

COMMERCE BANCSHARES INC /MO/

Form 10-Q

November 07, 2008

**Table of Contents**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

**(Mark One)**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2008  
OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the transition period from           to  
Commission File No. 0-2989

**COMMERCE BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

**Missouri**  
(State of Incorporation)

**43-0889454**  
(IRS Employer Identification No.)

**1000 Walnut,  
Kansas City, MO**  
(Address of principal executive offices)

**64106**  
(Zip Code)

**(816) 234-2000**  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Edgar Filing: COMMERCE BANCSHARES INC /MO/ - Form 10-Q

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of November 3, 2008, the registrant had outstanding 72,205,707 shares of its \$5 par value common stock, registrant's only class of common stock.

---

**Commerce Bancshares, Inc. and Subsidiaries**

**Form 10-Q**

**INDEX**

**Page**

**Part I**

**Financial Information**

Item 1. Financial Statements

Consolidated Balance Sheets as of September 30, 2008 (unaudited) and December 31, 2007 3

Consolidated Statements of Income for the Three and Nine Months Ended September 30, 2008 and 2007 (unaudited) 4

Consolidated Statements of Stockholders' Equity for the Nine Months Ended September 30, 2008 and 2007 (unaudited) 5

Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2008 and 2007 (unaudited) 6

Notes to Consolidated Financial Statements 7

Item 2. Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations 23

Item 3. Quantitative and Qualitative Disclosures about Market Risk 49

Item 4. Controls and Procedures 49

**Part II**

**Other Information**

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds 50

Item 6. Exhibits 50

**Signatures** 51

**Index to Exhibits** 52

EX-31.1

EX-31.2

EX-32

Table of Contents**PART I: FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS****Commerce Bancshares, Inc. and Subsidiaries****CONSOLIDATED BALANCE SHEETS**

	<b>September 30 2008</b>	December 31 2007
	<i>(Unaudited)</i>	
	<i>(In thousands)</i>	
<b>ASSETS</b>		
Loans	<b>\$ 10,985,789</b>	\$ 10,605,368
Allowance for loan losses	<b>(156,031)</b>	(133,586)
<b>Net loans</b>	<b>10,829,758</b>	10,471,782
Loans held for sale	<b>392,697</b>	235,896
Investment securities:		
Available for sale (\$527,351,000 and \$524,399,000 pledged in 2008 and 2007, respectively, to secure structured repurchase agreements)	<b>3,659,488</b>	3,165,020
Trading	<b>12,353</b>	26,478
Non-marketable	<b>153,423</b>	105,517
<b>Total investment securities</b>	<b>3,825,264</b>	3,297,015
Federal funds sold and securities purchased under agreements to resell	<b>457,295</b>	655,165
Cash and due from banks	<b>496,970</b>	673,081
Land, buildings and equipment, net	<b>409,676</b>	406,249
Goodwill	<b>125,585</b>	124,570
Other intangible assets, net	<b>18,299</b>	21,413
Other assets	<b>397,856</b>	319,660
<b>Total assets</b>	<b>\$ 16,953,400</b>	\$ 16,204,831

**LIABILITIES AND STOCKHOLDERS EQUITY**

Deposits:		
Non-interest bearing demand	\$ 1,187,334	\$ 1,413,849
Savings, interest checking and money market	7,451,845	7,155,366
Time open and C.D. s of less than \$100,000	2,018,444	2,374,782
Time open and C.D. s of \$100,000 and over	1,654,464	1,607,555
<b>Total deposits</b>	<b>12,312,087</b>	<b>12,551,552</b>
Federal funds purchased and securities sold under agreements to repurchase	1,559,975	1,239,219
Other borrowings	1,250,510	583,639
Other liabilities	232,217	302,735
<b>Total liabilities</b>	<b>15,354,789</b>	<b>14,677,145</b>
Stockholders' equity:		
Preferred stock, \$1 par value		
Authorized and unissued 2,000,000 shares		
Common stock, \$5 par value		
Authorized 100,000,000 shares; issued 72,186,955 shares in 2008		
71,938,743 shares in 2007	360,935	359,694
Capital surplus	482,441	475,220
Retained earnings	760,145	669,142
Treasury stock of 3,779 shares in 2008 and 52,614 shares in 2007, at cost	(161)	(2,477)
Accumulated other comprehensive income (loss)	(4,749)	26,107
<b>Total stockholders' equity</b>	<b>1,598,611</b>	<b>1,527,686</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 16,953,400</b>	<b>\$ 16,204,831</b>

*See accompanying notes to consolidated financial statements.*

**Table of Contents****Commerce Bancshares, Inc. and Subsidiaries****CONSOLIDATED STATEMENTS OF INCOME**

	<b>For the Three Months</b>		<b>For the Nine Months</b>	
	<b>Ended September 30</b>		<b>Ended September 30</b>	
<i>(In thousands, except per share data)</i>	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
	<i>(Unaudited)</i>			
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$ <b>161,816</b>	\$ 188,863	\$ <b>497,161</b>	\$ 549,142
Interest and fees on loans held for sale	<b>3,774</b>	5,049	<b>11,314</b>	17,314
Interest on investment securities	<b>41,749</b>	38,011	<b>123,956</b>	112,800
Interest on federal funds sold and securities purchased under agreements to resell	<b>2,125</b>	6,351	<b>7,790</b>	20,093
<b>Total interest income</b>	<b>209,464</b>	238,274	<b>640,221</b>	699,349
<b>INTEREST EXPENSE</b>				
Interest on deposits:				
Savings, interest checking and money market	<b>14,802</b>	31,173	<b>49,769</b>	88,622
Time open and C.D. s of less than \$100,000	<b>16,128</b>	28,541	<b>61,855</b>	82,777
Time open and C.D. s of \$100,000 and over	<b>11,542</b>	18,812	<b>42,728</b>	55,291
Interest on federal funds purchased and securities sold under agreements to repurchase	<b>5,417</b>	20,277	<b>23,051</b>	64,021
Interest on other borrowings	<b>10,011</b>	4,209	<b>26,368</b>	8,033
<b>Total interest expense</b>	<b>57,900</b>	103,012	<b>203,771</b>	298,744
<b>Net interest income</b>	<b>151,564</b>	135,262	<b>436,450</b>	400,605
Provision for loan losses	<b>29,567</b>	11,455	<b>67,567</b>	28,670
<b>Net interest income after provision for loan losses</b>	<b>121,997</b>	123,807	<b>368,883</b>	371,935
<b>NON-INTEREST INCOME</b>				
Deposit account charges and other fees	<b>27,854</b>	30,148	<b>83,189</b>	86,740
Bank card transaction fees	<b>29,317</b>	26,409	<b>85,019</b>	75,347
Trust fees	<b>20,518</b>	19,823	<b>60,917</b>	58,448
Consumer brokerage services	<b>3,439</b>	3,056	<b>10,259</b>	9,431
Trading account profits and commissions	<b>2,604</b>	2,174	<b>9,951</b>	5,475
Loan fees and sales	<b>1,594</b>	2,919	<b>4,884</b>	6,916

Other	<b>10,267</b>	10,608	<b>36,267</b>	31,123
<b>Total non-interest income</b>	<b>95,593</b>	95,137	<b>290,486</b>	273,480
<b>INVESTMENT SECURITIES GAINS, NET</b>	<b>1,149</b>	1,562	<b>25,480</b>	4,964
<b>NON-INTEREST EXPENSE</b>				
Salaries and employee benefits	<b>83,766</b>	77,312	<b>250,023</b>	230,335
Net occupancy	<b>11,861</b>	11,572	<b>34,735</b>	34,205
Equipment	<b>6,122</b>	5,761	<b>18,273</b>	17,875
Supplies and communication	<b>9,276</b>	8,546	<b>26,545</b>	25,638
Data processing and software	<b>14,229</b>	12,697	<b>41,951</b>	36,657
Marketing	<b>4,926</b>	4,775	<b>15,660</b>	13,952
Loss on purchase of auction rate securities	<b>32,967</b>		<b>33,266</b>	
Indemnification obligation	<b>2,879</b>		<b>(5,929)</b>	
Other	<b>18,506</b>	18,430	<b>58,186</b>	53,199
<b>Total non-interest expense</b>	<b>184,532</b>	139,093	<b>472,710</b>	411,861
Income before income taxes	<b>34,207</b>	81,413	<b>212,139</b>	238,518
Less income taxes	<b>9,534</b>	25,515	<b>67,320</b>	75,550
<b>NET INCOME</b>	<b>\$ 24,673</b>	\$ 55,898	<b>\$ 144,819</b>	\$ 162,968
Net income per share basic	<b>\$ .34</b>	\$ .78	<b>\$ 2.02</b>	\$ 2.25
Net income per share diluted	<b>\$ .34</b>	\$ .77	<b>\$ 2.00</b>	\$ 2.22

*See accompanying notes to consolidated financial statements.*



**Table of Contents****Commerce Bancshares, Inc. and Subsidiaries****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

<i>(In thousands, except per share data)</i>	<b>Common Stock</b>	<b>Capital Surplus</b>	<b>Retained Earnings</b>	<b>Treasury Stock</b>	<b>Accumulated Other Comprehensive Income (Loss)</b>	<b>Total</b>
	<i>(Unaudited)</i>					
<b>Balance January 1, 2008</b>	<b>\$ 359,694</b>	<b>\$ 475,220</b>	<b>\$ 669,142</b>	<b>\$ (2,477)</b>	<b>\$ 26,107</b>	<b>\$ 1,527,686</b>
Net income			<b>144,819</b>			<b>144,819</b>
Change in unrealized gain (loss) on available for sale securities, net of tax					<b>(30,856)</b>	<b>(30,856)</b>
Total comprehensive income						<b>113,963</b>
Purchase of treasury stock				<b>(8,427)</b>		<b>(8,427)</b>
Issuance of stock under purchase and equity compensation plans	<b>1,153</b>	<b>1,708</b>		<b>9,991</b>		<b>12,852</b>
Net tax benefit related to equity compensation plans		<b>1,456</b>				<b>1,456</b>
Stock-based compensation		<b>4,897</b>				<b>4,897</b>
Issuance of nonvested stock awards	<b>88</b>	<b>(840)</b>		<b>752</b>		
Cash dividends paid (\$.750 per share)			<b>(54,003)</b>			<b>(54,003)</b>
Adoption of SFAS 157 on fair value measurements			<b>903</b>			<b>903</b>
Adoption of EITF 06-4 on accounting for split dollar life insurance policy benefits			<b>(716)</b>			<b>(716)</b>
<b>Balance September 30, 2008</b>	<b>\$ 360,935</b>	<b>\$ 482,441</b>	<b>\$ 760,145</b>	<b>\$ (161)</b>	<b>\$ (4,749)</b>	<b>\$ 1,598,611</b>
Balance January 1, 2007	\$ 352,330	\$ 427,421	\$ 683,176	\$ (20,613)	\$ (200)	\$ 1,442,114
Net income			162,968		13,620	162,968 13,620

Change in unrealized gain (loss) on available for sale securities, net of tax					344	344
Amortization of pension loss, net of tax						
Total comprehensive income						176,932
Purchase of treasury stock				(121,156)		(121,156)
Issuance of stock under purchase and equity compensation plans	(8,486)			19,420		10,934
Net tax benefit related to equity compensation plans	1,884					1,884
Stock-based compensation	4,609					4,609
Issuance of nonvested stock awards	(3,392)			3,392		
Cash dividends paid (\$.714 per share)			(51,811)			(51,811)
Common stock issued in South Tulsa Financial Corp. acquisition	(303)			27,917		27,614
Adoption of FIN 48			446			446
Balance September 30, 2007	\$ 352,330	\$ 421,733	\$ 794,779	\$ (91,040)	\$ 13,764	\$ 1,491,566

*See accompanying notes to consolidated financial statements.*

**Table of Contents****Commerce Bancshares, Inc. and Subsidiaries****CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>For the Nine Months Ended September 30</b>	
	<b>2008</b>	<b>2007</b>
<i>(In thousands)</i>		
	<i>(Unaudited)</i>	
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 144,819	\$ 162,968
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	67,567	28,670
Provision for depreciation and amortization	37,991	39,072
Amortization of investment security premiums, net	4,143	5,684
Investment securities gains, net(A)	(25,480)	(4,964)
Gain on sale of branch	(6,938)	
Net gains on sales of loans held for sale	(2,544)	(4,530)
Originations of loans held for sale	(319,336)	(317,164)
Proceeds from sales of loans held for sale	164,824	296,652
Net (increase) decrease in trading securities	13,270	(4,702)
Stock-based compensation	4,897	4,609
(Increase) decrease in interest receivable	10,161	(715)
Increase (decrease) in interest payable	(33,957)	11,136
Increase (decrease) in income taxes payable	(2,156)	4,850
Net tax benefit related to equity compensation plans	(1,456)	(1,884)
Loss on purchase of auction rate securities	33,266	
Other changes, net	(645)	(20,802)
<b>Net cash provided by operating activities</b>	<b>88,426</b>	<b>198,880</b>
<b>INVESTING ACTIVITIES:</b>		
Net cash and cash equivalents paid in acquisitions		(14,046)
Net cash paid in sale of branch	(54,490)	
Proceeds from sales of investment securities(A)	128,157	35,094
Proceeds from maturities/pay downs of investment securities(A)	1,146,089	871,118
Purchases of investment securities(A)	(1,869,250)	(873,456)
Net increase in loans	(448,842)	(620,747)
Purchases of land, buildings and equipment	(31,891)	(42,623)
Sales of land, buildings and equipment	493	4,186
<b>Net cash used in investing activities</b>	<b>(1,129,734)</b>	<b>(640,474)</b>

**FINANCING ACTIVITIES:**

Net increase (decrease) in non-interest bearing demand, savings, interest checking and money market deposits	<b>653</b>	(264,677)
Net increase (decrease) in time open and C.D. s	<b>(273,138)</b>	228,345
Net increase in federal funds purchased and securities sold under agreements to repurchase	<b>321,063</b>	276,884
Additional long-term borrowings	<b>375,000</b>	300,000
Repayment of long-term borrowings	<b>(8,126)</b>	(29,015)
Net increase in short-term borrowings	<b>299,997</b>	
Purchases of treasury stock	<b>(8,427)</b>	(121,156)
Issuance of stock under stock purchase and equity compensation plans	<b>12,852</b>	10,934
Net tax benefit related to equity compensation plans	<b>1,456</b>	1,884
Cash dividends paid on common stock	<b>(54,003)</b>	(51,811)
<b>Net cash provided by financing activities</b>	<b>667,327</b>	351,388
Decrease in cash and cash equivalents	<b>(373,981)</b>	(90,206)
Cash and cash equivalents at beginning of year	<b>1,328,246</b>	1,154,316
<b>Cash and cash equivalents at September 30</b>	<b>\$ 954,265</b>	\$ 1,064,110

## (A) Available for sale and non-marketable securities

Income tax payments, net of refunds	<b>\$ 70,248</b>	\$ 69,487
Interest paid on deposits and borrowings	<b>\$ 237,734</b>	\$ 287,877

*See accompanying notes to consolidated financial statements.*

**Table of Contents****Commerce Bancshares, Inc. and Subsidiaries****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****September 30, 2008** (Unaudited)**1. Principles of Consolidation and Presentation**

The accompanying consolidated financial statements include the accounts of Commerce Bancshares, Inc. and all majority-owned subsidiaries (the Company). The consolidated financial statements in this report have not been audited. All significant intercompany accounts and transactions have been eliminated. Certain reclassifications were made to 2007 data to conform to current year presentation. In the opinion of management, all adjustments necessary to present fairly the financial position and the results of operations for the interim periods have been made. All such adjustments are of a normal recurring nature. The results of operations for the three and nine month periods ended September 30, 2008 are not necessarily indicative of results to be attained for the full year or any other interim periods.

The significant accounting policies followed in the preparation of the quarterly financial statements are disclosed in the 2007 Annual Report on Form 10-K.

**2. Acquisitions and Dispositions**

The Company completed the previously announced sale of its banking branch in Independence, Kansas, in May 2008. In this transaction, approximately \$23.3 million in loans, \$85.0 million in deposits, and various other assets and liabilities were sold. The Company paid \$54.1 million in cash, representing the net liabilities sold, and recorded a gain of \$6.9 million, representing the approximate premium paid by the buyer.

During the second quarter of 2007, the Company acquired South Tulsa Financial Corporation (South Tulsa). In this transaction, the Company acquired the outstanding stock of South Tulsa and issued shares of Company stock valued at \$27.6 million. The Company's acquisition of South Tulsa added \$142.4 million in assets and two branch locations in Tulsa, Oklahoma. During the third quarter of 2007, the Company acquired Commerce Bank in Denver, Colorado. In this transaction, the Company acquired all of the outstanding stock of Commerce Bank for \$29.5 million in cash. The acquisition added \$123.9 million in assets and the Company's first location in Colorado.

**3. Loans and Allowance for Loan Losses**

Major classifications within the Company's loan portfolio at September 30, 2008 and December 31, 2007 are as follows.

<i>(In thousands)</i>	<b>September 30 2008</b>	December 31 2007
Business	<b>\$ 3,455,907</b>	\$ 3,257,047
Real estate - construction	<b>680,089</b>	668,701
Real estate - business	<b>2,335,495</b>	2,239,846
Real estate - personal	<b>1,505,549</b>	1,540,289

Consumer	<b>1,704,051</b>	1,648,072
Home equity	<b>487,783</b>	460,200
Consumer credit card	<b>805,160</b>	780,227
Overdrafts	<b>11,755</b>	10,986
<b>Total loans</b>	<b>\$ 10,985,789</b>	<b>\$ 10,605,368</b>

Included in the table above are impaired loans amounting to \$41.6 million at September 30, 2008 and \$19.7 million at December 31, 2007. A loan is impaired when, based on current information and events, it is probable that all amounts due under the contractual terms of the agreement will not be collected.

**Table of Contents**

The Company's portfolio of construction loans amounted to 6.2% of total loans outstanding at September 30, 2008. This portfolio is comprised of land development, residential construction and commercial construction loans, as shown in the table that follows.

<i>(Dollars in thousands)</i>	<b>Balance at September 30</b>		<b>Balance at December 31</b>	
	<b>2008</b>	<b>% of Total</b>	<b>2007</b>	<b>% of Total</b>
Land development	\$ 241,228	35.5%	\$ 254,072	38.0%
Residential construction	147,744	21.7	159,624	23.9
Commercial construction	291,117	42.8	255,005	38.1
<b>Total real estate-construction loans</b>	<b>\$ 680,089</b>	<b>100.0%</b>	<b>\$ 668,701</b>	<b>100.0%</b>

In addition to its basic portfolio, the Company originates other loans which it intends to sell in secondary markets. Loans held for sale are carried at the lower of cost or fair value, and their carrying values were \$392.7 million at September 30, 2008 compared to \$235.9 million at December 31, 2007. These loans consist mainly of student loans, amounting to \$387.3 million at September 30, 2008, in addition to \$5.4 million in certain fixed rate residential mortgage loans. While most of the student loans are currently being sold in accordance with contractual terms and are carried at cost, an impairment loss of \$367 thousand was recorded on a small portion of these loans at September 30, 2008, as discussed further in Note 14 on Fair Value Measurements.

The following is a summary of the allowance for loan losses.

<i>(In thousands)</i>	<b>For the Three Months Ended September 30</b>		<b>For the Nine Months Ended September 30</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>Balance, beginning of period</b>	<b>\$ 145,198</b>	<b>\$ 132,960</b>	<b>\$ 133,586</b>	<b>\$ 131,730</b>
Additions:				
Allowance for loan losses of acquired banks		629		1,857
Provision for loan losses	<b>29,567</b>	11,455	<b>67,567</b>	28,670
<b>Total additions</b>	<b>29,567</b>	12,084	<b>67,567</b>	30,527

Deductions:				
Loan losses	<b>22,575</b>	15,360	<b>57,397</b>	41,641
Less recoveries on loans	<b>3,841</b>	3,904	<b>12,275</b>	12,972
<b>Net loan losses</b>	<b>18,734</b>	11,456	<b>45,122</b>	28,669
<b>Balance, September 30</b>	<b>\$ 156,031</b>	\$ 133,588	<b>\$ 156,031</b>	\$ 133,588



**Table of Contents****4. Investment Securities**

Investment securities, at fair value, consist of the following at September 30, 2008 and December 31, 2007.

<i>(In thousands)</i>	<b>September 30 2008</b>	December 31 2007
Available for sale:		
U.S. government and federal agency obligations	\$ 8,246	\$ 7,117
Government-sponsored enterprise obligations	97,808	353,200
State and municipal obligations	1,059,450	503,363
Mortgage-backed securities	2,192,112	1,960,120
Other asset-backed securities	243,795	180,365
Other debt securities	100	21,327
Equity securities	57,977	139,528
Total available for sale	<b>3,659,488</b>	3,165,020
Trading	12,353	26,478
Non-marketable	153,423	105,517
<b>Total investment securities</b>	<b>\$ 3,825,264</b>	\$ 3,297,015

Available for sale equity securities included short-term investments in mutual funds of \$1.4 million at September 30, 2008 and \$58.9 million at December 31, 2007. Equity securities also included common and preferred stock held by Commerce Bancshares, Inc. (the Parent) with a fair value of \$56.6 million at September 30, 2008 and \$62.2 million at December 31, 2007.

As previously announced in Current Report on Form 8-K dated August 15, 2008, in the third quarter of 2008 the Company began a purchase program of auction rate securities (ARS) from its customers, resulting in the purchase of \$529.9 million at par value. These investments were recorded at fair value on their purchase date, and the amount by which par value exceeded fair value was recorded as a \$33.0 million loss in current earnings during the third quarter of 2008. The program was intended to assist customers with cash flow needs arising from the current illiquidity in the ARS market. ARS are long-term variable rate bonds which are tied to short-term interest rates. In a normal market ARS are sold through a competitive bidding process, or auction, occurring at weekly or monthly intervals. However, in February 2008, auctions for these bonds began to fail as issues within the broader markets disrupted the ARS market. Currently, there is little, if any, auction activity for these bonds. The underlying credit quality of the ARS remains investment grade and interest is being paid at the maximum failed auction rates. The purchase program was complete at September 30, 2008, as the Company had repurchased all such securities it originally sold. At September 30, 2008, the Company's holdings of ARS amounted to \$510.0 million at fair value, which included \$409.5 million secured by government guaranteed student loans. These investments are included in the state and

municipal obligations category in the table above.

Non-marketable securities included Federal Home Loan Bank (FHLB) stock and Federal Reserve Bank stock held for debt and regulatory purposes, which totaled \$95.4 million and \$60.2 million at September 30, 2008 and December 31, 2007, respectively. Most of the increase over year end totals was due to higher required holdings of FHLB stock, tied to higher borrowings from the FHLB. Also included were venture capital and private equity investments, which amounted to \$58.0 million and \$45.3 million at September 30, 2008 and December 31, 2007, respectively. During the first nine months of 2008 and 2007, net gains of \$5.7 million and \$4.2 million, respectively, were recognized on venture capital and private equity investments. The net gains consisted of both realized gains and losses and fair value adjustments on these investments.

At September 30, 2008, securities carried at \$2.4 billion were pledged to secure public fund deposits, securities sold under agreements to repurchase, trust funds, and borrowing capacity at the Federal Reserve Bank. Securities pledged under agreements pursuant to which the collateral may be sold or re-pledged by the secured parties approximated \$527.4 million, while the remaining securities were pledged under agreements pursuant to which the secured parties may not sell or re-pledge the collateral.

**Table of Contents****5. Goodwill and Other Intangible Assets**

The following table presents information about the Company's intangible assets which have estimable useful lives.

<i>(In thousands)</i>	September 30, 2008			December 31, 2007		
	Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Amortizable intangible assets:						
Core deposit premium	\$ 25,720	\$ (8,363)	\$ 17,357	\$ 25,720	\$ (5,182)	\$ 20,538
Mortgage servicing rights	1,768	(826)	942	1,556	(681)	875
<b>Total</b>	<b>\$ 27,488</b>	<b>\$ (9,189)</b>	<b>\$ 18,299</b>	<b>\$ 27,276</b>	<b>\$ (5,863)</b>	<b>\$ 21,413</b>

Aggregate amortization expense on intangible assets was \$1.1 million and \$1.3 million, respectively, for the three month periods ended September 30, 2008 and 2007, and \$3.3 million and \$3.1 million for the nine month periods ended September 30, 2008 and 2007. The following table shows the estimated annual amortization expense for the next five fiscal years. This expense is based on existing asset balances and the interest rate environment as of September 30, 2008. The Company's actual amortization expense in any given period may be different from the estimated amounts depending upon the acquisition of intangible assets, changes in mortgage interest rates, pre-payment rates and other market conditions.

*(In thousands)*

2008	\$ 4,330
2009	3,803
2010	3,290
2011	2,776
2012	2,244

Changes in the carrying amount of goodwill and net other intangible assets for the nine month period ended September 30, 2008 are as follows.

	Core Deposit	Mortgage Servicing
--	--------------	--------------------

Edgar Filing: COMMERCE BANCSHARES INC /MO/ - Form 10-Q

<i>(In thousands)</i>	Goodwill	Premium	Rights
Balance at December 31, 2007	\$ 124,570	\$ 20,538	\$ 875
Originations			212
Adjustments to prior year acquisitions	1,293		
Amortization		(3,181)	(145)
Other	(278)		
<b>Balance at September 30, 2008</b>	<b>\$ 125,585</b>	<b>\$ 17,357</b>	<b>\$ 942</b>

Changes in the carrying amount of goodwill by operating segment for the nine month period ended September 30, 2008 are as follows.

<i>(In thousands)</i>	Consumer Segment	Commercial Segment	Money Management Segment	Total Goodwill
Balance at December 31, 2007	\$ 67,653	\$ 56,171	\$ 746	\$ 124,570
Adjustments to 2007 acquisitions	259	1,034		1,293
Other	(147)	(131)		(278)
<b>Balance at September 30, 2008</b>	<b>\$ 67,765</b>	<b>\$ 57,074</b>	<b>\$ 746</b>	<b>\$ 125,585</b>

**Table of Contents****6. Guarantees**

The Company, as a provider of financial services, routinely issues financial guarantees in the form of financial and performance standby letters of credit. Standby letters of credit are contingent commitments issued by the Company generally to guarantee the payment or performance obligation of a customer to a third party. While these represent a potential outlay by the Company, a significant amount of the commitments may expire without being drawn upon. The Company has recourse against the customer for any amount it is required to pay to a third party under a standby letter of credit. The letters of credit are subject to the same credit policies, underwriting standards and approval process as loans made by the Company. Most of the standby letters of credit are secured and in the event of nonperformance by the customers, the Company has rights to the underlying collateral, which could include commercial real estate, physical plant and property, inventory, receivables, cash and marketable securities.

Upon issuance of standby letters of credit, the Company recognizes a liability for the fair value of the obligation undertaken, which is estimated to be equivalent to the amount of fees received from the customer over the life of the agreement. At September 30, 2008, that net liability was \$3.6 million, which will be accreted into income over the remaining life of the respective commitments. The contractual amount of these letters of credit, which represents the maximum potential future payments guaranteed by the Company, was \$421.1 million at September 30, 2008.

The Company guarantees payments to holders of certain trust preferred securities issued by two wholly owned grantor trusts. Preferred securities issued by Breckenridge Capital Trust I, amounting to \$4.0 million, are due in 2030 and may be redeemed beginning in 2010. These securities have a 10.875% interest rate throughout their term. Securities issued by West Pointe Statutory Trust I, amounting to \$10.0 million, are due in 2034 and may be redeemed beginning in 2009. These securities have a variable interest rate, which was 5.069% at September 30, 2008. The rate is based on LIBOR, and resets on a quarterly basis. The maximum potential future payments guaranteed by the Company on the two issues, which includes future interest and principal payments through maturity, were estimated to be approximately \$36.6 million at September 30, 2008. At September 30, 2008, the Company had a recorded liability of \$14.1 million in principal and accrued interest to date, representing amounts owed to the security holders of the two issues.

In 2007, the Company entered into several risk participation agreements (RPAs) as guarantor to other financial institutions, which mitigate those institutions' credit risk arising from interest rate swaps with third parties. The RPA stipulates that, in the event of default by the third party on the interest rate swap, the Company will reimburse a portion of the loss borne by the institution. The Company's exposure is based on swap notional amounts totaling \$31.0 million. At the inception of each contract, the Company received a fee from the institution which was recorded as a liability representing the fair value of the RPA. Any future changes in fair value, including those due to a change in the third party's creditworthiness, are recorded in current earnings. At September 30, 2008, the total liability relating to RPAs guaranteed by the Company was \$186 thousand. The maximum potential future payment guaranteed by the Company cannot be readily estimated, but is dependent upon the fair value of the interest rate swaps at the time of default. If an event of default on all contracts had occurred at September 30, 2008, the Company would have been required to make payments of approximately \$1.5 million.

As a result of an overall reorganization among Visa, Inc. (Visa) and its affiliates in 2007, the Company has recorded a commitment to share certain estimated litigation costs of Visa. At September 30, 2008, the Company's indemnification obligation relating to this commitment totaled \$15.0 million. This amount represents the Company's estimate of its share of certain litigation costs in excess of a cash escrow established in connection with Visa's initial public offering in March 2008. The escrow account is expected to be replenished in the fourth quarter of 2008, and in that event, the Company's liability would be reversed to the extent of its share of the replenishment.



**Table of Contents****7. Pension**

The amount of net pension cost (income) is as follows:

<i>(In thousands)</i>	<b>For the Three Months Ended September 30</b>		<b>For the Nine Months Ended September 30</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Service cost – benefits earned during the period	\$ 263	\$ 248	\$ 769	\$ 743
Interest cost on projected benefit obligation	1,337	1,145	3,925	3,436
Expected return on plan assets	(2,124)	(1,705)	(6,124)	(5,115)
Amortization of unrecognized net loss		185		555
<b>Net periodic pension cost (income)</b>	<b>\$ (524)</b>	<b>\$ (127)</b>	<b>\$ (1,430)</b>	<b>\$ (381)</b>

Substantially all benefits under the Company's defined benefit pension plan were frozen effective January 1, 2005. During the first nine months of 2008, the Company made no funding contributions to its defined benefit pension plan, and made minimal funding contributions to a supplemental executive retirement plan (the CERP), which carries no segregated assets. The Company has no plans to make any further contributions, other than those related to the CERP, during the remainder of 2008. The higher income recognized for the defined benefit pension plan in the three and nine month periods ended September 30, 2008 compared to the same periods in 2007 was primarily due to the greater than expected return on plan assets for the year ended September 30, 2007 (the measurement date) and an increase in the discount rate assumption.

Statement of Financial Accounting Standards No. 158, which the Company adopted on December 31, 2006, requires measurement of plan assets and benefit obligations as of fiscal year end, beginning in 2008. The Company intends to make this adjustment on December 31, 2008 and does not expect it to have a material effect on its consolidated financial statements.

**8. Common Stock**

Presented below is a summary of the components used to calculate basic and diluted earnings per share.

<i>(In thousands, except per share data)</i>	<b>For the Three Months Ended September 30</b>		<b>For the Nine Months Ended September 30</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>

**Basic earnings per share:**

Edgar Filing: COMMERCE BANCSHARES INC /MO/ - Form 10-Q

Net income available to common shareholders	\$ <b>24,673</b>	\$ 55,898	\$ <b>144,819</b>	\$ 162,968
Weighted average basic common shares outstanding	<b>71,863</b>	71,919	<b>71,769</b>	72,589
Basic earnings per share	\$ <b>.34</b>	\$ .78	\$ <b>2.02</b>	\$ 2.25
<b>Diluted earnings per share:</b>				
Net income available to common shareholders	\$ <b>24,673</b>	\$ 55,898	\$ <b>144,819</b>	\$ 162,968
Weighted average common shares outstanding	<b>71,863</b>	71,919	<b>71,769</b>	72,589
Net effect of nonvested stock and the assumed exercise of stock-based awards based on the treasury stock method using the average market price for the respective periods	<b>682</b>	788	<b>691</b>	838
Weighted average diluted common shares outstanding	<b>72,545</b>	72,707	<b>72,460</b>	73,427
Diluted earnings per share	\$ <b>.34</b>	\$ .77	\$ <b>2.00</b>	\$ 2.22



**Table of Contents****9. Other Comprehensive Income (Loss)**

The Company's components of other comprehensive income (loss) consist of the unrealized holding gains and losses on available for sale investment securities and the amortization of accumulated pension loss which has been recognized in net periodic benefit cost.

<i>(In thousands)</i>	<b>For the Three Months Ended September 30</b>		<b>For the Nine Months Ended September 30</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>Available for sale investment securities:</b>				
Net unrealized holding gains (losses)	\$ (32,819)	\$ 33,890	\$ (52,131)	\$ 22,755
Reclassification adjustment for (gains) losses included in net income	1	(678)	2,366	(753)
Net unrealized gains (losses) on securities	(32,818)	33,212	(49,765)	22,002
Income tax expense (benefit)	(12,469)	12,621	(18,909)	8,382
<b>Net holding gains (losses) on investment securities</b>	<b>(20,349)</b>	<b>20,591</b>	<b>(30,856)</b>	<b>13,620</b>
<b>Prepaid pension cost:</b>				
Amortization of accumulated pension loss		185		555
Income tax benefit		(70)		(211)
<b>Accumulated pension loss</b>		<b>115</b>		<b>344</b>
<b>Other comprehensive income (loss)</b>	<b>\$ (20,349)</b>	<b>\$ 20,706</b>	<b>\$ (30,856)</b>	<b>\$ 13,964</b>

**10. Segments**

The Company segregates financial information for use in assessing its performance and allocating resources among three operating segments. The Consumer segment includes the retail branch network, consumer finance, bank card, student loans and discount brokerage services. The Commercial segment provides corporate lending, leasing, and international services, as well as business, government deposit and cash management services. The Money Management segment provides traditional trust and estate tax planning services, and advisory and discretionary investment management services.



**Table of Contents**

The following table presents selected financial information by segment and reconciliations of combined segment totals to consolidated totals. There were no material intersegment revenues among the three segments.

<i>(In thousands)</i>	Consumer	Commercial	Money Management	Segment Totals	Other/ Elimination	Consolidated Totals
<b>Three Months Ended</b>						
<b>September 30, 2008:</b>						
Net interest income	\$ 90,152	\$ 48,792	\$ 2,008	\$ 140,952	\$ 10,612	\$ 151,564
Provision for loan losses	(15,100)	(3,493)		(18,593)	(10,974)	(29,567)
Non-interest income	45,737	24,092	24,372	94,201	1,392	95,593
Investment securities gains, net					1,149	1,149
Non-interest expense	(82,107)	(42,206)	(50,809)	(175,122)	(9,410)	(184,532)
Income (loss) before income taxes	\$ 38,682	\$ 27,185	\$ (24,429)	\$ 41,438	\$ (7,231)	\$ 34,207
Three Months Ended September 30, 2007:						
Net interest income	\$ 86,477	\$ 48,668	\$ 1,894	\$ 137,039	\$ (1,777)	\$ 135,262
Provision for loan losses	(8,074)	(3,398)		(11,472)	17	(11,455)
Non-interest income	49,546	21,470	23,228	94,244	893	95,137
Investment securities gains, net					1,562	1,562
Non-interest expense	(78,101)	(39,482)	(16,301)	(133,884)	(5,209)	(139,093)
Income (loss) before income taxes	\$ 49,848	\$ 27,258	\$ 8,821	\$ 85,927	\$ (4,514)	\$ 81,413
<b>Nine Months Ended</b>						
<b>September 30, 2008:</b>						
Net interest income	\$ 260,379	\$ 153,746	\$ 5,454	\$ 419,579	\$ 16,871	\$ 436,450
Provision for loan losses	(39,426)	(5,814)		(45,240)	(22,327)	(67,567)
Non-interest income	133,028	72,137	75,135	280,300	10,186	290,486
Investment securities gains, net					25,480	25,480
Non-interest expense	(241,907)	(127,171)	(85,862)	(454,940)	(17,770)	(472,710)
Income (loss) before income taxes	\$ 112,074	\$ 92,898	\$ (5,273)	\$ 199,699	\$ 12,440	\$ 212,139

Nine Months Ended  
September 30, 2007:

Net interest income	\$ 257,729	\$ 144,018	\$ 5,716	\$ 407,463	\$ (6,858)	\$ 400,605
Provision for loan losses	(24,007)	(4,606)		(28,613)	(57)	(28,670)
Non-interest income	137,992	62,342	67,794	268,128	5,352	273,480
Investment securities gains, net					4,964	4,964
Non-interest expense	(228,071)	(117,670)	(47,858)	(393,599)	(18,262)	(411,861)
Income (loss) before income taxes	\$ 143,643	\$ 84,084	\$ 25,652	\$ 253,379	\$ (14,861)	\$ 238,518

The information presented above was derived from the internal profitability reporting system used by management to monitor and manage the financial performance of the Company. This information is based on internal management accounting policies, which have been developed to reflect the underlying economics of the businesses. The policies address the methodologies applied in connection with funds transfer pricing and assignment of overhead costs among segments. Funds transfer pricing was used in the determination of net interest income by assigning a standard cost (credit) for funds used (provided) by assets and liabilities based on their maturity, prepayment and/or repricing characteristics.

Management periodically makes changes to methods of assigning costs and income to its business segments to better reflect operating results. Beginning in 2008, modifications were made to the funds transfer pricing process which eliminated allocations to net interest income for capital. This change was also reflected in the prior year information presented above.

The performance measurement of the operating segments is based on the management structure of the Company and is not necessarily comparable with similar information for any other financial institution. The information is also not necessarily indicative of the segments' financial condition and results of operations if they were independent entities.

**Table of Contents****11. Derivative Instruments**

The Company's interest rate risk management strategy includes the ability to modify the re-pricing characteristics of certain assets and liabilities so that changes in interest rate do not adversely affect the net interest margin and cash flows. Interest rate swaps are used on a limited basis as part of this strategy. At September 30, 2008, the Company had entered into two interest rate swaps with a notional amount of \$12.5 million, which are designated as fair value hedges of certain fixed rate loans. The Company also sells swap contracts to customers who wish to modify their interest rate sensitivity. These swaps are offset by matching contracts purchased by the Company from other financial institutions. Because of the matching terms of the offsetting contracts, in addition to collateral provisions which mitigate the impact of non-performance risk, changes in fair value subsequent to initial recognition have a minimal effect on net income. The notional amount of these types of swaps at September 30, 2008 was \$467.9 million. These swaps are accounted for as free-standing derivatives and changes in their fair value were recorded in other non-interest income. The Company is party to master netting arrangements with its institutional counterparties; however, the effect of offsetting assets and liabilities under these arrangements is not significant. Collateral exchanges typically involve marketable securities.

Through its International Department, the Company enters into foreign exchange contracts consisting mainly of contracts to purchase or deliver foreign currencies for customers at specific future dates. Also, mortgage loan commitments and forward sales contracts result from the Company's mortgage banking operation, in which fixed rate personal real estate loans are originated and sold to other institutions.

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements. This Statement modified the accounting for initial recognition of fair value for certain interest rate swap contracts held by the Company. Former accounting guidance precluded immediate recognition in earnings of an unrealized gain or loss, measured as the difference between the transaction price and fair value of these instruments at initial recognition. This former guidance was nullified by SFAS No. 157, which allows for the immediate recognition of a gain or loss under certain circumstances. In accordance with the new recognition requirements, the Company increased equity by \$903 thousand on January 1, 2008 to reflect the swaps at fair value as defined by SFAS No. 157.

The Company's derivative instruments are listed below.

	September 30, 2008			December 31, 2007		
	Notional Amount	Positive Fair Value	Negative Fair Value	Notional Amount	Positive Fair Value	Negative Fair Value
<i>(In thousands)</i>						
Interest rate swaps	\$ 480,424	\$ 7,304	\$ (7,883)	\$ 308,361	\$ 4,766	\$ (6,333)
Credit risk participation agreements	48,911	124	(186)	25,389		(174)
Foreign exchange contracts:						
Forward contracts	6,821	128	(112)	12,212	105	(149)
Option contracts	3,300	1	(1)	3,120	9	(9)
Mortgage loan commitments	5,336	57	(3)	7,123	18	(10)
Mortgage loan forward sale contracts	10,452	24	(36)	15,017	25	(34)

<b>Total</b>	<b>\$ 555,244</b>	<b>\$ 7,638</b>	<b>\$ (8,221)</b>	<b>\$ 371,222</b>	<b>\$ 4,923</b>	<b>\$ (6,709)</b>
--------------	-------------------	-----------------	-------------------	-------------------	-----------------	-------------------

**Table of Contents****12. Income Taxes**

For the third quarter of 2008, income tax expense amounted to \$9.5 million compared to \$25.5 million in the third quarter of 2007. The effective income tax rate for the Company was 27.9% in the current quarter compared to 31.3% in the same quarter last year. For the nine months ended September 30, 2008 and 2007, income tax expense amounted to \$67.3 million and \$75.6 million, resulting in an effective income tax rate of 31.7% in both periods.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of multiple state and local jurisdictions. Tax years 2005 through 2007 remain open to examination for U.S. federal income tax. Tax years 2004 through 2007 remain open to examination by significant state tax jurisdictions.

**13. Stock-Based Compensation**

During the first nine months of 2008, stock-based compensation was issued in the form of stock appreciation rights (SARs) and nonvested stock. The stock-based compensation expense that has been charged against income was \$1.6 million for each of the three month periods ended September 30, 2008 and 2007, and \$4.9 million and \$4.6 million in the nine months ended September 30, 2008 and 2007, respectively.

In determining compensation cost, the Black-Scholes option-pricing model is used to estimate the fair value of SARs and options on date of grant. SARs and stock options are granted with an exercise price equal to the market price of the Company's stock at the date of grant and have 10-year contractual terms. SARs, which were granted for the first time in 2006, vest on a graded basis over 4 years of continuous service. All SARs must be settled in stock under provisions of the plan. Stock options, which were granted in 2005 and previous years, vest on a graded basis over 3 years of continuous service. The table below shows the fair values of SARs granted during the first nine months of 2008 and 2007, including the model assumptions for those grants.

	<b>Nine Months Ended September 30</b>	
	<b>2008</b>	<b>2007</b>
Weighted per share average fair value at grant date	<b>\$8.69</b>	\$11.96
Assumptions:		
Dividend yield	<b>2.3%</b>	1.9%
Volatility	<b>18.4%</b>	19.9%
Risk-free interest rate	<b>3.5%</b>	4.6%
Expected term	<b>7.2 years</b>	7.4 years

A summary of option activity during the first nine months of 2008 is presented below.

Weighted Average	Weighted Average Remaining	Aggregate
---------------------	----------------------------------	-----------

Edgar Filing: COMMERCE BANCSHARES INC /MO/ - Form 10-Q

<i>(Dollars in thousands, except per share data)</i>	Shares	Exercise Price	Contractual Term	Intrinsic Value
Outstanding at January 1, 2008	2,864,415	\$ 32.40		
Granted				
Forfeited				
Expired	(302)	39.03		
Exercised	(478,909)	28.01		
<b>Outstanding at September 30, 2008</b>	2,385,204	\$ 33.28	4.1 years	\$ 31,289



**Table of Contents**

A summary of SAR activity during the first nine months of 2008 is presented below.

<i>(Dollars in thousands, except per share data)</i>	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2008	979,063	\$ 47.05		
Granted	562,501	44.23		
Forfeited	(8,194)	45.57		
Expired	(2,000)	46.85		
Exercised	(2,604)	46.84		
<b>Outstanding at September 30, 2008</b>	<b>1,528,766</b>	<b>\$ 46.02</b>	<b>8.4 years</b>	<b>\$ 1,216</b>

A summary of the status of the Company's nonvested share awards, as of September 30, 2008, and changes during the nine month period then ended is presented below.

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2008	226,124	\$ 42.04
Granted	36,665	44.17
Vested	(42,786)	34.55
Forfeited	(1,497)	41.81
<b>Nonvested at September 30, 2008</b>	<b>218,506</b>	<b>\$ 43.87</b>

**14. Fair Value Measurements**

The Company uses fair value measurements to record fair value adjustments to certain financial and nonfinancial assets and liabilities and to determine fair value disclosures. Various financial instruments such as available for sale and trading securities, certain non-marketable securities relating to venture capital/private equity activities, and derivatives are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets and liabilities on a nonrecurring basis, such as loans held for sale, mortgage servicing rights and certain other investment securities. These nonrecurring fair value adjustments typically involve lower of cost or market accounting, or write-downs of individual assets.

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements . Under SFAS No. 157, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Depending on the nature of the asset or liability, the Company uses various valuation techniques and assumptions when estimating fair value, which are in accordance with SFAS No. 157. SFAS No. 157 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1 inputs to the valuation methodology are quoted prices for identical assets or liabilities in active markets.

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the assets or liabilities, either directly or indirectly (such as interest rates, yield curves, and prepayment speeds).

## **Table of Contents**

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value. These may be internally developed, using the Company's best information and assumptions that a market participant would consider.

When determining the fair value measurements for assets and liabilities required or permitted to be recorded or disclosed at fair value, the Company considers the principal or most advantageous market in which it would transact and considers assumptions that market participants would use when pricing the asset or liability. When possible, the Company looks to active and observable markets to price identical assets or liabilities. When identical assets and liabilities are not traded in active markets, the Company looks to market observable data for similar assets and liabilities. Nevertheless, certain assets and liabilities are not actively traded in observable markets and the Company must use alternative valuation techniques to derive an estimated fair value measurement.

The following disclosures exclude certain nonfinancial assets and liabilities which are deferred under the provisions of FASB Staff Position 157-2. These include foreclosed real estate, long-lived assets, goodwill, and core deposit premium, which are written down to fair value upon impairment. The FASB's deferral is intended to allow additional time to consider the effect of various implementation issues relating to these nonfinancial instruments, and defers disclosures under SFAS No. 157 until fiscal periods beginning after December 31, 2008.

### **Valuation methods for instruments measured at fair value on a recurring basis**

Following is a description of the Company's valuation methodologies used for instruments measured at fair value on a recurring basis:

#### *Available for sale investment securities*

Available for sale securities are accounted for in accordance with SFAS 115, with changes in fair value recorded in other comprehensive income. This portfolio comprises the majority of the assets which the Company records at fair value. Most of the portfolio, which includes federal agencies, mortgage-backed and asset-backed securities, are priced utilizing industry-standard models that consider various assumptions, include time value, yield curves, volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the marketplace. Municipal and corporate securities are valued using a type of matrix, or grid, pricing in which securities are benchmarked against the treasury rate based on credit rating. These model and matrix measurements are classified as Level 2 in the fair value hierarchy. Where quoted prices are available in an active market, the measurements are classified as Level 1. Most of the Level 1 measurements apply to exchange-traded equities.

At September 30, 2008, the Company held certain auction rate securities (ARS) in its available for sale portfolio, totaling \$510.0 million, or 13.9% of the portfolio. Nearly all of these securities were purchased from customers during the third quarter of 2008. The auction process by which the ARS are normally priced has failed since the first quarter of 2008, and the fair value of these securities cannot be based on observable market prices due to the illiquidity in the market. The fair values of the ARS are currently estimated using a discounted cash flows analysis. The analysis compares the present value of cash flows based on mandatory rates paid under failing auctions with the present value of estimated cash flows for similar securities, after adjustment for liquidity premium and nonperformance risk. The cash flows for most issues were projected over a period of approximately 3 years, based on the Company's estimate of an expected market recovery period, or in some cases, a shorter period if refinancing by specific issuers is expected. The discount rate was based on the published Treasury rate for the period commensurate with the estimated holding

period. In developing the inputs, discussions were held with traders, both internal and external to the Company, who are familiar with the ARS markets. Because many of the inputs significant to the measurement are not observable, these measurements are classified as Level 3 measurements.

## **Table of Contents**

### *Trading securities*

The majority of the securities in the Company's trading portfolio are priced by averaging several broker quotes for identical instruments, and are classified as Level 2 measurements. During most of 2008, this portfolio also included certain auction rate securities, whose fair value measurement was classified as Level 3 and estimated in the manner described above. In the third quarter of 2008 these securities were transferred to the available for sale portfolio, as their decline in marketability made the likelihood of selling these in the near term more remote. The securities were transferred at their fair value, which was estimated to be \$7.7 million on the transfer date. Prior to their transfer a loss in fair value, totaling \$695 thousand, was recorded in current earnings.

### *Venture capital/private equity securities*

These securities are held by the venture capital subsidiaries and are included in non-marketable investment securities in the consolidated balance sheets. Valuation of these nonpublic investments requires significant management judgment due to the absence of quoted market prices. Each quarter, valuations are performed utilizing available market data and other factors. Market data includes published trading multiples for venture companies of similar size. The multiples are considered in conjunction with current operating performance, future expectations, financing and sales transactions, and other company-specific issues. The Company applies its valuation methodology consistently from period to period, and believes that its methodology is similar to that used by other market participants. These fair value measurements are classified as Level 3.

### *Derivatives*

The Company's derivative instruments include interest rate swaps, foreign exchange forward contracts, commitments and sales contracts related to personal mortgage loan origination activity, and certain credit risk guarantee agreements. When appropriate, the impact of credit standing as well as any potential credit enhancements, such as collateral, has been considered in the fair value measurement.

Valuations for interest rate swaps are derived from proprietary models whose significant inputs are readily observable market parameters, primarily yield curves. The results of the models are constantly validated through comparison to active trading in the marketplace. These fair value measurements are classified as Level 2.

Fair value measurements for foreign exchange contracts are derived from a model whose primary inputs are quotations from global market makers, and are classified as Level 2.

The fair values of mortgage loan commitments and forward sales contracts on the associated loans are based on quoted prices for similar loans in the secondary market. However, these prices are adjusted by a factor which considers the likelihood that a commitment will ultimately result in a closed loan. This estimate is based on the Company's historical data and its judgment about future economic trends. Based on the unobservable nature of this adjustment, these measurements are classified as Level 3.

The Company's minimal holdings of liabilities related to credit risk guarantees, as discussed in Note 6, are valued under an internally developed methodology which uses significant unobservable inputs and assumptions about the creditworthiness of the counterparty to the guaranteed interest rate swap contract. Consequently, these measurements are classified as Level 3.

### *Assets held in trust*

Assets held in trust for the Company's deferred compensation plan consist of investments in mutual funds. The fair value measurements are based on quoted prices in active markets and classified as Level 1. The Company has also recorded a corresponding nonfinancial liability, representing the Company's liability to the plan participants.

**Table of Contents**

The table below presents the carrying values of assets and liabilities measured at fair value on a recurring basis.

		Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<i>(In thousands)</i>	9/30/08			
<b>Assets:</b>				
Available for sale securities	\$ 3,659,488	\$ 32,574	\$ 3,116,888	\$ 510,026
Trading securities	12,353		12,353	
Venture capital investments	51,961			51,961
Derivatives	7,638		7,433	205
Assets held in trust	2,777	2,777		
<b>Total assets</b>	<b>3,734,217</b>	<b>35,351</b>	<b>3,136,674</b>	<b>562,192</b>
<b>Liabilities:</b>				
Derivatives	8,221		7,996	225
<b>Total liabilities</b>	<b>\$ 8,221</b>	<b>\$</b>	<b>\$ 7,996</b>	<b>\$ 225</b>

**Table of Contents**

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis are summarized as follows:

<i>(In thousands)</i>	Available for Sale Securities	Trading Securities	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		Total
			Venture Capital Investments	Derivatives	
<b>For the three months ended September 30, 2008:</b>					
Balance at June 30, 2008	\$ 9,682	\$ 8,122	\$ 48,374	\$ 12	\$ 66,190
Total gains or losses (realized/unrealized):					
Included in earnings		(402)	1,176	(126)	648
Included in other comprehensive income	(4,380)				(4,380)
Purchases, issuances, and settlements, net	497,004		2,411	94	499,509
Transfer from trading to available for sale	7,720	(7,720)			
Balance at September 30, 2008	\$ 510,026	\$	\$ 51,961	\$ (20)	\$ 561,967
Total gains or losses for the three month period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2008	\$ (402)	\$	\$ 1,176	\$ 46	\$ 820
<b>For the nine months ended September 30, 2008:</b>					
Balance at January 1, 2008	\$	\$	\$ 37,603	\$ (175)	\$ 37,428
Total gains or losses (realized/unrealized):					
Included in earnings		(695)	5,676	61	5,042
Included in other comprehensive income	(4,410)				(4,410)
Purchases, issuances, and settlements, net	506,716		8,682	94	515,492
Transfer from trading to available for sale	7,720	(7,720)			
Transfers in and/or out of Level 3		8,415			8,415
Balance at September 30, 2008	\$ 510,026	\$	\$ 51,961	\$ (20)	\$ 561,967



Total gains or losses for the nine month period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2008

\$	(695)	\$		\$	5,676	\$	59	\$	5,040
----	-------	----	--	----	-------	----	----	----	-------

**Table of Contents**

Gains and losses on the Level 3 assets and liabilities in the table above are reported in the following income categories:

<i>(In thousands)</i>	Interest on Investment Securities	Trading Account Profits and Commissions	Loan Fees and Sales	Other Non-Interest Income	Investment Securities Gains, Net	Total
-----------------------	--------------------------------------------	--------------------------------------------------	---------------------------	---------------------------------	-------------------------------------------	-------

**For the three months ended  
September 30, 2008:**

Total gains or losses included in earnings	\$	\$ (402)	\$ (130)	\$ 4	\$ 1,176	\$ 648
--------------------------------------------	----	----------	----------	------	----------	--------

Change in unrealized gains or losses relating to assets still held at September 30, 2008	\$	\$ (402)	\$ 42	\$ 4	\$ 1,176	\$ 820
------------------------------------------------------------------------------------------	----	----------	-------	------	----------	--------

**For the nine months ended  
September 30, 2008:**

Total gains or losses included in earnings	\$ (99)	\$ (695)	\$ 44	\$ 17	\$ 5,775	\$ 5,042
--------------------------------------------	---------	----------	-------	-------	----------	----------

Change in unrealized gains or losses relating to assets still held at September 30, 2008	\$ (99)	\$ (695)	\$ 42	\$ 17	\$ 5,775	\$ 5,040
------------------------------------------------------------------------------------------	---------	----------	-------	-------	----------	----------

**Valuation methods for instruments measured at fair value on a nonrecurring basis**

Following is a description of the Company's valuation methodologies used for other financial instruments measured at fair value on a nonrecurring basis.

*Collateral dependent impaired loans*

While the overall loan portfolio is not carried at fair value, adjustments are recorded on certain loans to reflect partial write-downs that are based on the value of the underlying collateral. In determining the value of real estate collateral, the Company relies on external appraisals and assessment of property values by its internal staff. In the case of non-real estate collateral, reliance is placed on a variety of sources, including external estimates of value and judgments based on the experience and expertise of internal specialists. Because many of these inputs are not observable, the measurements are classified as Level 3. The carrying value of these impaired loans was \$41.6 million at September 30, 2008. Charge-offs on impaired loans were \$2.4 million during the current quarter and \$6.2 million during the nine month period ending September 30, 2008, while their related allowance was \$81 thousand higher at September 30, 2008 compared to December 31, 2007.

*Private equity investments and restricted stock*

These assets are included in non-marketable investment securities in the consolidated balance sheets. They include private equity investments held by the Parent company which are carried at cost, reduced by other than temporary impairment. These investments are periodically evaluated for impairment based on their estimated fair value. The valuation methodology is described above under the recurring measurements for Venture capital/private equity securities . Also included is stock issued by the Federal Reserve and Federal Home Loan Banks which is held by the bank subsidiaries as required for regulatory purposes. There are generally restrictions on the sale and/or liquidation of these investments, and their carrying value approximates fair value. Fair value measurements for these securities are classified as Level 3. Fair value adjustments recorded during 2008 were not significant.

## **Table of Contents**

### *Loans held for sale*

Loans held for sale are carried at the lower of cost or market value. The portfolio consists primarily of student loans, and to a lesser extent, residential real estate loans. In the absence of quoted prices, the fair value of student loans held for sale is based on specific prices mandated in underlying sale contracts with investors in the secondary market. As such, these measurements are classified as Level 2. Beginning early in the second quarter of 2008, the secondary market for student loans was disrupted by liquidity concerns. Consequently, one of the investors who purchase loans from the Company was unable to consistently purchase loans under existing contractual terms. As a result, impairment losses were recorded on certain student loans held for sale, amounting to \$170 thousand during the current quarter and \$367 thousand during the nine month period ending September 30, 2008. The fair value of these impaired loans at September 30, 2008 was \$10.4 million. The fair value measurement method developed by the Company was based on a discounted cash flows analysis and is classified as Level 3. Fair value measurements on mortgage loans held for sale are based on quoted market prices for similar loans in the secondary market and are classified as Level 2.

### *Mortgage servicing rights*

The Company initially measures its mortgage servicing rights at fair value, and amortizes them over the period of estimated net servicing income. They are periodically assessed for impairment based on fair value at the reporting date. Mortgage servicing rights do not trade in an active market with readily observable prices. Accordingly, the fair value is estimated based on a valuation model which calculates the present value of estimated future net servicing income. The model incorporates assumptions that market participants use in estimating future net servicing income, including estimates of prepayment speeds, market discount rates, cost to service, float earnings rates, and other ancillary income, including late fees. The fair value measurements are classified as Level 3. No fair value adjustments were recorded during 2008.

## **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF CONSOLIDATED FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes and with the statistical information and financial data appearing in this report as well as the Company's 2007 Annual Report on Form 10-K. Results of operations for the three and nine month periods ended September 30, 2008 are not necessarily indicative of results to be attained for any other period. In its third quarter earnings announcement on October 15, 2008, the Company noted the unknown potential effect on its third quarter earnings of recent litigation settlement between Visa, Inc. (Visa) and Discover Financial Services. The terms of the litigation settlement, disclosed by Visa after the Company's earnings announcement, resulted in a \$2.9 million increase to the Company's indemnification obligation for certain litigation costs, which has been reflected in the financial statements and discussions contained in this report.

### **Forward Looking Information**

This report may contain forward-looking statements that are subject to risks and uncertainties and include information about possible or assumed future results of operations. Many possible events or factors could affect the future financial results and performance of the Company. This could cause results or performance to differ materially from those expressed in the forward-looking statements. Words such as *expects*, *anticipates*, *believes*, *estimates*, *variation* of such words and other similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in, or implied by, such forward-looking statements. Readers should not rely solely on the forward-looking statements and should consider all uncertainties and risks discussed throughout this report. Forward-looking statements speak

only as of the date they are made. The Company does not undertake to update forward-looking statements to reflect circumstances or events that occur after the date the forward-looking

## **Table of Contents**

statements are made or to reflect the occurrence of unanticipated events. Such possible events or factors include: changes in economic conditions in the Company's market area, changes in policies by regulatory agencies, governmental legislation and regulation, fluctuations in interest rates, changes in liquidity requirements, demand for loans in the Company's market area, and competition with other entities that offer financial services.

## **Critical Accounting Policies**

The Company's consolidated financial statements are prepared based on the application of certain accounting policies, some of which require numerous estimates and strategic or economic assumptions that may prove inaccurate or be subject to variations which may significantly affect the Company's reported results and financial position for the current period or future periods. The use of estimates, assumptions, and judgments are necessary when financial assets and liabilities are required to be recorded at, or adjusted to reflect, fair value. The Company has identified several policies as being critical because they require management to make particularly difficult, subjective and/or complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions. These policies relate to the allowance for loan losses, the valuation of certain investment securities, and accounting for income taxes.

### *Allowance for Loan Losses*

The Company performs periodic and systematic detailed reviews of its loan portfolio to assess overall collectability. The level of the allowance for loan losses reflects the Company's estimate of the losses inherent in the loan portfolio at any point in time. While these estimates are based on substantive methods for determining allowance requirements, actual outcomes may differ significantly from estimated results, especially when determining allowances for business, lease, construction and business real estate loans. These loans are normally larger and more complex, and their collection rates are harder to predict. Personal loans, including personal mortgage, credit card and consumer loans, are individually smaller and perform in a more homogenous manner, making loss estimates more predictable. Further discussion of the methodologies used in establishing the allowance is provided in the Provision and Allowance for Loan Losses section of this discussion.

### *Valuation of Investment Securities*

The Company carries its investment securities at fair value, and in accordance with the requirements of SFAS No. 157, the Company employs valuation techniques which utilize observable inputs when those inputs are available. These observable inputs reflect assumptions market participants would use in pricing the security, developed based on market data obtained from sources independent of the Company. When such information is not available, the Company employs valuation techniques which utilize unobservable inputs, or those which reflect the Company's own assumptions about market participants, based on the best information available in the circumstances. These valuation methods typically involve cash flow and other financial modeling techniques. Changes in underlying factors, assumptions, estimates, or other inputs to the valuation techniques could have a material impact on the Company's future financial condition and results of operations. Assets and liabilities carried at fair value inherently result in more financial statement volatility. SFAS 157, which requires fair value measurements to be classified as Level 1 (quoted prices), Level 2 (based on observable inputs) or Level 3 (based on unobservable, internally-derived inputs) is discussed in more detail in Note 14 to the consolidated financial statements.

Available for sale securities are reported at fair value, with changes in fair value reported in other comprehensive income. Most of the portfolio is priced utilizing industry-standard models that consider various assumptions which are observable in the marketplace, or can be derived from observable data. Such securities totaled approximately \$3.1 billion, or 85.2% of the portfolio at September 30, 2008, and were classified as Level 2 measurements. The Company also holds \$510.0 million in auction rate securities. These were classified as Level 3 measurements, as no

market currently exists for these securities, and fair values were derived from internally generated cash flow valuation models which used unobservable inputs which

**Table of Contents**

were significant to the overall measurement. The Company periodically evaluates the available for sale portfolio for other than temporary impairment. The review includes an analysis of the facts and circumstances of each individual security such as the severity of loss, the length of time the fair value has been below cost, the creditworthiness of the issuer, and the Company's intent and ability to hold the security to maturity. Impairment which is deemed other than temporary is reflected in current earnings and reported in securities gains and losses in the consolidated statements of income.

The Company, through its direct holdings and its Small Business Investment subsidiaries, has numerous private equity and venture capital investments, categorized as non-marketable securities in the accompanying consolidated balance sheets. These investments are reported at fair value, and totaled \$58.0 million at September 30, 2008. Changes in fair value are reflected in current earnings, and reported in securities gains and losses in the consolidated statements of income. Because there is no observable market data for these securities, their fair values are internally developed using available information and management's judgment. Although management believes its estimates of fair value reasonably reflect the fair value of these securities, key assumptions regarding the projected financial performance of these companies, the evaluation of the investee company's management team, and other economic and market factors may affect the amounts that will ultimately be realized from these investments.

*Accounting for Income Taxes*

The objectives of accounting for income taxes are to recognize the amount of taxes payable or refundable for the current year and deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an entity's financial statements or tax returns. Judgment is required in assessing the future tax consequences of events that have been recognized in the Company's financial statements or tax returns. Fluctuations in the actual outcome of these future tax consequences, including the effects of IRS examinations and examinations by other state agencies, could materially impact the Company's financial position and its results of operations. Further discussion of income taxes is presented in the Income Taxes section of this discussion.



**Table of Contents****Selected Financial Data**

	Three Months Ended September 30		Nine Months Ended September 30	
	2008	2007	2008	2007
<b>Per Share Data</b>				
Net income basic	\$ .34	\$ .78	\$ 2.02	\$ 2.25
Net income diluted	.34	.77	2.00	2.22
Cash dividends	.250	.238	.750	.714
Book value			22.17	20.75
Market price			46.40	43.70
<b>Selected Ratios</b>				
(Based on average balance sheets)				
Loans to deposits*	93.29%	88.67%	92.46%	88.06%
Non-interest bearing deposits to total deposits	5.49	5.53	5.44	5.44
Equity to loans*	14.23	13.86	14.11	14.05
Equity to deposits	13.28	12.29	13.05	12.37
Equity to total assets	9.86	9.46	9.73	9.54
Return on total assets	.60	1.43	1.18	1.42
Return on total stockholders equity	6.07	15.10	12.16	14.88
(Based on end-of-period data)				
Non-interest income to revenue**	38.68	41.29	39.96	40.57
Efficiency ratio***	74.23	59.81	64.57	60.64
Tier I capital ratio			10.65	10.34
Total capital ratio			11.94	11.55
Leverage ratio			9.11	8.79

\* Includes loans held for sale.

\*\* Revenue includes net interest income and non-interest income.

\*\*\* The efficiency ratio is calculated as non-interest expense (excluding intangibles amortization) as a percent of revenue.

**Results of Operations****Summary**

	Three Months Ended September 30			Nine Months Ended September 30		
	2008	2007	% Change	2008	2007	% Change
(Dollars in thousands)						
Net interest income	\$ 151,564	\$ 135,262	12.1%	\$ 436,450	\$ 400,605	8.9%
Provision for loan losses	(29,567)	(11,455)	158.1	(67,567)	(28,670)	135.7

Edgar Filing: COMMERCE BANCSHARES INC /MO/ - Form 10-Q

Non-interest income	<b>95,593</b>	95,137	.5	<b>290,486</b>	273,480	6.2
Investment securities gains, net	<b>1,149</b>	1,562	(26.4)	<b>25,480</b>	4,964	413.3
Non-interest expense	<b>(184,532)</b>	(139,093)	32.7	<b>(472,710)</b>	(411,861)	14.8
Income taxes	<b>(9,534)</b>	(25,515)	(62.6)	<b>(67,320)</b>	(75,550)	(10.9)
<b>Net income</b>	<b>\$ 24,673</b>	\$ 55,898	(55.9)%	<b>\$ 144,819</b>	\$ 162,968	(11.1)%

For the quarter ended September 30, 2008, net income amounted to \$24.7 million, a decrease of \$31.2 million, or 55.9%, from the third quarter of the previous year. For the current quarter, the annualized return on average assets was .60%, the annualized return on average equity was 6.07%, and the efficiency ratio was 74.23%. The current quarter included a non-cash pre-tax loss of \$33.0 million as a result of the Company's previously announced purchase of auction rate securities from its customers.

**Table of Contents**

Excluding this loss, the annualized return on average assets was 1.10%, the annualized return on average equity was 11.18%, and the efficiency ratio was 60.89%. Compared to the third quarter of last year, net interest income increased \$16.3 million, or 12.1%, mainly due to lower rates paid on deposits and borrowings coupled with higher average loan balances, but offset by lower rates earned on the loan portfolio. Non-interest income increased \$456 thousand, or .5%, with double-digit growth in bank card fees, bond trading income and brokerage fees, offset by a 7.6% decrease in deposit account fees. The provision for loan losses was \$29.6 million in the current quarter, an \$18.1 million increase over the third quarter of last year, and exceeded net loan charge-offs by \$10.8 million. Non-interest expense grew by \$45.4 million, or 32.7%, largely due to the \$33.0 million loss related to the purchase of auction rate securities. Exclusive of this item, non-interest expense would have grown \$12.5 million, or 9.0%, over the third quarter of last year, due to higher salaries and employee benefits expense and an increase in an indemnification obligation (discussed below). Diluted earnings per share was \$.34, a decrease of 55.8% from \$.77 per share in the third quarter of 2007. On an after-tax basis, the loss on the purchase of auction rate securities lowered diluted earnings per share by \$.29.

Net income for the first nine months of 2008 was \$144.8 million, an \$18.1 million, or 11.1%, decrease from the first nine months of 2007. For the first nine months of 2008, the annualized return on average assets was 1.18%, the annualized return on average equity was 12.16%, and the efficiency ratio was 64.57%. Diluted earnings per share was \$2.00, a decrease of 9.9% from \$2.22 per share during the first nine months of 2007. The decrease in net income was primarily due to a \$60.8 million increase in non-interest expense, coupled with a \$38.9 million increase in the provision for loan losses. Non-interest expense included auction rate security losses and higher salaries and benefits expense, offset by a \$5.9 million reversal of indemnification charges (discussed below). These expenses were partially offset by a \$35.8 million increase in net interest income, largely due to the same factors mentioned in the quarterly discussion above, and a \$17.0 million increase in non-interest income. In addition, securities gains increased \$20.5 million, mainly due to the Visa stock redemption mentioned below.

In the fourth quarter of 2007, the Company established an indemnification obligation of \$21.0 million for its share of certain estimated litigation costs of Visa, Inc. (Visa) arising from the Company's relationship as a member bank and resulting from a reorganization among Visa and its affiliates. In the first quarter of 2008, Visa made an initial public offering (IPO). In conjunction with the IPO, the Company's shares of Class B Visa stock were redeemed, resulting in a \$22.2 million pre-tax gain. In addition, Visa escrowed approximately \$3.0 billion in cash from the offering to be used to fund certain estimated litigation costs, and the Company consequently reduced its indemnification obligation by \$8.8 million.

On October 14, 2008, the settlement amount of a suit between Visa and Discover Financial Services was announced. As a result, the Company increased its indemnification obligation by \$2.9 million in the third quarter of 2008, lowering diluted earnings per share by \$.02 for the quarter. On an after-tax basis, the Visa transactions contributed \$17.7 million to net income in the first nine months of 2008, while the auction rate securities losses reduced net income by \$21.0 million, which on a combined basis lowered diluted earnings per share by \$.04 for the year to date period.

The Company regularly evaluates the potential acquisition of various financial institutions, and the disposition of certain of its branch assets and liabilities. During the second quarter of 2008, the Company sold its banking branch in Independence, located in southeast Kansas, which had \$23.3 million in loans and \$85.0 million in deposits. The Company paid cash of \$54.1 million in the transaction, representing the net liabilities sold, and recorded a gain of \$6.9 million.

During the second quarter of 2007, the Company acquired South Tulsa Financial Corporation (South Tulsa). In this transaction, the Company acquired the outstanding stock of South Tulsa and issued shares of Company stock valued at \$27.6 million. The Company's acquisition of South Tulsa added \$142.4 million in assets and two branch locations in Tulsa, Oklahoma. During the third quarter of 2007, the Company acquired Commerce Bank in Denver, Colorado. In

this transaction, the Company acquired all of the outstanding stock of Commerce Bank for \$29.5 million in cash. The acquisition added \$123.9 million in assets and the Company's first location in Colorado.

**Table of Contents****Net Interest Income**

The following table summarizes the changes in net interest income on a fully taxable equivalent basis, by major category of interest earning assets and interest bearing liabilities, identifying changes related to volumes and rates. Changes not solely due to volume or rate changes are allocated to rate.

**Analysis of Changes in Net Interest Income**

<i>(In thousands)</i>	<b>Three Months Ended September 30, 2008 vs. 2007</b>			<b>Nine Months Ended September 30, 2008 vs. 2007</b>		
	<b>Average Volume</b>	<b>Average Rate</b>	<b>Total</b>	<b>Average Volume</b>	<b>Average Rate</b>	<b>Total</b>
<b>Interest income, fully taxable equivalent basis:</b>						
Loans	\$ 14,133	\$ (41,014)	\$ (26,881)	\$ 50,056	\$ (101,715)	\$ (51,659)
Loans held for sale	1,006	(2,281)	(1,275)	(42)	(5,958)	(6,000)
Investment securities:						
U.S. government and federal agency securities	(2,845)		(2,845)	(6,489)	152	(6,337)
State and municipal obligations	1,171	947	2,118	(331)	1,702	1,371
Mortgage and asset-backed securities	4,343	1,433	5,776	13,567	4,420	17,987
Other securities	(78)	(635)	(713)	1,195	(2,467)	(1,272)
<b>Total interest on investment securities</b>	<b>2,591</b>	<b>1,745</b>	<b>4,336</b>	<b>7,942</b>	<b>3,807</b>	<b>11,749</b>
Federal funds sold and securities purchased under agreements to resell	(1,035)	(3,191)	(4,226)	(2,910)	(9,393)	(12,303)
<b>Total interest income</b>	<b>16,695</b>	<b>(44,741)</b>	<b>(28,046)</b>	<b>55,046</b>	<b>(113,259)</b>	<b>(58,213)</b>
<b>Interest expense:</b>						
Deposits:						
Savings	25	(244)	(219)	8	(637)	(629)
Interest checking and money market	2,159	(18,311)	(16,152)	6,137	(44,361)	(38,224)
Time open & C.D. s of less than \$100,000	(4,260)	(8,153)	(12,413)	(5,592)	(15,330)	(20,922)
	874	(8,144)	(7,270)	4,043	(16,606)	(12,563)

Time open & C.D. s of \$100,000  
and over

Total interest on deposits	(1,202)	(34,852)	(36,054)	4,596	(76,934)	(72,338)
Federal funds purchased and securities sold under agreements to repurchase	(3,343)	(11,517)	(14,860)	(8,655)	(32,315)	(40,970)
Other borrowings	9,191	(3,389)	5,802	25,714	(7,379)	18,335
<b>Total interest expense</b>	4,646	(49,758)	(45,112)	21,655	(116,628)	(94,973)
<b>Net interest income, fully taxable equivalent basis</b>	\$ 12,049	\$ 5,017	\$ 17,066	\$ 33,391	\$ 3,369	\$ 36,760

**Table of Contents**

Net interest income in the third quarter of 2008 amounted to \$151.6 million, an increase of \$16.3 million, or 12.1%, compared to the third quarter of last year. During the third quarter of 2008, the net yield on earning assets was 4.02% on a tax equivalent basis, compared to 3.77% in the same period last year. This increase was primarily the result of lower rates paid on deposits and other borrowings, coupled with an increase in average loan balances, but offset by lower rates earned on loans. Total interest income on loans (tax equivalent) for the third quarter of 2008 decreased \$26.9 million, mainly due to lower rates earned on virtually all loan products, which fell 141 basis points overall. Most of the rate declines were seen in business, business real estate, construction, home equity and consumer credit card loans. This effect was partly offset by higher average balances in the overall portfolio, which rose on average by \$699.3 million over the third quarter of last year. Interest income on investment securities (tax equivalent) increased \$4.3 million as a result of a \$184.0 million increase in average balances and a 25 basis point rise in average rates earned. On average, mortgage and asset-backed securities rose \$358.4 million and state and municipal obligations rose \$105.2 million, partly offset by a \$280.2 million decline in federal agency securities. Interest income on federal funds sold and securities purchased under agreements to resell (resale agreements) declined \$4.2 million, due to both lower rates earned and lower average balances.

Interest expense on deposits declined \$36.1 million in the third quarter of 2008 due to a 129 basis point decline in rates paid on deposit products, especially affecting money market accounts and certificates of deposit. Interest expense on other borrowings declined \$9.1 million in the third quarter of 2008 compared to the same period last year mainly as a result of lower rates paid on federal funds purchased and repurchase agreements. However, interest expense paid on advances from the Federal Home Loan Bank (FHLB) increased as a result of growth of \$664.8 million in average advances outstanding, offset by lower rates paid on the advances. The overall tax equivalent yield on earning assets in the third quarter of 2008 declined 108 basis points to 5.52%, while the overall cost of interest bearing liabilities decreased 143 basis points to 1.65%.

Net interest income for the first nine months of 2008 amounted to \$436.5 million compared with \$400.6 million in 2007, an increase of \$35.8 million, or 8.9%. For the first nine months of 2008, the net yield on earning assets (tax equivalent) was 3.89%, compared with 3.81% in the same period last year. The increase in net interest income for the first nine months of 2008 followed similar trends as the quarterly discussion above, as lower rates paid on interest bearing liabilities, coupled with growth in average loan balances, helped to increase net interest income overall. For the first nine months of 2008, total interest income decreased \$59.1 million, or 8.5%, mainly due to lower interest earned on loans but offset by higher average balances in loans and investment securities. Interest on loans (tax equivalent) declined \$51.7 million in 2008 compared with 2007 as a result of lower yields on all lending products, especially business, business real estate, construction, home equity and consumer credit card loans. Average yields declined 120 basis points overall during the first nine months of 2008 compared to 2007. However, growth in average balances of the Company's overall loan portfolio, which rose \$843.5 million, partly offset the effects of lower yields. Interest on the investment portfolio (tax equivalent) increased \$11.7 million due to higher average balances, which rose \$171.0 million overall, in addition to higher average rates earned, which rose 21 basis points. Interest on overnight investments decreased \$12.3 million, mainly due to declines in rates earned and balances invested in resale agreements.

Interest expense on deposits for the first nine months of 2008 declined \$72.3 million due to lower rates paid, especially on the Company's money market accounts and certificates of deposit. The overall decline of 92 basis points was slightly offset by a \$390.6 million increase in money market account balances. Interest expense on borrowings for the first nine months of 2008 decreased \$22.6 million as a result of lower rates paid on both federal funds purchased and repurchase agreements, in addition to lower borrowings of federal funds purchased. These declines were offset by higher interest expense on FHLB debt, as these advances grew \$620.7 million on average as the Company employed initiatives to diversify funding sources from short-term federal funds purchased into longer term advances. For the first nine months of 2008, the overall tax equivalent yield on earning assets declined 92 basis points to 5.68%, while

the overall cost of interest bearing liabilities also decreased 110 basis points to 1.95%.

Summaries of average assets and liabilities and the corresponding average rates earned/paid appear on the last page of this discussion.



Table of Contents**Non-Interest Income**

<i>(Dollars in thousands)</i>	<b>Three Months Ended September 30</b>			<b>Nine Months Ended September 30</b>		
	<b>2008</b>	2007	<i>%</i> Change	<b>2008</b>	2007	<i>%</i> Change
Deposit account charges and other fees	\$ 27,854	\$ 30,148	(7.6)%	\$ 83,189	\$ 86,740	(4.1)%
Bank card transaction fees	29,317	26,409	11.0	85,019	75,347	12.8
Trust fees	20,518	19,823	3.5	60,917	58,448	4.2
Consumer brokerage services	3,439	3,056	12.5	10,259	9,431	8.8
Trading account profits and commissions	2,604	2,174	19.8	9,951	5,475	81.8
Loan fees and sales	1,594	2,919	(45.4)	4,884	6,916	(29.4)
Other	10,267	10,608	(3.2)	36,267	31,123	16.5
<b>Total non-interest income</b>	<b>\$ 95,593</b>	<b>\$ 95,137</b>	<b>.5%</b>	<b>\$ 290,486</b>	<b>\$ 273,480</b>	<b>6.2%</b>
Non-interest income as a % of total revenue*	<b>38.7%</b>	41.3%		<b>40.0%</b>	40.6%	

\* Total revenue is calculated as net interest income and non-interest income.

For the third quarter of 2008, total non-interest income was \$95.6 million, an increase of \$456 thousand, or .5%, compared with \$95.1 million in the same quarter last year. The increase in non-interest income over the third quarter of last year resulted mainly from continued double-digit growth in bank card, brokerage and bond trading income. Bank card fees increased \$2.9 million, or 11.0%, over the third quarter of last year, primarily due to growth in fees earned on debit, merchant and corporate card transactions, which grew by 9.5%, 9.1% and 27.3%, respectively. Trust fees for the quarter increased 3.5% over the same period last year, mainly as a result of growth in personal trust fees, which increased 7.2%, but were partly offset by lower institutional trust fee income. Deposit account fees decreased \$2.3 million, or 7.6%, as a result of a 10.9% decline in overdraft fees, offset by growth in corporate cash management fees of 5.9%. Overdraft fee income has been negatively impacted by lower transaction volume compared to the prior period. Brokerage fee income for the quarter totaled \$3.4 million, an increase of 12.5% over the same period last year, and bond trading income totaled \$2.6 million in the current quarter, an increase of 19.8% over the same period last year. Loan fees and sales were lower by \$1.3 million from the same period last year, which was the result of a decrease in gains on student loan sales as fewer loans were sold in the current quarter. Other non-interest income decreased \$341 thousand from the third quarter of 2007, mainly due to small declines in official check sales, equipment rental income and lower gains recorded on the sales of leased equipment. Small increases occurred in cash sweep commissions and fair value gains on interest rate swaps.

Non-interest income for the nine months ended September 30, 2008 was \$290.5 million compared to \$273.5 million in the first nine months of 2007, resulting in a \$17.0 million, or 6.2%, increase. Deposit account fees declined \$3.6 million, or 4.1%, as a result of lower overdraft fee revenue, which fell \$6.4 million, or 10.6%, but was partly offset by higher cash management fees, which rose \$3.6 million, or 18.9%. Bank card fees rose \$9.7 million, or 12.8% overall, due to increases of 11.6%, 12.5% and 28.9%, respectively, in debit, merchant and corporate card transaction fees. Trust fees increased \$2.5 million, or 4.2%, mainly due to growth in personal and corporate trust fees. Bond trading income rose \$4.5 million due to increased sales activity, while consumer brokerage income grew \$828 thousand, mainly as a result of higher annuity and bond sales fee income. Loan fees and sales decreased by \$2.0 million, as gains on student loan sales declined from \$3.7 million in the first nine months of 2007 to \$1.7 million in 2008. Other non-interest income increased \$5.1 million compared to the prior period, mainly due to a \$6.9 million gain recognized in the second quarter of 2008 on the sale of a bank branch, as mentioned previously. Partly offsetting this increase was an impairment charge of \$1.1 million on an office building held for sale, formerly housing the Company's main check processing operations, which was recognized in the first quarter of 2008. Smaller increases occurred in cash sweep commissions, swap fair value gains and tax credit sales income, partly offset by lower official check sales and equipment rental income.

**Table of Contents****Investment Securities Gains and Losses, Net**

Net gains and losses on investment securities during the three and nine month periods ended September 30, 2008 and 2007 are shown in the table below. A net gain of \$1.1 million was recorded in the third quarter of 2008, compared to a net gain of \$1.6 million in the third quarter of 2007. On a year to date basis, net securities gains of \$25.5 million were recorded in the nine months ended September 30, 2008 compared to \$5.0 million recorded in the same period in 2007. Most of the net gain in 2008 occurred because of the redemption of Visa Class B stock in conjunction with the Visa IPO in March 2008, resulting in a \$22.2 million gain. Sales of preferred equity securities and federal agency securities from the available for sale portfolio in 2008 generated realized losses of \$3.5 million and realized gains of \$1.1 million, respectively. Also shown below are net gains and losses relating to non-marketable private equity and venture capital investments, which are primarily held by the Parent's majority-owned venture capital subsidiaries. These include fair value adjustments, in addition to gains and losses realized upon disposition. The minority interest expense pertaining to the securities gains during the first nine months of 2008 and 2007 totaled \$660 thousand and \$208 thousand, respectively, and was reported in other non-interest expense.

<i>(In thousands)</i>	<b>Three Months Ended September 30</b>		<b>Nine Months Ended September 30</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>Available for sale:</b>				
Preferred equity securities	\$	\$ (314)	\$ (3,504)	\$ (663)
Common stock	(1)	986	(1)	1,807
Other bonds		7	1,139	(391)
<b>Non-marketable:</b>				
Private equity and venture capital investments	1,150	883	5,650	4,211
Visa Class B stock			22,196	
<b>Total investment securities gains, net</b>	<b>\$ 1,149</b>	<b>\$ 1,562</b>	<b>\$ 25,480</b>	<b>\$ 4,964</b>

**Non-Interest Expense**

<i>(Dollars in thousands)</i>	<b>Three Months Ended September 30</b>			<b>Nine Months Ended September 30</b>		
	<b>2008</b>	<b>2007</b>	<b>% Change</b>	<b>2008</b>	<b>2007</b>	<b>% Change</b>
Salaries and employee benefits	\$ 83,766	\$ 77,312	8.3%	\$ 250,023	\$ 230,335	8.5%
Net occupancy	11,861	11,572	2.5	34,735	34,205	1.5
Equipment	6,122	5,761	6.3	18,273	17,875	2.2

Edgar Filing: COMMERCE BANCSHARES INC /MO/ - Form 10-Q

Supplies and communication	<b>9,276</b>	8,546	8.5	<b>26,545</b>	25,638	3.5
Data processing and software	<b>14,229</b>	12,697	12.1	<b>41,951</b>	36,657	14.4
Marketing	<b>4,926</b>	4,775	3.2	<b>15,660</b>	13,952	12.2
Loss on purchase of auction rate securities	<b>32,967</b>		N.M.	<b>33,266</b>		N.M.
Indemnification obligation	<b>2,879</b>		N.M.	<b>(5,929)</b>		N.M.
Other	<b>18,506</b>	18,430	.4	<b>58,186</b>	53,199	9.4
<b>Total non-interest expense</b>	<b>\$ 184,532</b>	\$ 139,093	32.7%	<b>\$ 472,710</b>	\$ 411,861	14.8%

Non-interest expense for the quarter amounted to \$184.5 million, which represented an increase of \$45.4 million, or 32.7%, over the expense recorded in the third quarter of last year. Non-interest expense for the current quarter included a non-cash loss of \$33.0 million related to the purchase of auction rate securities from customers. The securities were purchased at par value from the customers, and this loss represents the amount by which par value exceeded estimated fair value on the purchase date. Exclusive of this item, non-interest expense would have amounted to \$151.6 million, or an increase of \$12.5 million over the same period

**Table of Contents**

last year. Compared with the third quarter of last year, salaries and benefits expense increased \$6.5 million, or 8.3%, resulting partly from increased staffing related to the effects of several growth initiatives, higher incentives earned and increased medical insurance costs. Occupancy costs increased \$289 thousand, or 2.5%, compared to the same quarter last year, mainly as a result of higher building services expense. Equipment costs increased \$361 thousand, or 6.3%, and supplies and communication expense increased \$730 thousand, or 8.5%, as both were affected by certain non-recurring expense reductions recorded in the previous year, totaling \$605 thousand combined. Exclusive of these non-recurring reductions in the prior year, equipment expense would have been flat with the prior year, while supplies and communication expense would have shown growth of 4.8%. Data processing expense increased \$1.5 million, or 12.1%, mainly due to higher bank card processing costs which increased in relation to higher bank card revenues this quarter. Exclusive of bank card costs, core data processing expense increased 5.1% as a result of investments in new software programs. Marketing costs increased \$151 thousand, or 3.2%, while other non-interest expense increased only slightly.

As mentioned in previous reports, also included in non-interest expense are adjustments to the Company's estimate of its share of certain litigation costs arising from its member bank relationship with Visa. A charge of \$21.0 million was recorded in the fourth quarter of 2007 to establish the Company's obligation for its portion of litigation costs relating to various suits against Visa. The obligation was reduced in the first quarter of 2008 upon the funding of an escrow for these suits in conjunction with Visa's initial public offering, and was increased in the third quarter of 2008 upon Visa's settlement of a suit with Discover Financial Services. As a result of these events, the Company recorded an increase of \$2.9 million in the obligation in the current quarter, and has recorded an overall reduction in the obligation of \$5.9 million during the first nine months of 2008.

Total non-interest expense was \$472.7 million in the first nine months of 2008, which was an increase of \$60.8 million, or 14.8%, over the first nine months of 2007. As mentioned previously, the current period expense included a non-cash loss of \$33.3 million related to the purchase of auction rate securities. Excluding this item, non-interest expense would have been \$439.4 million, or an increase of \$27.6 million, or 6.7%, over the same period last year. Salaries and benefits expense grew \$19.7 million, or 8.5%, due to merit increases, higher incentive payments, and increased medical insurance costs. Full-time equivalent employees totaled 5,202 and 5,077 at September 30, 2008 and 2007, respectively. Occupancy costs grew by \$530 thousand, or 1.5%, over the same period last year, mainly as a result of higher real estate taxes and building services expense. Small variances occurred in supplies and communication expense, which increased \$907 thousand due to higher courier expense, and in equipment expense, which increased \$398 thousand due to higher repair and maintenance costs. Data processing and software expense increased \$5.3 million, or 14.4%, due to higher bank card processing fees and software investments. Marketing expense increased \$1.7 million, resulting from promotional efforts to attract new deposits and credit card business in the first six months of 2008. Other non-interest expense increased \$5.0 million over the first nine months of 2007, partly due to an impairment charge of \$2.5 million related to foreclosed land sold in the third quarter of 2008. Other increases occurred in travel and entertainment, recruiting costs, minority interest expense, and credit card rewards expense, partly offset by a decline in professional fees.

**Table of Contents****Provision and Allowance for Loan Losses**

<i>(In thousands)</i>	<b>Three Months Ended</b>			<b>Nine Months Ended</b>	
	<b>September 30 2008</b>	June 30 2008	September 30 2007	<b>September 30 2008</b>	2007
<b>Provision for loan losses</b>	<b>\$ 29,567</b>	\$ 18,000	\$ 11,455	<b>\$ 67,567</b>	\$ 28,670
Net loan charge-offs:					
Business	<b>1,775</b>	1,049	1,853	<b>2,315</b>	2,546
Real estate-construction	<b>1,217</b>	203	605	<b>2,194</b>	1,475
Real estate-business	<b>257</b>	39	744	<b>1,198</b>	307
Consumer credit card	<b>8,314</b>	7,935	5,331	<b>22,842</b>	17,092
Consumer	<b>6,060</b>	4,530	2,318	<b>14,546</b>	5,996
Home equity	<b>208</b>	136	131	<b>338</b>	241
Real estate-personal	<b>182</b>	73	71	<b>356</b>	125
Overdrafts	<b>721</b>	526	403	<b>1,333</b>	887
<b>Total net loan charge-offs</b>	<b>\$ 18,734</b>	\$ 14,491	\$ 11,456	<b>\$ 45,122</b>	\$ 28,669

	<b>Three Months Ended</b>			<b>Nine Months Ended</b>	
	<b>September 30 2008</b>	June 30 2008	September 30 2007	<b>September 30 2008</b>	2007
Annualized net loan charge-offs*:					
Business	<b>.20%</b>	.12%	.24%	<b>.09%</b>	.11%
Real estate-construction	<b>.69</b>	.12	.34	<b>.42</b>	.29
Real estate-business	<b>.04</b>	.01	.13	<b>.07</b>	.02
Consumer credit card	<b>4.19</b>	4.06	3.15	<b>3.92</b>	3.51
Consumer	<b>1.40</b>	1.09	.57	<b>1.16</b>	.52
Home equity	<b>.17</b>	.12	.12	<b>.10</b>	.07
Real estate-personal	<b>.05</b>	.02	.02	<b>.03</b>	.01
Overdrafts	<b>23.17</b>	19.84	11.05	<b>14.37</b>	9.34
<b>Total annualized net loan charge-offs</b>	<b>.68%</b>	.53%	.44%	<b>.55%</b>	.38%

\* as a percentage of average loans (excluding loans held for sale)

The Company has an established process to determine the amount of the allowance for loan losses, which assesses the risks and losses inherent in its portfolio. This process provides an allowance consisting of a specific allowance component based on certain individually evaluated loans and a general component based on estimates of reserves needed for pools of loans with similar risk characteristics.

Loans subject to individual evaluation are defined by the Company as impaired, and generally consist of business, construction and commercial real estate loans on non-accrual status. These loans are evaluated individually for the impairment of repayment potential and collateral adequacy, and in conjunction with current economic conditions and loss experience, allowances are estimated. Loans not individually evaluated are aggregated and reserves are recorded using a consistent methodology that considers historical loan loss experience by loan type, delinquencies, current economic factors, loan risk ratings and industry concentrations.

In using this process and the information available, management must consider various assumptions and exercise considerable judgment to determine the overall level of the allowance for loan losses. Because of these subjective factors, actual outcomes of inherent losses can differ from original estimates. The process of determining adequate levels of the allowance for loan losses is subject to regular review by the Company's Credit Administration personnel and outside regulators.

**Table of Contents**

Net loan charge-offs in the third quarter of 2008 amounted to \$18.7 million, compared with \$14.5 million in the prior quarter and \$11.5 million in the third quarter of last year. The \$7.3 million increase in net charge-offs in the third quarter of 2008 compared to the same quarter of last year was primarily due to increases of \$3.0 million in consumer credit card loan net charge-offs and \$3.7 million in consumer banking loan net charge-offs. Included in the increase in consumer loan net charge-offs was an increase of \$2.7 million in marine and recreational vehicle (RV) loan charge-offs. The current quarter also included a \$1.0 million construction loan charge-off and a \$1.1 million business loan charge-off. For the third quarter of 2008, annualized net charge-offs on average consumer credit card loans were 4.19%, compared with 4.06% in the previous quarter and 3.15% in the same period last year. Additionally, consumer banking loan net charge-offs for the quarter amounted to 1.40% of average consumer loans, compared to 1.09% in the previous quarter and .57% in the same quarter last year. Annualized charge-offs on marine and RV loans, which comprise approximately 50% of consumer banking loans, were 1.73% of average marine and RV loans in the current quarter, compared to 1.40% in the previous quarter and .57% in the same quarter last year.

The provision for loan losses for the quarter totaled \$29.6 million, and was \$11.6 million higher than the previous quarter and \$18.1 million higher than the third quarter of 2007. The amount of the provision to expense in each quarter was determined by management's review and analysis of the adequacy of the allowance for loan losses, involving all the activities and factors described above regarding that process. During the current quarter and as a result of its regular review, the Company increased the allowance by \$10.8 million, mainly due to increasing levels of watch list loans (including substandard-classed loans) and deteriorating general economic conditions.

Net charge-offs during the first nine months of 2008 amounted to \$45.1 million, compared to \$28.7 million in the comparable prior year period. The increase occurred because of higher consumer credit card, consumer banking and real estate net loan charge-offs in 2008, which increased \$5.8 million, \$8.6 million, and \$1.8 million, respectively. The provision for loan losses was \$67.6 million in the first nine months of 2008 compared to \$28.7 million in the same period in 2007. The provision for loan losses in the first nine months of 2008 exceeded net loan charge-offs in the same period by \$22.4 million.

The allowance for loan losses at September 30, 2008 amounted to \$156.0 million, or 1.42% of total loans (excluding loans held for sale), compared to \$133.6 million, or 1.26%, at December 31, 2007 and \$133.6 million, or 1.28%, at September 30, 2007. The increase in the allowance compared to previous periods resulted primarily from higher provisions, as noted above. The Company considers the allowance for loan losses adequate to cover losses inherent in the loan portfolio at September 30, 2008.



**Table of Contents****Risk Elements of Loan Portfolio**

The following table presents non-performing assets and loans which are past due 90 days and still accruing interest. Non-performing assets include non-accruing loans and foreclosed real estate. Loans are placed on non-accrual status when management does not expect to collect payments consistent with acceptable and agreed upon terms of repayment. Loans that are 90 days past due as to principal and/or interest payments are generally placed on non-accrual, unless they are both well-secured and in the process of collection, or they are 1-4 family first mortgage loans or consumer loans that are exempt under regulatory rules from being classified as non-accrual.

<i>(Dollars in thousands)</i>	<b>September 30 2008</b>	December 31 2007
Non-accrual loans:		
Business	\$ 5,140	\$ 4,700
Real estate construction	22,148	7,769
Real estate business	11,275	5,628
Consumer	1,038	547
Real estate personal	1,999	1,095
<b>Total non-accrual loans</b>	<b>41,600</b>	19,739
<b>Foreclosed real estate</b>	<b>4,622</b>	13,678
<b>Total non-performing assets</b>	<b>\$ 46,222</b>	\$ 33,417
Non-performing assets to total loans	.42%	.32%
Non-performing assets to total assets	.27%	.21%
Loans past due 90 days and still accruing interest:		
Business	\$ 5,917	\$ 1,427
Real estate construction	1,364	768
Real estate business	4,403	281
Consumer credit card	11,262	10,664
Consumer	2,093	1,914
Student	13	1
Home equity	441	700
Real estate personal	6,385	5,131
<b>Total loans past due 90 days and still accruing interest</b>	<b>\$ 31,878</b>	\$ 20,886

Non-accrual loans, which are also considered impaired, totaled \$41.6 million at September 30, 2008, and increased \$21.9 million over amounts recorded at December 31, 2007. The increase over December 31, 2007 resulted from increases of \$14.4 million in construction and \$5.6 million in business real estate non-accrual loans. At September 30, 2008 non-accrual loans were comprised mainly of construction loans (53.2%), business real estate loans (27.1%) and business loans (12.4%). Foreclosed real estate declined \$9.1 million to a balance of \$4.6 million at September 30, 2008. The decline was mainly due to sales of several large properties with a carrying value of \$9.8 million at sale date, in addition to a \$2.5 million impairment charge on one of the properties sold.

Total loans past due 90 days or more and still accruing interest amounted to \$31.9 million as of September 30, 2008, and increased \$11.0 million over December 31, 2007. The increase in the past due totals at September 30, 2008 compared to December 31, 2007 resulted mainly from increases of \$4.5 million in business, \$4.1 million in business real estate and \$1.3 million in personal real estate loan delinquencies.

**Table of Contents**

In addition to the non-accrual loans mentioned above, the Company also has identified loans for which management has concerns about the ability of the borrowers to meet existing repayment terms. They are primarily classified as substandard under the Company's internal rating system. The loans are generally secured by either real estate or other borrower assets, reducing the potential for loss should they become non-performing. Although these loans are generally identified as potential problem loans, they may never become non-performing. Such loans totaled \$252.2 million at September 30, 2008 compared with \$127.2 million at December 31, 2007, resulting in an increase of 98%. Most of the increase occurred in construction real estate loans, which rose from \$36.7 million at year end to \$128.4 million at September 30, 2008. The overall balance at September 30, 2008 also included \$49.5 million in business real estate loans and \$46.1 million in business loans.

**Income Taxes**

Income tax expense was \$9.5 million in the third quarter of 2008, compared to \$27.1 million in the second quarter of 2008 and \$25.5 million in the third quarter of 2007. The Company's effective income tax rate was 27.9% in the third quarter of 2008, compared with 32.6% in the second quarter of 2008 and 31.3% in the third quarter of 2007. The lower effective tax rate in the current quarter was the result of lower pre-tax income, largely due to the loss on auction rate securities and the higher loan loss provision recorded in the current quarter. Income tax expense was \$67.3 million in the first nine months of 2008 compared to \$75.6 million in the previous year, resulting in an effective income tax rate of 31.7% in both periods.

**Table of Contents**

**Financial Condition**

**Balance Sheet**

Total assets of the Company were \$17.0 billion at September 30, 2008 compared to \$16.2 billion at December 31, 2007. Earning assets at September 30, 2008 were \$15.7 billion and consisted of 73% in loans and 24% in investment securities, compared to \$14.7 billion at December 31, 2007.

During the first nine months of 2008, total period end loans, including held for sale, increased \$537.2 million, or 5.0%, compared with balances at December 31, 2007. The increase was primarily the result of growth of \$198.9 million in business loans, \$158.3 million in student loans, \$95.6 million in business real estate loans, \$56.0 million in consumer loans, \$27.6 million in home equity, and \$24.9 million in consumer credit card loans. Growth in business loans was reflective of continued customer demand and higher line of credit usage, while the increase in student lending was due to continued loan originations, the majority of which occurred in the first and third quarters of 2008. Consumer loan growth reflected overall higher lending totals for marine and RV loans, which increased \$56.0 million, or 7.0%, over December 31, 2007. However, during the third quarter of 2008, the Company reduced its originations of certain types of marine and RV loans due to current market conditions. Growth in consumer credit cards reflected positive results from marketing promotions during the first six months of 2008.

On an average basis, loans (including held for sale) increased \$842.7 million, or 8.1%, during the first nine months of 2008 compared to the same period in 2007. Loan growth occurred in nearly all loan categories, with increases of \$433.0 million in business loans, \$146.2 million in consumer banking loans, \$128.7 million in consumer credit card loans, and \$82.7 million in business real estate loans.

Available for sale investment securities, excluding fair value adjustments, increased \$544.2 million, or 17.5%, at September 30, 2008 compared to December 31, 2007. This growth was mainly due to increases in municipal obligations and mortgage-backed securities totaling \$830.9 million, but offset by a reduction in federal agency securities of \$255.8 million. Municipal obligations increased \$565.1 million mainly due to the acquisition of auction rate securities in 2008, which totaled \$514.4 million, excluding fair value adjustments, at September 30, 2008. Non-marketable securities, mostly consisting of various investments in private equity concerns, Federal Reserve Bank stock and FHLB stock, increased \$47.9 million, or 45.4%, partly due to a \$30.1 million increase in FHLB stock that was tied to increased borrowings from the FHLB.

On an average basis, available for sale investment securities, excluding fair value adjustments, increased \$119.1 million, or 3.7%, during the first nine months of 2008 compared to the same period in 2007. Mortgage-backed securities increased \$404.2 million, while federal agency securities decreased \$213.9 million.

Total deposits decreased by \$239.5 million, or 1.9%, at September 30, 2008 compared to December 31, 2007. The decrease in deposits from year end 2007 balances was partially due to the bank branch sale mentioned above, in which deposits of \$85.0 million were sold. On an overall basis, decreases of \$356.3 million in certificates of deposit of less than \$100,000 and \$226.5 million in non-interest bearing demand accounts were offset by increases of \$340.8 million in money market deposit accounts as customers shifted out of certificates of deposit and into money market accounts.

On an average basis, total deposits increased \$348.3 million, or 2.9%, during the first nine months of 2008 compared to the same period in 2007, mainly due to increases of \$102.1 million in jumbo certificates of deposit and \$390.6 million in money market accounts. These average increases were partially offset by decreases of \$166.9 million in certificates of deposit of less than \$100,000.

Compared to 2007 year end balances, total short-term borrowings at September 30, 2008 increased \$320.8 million due to an increase of \$402.2 million in federal funds purchased, offset by an \$81.4 million decrease in repurchase agreements. However, on an average basis, short-term borrowings were lower by \$217.0 million during the first nine months of 2008 compared to the same period in 2007, resulting from lower average levels of federal funds purchased. Other borrowings increased \$666.9 million over 2007 year end balances due to increases in advances from the FHLB, which were used to fund continued loan growth.

Table of ContentsLiquidity and Capital Resources**Liquidity Management**

The Company's most liquid assets are comprised of available for sale marketable investment securities, federal funds sold, and securities purchased under agreements to resell, as follows:

<i>(In thousands)</i>	<b>September 30 2008</b>	June 30 2008	December 31 2007
Liquid assets:			
Federal funds sold	\$ 186,295	\$ 195,165	\$ 261,165
Securities purchased under agreements to resell	271,000	271,000	394,000
Available for sale investment securities	<b>3,659,488</b>	3,628,061	3,165,020
<b>Total</b>	<b>\$ 4,116,783</b>	\$ 4,094,226	\$ 3,820,185

Federal funds sold and resale agreements totaled \$457.3 million at September 30, 2008. These investments normally have overnight maturities and are used for general daily liquidity purposes. The fair value of the available for sale investment portfolio was \$3.7 billion at September 30, 2008, and included an unrealized net loss of \$1.3 million. The overall net loss includes a \$46.7 million unrealized loss on mortgage and asset-backed securities held by the banking affiliates and a \$48.0 million unrealized gain on common stock held by the Parent. The portfolio includes maturities of approximately \$416 million over the next 12 months, which offer substantial resources to meet either new loan demand or reductions in the Company's deposit funding base. The Company pledges portions of its investment securities portfolio to secure public fund deposits, securities sold under agreements to repurchase, trust funds, letters of credit issued by the FHLB, and borrowing capacity at the Federal Reserve Bank. At September 30, 2008, total investment securities pledged for these purposes were as follows:

<i>(In thousands)</i>	<b>September 30 2008</b>
Investment securities pledged for the purpose of securing:	
Federal Reserve Bank borrowings	\$ 181,007
FHLB borrowings and letters of credit	240,077
Repurchase agreements	1,376,411
Other deposits	642,684
<b>Total pledged, at fair value</b>	<b>\$ 2,440,179</b>

At September 30, 2008, the Company's unpledged securities in the available for sale portfolio totaled approximately \$1.2 billion, consisting mainly of municipal obligations, which included \$510.0 million of auction rate securities.

Liquidity is also available from the Company's large base of core customer deposits, defined as demand, interest checking, savings, and money market deposit accounts. At September 30, 2008, such deposits totaled \$8.6 billion and represented 70.2% of the Company's total deposits. These core deposits are normally less volatile and are often tied to other products of the Company through long lasting relationships. Time open and certificates of deposit of \$100,000 and over totaled \$1.7 billion at September 30, 2008. These accounts are normally considered more volatile and higher costing, and comprised 13.4% of total deposits at September 30, 2008.

**Table of Contents**

<i>(In thousands)</i>	<b>September 30 2008</b>	June 30 2008	December 31 2007
Core deposit base:			
Non-interest bearing demand	\$ 1,187,334	\$ 1,398,766	\$ 1,413,849
Interest checking	499,609	448,285	580,048
Savings and money market	6,952,236	7,032,780	6,575,318
<b>Total</b>	<b>\$ 8,639,179</b>	<b>\$ 8,879,831</b>	<b>\$ 8,569,215</b>

Other important components of liquidity are the level of borrowings from third party sources and the availability of future credit. The Company's outside borrowings are comprised of federal funds purchased, securities sold under agreements to repurchase, and FHLB advances, as follows:

<i>(In thousands)</i>	<b>September 30 2008</b>	June 30 2008	December 31 2007
Borrowings:			
Federal funds purchased	\$ 528,270	\$ 32,665	\$ 126,077
Securities sold under agreements to repurchase	1,031,705	1,581,136	1,113,142
Federal Reserve treasury auction		200,000	
FHLB advances	1,228,433	853,579	561,475
Subordinated debentures	14,310	14,310	14,310
Other long-term debt	7,767	7,796	7,851
<b>Total</b>	<b>\$ 2,810,485</b>	<b>\$ 2,689,486</b>	<b>\$ 1,822,855</b>

Federal funds purchased and securities sold under agreements to repurchase are generally borrowed overnight, and amounted to \$1.6 billion at September 30, 2008. Federal funds purchased are unsecured overnight borrowings obtained mainly from upstream correspondent banks with which the Company maintains approved lines of credit. Securities sold under agreements to repurchase are secured by a portion of the Company's investment portfolio and are comprised of both non-insured customer funds, totaling \$531.7 million at September 30, 2008, and structured repurchase agreements of \$500.0 million purchased from an upstream financial institution. The Company may periodically borrow additional short-term funds from the Federal Reserve Bank through its treasury auction facility or the discount window, although no such borrowings were outstanding at the current quarter end. The Company also borrows on a secured basis through advances from the FHLB, which totaled \$1.2 billion at September 30, 2008. Most of these advances have fixed interest rates and mature in 2008 through 2010. In addition, the Company has



\$14.3 million in outstanding subordinated debentures issued to wholly-owned grantor trusts, funded by preferred securities issued by the trusts. Other outstanding long-term borrowings relate mainly to the Company's leasing and venture capital operations.

**Table of Contents**

The Company pledges certain assets, including loans and investment securities, to both the Federal Reserve Bank and the FHLB as security to establish lines of credit and borrow from these entities. Based on the amount and type of collateral pledged, the FHLB establishes a collateral value from which the Company may draw advances against the collateral. Also, this collateral is used to enable the FHLB to issue letters of credit in favor of public fund depositors of the Company. The Federal Reserve Bank also establishes a collateral value of assets pledged and permits borrowings from either the discount window or the treasury auction facility. The following table reflects the collateral value of assets pledged, borrowings, and letters of credit outstanding, in addition to the estimated future funding capacity available to the Company at September 30, 2008:

<i>(In thousands)</i>	<b>September 30, 2008</b>	
	FHLB	Federal Reserve
Collateral value pledged	\$ 2,262,472	\$ 1,162,501
Advances outstanding	(1,228,433)	
Letters of credit issued	(772,735)	
<b>Available for future advances</b>	<b>\$ 261,304</b>	<b>\$ 1,162,501</b>

In addition to those mentioned above, several other sources of liquidity are available. The Company has strong long-term deposit ratings from Moody's and Standard & Poor's of Aa2 and A+, respectively. Additionally, its sound commercial paper rating of A-1 from Standard & Poor's and short-term rating of P-1 from Moody's would help ensure the ready marketability of its commercial paper, should the need arise. No commercial paper has been issued or outstanding during the past ten years. Neither the Company nor its principal banking subsidiary, Commerce Bank, N.A., has any subordinated debt or hybrid instruments which could affect future borrowing capacity. Because of its lack of significant long-term debt, the Company believes that it could generate additional liquidity through its Capital Markets Group from sources such as jumbo certificates of deposit or privately placed debt offerings. Future financing could also include the issuance of common or preferred stock.

Cash and cash equivalents (defined as Cash and due from banks and Federal funds sold and securities purchased under agreements to resell as segregated in the accompanying balance sheets) was \$954.3 million at September 30, 2008 compared to \$1.3 billion at December 31, 2007. The \$374.0 million decrease resulted from changes in the various cash flows produced by the operating, investing and financing activities of the Company, as shown in the accompanying statement of cash flows for September 30, 2008. The cash flow provided by operating activities is considered a very stable source of funds and consists mainly of net income adjusted for certain non-cash items. Operating activities provided cash flow of \$88.4 million during the first nine months of 2008. Investing activities, consisting mainly of purchases, sales and maturities of available for sale securities and changes in the level of the loan portfolio, used total cash of \$1.1 billion. Most of the cash outflow was due to \$448.8 million in loan growth and \$1.9 billion of investment securities purchases, partly offset by \$1.3 billion in proceeds from sales, maturities, and pay downs of investment securities. Financing activities provided cash of \$667.3 million, resulting from \$675.0 million in additional FHLB advances and a net increase of \$321.0 million in overnight borrowings. These cash inflows were partly offset by a net decrease of \$273.1 million in certificates of deposit and cash dividend payments of

\$54.0 million. Future short-term liquidity needs arising from daily operations are not expected to vary significantly, and the Company believes it will be able to meet these cash flow needs.

**Table of Contents****Capital Management**

The Company maintains strong regulatory capital ratios, including those of its principal banking subsidiaries, which exceed the well-capitalized guidelines under federal banking regulations. Information about the Company's risk-based capital is shown below.

<i>(Dollars in thousands)</i>	<b>September 30 2008</b>	December 31 2007	Minimum Ratios for Well-Capitalized Banks
Risk-adjusted assets	\$ 13,881,204	\$ 13,330,968	
Tier I capital	1,478,462	1,375,035	
Total capital	1,657,181	1,532,189	
Tier I capital ratio	10.65%	10.31%	6.00%
Total capital ratio	11.94%	11.49%	10.00%
Leverage ratio	9.11%	8.76%	5.00%

The Company maintains a treasury stock buyback program, and in February 2008 was authorized by the Board of Directors to repurchase up to 3,000,000 shares of its common stock. During 2008, the Company reduced its purchases under this program, and in the current quarter purchased only 2,000 shares of treasury stock at an average cost of \$41.62 per share. At September 30, 2008, 2,903,946 shares remained available for purchase under the current Board authorization.

The Company's common stock dividend policy reflects its earnings outlook, desired payout ratios, the need to maintain adequate capital levels, and alternative investment options. The Company increased its per share cash dividend to \$.25 in the first quarter of 2008, an increase of 5.0% compared to the fourth quarter of 2007, and maintained the same dividend payout in the second and third quarters of 2008. The year 2008 represents the 40th consecutive year of per share dividend increases.

**Commitments and Off-Balance Sheet Arrangements**

Various commitments and contingent liabilities arise in the normal course of business which are not required to be recorded on the balance sheet. The most significant of these are loan commitments, which at September 30, 2008 totaled \$8.0 billion (including approximately \$3.8 billion in unused approved credit card lines of credit). In addition, the Company enters into standby and commercial letters of credit with its business customers. These contracts amounted to \$421.1 million and \$25.2 million, respectively, at September 30, 2008. Since many commitments expire unused or only partially used, these totals do not necessarily reflect future cash requirements. The carrying value of the guarantee obligations associated with the standby letters of credit, which has been recorded as a liability on the balance sheet, amounted to \$3.6 million at September 30, 2008. Management does not anticipate any material losses arising from commitments and contingent liabilities and believes there are no material commitments to extend credit that represent risks of an unusual nature.

The Company periodically purchases various state tax credits arising from third-party property redevelopment. Most of the tax credits are resold to third parties, although some may be retained for use by the Company. During the first nine months of 2008, purchases and sales of tax credits amounted to \$31.4 million and \$32.5 million, respectively, and at September 30, 2008, outstanding purchase commitments totaled \$125.1 million. The Company has additional funding commitments arising from several investments in private equity concerns, classified as non-marketable investment securities in the accompanying consolidated balance sheets. These funding commitments amounted to \$2.0 million at September 30, 2008. The Company also has unfunded commitments relating to its investments in low-income housing partnerships, which amounted to \$1.9 million at September 30, 2008.

**Table of Contents****Segment Results**

The table below is a summary of segment pre-tax income results for the first nine months of 2008 and 2007. As mentioned in Note 10 in the notes to the consolidated financial statements, the 2008 and 2007 results in this table reflect a modification to the funds transfer pricing process.

<i>(In thousands)</i>	Consumer	Commercial	Money Management	Segment Totals	Other/ Elimination	Consolidated Totals
<b>Nine Months Ended September 30, 2008:</b>						
Net interest income	\$ 260,379	\$ 153,746	\$ 5,454	\$ 419,579	\$ 16,871	\$ 436,450
Provision for loan losses	(39,426)	(5,814)		(45,240)	(22,327)	(67,567)
Non-interest income	133,028	72,137	75,135	280,300	10,186	290,486
Investment securities gains, net					25,480	25,480
Non-interest expense	(241,907)	(127,171)	(85,862)	(454,940)	(17,770)	(472,710)
Income (loss) before income taxes	\$ 112,074	\$ 92,898	\$ (5,273)	\$ 199,699	\$ 12,440	\$ 212,139
<b>Nine Months Ended September 30, 2007:</b>						
Net interest income	\$ 257,729	\$ 144,018	\$ 5,716	\$ 407,463	\$ (6,858)	\$ 400,605
Provision for loan losses	(24,007)	(4,606)		(28,613)	(57)	(28,670)
Non-interest income	137,992	62,342	67,794	268,128	5,352	273,480
Investment securities gains, net					4,964	4,964
Non-interest expense	(228,071)	(117,670)	(47,858)	(393,599)	(18,262)	(411,861)
Income (loss) before income taxes	\$ 143,643	\$ 84,084	\$ 25,652	\$ 253,379	\$ (14,861)	\$ 238,518
Increase (decrease) in income before income taxes:						
Amount	\$ (31,569)	\$ 8,814	\$ (30,925)	\$ (53,680)	\$ 27,301	\$ (26,379)

Percent	(22.0)%	10.5%	(120.6)%	(21.2)%	N.M.	(11.1)%
---------	---------	-------	----------	---------	------	---------

### *Consumer*

For the nine months ended September 30, 2008, income before income taxes for the Consumer segment decreased \$31.6 million, or 22.0%, compared to the same period in the prior year. This decrease was due to increases of \$13.8 million in non-interest expense and \$15.4 million in the provision for loan losses. In addition, non-interest income declined \$5.0 million, while net interest income increased \$2.7 million. The increase in net interest income resulted mainly from a \$60.4 million decline in deposit interest expense, partly offset by a \$49.6 million decrease in net allocated funding credits assigned to the Consumer segment's deposit and loan portfolios, in addition to an \$8.4 million decrease in loan interest income. The decrease in non-interest income resulted largely from lower deposit account fees (mostly overdraft and return item charges) and lower gains on student loan sales, partly offset by an increase in bank card fee income (primarily debit card and merchant fees). Non-interest expense increased \$13.8 million, or 6.1%, over the previous year mainly due to higher bank card transaction fees, salaries expense, teller services fees, corporate management fees and telephone support fees. These increases were partly offset by declines in bank card servicing fees and bank card fraud losses. Net loan charge-offs increased \$15.4 million, or 64.2%, in the Consumer segment, with most of the increase due to higher consumer credit card, marine and RV loan charge-offs.

**Table of Contents***Commercial*

For the nine months ended September 30, 2008, income before income taxes for the Commercial segment increased \$8.8 million, or 10.5%, compared to the same period in the previous year. Most of the increase was due to a \$9.7 million, or 6.8%, increase in net interest income and a \$9.8 million increase in non-interest income. The increase in net interest income resulted from lower net allocated funding costs of \$52.0 million and lower deposit interest expense of \$5.0 million, partly offset by a \$47.2 million decline in loan interest income. Non-interest income increased by 15.7% over the previous year largely due to higher deposit account fees (mainly commercial cash management fees) and bank card fees (mainly corporate card fees). Partly offsetting these increases in income was an increase in non-interest expense, which rose \$9.5 million, or 8.1%, over the same period in the previous year. This increase included a \$2.5 million impairment charge on foreclosed land (sold in the current quarter), in addition to higher salaries expense and bank card servicing fees, partly offset by a decline in deposit account processing costs. Net loan charge-offs were \$5.8 million in the first nine months of 2008 compared to \$4.6 million in the first nine months of 2007.

*Money Management*

The Money Management segment reported a pre-tax loss of \$5.3 million for the first nine months of 2008, which was a decline of \$30.9 million compared to pre-tax profitability of \$25.7 million in the first nine months of 2007. The loss was the result of an increase in non-interest expense of \$38.0 million, which was mainly due to a non-cash loss of \$33.0 million related to the purchase of auction rate securities from Capital Markets customers recorded in the third quarter of 2008. The securities were purchased at par value from the customers, and this loss represents the amount by which par value exceeded estimated fair value on the purchase date. In addition, salaries expense increased, while allocated trust processing costs declined. Net interest income, which declined \$262 thousand, or 4.6%, from the prior year, was lower due to an \$18.1 million decline in income on overnight investments, partly offset by a \$9.9 million decline in overnight borrowings expense, a \$4.3 million decrease in deposit interest expense and higher assigned net funding credits of \$3.4 million. Non-interest income increased \$7.3 million, or 10.8%, over the previous year primarily due to higher trust fees and bond trading income.

The Other/elimination category shown in the table above includes support and overhead operating units of the Company, in addition to the investment securities portfolio and other items not allocated to the segments. For the first nine months of 2008, the pre-tax profitability in this category was \$27.3 million higher than in the previous period. The increase was partly due to unallocated amounts recorded in conjunction with the Visa IPO and Discover settlement, which included a securities gain of \$22.0 million and a \$5.9 million reduction in the indemnification obligation. In addition, net interest income in this category increased \$23.7 million partly as a result of higher earnings on the Company's investment portfolio and lower interest expense on overnight borrowings not allocated to a segment. These effects were partly offset by the higher provision for loan losses shown in this category, resulting from the excess of the overall provision over the actual net charge-offs allocated to the segments. In accordance with the Company's transfer pricing policies, the excess of the total provision over charge-offs is not allocated to a business segment. The excess provision totaled \$22.3 million and related mainly to estimated losses on commercial-type loans.

**Impact of Recently Issued Accounting Standards**

In June 2006, the FASB issued Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48), which prescribes the recognition threshold and measurement attributes necessary for recognition in the financial statements of a tax position taken, or expected to be taken, in a tax return. Under FIN 48, an income tax position will be recognized if it is more likely than not that it will be sustained upon IRS examination, based upon its technical merits. Once that status is met, the amount recorded will be the largest amount of benefit that is greater than 50 percent likely of being realized



upon ultimate settlement. It also provides guidance on derecognition, classification, interest and penalties, interim period accounting, disclosure, and transition requirements. As a result of the Company's adoption of FIN 48, additional income tax benefits of \$446 thousand were recognized as of January 1, 2007 as an increase to equity.

**Table of Contents**

The Company adopted Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, on January 1, 2008. This Statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. It emphasizes that fair value is a market-based measurement and should be determined based on assumptions that a market participant would use when pricing an asset or liability. Additionally, it establishes a fair value hierarchy that provides the highest priority to measurements using quoted prices in active markets and the lowest priority to measurements based on unobservable data. The Statement does not require any new fair value measurements. The Statement also modifies the guidance for initial recognition of fair value for certain derivative contracts held by the Company. Former accounting guidance precluded immediate recognition in earnings of an unrealized gain or loss, measured as the difference between the transaction price and fair value of these instruments at initial recognition. This guidance was nullified by the Statement. In accordance with the new recognition requirements of the Statement, the Company increased equity by \$903 thousand on January 1, 2008.

The Company adopted Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, at December 31, 2006. The Statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through other comprehensive income. The Company's initial recognition at December 31, 2006 of the funded status of its defined benefit pension plan reduced its prepaid pension asset by \$17.5 million, reduced deferred tax liabilities by \$6.6 million, and reduced the equity component of accumulated other comprehensive income by \$10.9 million. Beginning in 2008, the Statement also requires an employer to measure plan assets and obligations as of the date of its fiscal year end statement of financial position. In order to transition to a fiscal year end measurement date, the Company plans to use earlier measurements to allocate net periodic benefit cost for the period between September 30, 2007 (the previous measurement date) and December 31, 2008 proportionately between retained earnings and net periodic benefit cost recognized during 2008. The Company plans to record the transition adjustment to retained earnings on December 31, 2008 and does not expect it to have a material effect on the Company's consolidated financial statements.

In September 2006, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. This EITF Issue addresses accounting for separate agreements which split life insurance policy benefits between an employer and employee. The Issue requires the employer to recognize a liability for future benefits payable to the employee based on the substantive agreement with the employee, because the postretirement benefit obligation is not effectively settled through the purchase of the insurance policy. The EITF Issue was effective January 1, 2008, and the Company's adoption on that date resulted in a reduction to equity of \$716 thousand.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*. This Statement permits entities to choose to measure many financial instruments and certain other items at fair value, on an instrument-by-instrument basis. Once an entity has elected to record eligible items at fair value, the decision is irrevocable and the entity should report unrealized gains and losses for which the fair value option has been elected in earnings. The Statement's objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments. The Statement may be applied to financial instruments existing at the January 1, 2008 adoption date, financial instruments recognized after the adoption date, and upon certain other events. As of the adoption date and subsequent to that date, the Company has chosen not to elect the fair value option, but continues to consider future election and the effect on

its consolidated financial statements.

**Table of Contents**

In November 2007, the Securities and Exchange Commission staff issued Staff Accounting Bulletin No. 109 (SAB 109). SAB 109 provides revised guidance on the valuation of written loan commitments accounted for at fair value through earnings. Former guidance under SAB 105 indicated that the expected net future cash flows related to the associated servicing of the loan should not be incorporated into the measurement of the fair value of a derivative loan commitment. The new guidance under SAB 109 requires these cash flows to be included in the fair value measurement, and the SAB requires this view to be applied on a prospective basis to derivative loan commitments issued or modified after January 1, 2008. The Company's application of SAB 109 in 2008 did not have a material effect on its consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(revised), *Business Combinations*. The Statement retains the fundamental requirements in Statement 141 that the acquisition method of accounting be used for business combinations, but broadens the scope of Statement 141 and contains improvements to the application of this method. The Statement requires an acquirer to recognize the assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date. Costs incurred to effect the acquisition are to be recognized separately from the acquisition. Assets and liabilities arising from contractual contingencies must be measured at fair value as of the acquisition date. Contingent consideration must also be measured at fair value as of the acquisition date. The Statement also changes the accounting for negative goodwill arising from a bargain purchase, requiring recognition in earnings instead of allocation to assets acquired. For business combinations achieved in stages (step acquisitions), the assets and liabilities must be recognized at the full amounts of their fair values, while under former guidance the entity was acquired in a series of purchases, with costs and fair values being identified and measured at each step. The Statement applies to business combinations occurring after January 1, 2009.

Also in December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, *Noncontrolling Interests in Consolidated Financial Statements* an amendment of ARB No. 51. The Statement clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. The Statement establishes a single method of accounting for changes in a parent's ownership interest if the parent retains its controlling interest, deeming these to be equity transactions. Such changes include the parent's purchases and sales of ownership interests in its subsidiary and the subsidiary's acquisition and issuance of its ownership interests. The Statement also requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. It changes the way the consolidated income statement is presented, requiring consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest, and requires disclosure of these amounts on the face of the consolidated statement of income. The Statement is effective on January 1, 2009. The Company does not expect adoption of the Statement to have a significant effect on its consolidated financial statements.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an amendment of FASB Statement No. 133. This Statement requires enhanced disclosures about how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for, and how these activities affect its financial position, financial performance, and cash flows. The Statement is effective for financial statements issued in 2009. The Company does not expect adoption of the Statement to have a significant effect on its consolidated financial statements.

**Table of Contents**

In June 2008, the FASB posted Staff Position No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities . This pronouncement defines unvested stock awards which contain nonforfeitable rights to dividends as securities which participate in undistributed earnings. Such participating securities must be included in the computation of earnings per share under the two-class method. The two-class method is an earnings allocation formula that determines earnings per share for common stock and participating securities according to dividends declared and participation rights in undistributed earnings. The Company is required to apply the two-class method to its computation of earnings per share effective January 1, 2009, and does not expect its application to have a significant effect on the computation of earnings per share attributable to common shareholders.

In September 2008, the FASB issued Staff Position No. FAS 133-1 and FIN 45-4, which requires additional disclosures about credit derivatives and guarantees, effective for the December 31, 2008 and subsequent reporting periods. Its provisions require additional disclosures which address the potential adverse effects of changes in credit risk on the financial position, financial performance, and cash flows on the sellers of credit derivatives and certain guarantees subject to FIN 45. The Company does not expect the application of these requirements to have a significant effect on its consolidated financial statements.

**Table of Contents****AVERAGE BALANCE SHEETS AVERAGE RATES AND YIELDS****Three Months Ended September 30, 2008 and 2007**

<i>(Dollars in thousands)</i>	Third Quarter 2008			Third Quarter 2007		
	Average Balance	Interest Income/ Expense	Avg. Rates Earned/ Paid	Average Balance	Interest Income/ Expense	Avg. Rates Earned/ Paid
<b>ASSETS:</b>						
Loans:						
Business <sup>(A)</sup>	\$ 3,473,797	\$ 40,857	4.68%	\$ 3,103,903	\$ 53,104	6.79%
Real estate construction	698,420	8,393	4.78	705,232	13,274	7.47
Real estate business	2,324,683	33,879	5.80	2,220,136	39,674	7.09
Real estate personal	1,508,736	21,805	5.75	1,538,279	22,941	5.92
Consumer	1,717,075	30,533	7.07	1,605,879	30,165	7.45
Home equity	479,025	5,683	4.72	446,208	8,538	7.59
Consumer credit card	790,303	21,369	10.76	670,973	21,704	12.83
Overdrafts	12,381			14,468		
<b>Total loans</b>	<b>11,004,420</b>	<b>162,519</b>	<b>5.88</b>	<b>10,305,078</b>	<b>189,400</b>	<b>7.29</b>
Loans held for sale	352,283	3,774	4.26	293,610	5,049	6.82
Investment securities:						
U.S. government and federal agency	117,311	1,204	4.08	397,470	4,049	4.04
State and municipal obligations <sup>(A)</sup>	700,250	8,763	4.98	595,076	6,645	4.43
Mortgage and asset-backed securities	2,453,686	31,068	5.04	2,095,312	25,292	4.79
Trading securities	23,278	198	3.38	16,343	219	5.32
Other marketable securities <sup>(A)</sup>	81,552	668	3.26	134,156	2,171	6.42
Non-marketable securities	144,476	2,004	5.52	98,177	1,193	4.82
<b>Total investment securities</b>	<b>3,520,553</b>	<b>43,905</b>	<b>4.96</b>	<b>3,336,534</b>	<b>39,569</b>	<b>4.71</b>
Federal funds sold and securities purchased under agreements to resell	419,628	2,125	2.01	511,834	6,351	4.92

<b>Total interest earning assets</b>	<b>15,296,884</b>	<b>212,323</b>	<b>5.52</b>	14,447,056	240,369	6.60
Less allowance for loan losses	(144,174)			(132,878)		
Unrealized gain on investment securities	17,356			13,461		
Cash and due from banks	464,422			471,745		
Land, buildings and equipment, net	411,578			403,781		
Other assets	341,033			325,857		
<b>Total assets</b>	<b>\$ 16,387,099</b>			<b>\$ 15,529,022</b>		
<b>LIABILITIES AND EQUITY:</b>						
Interest bearing deposits:						
Savings	\$ 410,201	321	.31	\$ 392,317	540	.55
Interest checking and money market	7,498,605	14,481	.77	7,025,694	30,633	1.73
Time open and C.D. s of less than \$100,000	2,041,276	16,128	3.14	2,389,019	28,541	4.74
Time open and C.D. s of \$100,000 and over	1,554,804	11,542	2.95	1,485,637	18,812	5.02
<b>Total interest bearing deposits</b>	<b>11,504,886</b>	<b>42,472</b>	<b>1.47</b>	11,292,667	78,526	2.76
Borrowings:						
Federal funds purchased and securities sold under agreements to repurchase	1,368,050	5,417	1.58	1,628,453	20,277	4.94
Other borrowings <sup>(B)</sup>	1,103,224	10,011	3.61	346,076	4,209	4.83
<b>Total borrowings</b>	<b>2,471,274</b>	<b>15,428</b>	<b>2.48</b>	1,974,529	24,486	4.92
<b>Total interest bearing liabilities</b>	<b>13,976,160</b>	<b>57,900</b>	<b>1.65%</b>	13,267,196	103,012	3.08%
Non-interest bearing demand deposits	668,191			660,681		

Other liabilities	<b>126,280</b>	132,545
Stockholders' equity	<b>1,616,468</b>	1,468,600
<b>Total liabilities and equity</b>	<b>\$ 16,387,099</b>	\$ 15,529,022
<b>Net interest margin (T/E)</b>	<b>\$ 154,423</b>	\$ 137,357
<b>Net yield on interest earning assets</b>	<b>4.02%</b>	3.77%

(A) Stated on a tax equivalent basis using a federal income tax rate of 35%.

(B) Interest expense capitalized on construction projects is not deducted from the interest expense shown above.



**Table of Contents****AVERAGE BALANCE SHEETS AVERAGE RATES AND YIELDS****Nine Months Ended September 30, 2008 and 2007**

<i>(Dollars in thousands)</i>	Nine Months 2008			Nine Months 2007		
	Average Balance	Interest Income/ Expense	Avg. Rates Earned/ Paid	Average Balance	Interest Income/ Expense	Avg. Rates Earned/ Paid
<b>ASSETS:</b>						
Loans:						
Business <sup>(A)</sup>	\$ 3,509,030	\$ 131,475	5.00%	\$ 3,075,994	\$ 156,998	6.82%
Real estate construction	694,119	26,783	5.15	670,077	37,436	7.47
Real estate business	2,280,431	103,853	6.08	2,197,714	116,109	7.06
Real estate personal	1,515,084	66,310	5.85	1,514,058	67,372	5.95
Consumer	1,676,139	90,131	7.18	1,529,894	84,193	7.36
Home equity	468,060	18,273	5.21	440,030	25,381	7.71
Consumer credit card	779,025	62,265	10.68	650,345	63,260	13.01
Overdrafts	12,387			12,701		
<b>Total loans</b>	<b>10,934,275</b>	<b>499,090</b>	<b>6.10</b>	<b>10,090,813</b>	<b>550,749</b>	<b>7.30</b>
Loans held for sale	332,134	11,314	4.55	332,944	17,314	6.95
Investment securities:						
U.S. government and federal agency	206,627	6,336	4.10	423,310	12,673	4.00
State and municipal obligations <sup>(A)</sup>	590,902	21,817	4.93	600,622	20,446	4.55
Mortgage and asset-backed securities	2,449,704	92,026	5.02	2,075,947	74,039	4.77
Trading securities	31,834	958	4.02	19,768	719	4.86
Other marketable securities <sup>(A)</sup>	107,434	2,984	3.71	135,689	6,136	6.05
Non-marketable securities	128,525	5,406	5.62	88,645	3,765	5.68
<b>Total investment securities</b>	<b>3,515,026</b>	<b>129,527</b>	<b>4.92</b>	<b>3,343,981</b>	<b>117,778</b>	<b>4.71</b>
Federal funds sold and securities purchased under agreements to resell	444,042	7,790	2.34	523,747	20,093	5.13

<b>Total interest earning assets</b>	<b>15,225,477</b>	<b>647,721</b>	<b>5.68</b>	14,291,485	705,934	6.60
Less allowance for loan losses	<b>(140,166)</b>			(132,150)		
Unrealized gain on investment securities	<b>39,898</b>			18,799		
Cash and due from banks	<b>460,038</b>			461,347		
Land, buildings and equipment, net	<b>411,778</b>			396,968		
Other assets	<b>343,106</b>			304,465		
<b>Total assets</b>	<b>\$ 16,340,131</b>			\$ 15,340,914		
<b>LIABILITIES AND EQUITY:</b>						
Interest bearing deposits:						
Savings	<b>\$ 400,551</b>	<b>998</b>	<b>.33</b>	\$ 398,660	1,627	.55
Interest checking and money market	<b>7,363,577</b>	<b>48,771</b>	<b>.88</b>	6,971,670	86,995	1.67
Time open and C.D. s of less than \$100,000	<b>2,181,529</b>	<b>61,855</b>	<b>3.79</b>	2,348,467	82,777	4.71
Time open and C.D. s of \$100,000 and over	<b>1,576,578</b>	<b>42,728</b>	<b>3.62</b>	1,474,521	55,291	5.01
<b>Total interest bearing deposits</b>	<b>11,522,235</b>	<b>154,352</b>	<b>1.79</b>	11,193,318	226,690	2.71
Borrowings:						
Federal funds purchased and securities sold under agreements to repurchase	<b>1,471,561</b>	<b>23,051</b>	<b>2.09</b>	1,688,512	64,021	5.07
Other borrowings <sup>(B)</sup>	<b>944,516</b>	<b>26,368</b>	<b>3.73</b>	225,125	8,033	4.77
<b>Total borrowings</b>	<b>2,416,077</b>	<b>49,419</b>	<b>2.73</b>	1,913,637	72,054	5.03
<b>Total interest bearing liabilities</b>	<b>13,938,312</b>	<b>203,771</b>	<b>1.95%</b>	13,106,955	298,744	3.05%
Non-interest bearing demand deposits	<b>663,087</b>			643,702		

Other liabilities	<b>148,510</b>	126,139
Stockholders' equity	<b>1,590,222</b>	1,464,118
<b>Total liabilities and equity</b>	<b>\$ 16,340,131</b>	\$ 15,340,914
<b>Net interest margin (T/E)</b>	<b>\$ 443,950</b>	\$ 407,190
<b>Net yield on interest earning assets</b>	<b>3.89%</b>	3.81%

(A) Stated on a tax equivalent basis using a federal income tax rate of 35%.

(B) Interest expense capitalized on construction projects is not deducted from the interest expense shown above.

Table of Contents**Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Interest rate risk management focuses on maintaining consistent growth in net interest income within Board-approved policy limits. The Company primarily uses earnings simulation models to analyze net interest sensitivity to movement in interest rates. The Company performs monthly simulations which model interest rate movements and risk in accordance with changes to its balance sheet composition. For further discussion of the Company's market risk, see the Interest Rate Sensitivity section of Management's Discussion and Analysis of Consolidated Financial Condition and Results of Operations included in the Company's 2007 Annual Report on Form 10-K.

The table below shows the effect that gradual rising and/or falling interest rates over a twelve month period would have on the Company's net interest income given a static balance sheet.

	September 30, 2008		June 30, 2008		December 31, 2007	
	\$ Change in Net Interest Income	% Change in Net Interest Income	\$ Change in Net Interest Income	% Change in Net Interest Income	\$ Change in Net Interest Income	% Change in Net Interest Income
<i>(Dollars in millions)</i>						
200 basis points rising	\$ 8.7	1.46%	\$ 6.1	1.01%	\$ 2.3	.40%
100 basis points rising	4.7	.79	3.7	.60	2.0	.34
100 basis points falling	(3.1)	(.51)	(.8)	(.14)	(1.2)	(.20)

The table above reflects the expectation that the Company's net interest income would continue to improve as a result of rising rates, however, the Company's risk to falling rates showed an increase in overall risk. As of September 30, 2008, under a 200 basis point rising rate scenario, net interest income is expected to increase by \$8.7 million, compared with increases of \$6.1 million and \$2.3 million at June 30, 2008 and December 31, 2007, respectively. Under a 100 basis point increase, as of September 30, 2008 net interest income is expected to increase \$4.7 million compared with increases of \$3.7 million at June 30, 2008 and \$2.0 million at December 31, 2007. The Company's exposure to falling rates during the current quarter increased over the prior quarter, as under a 100 basis point falling rate scenario, net interest income would decrease by \$3.1 million compared with an \$800 thousand decline in the previous quarter.

As shown in the table above, at September 30, 2008 under the rising rate scenarios, the Company's net interest income is expected to increase due to several factors, including growth in loan balances with variable rates or short-term fixed rates, and growth in non-maturity deposits, which have lower rates and can re-price upwards more slowly. Also during the third quarter of 2008, certificates of deposit balances, which carry higher rates, declined while other borrowed funds, mostly with lower fixed rates, increased. The same factors which increased the modeled interest income under rising rate scenarios also helped to increase interest rate risk in a falling rate environment. The higher risk to falling rates this quarter was mainly the result of an increase in loans, a decline in federal funds purchased and repurchase agreements, which essentially have variable rates, and an increase in other borrowings, which have fixed rates. However, the fact that rates on such products as interest checking, savings and certain money market accounts were

already low, limits further rate declines in the modeling assumptions. The Company believes that its approach to interest rate risk has appropriately considered its susceptibility to both rising and falling rates and has adopted strategies which minimize impacts of interest rate risk.

**Item 4. CONTROLS AND PROCEDURES**

An evaluation was performed under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of September 30, 2008. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective. There were not any significant changes in the Company's internal control over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents**PART II: OTHER INFORMATION****Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table sets forth information about the Company's purchases of its \$5 par value common stock, its only class of stock registered pursuant to Section 12 of the Exchange Act.

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares Purchased as part of Publicly Announced Program</b>	<b>Maximum Number that May Yet Be Purchased Under the Program</b>
July 1 - 31, 2008	1,132	\$ 39.34	1,132	2,904,814
August 1 - 31, 2008	668	\$ 44.46	668	2,904,146
September 1 - 30, 2008	200	\$ 45.00	200	2,903,946
<b>Total</b>	<b>2,000</b>	<b>\$ 41.62</b>	<b>2,000</b>	<b>2,903,946</b>

In February 2008, the Board of Directors approved the purchase of up to 3,000,000 shares of the Company's common stock. At September 30, 2008, 2,903,946 shares remain available to be purchased under the current authorization.

**Item 6. EXHIBITS**

See Index to Exhibits

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Commerce Bancshares, Inc.

By /s/ J. Daniel Stinnett  
J. Daniel Stinnett  
*Vice President & Secretary*

Date: November 7, 2008

By /s/ Jeffery D. Aberdeen  
Jeffery D. Aberdeen  
*Controller*  
*(Chief Accounting Officer)*

Date: November 7, 2008

**Table of Contents**

**INDEX TO EXHIBITS**

31.1 Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32 Certifications of CEO and CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002