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RE: Federal Deposit Insurance Corporation
12 CFR Part 327
Federal Register / Vol. 76, No. 38, February 25, 2011 / Rules and Regulations
Assessments, Large Bank Pricing
Final Rule: Risk-Based Assessment System for Large Insured Depository Institutions

Ladies and Gentlemen:

Commerce Bancshares, Inc. strongly supports the concept of applying risk-based evaluation tools in the determination of FDIC assessment fees, and we encourage the FDIC to look for approaches that charge a premium for taking greater risk. We are concerned, however, that the definitions, as they appear in the Final Rule for "leveraged loans" and for "subprime loans," will yield a ratio that does not accurately represent the risk incurred and, therefore, we respectfully request that the FDIC reexamine the definitions of those terms.

The context of our focus is on the definition of *higher-risk assets,* more specifically the definition of two of the four components of this ratio: (a) *leveraged lending* and (b) *subprime loans*.

Leveraged Lending

The traditional definition of leveraged lending or leveraged finance has been driven by two themes…

- First, the definition is purpose-driven and arises when a borrower elects to execute a financial transaction (e.g. unusually large dividend or stock repurchase, etc.) that changes the financial condition, particularly the balance sheet and potential debt service capabilities, in a very material way. Alternatively, we have viewed leveraged lending or leveraged finance to include management decisions to dramatically alter the business plan or strategy that has a similar affect on the financial condition of the borrower. Examples would include business acquisitions, business expansions, additions to product lines, major capital asset purchases, changes in geographic distribution, etc., that would add dramatically to the operating and financial leverage of the borrower(s).

- Second, the actions or events described above, will affect the operating and financial leverage to the extent that it will cause the leverage to exceed average and reasonable measures for other companies in the same or similar lines of business or industries. Some banks elect to use traditional and conventional leverage ratios, which may include but will not likely be exclusively limited to the proposed ratio, when evaluating the effect on operating and financial leverage. Other banks, like our own, may have used RMA Statement Studies averages to evaluate the borrower's leverage against similar NAICS code industry participants.

The proposal to define leveraged lending or leveraged finance based on a single ratio of funded debt or senior funded debt to EBITDA, or some measure of cash flow, is not, by itself, a best measure of leveraged lending or leveraged finance. It is overly simplistic and does not take a number of factors into consideration in reducing the definition to such a singular measure and without regard for the purpose of the financing.

- The Funded Debt to EBITDA ratio, by itself, is not the best measure of risk for all borrowers in all industries. The nature and reasonable predictability of business earnings and cash flow, particularly for amortizing debt, allows for substantially more financial leverage in some industries than in others. Public utilities, for example, have always enjoyed more leverage than other industries, say contractors, which are generally considered highly risky, even for relatively small measures of working capital borrowings. Secured traditional asset based lending, with well conceived collateral values and margin requirements and controls, though highly leveraged by the proposed measure, may bear considerably less risk of loss than a borrower with a substantially lower Funded Debt to EBITDA ratio, but the latter borrower may be far more risky if it is in an industry that has little tangible asset value and large proportions of enterprise value-type intangible assets on its balance sheet.

- The proposal to use a single ratio as the measure of risk in loans in the banks' portfolio actually has little to do with bank definitions of leveraged lending or leveraged finance. Rather, what is being proposed is a single proxy for the well thought out and increasingly complex credit risk rating systems of commercial banks that take far more into account than the proposed ratio. Bank risk rating systems are designed to measure the degree of risk in the financial condition of the borrower, the probability of default (PD) and the prospective loss given default (LGD), and to provide for this assessment throughout the economic and credit cycle. The definitions of Criticized and Classified assets used by the banks mirror the traditional regulatory definitions, and they are tested frequently by the industry's primary regulators…OCC, FED, FDIC, etc. The

substitution of the single ratio as a proxy for risk would seem inappropriate and inconsistent with the historical practices of commercial bank regulators.

- In particular, the proposal to substitute a single ratio for credit risk in the banks' portfolios seems most inappropriate "through the business cycle," from periods of expansion to periods of recession. That is true even if it has (what may be) the FDIC's desired effect of significantly raising assessment fees during the "down" period of the economic and credit cycle. This single ratio will produce an undesirable level of volatility through the cycle. It will be pro-cyclical with the kinds of defects that plagued the calculation of the loan loss provision and the ALLL during the most recent cycle. It will not apply a consistent measure of risk to individual loans or portfolios of loans in commercial banks, and it will produce unfair and unintended consequences in the assessment of risk of the insured banks.

Virtually every major recession and credit cycle has shown concentrations of risk in particular loan products or borrower industries to lead to greater credit losses and threats to the earnings stream and capital of commercial banks. Looking back over the past 40+ years, certain lending concentrations stand out that led to the greatest number of bank failures and the use of FDIC reserves to maintain confidence in the commercial banking system and its industry participants. To name just a few: the agricultural and farm crisis of the late 1970s and early 1980s; the Latin American debt crisis of the early 1970s and 1980s; the oil and gas industry crisis of the early 1980s; the income or investment commercial real estate crisis of the mid-and late 1980s; the tech financing bubble of the late 1990s and early 2000s; and this most recent crisis that produced particularly large losses for midsize and community banks with excessive concentrations in residential construction and development loans, fueled by an extended housing bubble. In all of these examples, the idea of using a single ratio of funded debt to cash flow as the measure of risk and potential claims on the reserves of the FDIC would seem inappropriate.

Sub Prime Lending

The 2001 Interagency "Expanded Guidance for Subprime Lending Programs" identifies subprime consumer borrowers based on a range of credit risk characteristics that "***may**** include one or more of the following:" (1) two or more 30-day delinquencies in the last 12 months or one or more 60-day delinquencies in the last 24 months; (2) judgment, foreclosure, repossession, or charge-off in the prior 24 months; (3) bankruptcy in the last 5 years, (4) FICO score below 660 (depending on the product/collateral) or equivalent; and (5) debt service-to-income ratio above fifty percent. ***[* emphasis added***]

We would recommend that the following provision would be added to the definition of Sub Prime Loans in the Final Rule.

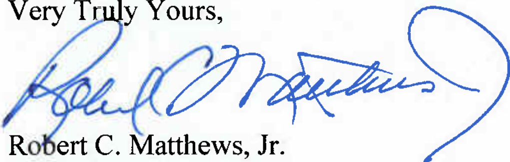
- A measure of risk presented by the applicant, produced by a credit scoring algorithm/system, that conforms to sound mathematical practices, regulatory guidance and rules, as well as any applicable laws.
    - The credit scoring algorithm/system may be provided by either a vendor (e.g. FICO or Vantage) or developed internally, or some combination of the two resources.
    - The measure of risk, i.e. a relatively high probability of default, would establish a threshold (subject to product type and collateral) for determining what is considered subprime. The threshold would be determined by the market or the institution.

In addition, while not the focus of this letter, compliance with the definitions, as defined, presents significant issues regarding a bank's ability to report their position. The information is not readily accessible and in some cases, not available at all. The effort and cost burden, associated with complying will be significant. And, even if an abundance of resources were available – money, people, systems capabilities, etc. - the ability to report for the June 30, 2011 deadline will be impossible for many if not most banks.

Again, Commerce Bancshares, Inc. strongly supports the concept of applying risk-based evaluation tools in the determination of FDIC assessment fees, and we applaud the FDIC in its efforts to look for approaches that charge a premium for taking greater risk.

Commerce Bancshares Inc. is a $19.0 billion regional bank holding company. For more than 140 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, financial planning, and investments through its affiliated companies. Commerce operates in the Midwest, primarily in Missouri, Kansas, Illinois, Oklahoma and Colorado with more than 360 locations and also has operating subsidiaries involved in mortgage banking, credit related insurance, venture capital and real estate activities.

Very Truly Yours,



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