TESTIMONY OF

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ON

"TOO BIG HAS FAILED: LEARNING FROM MIDWEST BANKS AND CREDIT UNIONS"

Before the

THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

FINANCIAL SERVICES COMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES

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Introduction

Good morning Congressman Moore and distinguished members of the Subcommittee on Oversight and Investigations. My name is Jonathan Kemper, and I am chairman and chief executive officer of Commerce Bank Kansas City and vice chairman of Commerce Bancshares, Inc. It is my pleasure to speak with you today on behalf of Commerce Bank.

The last two years have brought about some very trying times for our country. We've all been witness to the biggest financial crisis since the Great Depression and, along with that, sweeping changes in the banking business. We do appreciate your effort today to help us make the distinction between the mega-banks and traditional banks like Commerce and my colleagues here. In fact, while much of this financial crisis was caused by the actions of the largest financial services companies – both largest banks and non-banks – it often appears that "banks" have been lumped together without distinction and have been blamed for this financial meltdown.

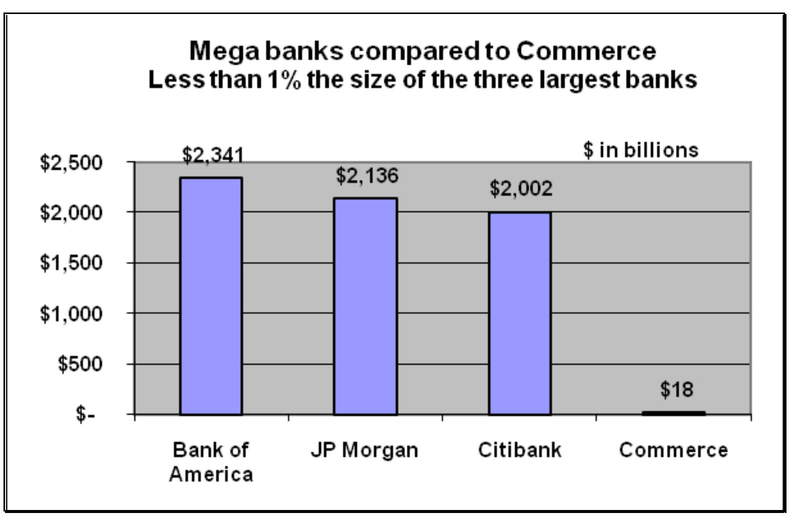
Commerce Bank is a mid-sized bank founded in Kansas City 145 years ago – our long history suggests that we take the long-term focus, and we do. Today, our strong Midwestern culture and engaged workforce of more than 5,000 serves our customers from 214 full-service branches and 412 ATMs in five states – Missouri, Kansas, Illinois, Oklahoma and Colorado. We attribute our success to stronger customer focus, solid, organic growth and a knowledge and involvement in our communities.

The Dodd-Frank legislation which was presented as "financial reform" will affect us deeply. Our costs for FDIC insurance rose tenfold during 2009 as we were compelled to support the government insurance fund for bank failures of huge banks such as IndyMac due primarily in retrospect to lax regulatory oversight. The new law will create a new agency – the Consumer Financial Protection Bureau -- which has the clear potential to add to our costs and restrict our business. Price setting established by the "Durbin Amendment" will significantly affect future fee income, which have been important vehicles for banks to maintain profits and cushion against volatile credit losses. Costs for more than 200 new regulations in the Dodd-Frank bill will tax the staffs of all banks and greatly increase costs for ongoing compliance.

Commerce Bank is a good bank and a good corporate citizen. We are counted among the best capitalized banks in the country, we declined TARP funds and we did not contribute to this crisis by originating even $1 in sub-prime products, yet we are being made to pay the cost and bear the extra regulatory burdens of this problem.

On July 21, while signing the Dodd-Frank bill, President Obama said “unless your business model depends on cutting corners or bilking your customers, you have nothing to fear from this reform.” I respectfully respond that the idea that this new law is not adversely affecting good banks is not true.

As a point of clarification, we would like to expand a key term being used here, “small, Midwestern banks,” to “traditional banks.” Commerce is a good example of a traditional bank, with $18.4 billion in assets. In fact, as the chart below shows, except for the top banks in the country, you could say that the rest of us are all “small banks.”



This is a key point, because the “trillion dollar club” of mega banks and brokers are simply a different breed from traditional banks – different in their size, business style, and their individual impact on the national and global financial system.

It is fashionable today to say that the U.S. Government “bailed out the banks with TARP” and a multitude of other extraordinary programs – but just to set the record straight, with the benefit of hindsight we now know that it wasn’t the traditional banks which caused the crisis, and that the Government will make a significant profit on the funds it injected into banks – even the largest banks. The bad actors who took the large “bailouts” were AIG and GMAC, and it was the surviving banks and their customers who will pay for this exercise in government discretion.

Performance of smaller banks before and through the crisis

The question refers to all Midwest banks, but I can best start by speaking about Commerce Bank and our own experiences in the lower Midwest, which I think may be even more useful for your purposes.

Commerce is conservative by nature but we are clearly impacted by national trends. Commerce has avoided the highs and lows in the financial world by resisting fads such as sub-prime lending and by considering the assured return of our money more important than the return on our money. As a rule, we have not made loans outside of our service area. Regarding other banks in the Midwest, however, especially among smaller, community banks in our markets; there is still a lot of stress because they are more reliant on real estate lending. Fee income is an important part of the banking business model, and many smaller banks have few fee income sources to offset the costs from credit issues and the costs of maintaining their staff and facilities. Moreover, because of their smaller size, their access to capital markets to raise additional capital is very limited, especially in these difficult times.

In the last five years, deregulation, promoted by the largest banks and financial services companies, has intentionally blurred the distinction between banks and non-banks such as merchant banks, brokers and insurance companies. Accompanying this was the creation of a “shadow banking system” where brokers bought and sold loans of very questionable quality to the mega-banks and “conduits” then repackaged them into securities such as Collateralized Debt Securities. This new financial mix was the fuel for the disastrous housing bubble, and unsustainable growth in consumer debt. Add to this the growth in borrowing, topped by hedge funds using leverage and credit default swaps which destabilized markets. It all adds up to a very ugly financial picture.

In 2007, banks recorded the best performance ever. But low interest rates and low loan losses which made bank performance appear strong masked material problems. A low capital level in the largest banks was masked by accounting goodwill and off balance-sheet entities. In fact, back then the accountants and regulators criticized conservative banks, like Commerce Bank and UMB for holding reserves in excessive of their historical loss experience. Today, traditional banks like Commerce and UMB are the envy of the industry for our conservative practices, including those same loan loss reserves.

Outlook for U.S. Financial system

Our best assessment of the current outlook for the U.S. financial system in the coming years is a cautious optimism, adjusting to the “new normal” – which means higher unemployment, lower consumption, less reliance on debt for growth, but a recommitment to fundamental growth in employment and industrial competitiveness. This said, we agree with those who warn that Federal borrowing will soon begin to crowd out access to capital markets; that monetary policy will continue its course of being “highly accommodative” which translates to continued extraordinarily low interest rates. This monetary policy may be good in the short term for borrowers and the mega banks, but becomes a zero-sum game, punishing the savers, especially retirees, who are an essential component to a healthy financial system. And the continued extraordinary intervention of the Federal Reserve has clear potential for future inflation.

Smaller banks will be negatively impacted by a prolonged period of ‘zero” interest rates. These banks, which are more dependent on net interest income, under this scenario, have this prospect: decline in income on their investments while they will be unable to futher reduce the cost of their funding. On top of this, total revenues will be depressed by lower loan volume due to the continued slack loan demand caused by the economic recession.

We are fearful that the United States will continue to be ever more dependent on foreign investment; and that uncertainty over the domestic economy will reduce investment in new plant and equipment; while uncertainty over the cost of labor will reduce demand to hire new employees. Finally, the depressed real estate market will continue to put stress on banks in the Midwest.

Systemic risks from smaller banks; [or] from larger banks

Traditional banks have, by definition, lower systemic risk because:

1. Traditional banks have a simpler, understandable business model,
2. Traditional banks have more stable funding sources,
3. Traditional banks have diversified portfolios and loans and securities, and
4. Traditional banks have experienced regulatory oversight with easy access to all managers and systems.

In the lower Midwest, there are still a sizeable number of independent banks, but their continued vitality is threatened. There have been some bank failures, primarily stemming from over-concentration in real estate lending. New regulations have put even more pressure on community banks and we will not be surprised if the combination of stresses on community banks concentrates more banking with the largest banks, creating an even heavier concentration of business among the big banks.

Comparative advantages of smaller banks

The key advantage of traditional banks strong is that they reflect the strength of their communities and their customers. These banks know their self-interest creates a duty to serve those customers on a daily basis in relationships measured in years. In fact, that customer-centered business model stresses relationships over transactions, which means more use of local judgment and less use of robotized decision making.

Generally, traditional banks are not disadvantaged in the breadth of products they offer. Traditional banks offer simpler structures of products but do not require securitizations or derivatives.

Our people are often our best competitive advantage. Managers of smaller banks are much more engaged, they know their customers, they know the products being sold and they understand the systems being used. High employee engagement means that employees know they are responsible for their actions and the bank relies on their personal values and trust.

On top of this external strength is how we view our financial strength: we have "skin in the game" and do not generate substandard assets, and have not developed exotic loans to be securitized and sold.

Traditional banks also tend to have a longer term investor focus which does not stress unsustainable growth in quarterly earnings.

Effects of further consolidation

The effect of greater consolidation among banks and credit unions is that "Too Big to Fail" will become a basic tenet undermining market discipline. The crisis proved that several very large banks and non-banks were too complex and basically unmanageable and unregulatable.

It has been widely reported that Dodd-Frank will further significantly depress fee income. An unintended consequence of this so-called reform bill will be to lessen the stability of community banks which depend on debit and overdraft fees to support their participation in the payment system. We also fear that the many new regulations add up to a complexity which will cause smaller banks to just give up, with the result that even more banking business will end up with the very largest banks, further concentrating assets among few institutions -- where all the risk has been taken in the past.

While the rhetoric has been that Dodd-Frank would eliminate future bail outs, in fact there is the strong probability that just the opposite will occur and with the continued push to concentration, that there will be more chances for future crises and future bailouts. In addition to the increased susceptibility to panics, we believe that there is a danger in concentrating the decision making into ever smaller number of banks.

The economic vitality and growth of any region – especially the Midwest – depends on the participation and support of bankers who understand and are part of their communities. The effects of further consolidation include the severe reduction of local decision making, which could be replaced by a concentrated national, robotic, decision processes.

Lessons which other (largest) banks can learn from smaller banks

The answer is that we don't have any "secret sauce" – just the opposite; we avoided trendy financial innovations such as sub-prime loans and we have maintained strong capital positions as part of our business culture.

We're talking the basics here. We were recently asked how we have been able to weather the current financial crisis relatively unscathed.

- We firmly believe that traditional banking, based on private capital, plays an essential role in a market-based, capitalist society. Informed judgment is more valuable than mechanistic systems based on flawed models. The best value we can provide is in the careful, considered judgment we employ in investing the assets entrusted to us by our customers.

- We can only speak about Commerce Bank, but we think good bankers should constantly be thinking about their customers, the communities in which they do business and their stockholders. We have strived to develop quality, long-term customer relationships rather than simply to produce volumes of business.

- Commerce Bank has chosen not to engage in huge mergers and acquisitions. We have chosen to grow organically rather than make "game changing" acquisitions which entail huge risk. While we have acquired banks within our region, this was done with great care and always **an eye toward the reduction of risks.**

Commerce has a strong risk culture and we have never loosened our lending standards. Our consistent management and engaged employees have allowed us to have consistent goals and objectives. It all comes down to making decisions for the best long term, economic outcome versus short term reported results.

The unfortunate reality is that far from creating good policy, Dodd-Frank reflects political punishment and compromise. While traditional banking didn't cause this financial crisis, we are being saddled with the costs. And the solutions are riddled with loopholes and carve outs favoring politically powerful entities which limit the overall effectiveness of the legislation.

Other observations

Some things should be obvious to anyone who has read any history. Economic cycles are endemic to market economies. “New era” thinking that maintains “this time it’s different” is in fact, a sure sign of the end of an expansion cycle and a sure sign of trouble ahead. Bad loans are made in good times, and in fact prudent regulation is most needed in times of growth.

Aggregation models used so much by the mega banks, have fatal downsides in developing systematic risks, including replicating simplistic and/or replicating bad judgment and mechanized decisions on massive pools of assets.

Dodd-Frank may have profound unintended consequences for banking in the United States. The policy of government price setting will tend to devolve into a utility model for financial services, focusing on the recovery of defined costs rather than profits, making capital attraction and formation difficult if not impossible for traditional banks.

Let’s be clear: Dodd-Frank misses the mark. The 2,300 page financial regulation bill is excessively complex; with new agencies established and much uncertainty about what the final rules will be. The financial industry has serious concerns about where this is going. We believe the strength of the banking system is tied to the many small to mid-sized banks in this country working in the communities, making small business loans to help the United States grow. Many of the regulations did not support fixing the banking system and seemed to increase government without benefit; much of it to bash banks rather than create good solutions. The intervention on debit card interchange is a good example of this. This will undoubtedly result in added costs, reduced service levels and reduced innovation. Contrary to what has been said, we believe the change to debit interchange will dramatically hurt small banks and force business to the largest banks.

What the economy needs now is an environment for loan demand which gives opportunities for all 7,900 banks to make good loans. We believe that Congress should be concerned that many smaller banks, now finding themselves falsely targeted by new regulation and burdened with the new costs and limited opportunities for new revenue, will instead simply wither and go out of business.

Other important issues

"Fair Value accounting" doesn't work when markets are dislocated, and in fact is pro-cyclical and works against long term decision making. This is a significant issue and the new bill **does** provide Congressional oversight in this area. Accounting is simply too important to leave to the accountants, and clear policy direction on "Fair Value accounting" is critically important -- this should be assigned a higher priority as currently proposed new rules will have severe impacts to banks of all sizes and provide less stability to our banking system. Smaller banks again will struggle with these proposals.

Actually, fundamental remedies can often be simpler and yet more effective: require stronger capital standards, tighter regulation of complex derivatives such as Collateralized Debt Obligations and Credit Default Swaps. Far from reducing risk and volatility, Credit Default Swaps have now been seen to introduce instability and become uncontrollable forces at times of panic. In a multitude of ways, the Dodd-Frank bill went way beyond what was necessary to address the causes of the financial crisis and will severely impact the banking industry, especially smaller banks.

Public guarantees should be limited and extraordinary. The government can't and shouldn't guarantee everything. The further the government involves itself, the more the economy will be directed by political rather than economic decision making. If we believe in the free market, then we believe in the rights of people to succeed and to fail. It's really about asking people to make responsible choices, fully understanding the implications of their actions.

Unaddressed has been the issue of fixing Fannie Mae and Freddie Mac. While these agencies have been an increasingly important part of the U.S. housing industry for many years, through Congressional urging, they assumed huge new risks of the last ten years that has resulted in a monumental problem for our country and economy. Risky lending and limitless growth in these entities must stop and solutions to fix these agencies going forward must be determined quickly.

Paying for Dodd-Frank

And, in order to pay for this, Dodd-Frank includes new tax on banks over $10B under the guise of FDIC surcharge which was not contained in either House or Senate bill. This punishes mid-sized traditional banks, which fund themselves on deposits rather than mega-banks, who use cheaper, more exotic, short-term, wholesale funding, but backstop themselves with "Too Big to Fail" access to Fed and ultimately bailouts during panics.

This concludes my testimony. Again, on behalf of Commerce Bank, I want to express my sincere appreciation for being asked to appear in this hearing.