of the 1998 examination, an SSN was issued to Hamilton. This action required the bank to formulate a plan to address and correct the deficiencies outlined in the notice. Although an action plan was submitted within the required timeframes, compliance with the plan was never fully achieved.

Table 4 below summarizes the results of OCC's annual safety and soundness examinations, enforcement actions, and other significant events from the 1997 examination through the 2001 examination.

Table 4: OCC Safety and Soundness Examination Issues and Enforcement Actions 1997-2001

Date Started	CAMELS Ratings	Assets In millions	Significant Safety and Soundness and Other Issues	Enforcement Actions
6/2/97	1/111111	$841	• Weaknesses in loan grading, internal loan review and ALLL methodology • Large concentrations to borrowers exceeded 25% of capital in riskier or new markets	NONE
2/22/98	2/221111 Off-site review	Not available	• Composite rating changed due to rapid growth, declining capital ratios, and substantial concentrations of risk in emerging markets	NONE
6/29/98	3/333211	$1,390	• Deficiencies in internal grading, concentrations in emerging markets, and capital adequacy • Inadequate ALLL • Watch List did not accurately reflect the risk in the bank's loan portfolio • Total assets doubled in 18 months • Violation of the legal lending limit	12/14/98 S/S Notice
8/23/99	4/344422	$1,674	• Risk identification & monitoring-failed to appropriately grade asset risk on a timely basis and to establish appropriate ALLL • Asset Quality deteriorated significantly • Country Risk Management remained deficient • Violation of legal lending limit and inaccurate call reports	2/23/00 Notice of Charges for Cease and Desist Order issued to bank; 4/25/00 Amended notice of Charges & Temporary C&D; 9/8/00 Consent C&D
8/28/00	4/445432	$1,704	• Credit risk was high and virtually all credit risk processes remained deficient • Loan grading improperly and untimely • Credit risk classifications were 105% of capital • Inadequate reserves for ALLL and ATRR • Call reports contained material inaccuracies • The Bank was in non-compliance of the Bank Secrecy Act (BSA) • Inadequate capital to support high level of credit, reputation, and litigation risks • Compensation paid to the Chairman/CEO and directors is too high given the condition of the bank	11/2/00 OCC sent "15 day letters" to insiders informing them of the possible assessment of CMPs for failure to recognize ATRRs; 3/22/01 CMP notices of assessment issued to insiders; 3/28/01 Notice of Charges for amended C&D and Temporary C&D issued; 3/28/01 PCA Notice to reclassify "Undercapitalized" issued
5/7/01	5/455543	$1,535	• Credit analysis remained an area of significant concern • Lack of transparency in understanding the risks in loans reviewed • The ALLL methodology remained deficient and inadequate to cover inherent losses • Asset Quality significantly deteriorated and was not considered stable • Large concentrations in volatile emerging markets • Management has not achieved compliance with either enforcement documents • Violations of Law: Inaccurate call reports, brokered deposits, and "golden parachute" payment to a former executive vice president (spouse of Chairman/CEO) • Capital had declined and was inadequate • Management compensation is excessive	11/20/01 Undercapitalized by PCA; capital restoration plan required by 12/04/01

Source: OCC Reports of Examination and OCC Supervisory Memorandum

As indicated by Table 4, Hamilton's ratings began a downward spiral in 1998. Problems with loan administration, concentrations, violations of law, call report errors, as well as a host of other deficiencies continued to mount. Refer to Appendix 2 for a detailed listing of the concentrations in emerging markets that existed at Hamilton. Although management appeared to attempt to correct the loan administration deficiencies, the efforts were not sufficient to prevent a recurrence of the problem.

Although Hamilton's business strategy was altered to include a more diverse loan selection, the underlying problems associated with the credit underwriting and loan administration functions were never satisfactorily corrected. As noted in Table 3, there were deficiencies noted with the credit functions as early as 1991. Since these critical areas were never fully rectified, we believe that it was doubtful that any loan expansion, regardless of the type, could have been undertaken without exposing the bank to greater credit risk.

In addition to the proliferation of underwriting and loan administration deficiencies, violations of laws and regulations were noted at each safety and soundness examination from 1998 through 2001. The perpetuation of the violations further evidences management's total disregard for the regulatory framework in which it operated. The supervision of the institution was transferred to the Special Supervision/Fraud Division in 1999. The OCC used various enforcement actions, primarily the Cease and Desist Orders, to effect correction. However, none of these efforts was able to abate the effects of the asset structure. Despite regulatory efforts to curb Hamilton's unsafe and unsound practices, problems associated with the lending function, declining capital ratios, and deteriorating earnings continued until the OCC closed the institution in 2002.

Delayed Supervisory Actions

During our review, there were two specific instances involving Hamilton's unusual transactions associated with the Russian loans and non-compliance with a Safety and Soundness Plan (SSP) where we believe that the OCC did not take timely action.

Unusual Transactions Associated with Russian Loans

According to the 1999 ROE, OCC informed Hamilton management in September 1998 that it needed to take significant loss provisions for its problematic Russian exposure. However, management sold most of the Russian exposure “at par” (for full value) before the quarter ended September 30, 1998. The fact that the bank received par for these assets was unusual because at that time virtually all Russian exposures were trading at severe discounts. After OCC first learned of these transactions and became concerned about them, it did not fully investigate them until 10 months later.

At the exit meeting for the 1998 on-site safety and soundness examination held on September 9, 1998, OCC directed Hamilton to downgrade a Russian loan to “loss,” the remainder of its Russian exposure to “substandard”, and to provide a 25 percent reserve allocation for four Russian loans. Also, OCC informed management that they needed to take significant loss provisions for the bank’s problematic Russian exposure. However, a few days later, Hamilton informed the examiners that it had sold the approximately $20 million of the Russian exposure at par value.

After the conclusion of the 1998 examination, OCC remained concerned about Hamilton’s ability to sell the distressed Russian debt at par value. Therefore, in a letter dated September 29, 1998, the examiners requested that Hamilton provide details regarding the purchaser, price, and recourse agreements for the Russian debt sales. In a letter dated October 2, 1998, Hamilton provided information regarding the purchasers and prices and informed OCC that the sales were on a non-recourse basis. The bank did not indicate in the letter that the sales were in any way linked to other transactions.

While OCC requested the documentation in September 1998, it did not fully investigate the sale and Hamilton’s accounting for the transactions until the August 1999 examination, 10 months later. OCC’s examiners-in-charge in the South Florida Field Office told us that examination resources were not available to perform the review of the transactions sooner.

The August 1999 examination noted that Hamilton sold distressed assets at par and purchased discounted assets at par without reflecting a loss on either the sold or purchased assets. In some cases, the sales/purchases were with the same broker, which heightened OCC's concerns. Also, in all cases, Hamilton prepaid for the obligations it purchased, which exposed the bank to unnecessary risk and loss of income. In our opinion, OCC should have more promptly reviewed the circumstances surrounding the sale of the Russian loans, given the examiners' concerns with these transactions. Had it done so, the April 2000 Temporary C&D which in part, directed Hamilton to cease engaging in the unusual transactions, may have been issued sooner. Also, OCC may have acted to transfer the supervision of Hamilton to the Special Supervision/Fraud Division in Washington, D.C. sooner.

During our exit conference, OCC officials informed us that Hamilton' s Russian loan transactions were still under investigation.

Review of Compliance with the Safety and Soundness Notice

On December 14, 1998, in an effort to address problems identified in the 1998 examination, OCC sent a SSN to Hamilton. The notice directed the bank to file a SSP within 30 days from the date of the notice. The bank filed a SSP with the Southeastern District Office on January 15, 1999. On March 4, 1999, OCC approved the SSP as amended by the bank to revise the projections on exposure by country.

OCC's Policies and Procedures Manual 5310-3 (REV) Supplement 2, "Enforcement Action Tracking System and Compliance Assessment", dated January 31, 1997, requires examiners to conduct an on-site follow-up assessment of compliance with a new enforcement action within 60 days of the latest due date in the action. However, OCC did not conduct an on-site follow up of compliance with the SSP until the August 1999 examination.

The examination, which was completed in December 1999 uncovered that the bank had demonstrated material non-compliance with the SSP because it failed to establish adequate practices to identify and monitor risk.

According to the Assistant Deputy Comptroller, the South Florida Field Office's ability to follow up and document corrective action was impeded by limited resources and a heavy burden of supervising nine problem banks. In September 1999, the bank was turned over to OCC's Special Supervision/ Fraud Division in Washington, D.C., which devoted extensive resources to supervise the bank.

Prompt Corrective Action

OCC took supervisory action under Prompt Corrective Action to reclassify Hamilton's capital level from "adequately capitalized" to "undercapitalized." By treating the bank as if it were "undercapitalized." the bank was forced to comply with certain mandatory or discretionary supervisory actions, such as restricting asset growth and requiring prior approval of certain expansion proposals.

According to 12 U.S.C. § 1831o(a)(1) and 12 C.F.R. § 6.1 (a) and (b), the purpose of the PCA legislation is to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund. As a general matter, PCA provides the Federal banking agencies with the authority to take certain actions with respect to insured depository institutions when an institution's capital drops to a certain level. However, in establishing a system of Prompt Corrective Action based primarily on the capital level of each institution, Congress recognized that factors other than capital should in certain circumstances be used to assess the financial condition of an institution. Therefore, PCA gives regulators flexibility to discipline institutions based on criteria other than capital, to help reduce deposit insurance losses caused by unsafe and unsound practices.

On March 28, 2001, OCC notified Hamilton of its intent to reclassify its capital level from "adequately capitalized" to "undercapitalized" for purposes of PCA. PCA provides that OCC may deem an institution to be engaging in an unsafe and unsound practice if the institution receives a less than-satisfactory rating for CAMELS components related to asset quality, management, earnings, or liquidity in its most recent report of examination (if the deficiency is not corrected). The OCC examiners concluded in the 2000 examination that the bank's aforementioned CAMELS components were in fact less than satisfactory and the bank had engaged in unsafe and unsound practices. Thus, OCC was authorized as a matter of law to reclassify the bank as "undercapitalized."

The bank requested a hearing, and on May 11, 2001, OCC and the bank management met at OCC headquarters. The presiding officer agreed with OCC regarding the reclassification and recommended that the Comptroller reclassify the institution. As a result, OCC sent the bank an "undercapitalized" letter on June 13, 2001.

Other Supervisory Matters

Executive Compensation

As part of the Chairman/CEO's compensation package, he was given a bonus based on Hamilton's profitability before taxes. The following table shows the Chairman/CEO's compensation and bonuses for 1995 through 2000.

TABLE 5: Compensation Paid to Hamilton's Chairman/CEO

Year	Salary	Bonus	Other Compensation	Total Compensation
1995	$395,000	$755,891	$83,155[1]	$1,234,046
1996	$550,000	$891,410	$102,775[1]	$1,544,185
1997	$705,400	$798,058	$13,900[1]	$1,517,358
1998	$775,900	$1,103,591	$4,621	$1,884,112
1999	$853,534	$662,000	$2,500	$1,518,034
2000	$896,210	$0	$2,483	$898,693

Source: Hamilton 10 K reports, SEC
Note 1: Principally, represents bank director fees paid during 1995, 1996 and the first 3 months of 1997.

OCC notified Hamilton management in the August 2000 ROE that compensation paid to the Chairman/CEO was too high given the condition of the bank. OCC informed the bank that compensation was a significant issue that needed to be addressed. However, the report did not elaborate on recommendations to ensure that the board addressed this issue and that corrective measures were implemented. As a result of the examination comments, the OCC included a provision in the proposed March 28, 2001, Amended Consent Order that required the bank to conduct a study and provide recommendations regarding its compensation program. However, the bank did not sign the Amended Consent Order, and the OCC issued a Notice of Charges for Issuance of an Amended Order to Cease and Desist and a Temporary C&D on March 28, 2001. The Temporary C&D did not include a provision requiring a review of the bank's compensation program. Staff from the OCC's Enforcement and Compliance Division informed us that a Temporary C&D was not the correct enforcement vehicle in which to include this provision. Hamilton was closed before a hearing concerning the Notice of Charges could be conducted.

The 2001 ROE again reported that the board had not dealt with the management compensation issues in the bank, despite the repeated indications by OCC that compensation was excessive. As noted above, Hamilton was closed prior to the implementation of any enforcement actions by the OCC pertaining to the compensation issue.

<u>"Golden Parachute" Payment</u>

In April 2001, the bank also paid a former executive officer, the Chairman/CEO's spouse, a severance payment of $592,208 in violation of a regulation prohibiting "golden parachute" payments[25] without OCC and FDIC approval, which was required due to the bank's condition. In the 2001 ROE OCC advised the board that it should seek restitution for the payment. In a letter to the board dated September 24, 2001, OCC and FDIC advised that restitution for the severance payment should be made to Hamilton immediately. Currently, restitution is being pursued.

[25] 12 C.F.R. Part 359 generally prohibits the payment of "golden parachutes", or payments contingent on the termination of employment by a bank, if the bank has a composite rating of 4 or 5. Such payments may be made only upon approval by the bank's primary regulator (in the case of the bank, the OCC) with the concurrence of FDIC.

Finding 3 Other Matters

Following the failure of the First National Bank of Keystone[26] the Comptroller organized a group of senior deputy comptrollers for the purpose of gleaning lessons learned from that experience and developing a plan to prevent a recurrence. The action plan they developed included the initiation of formal LLRs to be conducted by the OCC's Quality Assurance Division in Bank Supervision Operations. A companion recommendation was that the division be separated from bank supervision to provide an appropriate level of independence. The division is now the Quality Management Unit with the Program and Management Accountability Division. The Hamilton LLR project team issued its report to OCC's Problem Bank Subcommittee (PBSC) in July 2002.

In our opinion, the LLR process provided OCC with useful information to improve its supervisory process. The LLR report documents several key issues, the lessons learned from these issues, a description of actions the OCC has taken, and recommendations for additional action. The conclusions in the LLR report are provided as Appendix 4. However, we also noted several areas where improvement could be made for future LLRs. Specifically, the report stated that personnel from the legal division, while interviewed, were not included as part of the LLR project team. We believe that the inclusion of a legal representative would have been beneficial to review the various enforcement actions and also to review enforcement actions that were considered but ultimately were not taken. Also, the basis for several conclusions in the LLR was not evident. Examples include cultural issues with the "kinder, gentler regulator" during the early years of Hamilton's supervision and a recommendation that the Examiner-in-Charge (EIC) for community banks be periodically rotated.

After the LLR report was issued, the PBSC asked the project team to identify the most critical issues requiring corrective action, and

[26] We conducted a material loss review of Keystone and issued a report in March 2000, *Material Loss Review of The First National Bank of Keystone*, OIG-00-067. At the time of our Keystone audit, the estimated loss of the failure was between $750 and $850 million.

the team's recommendations to address these issues. In response, the team identified four findings, as follows:

- OCC's early warning tools did not identify many of Hamilton's longstanding deficiencies and red flags, nor was the use of information provided by OCC's early warning systems consistent. Examples of these deficiencies and red flags include loan review, risk identification, ALLL adequacy, country risk concentrations/exposure management, and investment securities analysis and reporting. One classic red flag that existed throughout the 1990s was the bank's extraordinary growth rate.

- Earlier allocation of specialized examiner and EIC expertise was warranted. This is based on Hamilton's dominant, untruthful, and uncooperative management and the bank's change to a higher risk strategic focus and rapid growth in exotic products despite appearing financially sound. The complexities of the types of growth and new products/services exceeded local staff depth of experience and physical capacity. Also, the lack of a formal EIC rotation policy allowed the same EIC to conduct six consecutive examinations of Hamilton from 1994 to 1999.

- Hamilton bank management provided misleading and deceptive information. This hindered OCC's supervisory efforts by delaying the timeliness and reducing the frequency of communications of feedback and conclusions. It also added burden and duplication to the OCC. In the bank's view, this contributed to the deterioration in the OCC's relationship with bank management. OCC's trust in bank management's truthfulness was also lost. A single point of focus for correspondence with Hamilton was not in place to coordinate the actions, activities, and responses of all OCC areas including legal and corporate divisions, the Ombudsman, and headquarters and field supervisory offices. The SMS documentation of bank correspondence was incomplete. Hamilton appeared to have attempted to manipulate the Ombudsman and the supervisory office by providing them with inconsistent information.

- Hamilton was excluded from OCC's bank supervision quality assurance program, thus preventing an independent review of the quality and effectiveness of OCC supervisory efforts. The bank was always excluded from the district's community bank sample at the request of district management. District management made this request because OCC examinations of the bank and/or gathering of documentation for CMP referrals were in process at the time the quality assurance review was scheduled. Hamilton was also excluded from review once the bank was transferred to Special Supervision/Fraud. The Quality Assurance Division was directed by OCC executive management to exclude this bank from review to ensure that ongoing litigation was not compromised.

The LLR project team made six recommendations to the PBSC. The recommendations, PBSC's decision on the recommendations, and their status as of October 8, 2002, were as follows:

- OCC should back-test banks prior to their problem status to validate the ongoing value of early warning tools in providing an earlier warning of problems to come.

  The PBSC accepted the recommendation; however, an implementation date had not been determined.

- An improved process should be developed for determining and allocating specialized expertise for situations such as emerging problem community banks, banks with recent changes in control, banks experiencing significant exotic growth, and banks with difficult management. Resources should be committed for the tenure of the project. The early identification of specialists and availability of those individuals for special assignments for district-supervised community banks (prior to the banks designated problem status and/or transfer to Headquarters' Special Supervision/Fraud Division) is critical in complex situations such as Hamilton.

  The PBSC responded that no additional actions were needed due to the efforts and process that were already underway. Specifically, these efforts include the "clean-the-plate" initiatives, designed to refocus OCC's resources on supervisory issues; further enhancements to OCC's supervision-by-risk program, including its extension to the specialty areas; and the implementation of a supervisory risk assessment and staffing process that will integrate information from

OCC's various management information systems with staffing plans and supervisory strategies and objectives. At the exit meeting we were apprised that a process is also in place where the Deputy Comptroller for Special Supervision is frequently called upon to coordinate resource requirements with District and Large Bank Deputy Comptrollers, District Lead Experts, and Large Bank EICs in order to obtain resource funding for high priority problem banks on a national basis. No specific implementation date was provided by the PBSC as these efforts will be ongoing.

- As part of the resource allocation process, OCC management should review current practice with regard to EIC and resident staff rotation and determine if written policy guidance is warranted. Such a review could ensure that current practice recognizes the need to match personalities and styles of EICs and examiners in key roles with those of bank management to maintain ongoing productive relationships and appropriate degrees of independence.

  The PBSC members agreed, as a general matter, that there should be periodic rotation of EICs, especially in problem bank situations. However, they believe that the current, informal process was more appropriate and provided needed flexibility for the community bank program. They noted the logistical difficulties of implementing strict, formal rotation policies given the size of the community bank population. No further action was planned for this recommendation.

- The project team recommends a process to enhance communications between OCC's lawyers, examiners, and supervisory offices, as well as between the OCC and bankers. A coordinated process addressing responsiveness to and documentation of bank correspondence received by all OCC divisions could enhance internal OCC communications, aid in providing timely feedback to bankers, and reduce burdens on OCC caused by deceptive bank management.

  The PBSC rejected the recommendation. It concluded that existing OCC guidance and processes are sufficient, if followed.

- An amendment to OCC Appeals Bulletin (OCC 2002-9) should be considered to reflect the implied understanding that ongoing communications during the appellate process are expected to be conducted truthfully and in good faith.

The PBSC rejected the recommendation, concluding that further revision to the bulletin was not needed. They noted that the revised bulletin addresses one of the issues that recalcitrant or dishonest bank management tried to exploit in the past, namely whether supervisory actions will be held in abeyance during an appeal.

- A written policy should be established for quality assurance bank selection, detailing exclusionary factors and the approval process for exclusion. Quality assurance should sample banks with high growth, banks with a recent change in control, and banks with red flags identified in the LLRs. Quality assurance reviews should include assessments of the adequacy of testing, the sufficiency of numbers and expertise of resources assigned, and sufficiency of follow-up on conditions, matters requiring attention, commitments and/or enforcement actions.

  The PBSC concluded that specific corrective action was not needed as the current quality assurance process was being revamped and, going forward, these types of banks would be picked up.

Recommendations

In Finding 3, we identified the recommendations noted in OCC's Lessons Learned Review Report. We recommend that the Comptroller of the Currency:

1. Ensure that the recommendations contained in the Lessons Learned Review Report are implemented as planned.

2. Reassess the Lessons Learned Review process to ensure that details to support conclusions reached and related recommendations are included, and expand the scope to include all pertinent information relating to the supervision of the institution. In this regard, the Hamilton Lessons Learned Review Report noted that the project team did not possess sufficient legal expertise to make judgments about the quality and effectiveness of decisions related to legal actions taken or underway. Consideration should be given to assigning staff with legal expertise on future Lessons Learned Reviews to

review both legal actions taken and legal actions considered, but not taken.

In Finding 2, we also noted additional concerns over OCC's supervision and examination coverage after the IPO. Accordingly, we recommend that the Comptroller of the Currency:

3. Develop or revise policies and procedures to ensure examiners promptly review significant capital injections to determine whether the capital resources are managed and invested in accordance with the financial institution's business plan and in a safe and sound business manner. On-site verification should be done as appropriate.

As discussed in Finding 2, we noted several instances in which OCC delayed supervision actions. For example, OCC took 10 months to investigate the sales and accounting transactions related to the Russian exposures. Also, examiners did not timely follow up for Hamilton's compliance with the Safety and Soundness Plan. Accordingly, we recommend that the Comptroller of the Currency:

4. Reassess examination guidance regarding actions to be taken when examiners encounter unusual accounting transactions that warrant further investigation.

5. Establish controls to ensure examiner follow-up on bank compliance with enforcement actions in a timely manner.

Management Response and OIG Comments

In its December 17, 2002 written response to the OIG's draft report, OCC concurred with the reported findings and agreed to implement the recommendations. Over the next few weeks, OCC plans to formulate action plans detailing the steps it will take to implement the recommendations. The actions will be formally reported and monitored through the Department's Joint Audit Management Enterprise System.

We believe OCC's planned actions are responsive to the intent of the recommendations. The OIG will also continue to monitor

OCC's progress in addressing the reported findings and recommendations. The full text of OCC's response is included in Appendix 5.

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We would like to extend our appreciation to OCC for the cooperation and courtesies extended to our staff during the audit. If you have questions, please call me at (202) 927-6512. Major contributors to the report are listed in Appendix 6.

Donald R. Kassel /s/
National Director, Banking and Fiscal Service Audits

We conducted this material loss review of Hamilton Bank in response to our mandate under Section 38(k) of FDIA, 12 USC § 1831o(k). This section provides that if a deposit insurance fund incurs a material loss with respect to an insured depository institution on or after July 1, 1993, the inspector general for the appropriate Federal banking agency shall prepare a report to the agency, which shall:

- ascertain why the institution's problems resulted in a material loss to the insurance fund;
- review the agency's supervision of the institution; and
- make recommendations for preventing any such loss in the future.

As defined by Section 38(k) FDIA, a loss occurring after June 30, 1997, is considered material if it exceeds $25 million or 2 percent of the institution's total assets. FDIA also requires the inspector general to complete the report within 6 months after it becomes apparent a material loss has been incurred.

We initiated a material loss review of Hamilton based on the loss estimate provided by FDIC. As of March 31, 2002, FDIC estimated that Hamilton's closure would cost the BIF between $350 and $500 million. As of June 31, 2002, FDIC adjusted the estimated cost of Hamilton's closure to a range of $175 to $225 million, after factoring in the recovery of the international loan and asset sales.

To accomplish our review, we conducted fieldwork at OCC Headquarters in Washington, D.C.; the OCC District Office in Atlanta, Georgia; the OCC Field Office in Miami, Florida; and the OCC Ombudsman Office in Houston, Texas. We also visited the FDIC Regional Office in Atlanta, Georgia; the FDIC Division of Supervision (DOS) in Plantation, Florida (in 2002 FDIC reorganized and DOS was merged into the new Division of Supervision and Consumer Protection); and the FDIC Division of Resolutions and Receiverships (DRR) and Division of Finance (DOF) in Dallas, Texas. We obtained information from the Federal Reserve Board OIG in Washington, D.C. regarding Hamilton's holding company, Hamilton

Bancorp. Furthermore, we interviewed staff from the Securities and Exchange Commission.

Our review covered the period from 1988 until Hamilton's closure on January 11, 2002. We conducted our on-site fieldwork from April 2002 through August 2002.

To assess the adequacy of OCC's supervision of Hamilton, we performed interviews and reviews to determine (1) when OCC first identified Hamilton's safety and soundness problems, (2) the gravity of the problems, and (3) the supervisory response OCC took to get the bank to correct the problems. We also performed interviews and reviews to determine whether OCC (1) might have discovered problems earlier, (2) identified and reported all the problems, and (3) issued comprehensive, timely, and effective enforcement actions that dealt with any unsafe or unsound activities. Specifically, we:

- Assessed OCC actions based on its internal guidance and legislative guidance provided by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and FDIA.

- Reviewed OCC supervisory and enforcement files and records for Hamilton from 1988 through 2002. We analyzed examination reports, supporting workpapers, and related supervisory and enforcement correspondence. We performed these analyses to gain an understanding of the problems identified, the approach and methodology OCC used to assess the bank's condition, and the regulatory action used by OCC to compel bank management to address the deficient conditions. We did not conduct an independent or separate detailed review of the external auditor's work or associated workpapers other than those incidentally available through the supervisory files.

- Reviewed files, workpapers, and examination reports maintained by FDIC DOS to determine the nature, scope, and conclusions regarding its reviews of Hamilton.

- Interviewed and discussed various aspects of the supervision of Hamilton with OCC officials, examiners, attorneys, and analysts, to obtain their perspective on the bank's condition and the scope of the examinations. We also interviewed FDIC officials and DOS examiners who either participated with OCC on the 2000 and 2001 examinations at Hamilton or were responsible for monitoring Hamilton for Federal deposit insurance purposes.

- Interviewed FDIC DRR and DOF personnel who were involved in the receivership process, which was conducted before and after Hamilton's closure and appointment of receiver.

- Discussed the progress of investigative efforts related to Hamilton with an FDIC DRR investigator; Securities and Exchange Commission attorneys in Miami, Florida; and Treasury OIG special agents that were working with the U.S. Attorney's Office.

We conducted our review in accordance with generally accepted government auditing standards. At the time of our review, Federal regulators and officials were still investigating alleged fraud at Hamilton.

Table 6: Loan Concentrations in Foreign Markets

Loan Concentrations in Foreign Markets by Year (Concentrations of credit over 25% of capital indicate increased risk)										
Country	**1997**		**1998**		**1999**		**2000**		**2001**	
	Amount In millions	*Percent of Capital	Amount In millions	*Percent of Capital	Amount In millions	*Percent of Capital	Amount In millions	*Percent of Capital	Amount In millions	*Percent of Capital
Argentina	$48	58%	$63	54%	$118	71%	$54	37%		
Bolivia	$20	25%	$46	39%						
Brazil	$55	65%	$113	97%	$192	116%	$99	67%		
Colombia			$34	30%	$50	30%	$45	31%		
Dom. Rep.	$24	29%	$53	46%			$45	30%	$42	36%
Ecuador	$70	83%	$120	104%	$80	48%	$50	34%	$34	29%
El Salvador	$45	55%	$61	53%			$58	39%	$75	64%
Great Britain									$40	34%
Guatemala	$106	127%	$142	122%	$61	37%	$89	60%	$81	69%
Honduras	$42	50%	$68	59%			$39	26%		
Jamaica	$32	38%	$40	35%	$49	30%	$62	42%		
Panama	$54	65%	$134	116%	$98	59%	$146	99%	$134	113%
Peru	$43	53%	$75	65%	$57	34%	$40	27%	$33	28%
**Other			$120	103%						
TOTALS	$539		$1,069		$705		$727		$439	

Source: OCC Reports of Examination

*Tier 1 Capital Plus ALLL
**Loans to foreign markets under 25% of capital include: China-1%, Costa Rica-8%, Guyana-7%, Haiti-4%, Kazakhstan-4%, Nicaragua-7%, Paraguay–8%, Russia-24%, Suriname-16%, Turkey-4%, Uruguay-4%, and Venezuela-16%

The following chronology describes significant events in Hamilton's history including examinations conducted, major problems identified, and enforcement actions taken by OCC.

2/7/83	Alliance National Bank received its national banking charter #17675.
5/25/88	Southern Bancorp, later renamed Hamilton Bancorp, Inc. (Hamilton Bancorp), bought the bank for $1.5 million.
8/19/88	Alliance changed its name to Hamilton Bank, N.A. (Hamilton) through a change in bank control.
10/5/88	OCC started an on-site examination. The exam was completed October 28, 1988, and resulted in composite and CAMEL ratings of 3/33242.
2/14/89	The Hamilton board signed a Commitment Letter replacing the existing February 20, 1987, Formal Agreement with OCC that had been initiated with the prior bank management. Based on the findings of the October 1988 examination, OCC determined that the Formal Agreement should be replaced with a Commitment Letter that more closely addressed current concerns. Under the Commitment Letter, Hamilton was to: (1) develop written policies/procedures for lending and international activity; (2) establish controls for lending and letter of credit documentation; (3) reduce problem assets and criticized off-balance sheet items; (4) improve earnings and budgeting; and (5) develop formal process to introduce new products.
7/10/89	OCC started an on-site examination. The exam was completed September 22, 1989, and resulted in composite and CAMEL ratings of 3/23232.
3/7/91	OCC started an on-site examination. The exam was completed June 7, 1991, and resulted in composite and CAMEL ratings of 3/23232.
7/19/91	OCC revised the March 7, 1991, Report of Examination to reflect data received during the exit meeting. The revision was completed September 9, 1991, and resulted in composite and CAMEL ratings of

3/22222. Both asset and earning ratings were upgraded to a "2." However, the field manager determined that the bank would remain a composite "3" until OCC was able to conduct a more extensive on-site test of the progress of the bank.

1/6/92 OCC started a limited examination based on financial information and management reports as of December 31, 1991. The examination was completed February 3, 1992 and resulted in composite and CAMEL ratings of 2/22312.

1/4/93 OCC started a full scope on-site examination. The exam was completed March 31, 1993, and resulted in composite and CAMEL ratings of 2/22312.

2/14/94 OCC started a full scope on-site examination. The exam was completed April 25, 1994, and resulted in composite and CAMEL ratings of 2/22212.

1/30/95 OCC started a full scope on-site examination. The exam was completed April 5, 1995, and resulted in composite and CAMEL ratings of 2/22211.

4/15/96 OCC started full scope on-site examination. The exam was completed June 5, 1996, and resulted in composite and CAMEL ratings of 2/21111.

3/31/97 Hamilton Bancorp, the bank's holding company, raised approximately $38 million from an IPO. Hamilton Bancorp subsequently infused $30 million into Hamilton to fund planned growth.

6/2/97 OCC started a full scope on-site examination. The exam was completed July 21, 1997, and resulted in composite and CAMELS ratings of 1/111111.

10/97 OCC's Washington Supervisory Review Committee authorized an Order of Investigation (OOI) based on allegations presented at the indictment in Puerto Rico concerning the Southern Bank and Trust Company, Ltd., of Montserrat, West Indies (Southern Bank and Trust) account at Hamilton.

11/97	Two Hamilton directors resigned after they were indicted along with other persons not related to the bank. The indictment alleged numerous violations of customs law, as well as various instances of tax evasion. They later pled guilty to misdemeanors but did not return to the bank.
2/5/98	OCC's Enforcement and Compliance Division submitted a written request to OCC's Washington Supervisory Review Committee to expand and amend the original OOI. New information for expanding the OOI involved allegations of loan fraud, false entries, and concealment of loan losses as well as additional allegations concerning an account at the bank in the name of Southern Bank and Trust.
3/3/98	OCC issued a letter to Hamilton informing it that the bank's composite CAMELS rating was downgraded to "2" based on an off-site examination which started on February 22, 1998. The change in rating was based on the increased concentrations of bank assets in emerging markets as a percentage of capital. Some of these concentrations occurred in countries with higher than normal transfer risk.
6/29/98	OCC started a full scope on-site examination. The exam was completed November 7, 1998, and resulted in composite and CAMELS ratings of 3/333211.
11/16/98	OCC started a BSA examination. The exam was completed March 15, 2000. OCC noted weaknesses in the following areas: (1) significant internal control deficiencies existed in the administration of the Southern Bank and Trust account; (2) operating policies and procedures did not include the minimum elements identified in OCC's BSA Handbook and identification of high-risk activities/businesses/countries; and (3) Hamilton's BSA training program was informal, and it was not evident whether all pertinent employees of the bank received periodic/tailored training.
12/14/98	OCC issued a SSN to Hamilton directing the bank to file a SSP within 30 days. The SSP was to address, at a minimum: (1) provisions addressing credit exposure in high-risk countries and emerging markets, (2) implementation of an appropriate risk grading system, (3) reassessment of the adequacy of the ALLL, and (4) implementation of a loan review program based on risk assessment.

1/15/99 Hamilton submitted an SSP to OCC's Southeastern District Office in Atlanta, Georgia. OCC determined that the plan did not provide sufficient detail, and requested that Hamilton provide a revised plan that included projections reflecting the amount of emerging market exposure expected to be outstanding at each month end in 1999 and a detailed discussion as to how Hamilton would meet the requirements of the SSN.

3/4/99 OCC approved the revised version of the SSP.

8/23/99 OCC started a full scope on-site examination. The exam was completed December 17, 1999, and resulted in composite and CAMELS ratings of 4/344422. The scope focused on safety and soundness issues with emphasis on testing compliance with the approved SSP. The bank demonstrated material non-compliance with the SSP because it failed to establish adequate practices to identify and monitor risk. The bank revised its internal risk grading systems but did not adequately implement those systems.

9/30/99 The supervision of Hamilton was transferred to OCC's Special Supervision/Fraud Division in Washington, D.C. Preliminary findings from the August 1999 examination disclosed several areas of increased risk, particularly in Hamilton's international lending and trade finance activities. In order to ensure the highest level of expert supervision and coordination with other regulatory agencies, OCC determined that direct supervision of the bank from Headquarters was appropriate.

12/28/99 OCC notified the bank that it had been reclassified from "Well Capitalized" to "Adequately Capitalized."

2/23/00 OCC presented Hamilton a Consent Order because of the bank's deteriorating condition. On the same day, OCC issued a Notice of Charges to commence administrative litigation because the bank declined to consent to the Order.

3/23/00 Hamilton appealed certain findings in the August 1999 examination to the OCC Ombudsman. In that appeal, the bank took exception to the following: (1) the composite CAMELS rating of 4; (2) OCC criticism of the bank's actions with respect to its loan portfolio in Ecuador, particularly with respect to the timely recognition of potential losses and the actions taken by the bank to enhance its position; (3) OCC criticism of the bank's investment practices of purchasing certain securities and loans and booking at par instead of at the fair market value which was below par, prepaying purchases, and making untimely and backdated entries and booking a placement that never existed; and (4) a $7.2 million lending limit violation cited by OCC involving an Ecuadorian corporation.

4/25/00	OCC imposed a Temporary C&D Order based on OCC's August 23, 1999, Report of Examination.
5/19/00	Hamilton appealed certain findings and conclusions of OCC's BSA examination to the OCC Ombudsman. In the appeal letter, the bank also stated that OCC's approach to the examination was in direct contravention of well-established OCC policy and that OCC misunderstood the requirements imposed on the bank with respect to the recordkeeping requirements of BSA.
6/30/00	Hamilton appealed to the OCC Ombudsman findings from the August 1999 examination that certain Ecuadorian loans constituted restructured debt for ATRR purposes and, therefore, were subject to ATRR's 90 percent reserve requirement.
8/3/00	The OCC Ombudsman found that the Southern Bank and Trust account was at issue in a pending formal enforcement action against the bank, namely the Temporary C&D Order. The OCC Ombudsman noted that he had no authority to accept appeals of enforcement-related actions or decisions. Therefore, he declined to accept an appeal on that issue.
8/15/00	The OCC Ombudsman found that the restructuring of the Ecuadorian loans had benefited the bank. However, the borrowers' debts had not been eliminated, and no new money was involved in the transactions. For those reasons, the OCC Ombudsman found that the examiners' treatment of the loans was appropriate.
8/28/00	OCC started a full scope on-site examination that included BSA, information technology, and compliance with the September 8, 2000, Consent Order. FDIC participated in the examination. The exam was completed February 13, 2001, and resulted in composite and CAMELS ratings of 4/445432.

9/8/00	Hamilton's board signed a comprehensive Consent Order. The Consent Order included a capital article, so even though capital ratios were "well- capitalized" by the numbers, the bank was notified that it was only considered "adequately capitalized."
9/18/00	The OCC Ombudsman reaffirmed the decision he made on August 15, 2000. In addition, the OCC Ombudsman noted in response to Hamilton that the OCC Ombudsman appeal process was intended to be an exceptional event, not a routine action or otherwise a substitute for the normal, everyday supervisory process.
10/3/00	Hamilton Bancorp publicly announced that its national bank subsidiary, Hamilton, reached an agreement with OCC and settled its administrative proceeding with OCC. Because of the Consent Order being entered into by the bank and OCC, the Temporary C&D Order was terminated.
10/30/00	Hamilton raised issues to the OCC Ombudsman concerning the ATRRs, the necessity to establish ATRRs on interest earned but not yet collected, and the need to recognize downgrades and provisions in the third quarter of 2000 when the bank believed that recognition in the fourth quarter would be more appropriate.
11/2/00	OCC sent "15-day letters" to several officers and directors informing them of the possible assessment of CMPs against them for their failure to recognize ATRRs.
11/22/00	Various Hamilton officers and directors sent OCC a letter in response to the "15-day letters." The letter provided reasons why they felt the CMPs should not be imposed.
12/12/00	In a letter to Hamilton, the OCC Ombudsman advised that the bank's routine appeals to his office had become an impediment to OCC's supervision of the bank and requested that future appeals be addressed to OCC personnel in charge of the office responsible for that supervision.
12/22/00	Hamilton Bancorp publicly announced that it would restate its earnings for 1998 and 1999. As a result, the 1998 and 1999 consolidated financial statements were restated to appropriately account for (1) the

	purchases of securities and sales of certain loans as an exchange instead of as separate transactions and the resulting losses of $22.2 million ($14.3 million after tax) in 1998, (2) the initial recording of the securities acquired at fair value which became their cost basis, (3) changes in unrealized gains and losses in 1999 relating to the securities acquired in the exchange transaction, and (4) the related income tax effects.
1/01 & 2/01	Shareholders filed lawsuits against Hamilton Bancorp for filing false and misleading financial statements.
3/8/01	OCC held a meeting with FDIC and Federal Reserve representatives to brief them about Hamilton's condition and to discuss contingency plans.
3/21/01	OCC commenced administrative CMP actions against various Hamilton senior officers and directors. The penalties were based on Hamilton's failure to establish required ATRRs on the September 30, 2000, call report after being directed to do so by OCC. As a result, the call report was inaccurate.
3/28/01	OCC requested in an amended regulatory notice that Hamilton increase its capital to a Tier 1 risk-based capital ratio of 12 percent (tier 1 capital/risk-weighted assets), total risk-based capital ratio of 14 percent (qualifying total capital/risk-weighted assets), and leverage ratio of 9 percent (tier 1 capital/ adjusted total assets). OCC advised the bank that it planned to reclassify the bank's capital level from "Adequately Capitalized" to "Undercapitalized" for purposes of PCA. OCC commenced administrative action against the bank to amend the September 2000 Consent Order. The proposed amended C&D Order required Hamilton to take seventeen steps. The bank's board refused to stipulate to the amended C&D Order; so, on the same day, OCC issued another Temporary C&D Order against the bank.
4/5/01	Hamilton brought suit against OCC in Federal District Court seeking a temporary restraining order to prohibit enforcement of the March 28, 2001, Temporary C&D Order.
4/13/01	A Federal District Court judge issued an order denying the temporary restraining order. The judge found that OCC's allegations of unsafe and

	unsound practices were extremely well supported and could not be taken lightly by the court.
4/26/01	Hamilton Bancorp publicly announced that it was subject to delisting from the NASDAQ National Market until it filed its Annual Report on Form 10-K to the SEC for the period ended December 31, 2000.
4/30/01	Hamilton made a $592,208 "golden parachute" payment to the Chairman/CEO's spouse, a former executive vice president of Hamilton.
5/4/01	Hamilton's Chairman/CEO sent a letter to OCC advising the appointment of an "Oversight Director." Shortly thereafter, this director became "Managing Director" and then "Chief Operating Officer." The director resigned as "Chief Operating Officer" on September 30, 2001, and as a director effective October 31, 2001.
5/7/01	OCC started a full scope on-site examination. The exam was completed in February 2002 and resulted in composite and CAMELS ratings of 5/455543.
5/16/01	Hamilton Bancorp publicly announced that its operating results for the year ended December 31, 1999, and the first 9 months of 2000 would be restated primarily to record provisions for ATRRs similar to amounts recorded in Hamilton's regulatory call reports. The reported net income of $18.4 million for year ended December 31, 1999, was revised to a net loss of $2.2 million. The reported net incomes/loss of $8.4 million, $7.6 million and $(5.6) million for the first three quarters of 2000 were revised to $5.4 million, $7.1 million, and $(17.9) million, respectively.
6/8/01	Hamilton Bancorp filed its 2000 annual 10-K and March 2001 first quarter 10-Q with SEC. On April 19 and May 22, 2001, the holding company had received NASDAQ Staff Determinations indicating that it was subject to delisting unless and until it filed its 2000 10-K and its March 2001 10-Q.
6/13/01	OCC sent the Hamilton an "undercapitalized" letter.
8/8/01	OCC met with Hamilton regarding the sale of the bank. The holding company hired Canadian Imperial Bank of Commerce to sell both Hamilton Bank and Hamilton Bancorp.

8/24/01	Fitch, a rating firm, lowered its rating for Hamilton Bancorp and Hamilton due to their precarious financial positions following a $24 million after-tax loss for the second Quarter of 2001, which depleted the bank's capital by nearly 24 percent.
9/21/01	Hamilton concluded the sale of $38.3 million in loans and bank placements to borrowers in Ecuador, reducing its Ecuadorian cross border exposure by 66 percent.
9/30/01	Hamilton's call report showed approximately $1.4 billion in assets as of September 30, 2001, and approximately $26.8 million in losses year-to-date.
10/10/01	Hamilton's external auditors resigned.
10/19/01	OCC filed a motion to dismiss the April 5, 2001, lawsuit. In its motion, OCC argued that the court no longer had authority to hear the matter.
10/22/01	Hamilton proposed a global settlement to the pending administrative actions and other outstanding issues. That proposal included incorporating some, but not all, of the proposed amendments to the Consent Order and dismissing with prejudice the CMP proceeding. The bank proposed to develop a business plan acceptable to OCC if OCC would agree to forbear from imposing additional capital requirements as long as the bank remained in compliance with the business plan.
10/31/01	Hamilton's Tier 1 capital was approximately 4.44 percent of total assets.
11/1/01	Hamilton Bancorp publicly announced that it had appointed another independent auditor.
11/19/01	Hamilton Bancorp publicly announced that Hamilton management agreed to increase ALLL by $4.2 million for the 3-month period ended September 30, 2001, as directed by OCC. Planning an appeal, the bank took no action on ALLL for the June 30, 2001, period.
11/20/01	OCC rejected the bank's proposed global settlement. OCC found that the bank's business plan was inadequate because major elements of the

plan were unrealistic. In particular, the bank's proposed capital levels did not reflect either the bank's high level of problem assets or the capital levels required by the Consent Order.

OCC informed Hamilton that the bank was "Undercapitalized" for purposes of PCA. This action was based entirely on the bank's capital ratios according to the bank's balance sheet as of October 31, 2001, and not on the reclassification process. The bank was required to file a Capital Restoration Plan (CRP) by December 4, 2001.

12/01	Hamilton Bancorp was under investigation by the SEC for accounting problems related to its loan loss reserves and disclosures to shareholders. Hamilton Bancorp restated its financial results for 1998, 1999, and most of 2000 to reflect Hamilton's higher losses.
12/19/01	Hamilton Bancorp publicly announced that SEC had issued a formal order of investigation of the company and individuals currently or formerly associated with the company, concerning accounting matters, financial reports, and other public disclosures.
12/26/01	OCC informed Hamilton that the CRP was not acceptable because: (1) the bank did not identify the assets that would be sold or any potential buyers, (2) the CRP provided that the bank would become adequately capitalized by the end of the first quarter of 2002 without a capital injection, but its assumptions left little margin for error, (3) the bank's plan to reach and maintain profitability did not provide for the distinct possibility of a material deterioration in credit quality that would require an increase in the ALLL, and (4) the bank based its 2002 capital ratios on inaccurate 2001 ratios.
1/11/02	OCC appointed FDIC as receiver for Hamilton.

The LLR concluded the following with respect to the quality of OCC's supervision of Hamilton. The LLR determined that:

- OCC appropriately closed the bank before it was critically undercapitalized. FDICIA permits the OCC more supervisory flexibility in closing institutions since it permits early resolution by the regulator. The early resolution of Hamilton was appropriate and may have reduced the ultimate loss to the FDIC insurance fund and helped the OCC avoid additional unnecessary supervisory expenses. To date, there is no information indicating that Hamilton's problems would have been resolved had it been allowed to continue to operate.

- During the mid to late 1990's, which coincided with the emergence of Hamilton's problems, the OCC's supervisory structure and culture may have had an adverse impact on the effectiveness of OCC's supervision. OCC could have taken stronger action. However, when OCC recognized the severity of problems and issues, a more experienced and strong-willed EIC, with a specialized supporting staff to effectively supervise Hamilton, was placed in the bank.

- In 1997, supervisory attention may have been inappropriately relaxed shortly after a significant capital injection resulting from the IPO. OCC was slow to test and verify the quality of the bank's assets during this growth period. While classified asset numbers remained at a modest level until 1999, the risk profile of the bank steadily increased.

- Even though the composite and CAMELS ratings indicated that the institution was in a satisfactory to good condition, the OCC examiners appropriately assigned risk assessments to reflect a moderate level of risk in key management and credit areas. Higher risk profiles were properly reflected in the assigned risk assessments as the composite and CAMELS ratings declined. Even when the bank's capital position improved significantly in 1997 due to the sizeable injection, the OCC examiners recognized the increase in the credit risk profile. However, in 1997, a stable rating was assigned to strategic risk even though additional capital altered the business plan and included more high-risk business activities.

- OCC asked bank management to reduce the emerging countries concentrations and the bank's assets in the months prior to the closing the bank. The reduction of several areas of concentrations as well as the volume of bank assets was achieved.

- Supervision of the bank's early efforts to comply with the initial Safety and Soundness Notice did not conform to OCC policy. The lack of timely, substantive feedback, such as the absence of substantive Supervisory Monitoring System (SMS)[27] documentation supporting the monthly offsite monitoring, the minimal documentation of compliance during the quarterly reviews, and the failure to verify the information obtained from the quarterly reviews, allowed uncorrected deficiencies to remain. Additionally, bank management provided misleading and deceptive information, which contributed to a deteriorating relationship between the regulators and management, and hindered OCC's efforts to provide feedback or conclusions.

- Some of the deficiencies that contributed to the demise of the institution existed in varying degrees in the years prior to the decline in the bank's CAMELS ratings. OCC must continue to hold the board and management accountable and take prompt action if noted deficiencies are not corrected within the applicable timeframe. Since 1997, the OCC has implemented supervision tools to identify institutions with increasing levels of risk.

- The bank filed numerous appeals to the Ombudsman, which created additional administrative burdens. However, the appeals did not materially impact OCC's supervisory and enforcement initiatives. If anything, the appeals caused

[27] SMS is an automated system used by OCC to record and communicate narrative and statistical information on institutions of supervisory interest to the OCC.

OCC examiners to document their findings more thoroughly. The Chairman/CEO manipulated the OCC supervisors in several ways. He withheld information, provided misleading information, and provided inconsistent information between the Ombudsman and the supervisory office. The bank demonstrated a well thought out pattern of resistance to OCC supervisory efforts, as evidenced by the numerous Ombudsman appeals demonstrating bank management's unwillingness to comply and to take needed action.

Regarding bank accountability, including the causes for failure, the LLR found:

- Hamilton's board consisted of a core group of directors throughout its history. The Chairman/CEO's domination of the board and its failure to institute corrective measures were key reasons for the bank's failure.

- Management's attempts to cover up problems and to mislead and undermine OCC's efforts hampered the supervision process.

Regarding "red flags" at Hamilton, the LLR found:

- The common theme in all enforcement actions taken against Hamilton was the absence of risk management systems and controls. The absence of adequate risk management systems and controls was particularly evident in the lending-related functions.

- In 1998, the high-risk profile and aggressive growth strategy began to have an impact on profitability.

- Asset growth rates were consistently high until 1999.

- Hamilton's country risk exposure at year-end 2000 placed it in the top ten financial institutions nationally. Much of this exposure was concentrated in countries suffering economic instability and in emerging markets.

- Bank management was not willing to recognize problems and strongly resisted OCC efforts. The greatest impediment to OCC examiners was dealing with untruthful and uncooperative bank management. Management's questionable practices and activities were evident throughout OCC's supervisory history with Hamilton. However, OCC believed that the evidence was not clear enough to take action in many cases.

The LLR project team also concluded that:

- The supervisory activities associated with Hamilton represented an unprecedented example of regulatory cooperation.

- OCC incurred significant supervisory costs and losses against assessments during Hamilton's decline to composite "4" and "5" ratings.

- The supervision of Hamilton required a resource-intensive and highly coordinated/cooperative effort by everyone involved. OCC has taken actions that were responsive to issues raised during the supervision of Hamilton and in response to some conclusions described in the LLR report.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Donald R. Kassel, National Director of Banking and Fiscal Service Audits

From: Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel

Date: December 17, 2002

Subject: OIG Draft Audit Report – Hamilton Bank, N.A.

We have received and reviewed your draft audit report titled *Material Loss Review of Hamilton Bank, N.A.* The Office of the Comptroller of the Currency closed Hamilton Bank, N.A. (Hamilton) on January 11, 2002 after finding that the bank was undercapitalized and suffered from deteriorating asset quality, poor earnings, a high level of non-performing loans, and sharply declining capital levels. The Federal Deposit Insurance Act mandated your review of the failure, because the Federal Deposit Insurance Corporation (FDIC) estimated that there would be a material loss to the deposit insurance fund.

Consistent with the purposes of the review, you found that the bank failed due to aggressive growth and asset concentrations in foreign markets, increased credit risk due to weak underwriting, inadequate risk management systems and controls and an ineffective board and non-responsive management. You also found that the OCC's on-site examinations and resulting enforcement actions could have been more forceful between 1992 and 1997; OCC did not follow up on a timely basis on 1998 examination deficiencies; and supervision and enforcement from 1999 to closing was adequate but too late to effectively address the bank's problems.

As your report indicates, bank management had a well-established pattern of non-responsiveness. We believe that it is important to point out that the OCC, in dealing with the bank's recalcitrant management and directorate, took a myriad of different and forceful administrative and supervisory actions in an effort to correct the problems and deficiencies noted in OCC examinations and to obtain corrective actions by the bank. Specifically, the OCC issued a safety and soundness notice of deficiency in 1998. Subsequently, the OCC issued a formal Order of Investigation and amended and expanded it four times in order to address additional areas of concern and suspected fraud at the bank. The OCC also issued three new or amended Notices of Charges seeking cease and desist orders; two Temporary Cease and Desist Orders within a period of 13 months – one of which was unsuccessfully contested by the bank in District Court; two permanent cease and desist orders against the bank; a Notice of Assessment of civil money penalties against various directors of the bank; a Notice of Intention to reclassify the bank's Prompt Corrective Action (PCA) category from adequately capitalized to undercapitalized – which notice the OCC successfully supported at an administrative hearing;

and a requirement that the bank file a Capital Restoration Plan. It should also be noted that during this time the bank filed two different lawsuits against the OCC in District Court, which the OCC successfully defended. At one point in time, in mid-2001, the OCC was responding to the bank's complaint to the Department of the Treasury's Office of Inspector General, pursuing an action to formally downgrade the bank's PCA level, defending the issuance of its second Temporary Cease and Desist Order in District Court, and preparing to litigate an expanded Notice of Charges against the bank. Despite these numerous efforts to obtain corrective action, as your report recognizes, they were consistently resisted by the bank, were ultimately unsuccessful in achieving the necessary corrective measures by the bank, and finally culminated in the OCC placing the bank into receivership at a time when it was reporting in excess of 4% Tier I capital.

Nevertheless, we concur with your findings and agree to implement your recommendations. Over the next few weeks, we will be formulating action plans detailing the steps we will take to implement the recommendations. The actions will be formally reported and monitored through the Department's Joint Audit Management Enterprise System (JAMES).

Thank you for the opportunity to review and comment on the draft report.

Office of Inspector General, Office of Audit

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U.S. Department of the Treasury

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Office of the Assistant Secretary for Public Affairs
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