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national bank, state bank, District bank, or savings association, and an insured branch of a foreign bank.

(b) *Commonly-controlled correspondent* means a correspondent that is commonly controlled with the bank and for which the bank is subject to liability under section 5(e) of the Federal Deposit Insurance Act. A correspondent is considered to be commonly controlled with the bank if:

(1) 25 percent or more of any class of voting securities of the bank and the correspondent are owned, directly or indirectly, by the same depository institution or company; or

(2) Either the bank or the correspondent owns 25 percent or more of any class of voting securities of the other.

(c) C*orrespondent* means a U.S. depository institution or a foreign bank, as defined in this part, to which a bank has exposure, but does not include a commonly controlled correspondent.

(d) *Exposure* means the potential that an obligation will not be paid in a timely manner or in full. ''Exposure'' includes credit and liquidity risks, including operational risks, related to intraday and interday transactions.

(e) *Foreign bank* means an institution that: (1) Is organized under the laws of a country other than the United States;

(2) Engages in the business of banking;

(3) Is recognized as a bank by the bank supervisory or monetary authorities of the country of the bank's organization;

(4) Receives deposits to a substantial extent in the regular course of business; and

(5) Has the power to accept demand deposits.

(f) *Primary federal supervisor* has the same meaning as the term ''appropriate Federal banking agency'' in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813).

(g) *Total capital* means the total of a bank's Tier 1 and Tier 2 capital under the risk-based capital guidelines provided by the bank's primary federal supervisor. For an insured branch of a foreign bank organized under the laws of a country that subscribes to the principles of the Basel Capital Accord, ''total capital'' means total Tier 1 and Tier 2 capital as calculated under the standards of that country. For an insured branch of a foreign bank organized under the laws of a country that does not subscribe to the principles of the Basel Capital Accord, ''total capital'' means total Tier 1 and Tier 2 capital as calculated under the provisions of the Accord.

(h) *U.S. depository institution* means a bank, as defined in §206.2(a) of this part, other than an insured branch of a foreign bank.

[Reg. F, 57 FR 60106, Dec. 18, 1992, as amended by Reg. F, 68 FR 53283, Sept. 10, 2003]

§ 206.3 Prudential standards.

(a) *General.* A bank shall establish and maintain written policies and procedures to prevent excessive exposure to any individual correspondent in relation to the condition of the correspondent.

(b) *Standards for selecting correspondents.* (1) A bank shall establish policies and procedures that take into account credit and liquidity risks, including operational risks, in selecting correspondents and terminating those relationships.

(2) Where exposure to a correspondent is significant, the policies and procedures shall require periodic reviews of the financial condition of the correspondent and shall take into account any deterioration in the correspondent's financial condition. Factors bearing on the financial condition of the correspondent include the capital level of the correspondent, level of nonaccrual and past due loans and leases, level of earnings, and other factors affecting the financial condition of the correspondent. Where public information on the financial condition of the correspondent is available, a bank may base its review of the financial condition of a correspondent on such information, and is not required to obtain non-public information for its review. However, for those foreign banks for which there is no public source of financial information, a bank will be required to obtain information for its review.

(3) A bank may rely on another party, such as a bank rating agency or the bank's holding company, to assess

the financial condition of or select a correspondent, provided that the bank's board of directors has reviewed and approved the general assessment or selection criteria used by that party.

(c) *Internal limits on exposure.* (1) Where the financial condition of the correspondent and the form or maturity of the exposure create a significant risk that payments will not be made in full or in a timely manner, a bank's policies and procedures shall limit the bank's exposure to the correspondent, either by the establishment of internal limits or by other means. Limits shall be consistent with the risk undertaken, considering the financial condition and the form and maturity of exposure to the correspondent. Limits may be fixed as to amount or flexible, based on such factors as the monitoring of exposure and the financial condition of the correspondent. Different limits may be set for different forms of exposure, different products, and different maturities.

(2) A bank shall structure transactions with a correspondent or monitor exposure to a correspondent, directly or through another party, to ensure that its exposure ordinarily does not exceed the bank's internal limits, including limits established for credit exposure, except for occasional excesses resulting from unusual market disturbances, market movements favorable to the bank, increases in activity, operational problems, or other unusual circumstances. Generally, monitoring may be done on a retrospective basis. The level of monitoring required depends on:

(i) The extent to which exposure approaches the bank's internal limits;

(ii) The volatility of the exposure; and

(iii) The financial condition of the correspondent.

(3) A bank shall establish appropriate procedures to address excesses over its internal limits.

(d) *Review by board of directors.* The policies and procedures established under this section shall be reviewed and approved by the bank's board of directors at least annually.

[Reg. F, 57 FR 60106, Dec. 18, 1992, as amended by Reg. F, 68 FR 53283, Sept. 10, 2003]

§ 206.4 Credit exposure.

(a) *Limits on credit exposure.* (1) The policies and procedures on exposure established by a bank under § 206.3(c) of this part shall limit a bank's interday credit exposure to an individual correspondent to not more than 25 percent of the bank's total capital, unless the bank can demonstrate that its correspondent is at least adequately capitalized, as defined in § 206.5(a) of this part.

(2) Where a bank is no longer able to demonstrate that a correspondent is at least adequately capitalized for the purposes of § 206.4(a) of this part, including where the bank cannot obtain adequate information concerning the capital ratios of the correspondent, the bank shall reduce its credit exposure to comply with the requirements of § 206.4(a)(1) of this part within 120 days after the date when the current Report of Condition and Income or other relevant report normally would be available.

(b) *Calculation of credit exposure.* Except as provided in §§ 206.4 (c) and (d) of this part, the credit exposure of a bank to a correspondent shall consist of the bank's assets and off-balance sheet items that are subject to capital requirements under the capital adequacy guidelines of the bank's primary federal supervisor, and that involve claims on the correspondent or capital instruments issued by the correspondent. For this purpose, off-balance sheet items shall be valued on the basis of current exposure. The term ''credit exposure'' does not include exposure related to the settlement of transactions, intraday exposure, transactions in an agency or similar capacity where losses will be passed back to the principal or other party, or other sources of exposure that are not covered by the capital adequacy guidelines.

(c) *Netting.* Transactions covered by netting agreements that are valid and enforceable under all applicable laws may be netted in calculating credit exposure.

(d) *Exclusions.* A bank may exclude the following from the calculation of credit exposure to a correspondent:

(1) Transactions, including reverse repurchase agreements, to the extent