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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

that the transactions are secured by government securities or readily marketable collateral, as defined in paragraph (f) of this section, based on the current market value of the collateral;

(2) The proceeds of checks and other cash items deposited in an account at a correspondent that are not yet available for withdrawal;

(3) Quality assets, as defined in paragraph (f) of this section, on which the correspondent is secondarily liable, or obligations of the correspondent on which a creditworthy obligor in addition to the correspondent is available, including but not limited to:

(i) Loans to third parties secured by stock or debt obligations of the correspondent;

(ii) Loans to third parties purchased from the correspondent with recourse;

(iii) Loans or obligations of third parties backed by stand-by letters of credit issued by the correspondent; or

(iv) Obligations of the correspondent backed by stand-by letters of credit issued by a creditworthy third party;

(4) exposure that results from the merger with or acquisition of another bank for one year after that merger or acquisition is consummated; and

(5) The portion of the bank's exposure to the correspondent that is covered by federal deposit insurance.

(e) *Credit exposure of subsidiaries.* In calculating credit exposure to a correspondent under this part, a bank shall include credit exposure to the correspondent of any entity that the bank is required to consolidate on its Report of Condition and Income or Thrift Financial Report.

(f) *Definitions.* As used in this section:

(1) *Government securities* means obligations of, or obligations fully guaranteed as to principal and interest by, the United States government or any department, agency, bureau, board, commission, or establishment of the United States, or any corporation wholly owned, directly or indirectly, by the United States.

(2) *Readily marketable collateral* means financial instruments or bullion that may be sold in ordinary circumstances with reasonable promptness at a fair market value determined by quotations based on actual transactions on an auction or a similarly available daily bid- ask-price market.

(3)(i) *Quality asset* means an asset:

(A) That is not in a nonaccrual status;

(B) On which principal or interest is not more than thirty days past due; and

(C) Whose terms have not been renegotiated or compromised due to the deteriorating financial conditions of the additional obligor.

(ii) An asset is not considered a ''quality asset'' if any other loans to the primary obligor on the asset have been classified as ''substandard,'' ''doubtful,'' or ''loss,'' or treated as ''other loans specially mentioned'' in the most recent report of examination or inspection of the bank or an affiliate prepared by either a federal or a state supervisory agency.

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

§ 206.5 Capital levels of correspondents.

(a) *Adequately capitalized correspondents.*[1] For the purpose of this part, a correspondent is considered adequately capitalized if the correspondent has:

(1) A total risk-based capital ratio, as defined in paragraph (e)(1) of this section, of 8.0 percent or greater;

(2) A Tier 1 risk-based capital ratio, as defined in paragraph (e)(2) of this section, of 4.0 percent or greater; and

(3) A leverage ratio, as defined in paragraph (e)(3) of this section, of 4.0 percent or greater.

(b) *Frequency of monitoring capital levels.* A bank shall obtain information to demonstrate that a correspondent is at least adequately capitalized on a quarterly basis, either from the most recently available Report of Condition and Income, Thrift Financial Report, financial statement, or bank rating report for the correspondent. For a foreign bank correspondent for which quarterly financial statements or reports are not available, a bank shall

[1] As used in this part, the term ''adequately capitalized'' is similar but not identical to the definition of that term as used for the purposes of the prompt corrective action standards. See, *e.g.* 12 CFR part 208, subpart D.