



October 22, 2012

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 2-3
Washington, DC 20219

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Attention: Jennifer J. Johnson, Secretary

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
Attention: Comments/Legal/Robert E. Feldman, Executive Secretary

Re: Comments on Basel III and Standardized Approach NPRs
OCC Docket ID OCC 2012-0008, OCC Docket ID OCC-2012-0009
Federal Reserve Board Docket No. R-1442
FDIC Docket RIN 3064-AD95, AD96
Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III,
Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions,
And Prompt Corrective Action

Ladies and Gentlemen:

Commerce Bancshares, Inc. (Commerce) is a super community regional bank with \$20 billion in assets offering an array of sophisticated financial products and traditional banking services mainly in the mid-west – Missouri, Kansas, Illinois, Oklahoma, and Colorado. We appreciate the opportunity to comment on the proposed capital rules.

In a speech given at a Regulatory Symposium in September, Federal Deposit Insurance Corp. board member Thomas Hoenig, the former president of the Federal Reserve Bank of Kansas City, said that the proposed Basel III rules are too complex and should be replaced by simpler rules that rely primarily on a bank's ratio of tangible equity to tangible assets. Mr. Hoenig was critical not only of the complicated rules governing capital but also worried about the steep learning curve for directors, managers and

supervisory staff as well as the huge new costs involved in implementing these new rules. Mr. Hoenig advocated higher required capital levels but much simpler rules.

At Commerce, we strongly agree with Mr. Hoenig. At over 750 pages of technical requirements which contain, among many provisions, new definitions of capital and new ways of determining risk weights for assets, this new proposed capital regulation introduces new forms of interest rate risk into the banking system, requires large new costs for IT systems required to track new required data, requires new personnel costs to comply with this vast new regulation, and will require significant, additional time and costs spent by regulatory exam personnel to monitor and track compliance.

Commerce has operated as a large regional bank in the Midwest of the United States for over 140 years. We are one of only two of the highest rated banks by Moody's globally. Our financial performance, including measures like return on assets and equity, has ranked consistently among top performing banks in the U.S. During the recent financial crisis, we never took TARP funds, never lost money in any quarter and operated with some of the highest capital levels among both mid and large cap banks. These results occurred from strong management oversight, conservative beliefs, a strong credit underwriting culture, strong liquidity and attention to detail. Most importantly we believe in strong capital levels and over the years have maintained capital levels well above the minimum amounts required to be considered well capitalized under Basel I rules.

While there can be much said about the existing Basel I rules, used by virtually all banks except a few of the very largest banks, Basel I has been in place for over 20 years, is not overly complex, and is well understood by all bankers.

Basel III is voluminous, complicated, and may well introduce a large number of new unintended consequences into the banking system. The proposal to include unrealized gains and losses of investment securities in capital is just one example of important new risks being introduced into this system. Add in the huge new costs of compliance and this new proposed regulation becomes untenable.

We believe that, as currently proposed, banks should hold higher levels of quality (common) capital than had previously been required. Had banking institutions been asked to keep Tier 1 risk based capital at 8% levels rather than 6% under Basel I rules, it is likely that far fewer banks would have failed. Further, had emphasis been placed on common equity instead of the various forms of "equity-like" debt, we believe the recent crisis would not have affected so many banks as severely.

Over the last decade up to the crisis, banks were allowed to reduce capital levels and, especially through Basel II, use internal models to keep capital levels low. A key lesson learned through this crisis was that capital matters, but also that bank management must perform and regulators must oversee and enforce good banking practices.

While we believe that simple Basel I rules with newly proposed higher capital standards would adequately address risk, the following comments specifically address several important issues in the new proposed rules.

Question 15 in the Regulatory Capital Rules NPR States:

To what extent would a requirement to include unrealized gains and losses on all debt securities whose changes in fair value are recognized in AOCI (i) result in excessive volatility in regulatory capital; (ii) impact the levels of liquid assets held by banking organizations; (iii) affect the composition of the banking organization’s securities portfolios; and (iv) pose challenges for banking organizations’ asset-liability management?

(i) Excessive volatility in regulatory capital

We, like many banks, rely heavily on our fixed-rate securities portfolio to prudently manage interest rate risk. Our portfolio also serves as a key source of liquidity and is largely funded with stable deposits.

While our bank maintains very strong capital ratios comprised almost solely of common equity, this proposal could result in significant volatility in our reported regulatory ratios. For illustrative purposes, the table below indicates the level of volatility in capital numbers that a fictitious, but typical conservative bank might expect based on this proposal.

Representative Conservative Bank – a \$10 billion regional bank

Assets	\$10,000,000,000
Securities – Agency debt - at market	\$3,500,000,000
Securities portfolio has a 2.5yr duration	
Risk-based capital	\$1,000,000,000
Risk weighted assets	\$8,000,000,000
Total capital required at 10.5%	\$840,000,000

The chart below shows the impact to capital that interest rate driven adjustments to securities would create if rates increase 200 and 400bp’s.

	<u>Current</u>	<u>Rates Rise 200bp's</u>	<u>Rates Rise 400bp's</u>
Required Capital \$	840,000,000	840,000,000	840,000,000
Required as a % of RWA	10.5%	10.5%	10.5%
Actual Risk-Based Capital \$	1,000,000,000	886,250,000	772,500,000
Actual Risk-Based Capital Ratio	12.5%	11.1%	9.7%
Capital Volatility Due to Unrealized Securities Losses			
Change in Market Value \$		-113,750,000	-227,500,000
Ratio Change		-1.4%	-2.8%
Over/Under Required	160,000,000	46,250,000	-67,500,000
Over/Under Required	2.0%	0.6%	-0.8%
Decrease in Lending Capacity at 10% capitalization		-1,137,500,000	-2,275,000,000

In the example, Representative Conservative Bank would go from a 12.5% total risk-based capital ratio to being under-capitalized simply due to rates moving modestly higher.

Note that this change is purely interest rate rather than credit driven. This bank would not expect to actually lose any money on these Agency securities.

This is a simple example but illustrates the level of volatility that will be introduced if the AOCI filter is removed. The last line in the chart illustrates the lending capacity that would be lost, assuming 10% capitalization, from this bank due simply to this proposal.

Based on securities portfolios of all banks, this could reduce U.S. lending capacity by as much as \$2-3 Trillion in a scenario where rates rise 4%.

Deferred tax assets

While not shown in the example above, capital volatility would be even larger due to the proposed “limited recognition” of deferred tax assets to 10% of common equity. Per current accounting standards, unrealized gains and losses on securities are tax-adjusted such that deferred tax assets are created when unrealized losses exist, reducing the total net amount of unrealized losses. Today, these tax assets are not limited when calculating capital. If the AOCI filter is removed and the tax asset limited, as proposed, then breaching the 10% limit will result in even greater volatility in capital. Capital lost in the example above would increase and lending capacity decline further.

We believe that the significant volatility created by this proposal and cap on deferred tax asset creates *less confidence in capital ratios* as a barometer of adequacy and as a cushion to contain losses.

(ii) Impact on the level of liquid assets held by banking organizations

If anything, we believe that this proposal will reduce the level of liquid assets held by banks. Most banks hold securities that are highly liquid with little credit risk. Since even the safest, most liquid securities will create significant volatility in capital ratios simply due to changes in rates, there will be little incentive to shift portfolios to the highest quality securities. In other words, there would be little incentive to increase holdings of highly liquid securities.

Importantly, as explained in (iv) below, banks would need to manage to the potential volatility introduced by this proposal which likely would result in less liquidity. Banks might use derivatives, thereby tying up liquid securities, or move securities to the Held to Maturity category, also limiting liquidity and flexibility.

(iii) Affect the composition of the securities portfolio

We believe that this proposal could significantly alter the composition of securities portfolios as noted in (iv) below. Banks would be forced to manage to the volatility risk created by the one-sided nature of this proposal as well as to the risk of the bank as a whole. Banks might respond by significantly shortening securities to limit market value exposure. Derivatives could be used to make the risk profile for the bank as a whole correct again. This would mean that longer securities like Treasury and Municipal bonds as well as mortgage-backed securities would be sold off, significantly steepening the long end of the yield curve. Mortgage and government finance would be adversely affected and home prices would be negatively impacted.

(iv) Challenges for asset/liability management

Most banks buy fixed rate securities for liquidity purposes and to manage the interest rate risk exposure created by basic core banking activities. Core banking activities generally create a mismatch in interest rate risk exposure because the repricing and maturities of loans are generally much shorter than those of deposits.

This proposal looks at only one piece of one side of the balance sheet – the securities portfolio.

Removing the AOCI filter fails to recognize the fact that most longer securities are funded with core deposits that most banks believe have similar or longer durations. If rates rise, banks would recognize that as their securities lose value their deposits (obligations) gain value, off-setting much of the loss. This is sound interest rate risk management practice.

A well run bank performs extensive interest rate risk management analyses every month. Well run banks make hedging decisions based on the performance of *the entire balance*

sheet as rates change. Large changes in rates could have significant implications for regulatory capital under this proposal which could influence banks' ability to hedge the entire balance sheet – *economically sound decisions for any bank could be compromised if forced to modify decisions that are in the best interest of the bank as a whole in order to limit mark-to-market implications from one piece of our balance sheet.*

How banks might react to managing to this additional risk

As noted in (iii), reducing market value volatility in the bond portfolio due to rate changes would require shortening the securities portfolio. A bank might choose to do this because a shorter duration portfolio would experience less volatility in market value changes. We can assume that a bank has positioned the portfolio to appropriately address risk to the bank as a whole such that any deviation (shortening) from this would be contrary to prudent interest rate risk management.

Once the securities portfolio has been shortened to address capital volatility, the bank's overall interest rate risk profile is no longer correct. A shortened securities portfolio could be synthetically converted back to longer assets using derivatives in order to re-create the correct risk profile for the bank as a whole. In other words, banks would sell longer securities and buy shorter securities and use derivatives to re-lengthen them. This does not seem like something regulators would like to see. It would also likely not be possible from a hedge accounting perspective. Furthermore, if most banks chose this option, the level of financial institution connectedness could be extreme such that concentration of counter-party derivatives exposure could present systemic risks.

If the securities portfolio were shortened, another option to re-create the appropriate risk profile would be to shorten liabilities in order to maintain an appropriate mismatch. However, much of bank funding is long-term, non-contractual funding, such that this re-positioning would require adding more short-term wholesale funding – this would clearly be at odds with the proposed liquidity standards (LCR and NSFR).

Finally, a bank might elect to move some or most securities from Available for Sale to Held to Maturity simply to avoid this proposed rule. Not only would this result in much less flexibility but reduce liquidity. It also appears that the FASB may remove this category anyway.

Because of the complexity and risks involved in these potential solutions to this NPR, banks would not be able to employ effective asset/liability management and maintain a safe level of capital volatility at the same time. We feel strongly that this outcome should be prevented and address that in response to 'Question 16' below.

Question 16 in the Regulatory Capital Rules NPR States:

What are the pros and cons of an alternative treatment that would allow U.S. banking organizations to exclude from regulatory capital unrealized gains and losses on debt securities whose changes in fair value are predominately attributable to fluctuations in a benchmark interest rate (for example, U.S. government and agency debt obligations and U.S. GSE debt obligations)? In the context of such an alternative treatment, what other categories of securities should be considered and why? Are there other alternatives that the agencies should consider (for example, retaining the current treatment for unrealized gains and losses on AFS debt and equity securities)?

We strongly believe that excluding unrealized gains and losses on debt securities whose changes in fair value are predominately attributable to fluctuations in a benchmark interest rate is appropriate for the reasons discussed in question 15 above.

Most banks rely heavily on these high-quality securities (Treasuries, agency debt and agency MBS) as safe sources of liquidity. As a result, these securities comprise a large percentage of banks' holdings. Excluding these securities would significantly limit capital volatility produced only by rate changes and go a long way towards limiting challenges created to employ effective asset/liability management.

Excluding these securities would also increase the level of liquid assets held by banks by encouraging banks to hold these assets which, in times of stress, will remain highly desirable due to their lack of credit risk.

One important negative result to specifically excluding just these securities is that banks would be incented to significantly reduce holdings of other securities. This would include municipal securities as well as highly rated securities backed by student, auto, and credit card loans. As demand for these securities declines, prices would decline and yields rise, in turn increasing the cost to the underlying borrowers. While it is hard to gauge the level by which costs would rise, it is likely that municipalities will suffer the most, as banks would reduce holdings of these longest securities which experience larger market value swings as rates change.

While we strongly encourage the elimination of U.S. government, agency debt and agency mortgage backed securities from this proposal, we also believe that it would be appropriate to consider other securities as well. This would include highly rated municipal securities as well as highly rated securities backed by student, auto, and credit card loans. Many of these securities are structured such that the risk of credit losses is extremely low, such that changes in market values are almost solely due to market rate changes. In times of severe stress, these securities may experience temporary market value losses simply due to a freeze in capital markets' activity and not reflect expected losses. The main benefit to including these highly rated securities as well as government and Agency securities would be to maintain a high level of demand, keeping borrowing costs for consumers and municipalities low. *We would encourage some recognition that changes in these highly rated securities are generally purely rate driven.*

The following relate to issues other than capital volatility from AOCI

Qualifying Capital Instruments Issued by Consolidated Subsidiaries of a Banking Organization

Proposed rules would limit the amount of capital issued by subsidiaries that could be included in the regulatory capital of the parent company. Specifically, if a consolidated subsidiary has regulatory capital in excess of the sum of its minimum capital requirement plus the required capital conservation buffer, the minority interest that contributes to the excess would not be includable in the parent company's regulatory capital. Our concern is that this would unnecessarily limit the recognition of Tier 2 capital, specifically subordinated debt, at the Holding Company when issued by the bank.

This makes sense for very large organizations with multiple subsidiaries of substance. However, this limitation should not apply to a holding company that conducts substantially all its business activities in its depository institution subsidiary and therefore has limited exposure to losses outside that subsidiary. Many banks find that subordinated debt provides a cost-efficient form of capital. Limiting the amount of bank-issued subordinated debt that could be included in the parent holding company's tier 2 capital would create a significant disincentive for raising such capital. Furthermore, because the proposed limitation would require deductions from the parent holding company's regulatory capital as minority investments in the subsidiary bank increase the regulatory capital of the bank, it would appear that the holding company is being penalized for increased capital adequacy at the subsidiary bank. Finally, and most importantly, when a holding company issues subordinated debt, the holding company liquidity risk profile may become an issue from a debt service or roll over perspective which could be avoided if issued from the banking subsidiary.

We suggest the elimination of this proposal on bank-level subordinated debt for banking companies with a single banking subsidiary and few risk weighted assets in non-bank subsidiaries of the holding company.

Risk weighted assets for residential mortgage exposures

We would like to comment on the following concerning mortgage exposure:

Risk weights appear excessive. It seems that the new risk weights have been heavily influenced by the recent financial crisis and do not reflect the riskiness of new mortgages made by banks. Post the financial crisis, market forces and regulatory developments have made mortgage underwriting standards extremely rigorous. In fact, the Fed has noted the significant increase in lending standards as a key factor holding back the housing market. Also, the proposal itself states that category 1 mortgages would, by

definition, not include risky structures and underwriting practices. The CFPB was created to enforce these standards.

The overwhelming majority of poorly underwritten mortgage loans which contributed to the crisis were not made by federally regulated and supervised banks, but mortgage banks and brokers. This proposal would introduce unnecessarily high capital charges on banks which will increase the cost to consumers and slow the economic recovery.

The proposed standardized risk weight approach attempts to gain more granularity in assessing risk by taking loan-to-value into account. While we agree that LTV is an important factor in assessing risk, the credit worthiness of the borrower is probably more important; this proposal still fails to look at specific customer risk. A customer with a suspect credit record would generate the same level of capital for the bank as a pristine customer all else equal, regardless of LTV. As noted, we believe that the risk weights as proposed are more representative of weaker borrowers (or poorly underwritten mortgages pre-crisis) in general rather than the average mortgage underwritten to high standards today.

We would also note that the risk weight for Tier 2 mortgages at 200% is higher than the risk weight for unsecured borrowings which seems excessive.

2nd lien home equity lines ‘tainting’ 1st liens should be re-examined. We understand the desire of policy makers to create rules to limit ways to ‘game the system’. In this case, to dis-incent banks from making an 80% LTV first loan with a ‘piggyback’ of 20% rather than a 100% LTV first lien, thereby receiving a lower all-in risk weight. However, as written, this proposal would make a second lien cost-prohibitive for the bank with the first lien by increasing the risk weight on the first. Essentially, the second lien would have a risk weight of 600% by increasing the cost of the first. This would result in the second being too expensive for the bank with the first lien to make. Another bank could make this same loan and receive a risk weight of 200% as proposed.

A solution to this might be to only apply this methodology to loans made contemporaneously or within a short period of time. This would eliminate banks’ ability to ‘game the system’ while allowing the bank with the first lien to compete on equal footing.

The definition of category 1 should be changed. Category 1 should not automatically exclude balloon and interest only mortgages. There is no evidence that we are aware of that, if properly underwritten to credit worthy customers, these loans will perform any worse than standard fully amortizing loans. In fact, these loans are popular with many of our most credit worthy, wealthier customers. These products are important to reduce costs for customers and should not be unilaterally excluded from category 1.

Capital Conservation Buffer

The proposal would mandate a capital conservation buffer of 250bp's on top of minimum levels. Banks would need to hold this additional capital in order to avoid limitations of capital distributions. We believe that the combination of the minimum plus the buffer will serve as the de facto minimum. To maintain the combined minimum, banks will feel compelled to hold a buffer over the buffer (especially if the AOCI filter is removed). We would ask that regulators consider these additional layers of capital when establishing the level of the buffer; especially for banks that engage primarily in traditional banking activities. Additionally, clarification as to whether the buffer applies to both the bank and the holding company would be helpful. And, does capital over the buffer imply 'well capitalized'?

Please contact us if we can clarify anything in the comments above.

Sincerely,

Charles Kim
Chief Financial Officer

Michael Bude
Treasurer