Commerce Bancshares, Inc.

1000 Walnut, BB 18-8
Kansas City, MO 64106

ROBERT C. MATTHEWS, JR.
EXECUTIVE VICE PRESIDENT
CHIEF RISK OFFICER

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Communications Division, Third Floor
Office of the Comptroller of the Currency
250 E Street SW
Washington D. C. 20219
regs.comments@occ.treas.gov

Ms. Jennifer J. Johnson
Secretary, Board of Governors of the
Federal Reserve System
20th Street and Constitution Ave NW
Washington D. C. 20551
regs.comments@federalreserve.gov

Re: Docket No. 03-

Re: Docket No. R-

Re: **Risk Based Capital Guidelines; Implementation of the New Basel Capital Accord**

Commerce Bancshares, Inc. (NASDAQ: CBSH) is a $13.6 billion regional bank holding company. For more than 135 years, Commerce has been meeting the financial services needs of individuals and businesses. Commerce provides a diversified line of financial services, including business and personal banking, wealth management and estate planning, and investments through its affiliated companies. Commerce Bancshares operates in more than 340 locations across Missouri, Kansas, and Illinois and also has operating subsidiaries involved in mortgage banking, credit related insurance, venture capital and real estate activities.

Commerce appreciates the opportunity to comment on the Advance Notice of Proposed Rule Making (ANPR) in relation to the implementation of the new Basel Capital Accord (Basel II) in the United States. Comments are centered on the following concerns:

- **Basel II is formula based, unnecessarily complex and costly to implement, especially related to value received**
- **The bifurcated supervisory framework is vague, and has the potential of putting many banks, such as Commerce, into a difficult position with regard to “opt-in” or “opt-out”**
- **There is a potential competitive disadvantage between banks that opt-in and opt-out**
- **The Operational Risk Capital Charge remains open to much debate**
- **Pillar III requirements are burdensome**
- **The Capital Requirements for Various Types of Assets may not make sense**

Basel II is formula based, unnecessarily complex and costly to implement

Basel II shifts emphasis toward a highly complex, formula based system, which will diminish the role that is currently played by human judgment, both by banks and their regulatory supervisors. These international rules will bring a more inflexible style of regulation to the United States, which traditionally has a more flexible, and reasonable, balance between "black and white" rules and supervisory interaction. Further, the estimates of the costs of implementation are truly staggering. Some of this cost does not appear to be variable, which means an undue burden on smaller banks, such as Commerce. Also, the value received is questionable for each institution and for the industry as a whole. If the QIS III is any guide, most banks will be more capitalized than they are today. Given our relatively simple structure, this would probably apply to us as well. Since we are already well capitalized under Basel I guidelines, it is hard to justify the expenditure to make us more so.

Basel II is an attempt to recognize the significant transformation in the banking sector since Basel I was implemented 15 years ago. However, the rules are so complex and heavily negotiated, they may be difficult to update over time. Further, Basel II requires banks to use specific processes in many areas, regardless of whether they are relevant for business practices. This could lead to banks either regarding Basel II as a costly and irrelevant regulatory practice, or it could alter bank's internal practices in a manner that is not consistent with the introduction and maintenance of better private sector risk management practices. Neither position should be considered desirable.

It is the position of Commerce that one of the aspects of United States banking that makes us the standard for the world is strong and flexible regulatory supervision. It would seem to make more sense to avoid dictating the form and structure of a bank's risk management system and to focus on simple basic requirements in Pillar I. More weight should be placed on Pillar II, which allows regulatory supervisors to adjust an individual bank's capital requirements on a case by case basis to address risks that are not adequately addressed in the Pillar I calculations.

The bifurcated supervisory framework is vague, and has the potential of putting many banks, such as Commerce, into a difficult position with regard to "opting – in" or "opting-out"

The ANPR suggested a three-tier structure with regard to implementing Basel II. The largest banks (say over $100 billion and publicly traded) will either be required, or strongly encouraged, to adhere to Basel II. The smallest banks (say under $5 billion and generally privately held) are, in essence, not expected to adhere to Basel II. The banks between those two groups have the ability to either adhere to Basel II ("opt-in") or stay out ("opt-out"). However, while the ANPR is graphically explicit on the process of opting-in, more detailed guidelines on the requirements for opting in are missing. While these options are intended to provide alternatives and flexibility, they put banks in this third category, including Commerce, in the awkward position of defending our decision from assault from a number of disparate sources. Our shareholders would question the unnecessary expenditure, while industry analysts might question our business strategies and our commitment to sound risk management practices should we choose non-adherence. If a bifurcated system is considered desirable, then it should be truly bifurcated. For example, all banks above a certain amount (say $75 billion in assets and $5bn in foreign assets) have to adhere to Basel II, and banks under that amount cannot.

There is a potential competitive disadvantage between banks that opt-in and opt-out

Again, if the QIS III is perceived to be an accurate indicator, it would suggest that banks who are at the fringe of minimum capital standards would be given more leeway to maintain an even lower capital requirement. More and more, banks in the US are moving to RAROC measures of relationship profitability and risk adjusted pricing. If capital requirements are lower, pricing can be lower in order to achieve the same return on capital. This has the potential effect of putting better capitalized banks at a even greater competitive disadvantage, or causing them to increase the risk profile of the banking system by lowering overall capital levels to meet the competitive pricing. This does not appear to be a desirable outcome. The potential for reduced capital using advanced IRB methods, and the related marginal benefits to market pricing that might ensue, may not offset the additional risk of lower industry capital from a public policy perspective.

In addition, Basel II only applies to banks. The financial services industry has greatly diversified over the past 15 years, such that much of the most intense competition comes not from other banks, but non-bank entities. If the cost to implement Basel II is high, banks will earn a lower return on capital vis-à-vis these non-banks, will grow more slowly and lose market share. There may even be the incentive to abandon some lines of business altogether.

The Operational Risk Capital Charge remains open to much debate

While the primary effect of the proposal will guide reform for capital charges allocated to credit-related risks, Basel II establishes a capital charge for operational risk, that is, the risk of breakdown in systems and people. It is important to distinguish between the concepts of managing operational risk and imposing a separate quantitative capital requirement for it. While we agree that operational risk is important, and indeed, we have devoted significant physical and financial resources to the issue, we remain uncertain as to whether a capital charge should be allocated. As outlined above, we think this can be better addressed through case-by-case reviews under Pillar II. In any event, there is still much debate on this topic in the industry, and any hasty implementation simply to meet a deadline would appear injudicious.

Pillar III requirements are burdensome

Pillar III seeks to enhance market discipline through increased public disclosure requirements. While Commerce is firmly committed to transparency and disclosure, the detailed requirements outlined in Basel II are burdensome, confusing and could impose a significant disadvantage on banks compared to institutions (banks and non-banks) which are not subject to Basel II.

Basel II requires voluminous disclosures that are highly technical in nature and would be of little benefit to many of the readers. Relevant information would be lost in a deluge of technical data, most of which would be mystifying to all but the most expert audiences. This would especially be the case of the requirement of running parallel disclosures for the three-year period of migration to Basel II.

Last, it appears that many of the requirements of Basel II could put banks in contradiction with privacy laws, or subject them to unnecessary litigation over the disclosure (or misunderstanding) of irrelevant information. And, in the case of operational risk, based on unpredictable events.

Further, such a complexity of disclosures could create issues related to the Sarbanes-Oxley requirements of officer certification and other provisions.

<u>The Capital Requirements for Various Types of Assets doesn't make sense</u>

There are two particular areas that deserve focus, from our point of view. First, the allocations for commercial real estate are based on statistics and prejudices that no longer exist. It is true that this country experienced significant issues in the commercial real estate market in the 1980s and early 90s. However, the sources of those difficulties were identified and addressed. For the last 10 years, the industry has experienced highly favorable experience with commercial real estate. Yet, under Basel II, an unsecured loan is considered a safer bet than one secured by incoming producing real estate. There is insufficient evidence to justify such high allocations, and they need to be revisited.

The second is the allocation on the unused portion of lines of credit, such as credit cards and home equity lines of credit (HELOC). Basel II takes the position that banks must consider the likelihood of additional drawings on the unused portion of a line when determining loss estimates. These estimates could lead to a significant and unwarranted increase in the amount of capital held against these facilities. It would appear sufficient that as draws are made against the lines, banks increase capital requirements in an amount sufficient to preserve the correct capital ratio. After all, we would never permit the booking of commitments without adequate funding sources in place. Since these sources have capital allocations against them already, the change in capital requirement would only occur with the change in the composition of the asset base (e.g. the movement from investment to loan). To apply capital otherwise is essentially to double count the capital requirement.

In conclusion, real risk is by definition "uncertain." *State of the industry* risk management tools and methods in previous periods of industry difficulties have not proven a worthy substitute for adequate reserves and capital to protect against unpredictable risk sources, levels, consequences. This was proven as recently as the mid-1980s and early 1990s.

Without repeating the issues set forth in the *Financial Services Roundtable's 15 page letter to the Basel Committee on Banking Supervision dated July 31, 2003,* we share all the concerns set forth in that correspondence.

Commerce appreciates your consideration of these comments. The Basel Committee and the regulatory agencies have devoted substantial resources to the project and its implementation. However, much remains to be done. Furthermore, it is strongly recommended that any implementation should serve to reinforce the sound internal risk management practices and external regulatory environment that the industry currently enjoys, and not replace it with something that could weaken it.

Sincerely,

Robert C. Matthews, Jr.
Executive Vice President
Chief Risk Officer