COMMERCE BANCSHARES INC /MO/
Form 10-Q
November 07, 2013
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark
One)
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2013

OR
o 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	43-0889454
(State of Incorporation)	(IRS Employer Identification No.)
1000 Walnut, Kansas City, MO	64106
(Address of principal executive offices)	(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 þ No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes þ No o
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):
Large accelerated filer þ Accelerated filer o Non-accelerated filer o 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 o No þ

As of November 1, 2013, the registrant had outstanding 91,294,404 shares of its $5 par value common stock, registrant's only class of common stock.

Commerce Bancshares, Inc. and Subsidiaries

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PART I: FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

Commerce Bancshares, Inc. and Subsidiaries

CONSOLIDATED BALANCE SHEETS

	September 30, 2013 (Unaudited)	December 31, 2012
	(In thousands)	
ASSETS		
Loans	$10,823,654	$9,831,384
Allowance for loan losses	(163,532)	(172,532)
Net loans	10,660,122	9,658,852
Loans held for sale	—	8,827
Investment securities:		
Available for sale ($704,650,000 and $736,183,000 pledged in 2013 and 2012, respectively, to secure swap and repurchase agreements)	8,577,282	9,522,248
Trading	18,295	28,837
Non-marketable	114,520	118,650
Total investment securities	8,710,097	9,669,735
Short-term federal funds sold and securities purchased under agreements to resell	87,167	27,595
Long-term securities purchased under agreements to resell	1,150,000	1,200,000
Interest earning deposits with banks	267,548	179,164
Cash and due from banks	594,309	573,066
Land, buildings and equipment, net	353,473	357,612
Goodwill	138,676	125,585
Other intangible assets, net	9,050	5,300
Other assets	481,855	353,853
Total assets	$22,452,297	$22,159,589
LIABILITIES AND EQUITY		
Deposits:		
Non-interest bearing	$6,185,098	$6,299,903
Savings, interest checking and money market	9,680,816	9,817,943
Time open and C.D.'s of less than $100,000	1,013,598	1,074,618
Time open and C.D.'s of $100,000 and over	1,338,252	1,156,189
Total deposits	18,217,764	18,348,653
Federal funds purchased and securities sold under agreements to repurchase	1,760,393	1,083,550
Other borrowings	105,928	103,710
Other liabilities	186,726	452,102
Total liabilities	20,270,811	19,988,015
Commerce Bancshares, Inc. 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 91,929,481 shares in 2013 and 91,729,235 shares in 2012	459,647	458,646
Capital surplus	1,104,669	1,102,507

Retained earnings	610,720	477,210
Treasury stock of 548,585 shares in 2013 and 196,922 shares in 2012, at cost	(23,528)	(7,580)
Accumulated other comprehensive income	26,025	136,344
Total Commerce Bancshares, Inc. stockholders' equity	2,177,533	2,167,127
Non-controlling interest	3,953	4,447
Total equity	2,181,486	2,171,574
Total liabilities and equity	$22,452,297	$22,159,589

See accompanying notes to consolidated financial statements.

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Commerce Bancshares, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)	For the Three Months Ended September 30		For the Nine Months Ended September 30	
	2013	2012	2013	2012
	(Unaudited)			
INTEREST INCOME				
Interest and fees on loans	$110,587	$111,619	$326,391	$335,627
Interest and fees on loans held for sale	—	85	176	278
Interest on investment securities	46,356	46,513	144,548	157,832
Interest on short-term federal funds sold and securities purchased under agreements to resell	35	24	72	70
Interest on long-term securities purchased under agreements to resell	5,095	4,913	16,734	13,770
Interest on deposits with banks	71	40	223	207
Total interest income	162,144	163,194	488,144	507,784
INTEREST EXPENSE				
Interest on deposits:				
Savings, interest checking and money market	3,502	4,623	10,801	14,338
Time open and C.D.'s of less than $100,000	1,380	1,945	4,785	6,055
Time open and C.D.'s of $100,000 and over	1,535	1,743	4,901	5,482
Interest on federal funds purchased and securities sold under agreements to repurchase	166	221	654	623
Interest on other borrowings	855	851	2,496	2,633
Total interest expense	7,438	9,383	23,637	29,131
Net interest income	154,706	153,811	464,507	478,653
Provision for loan losses	4,146	5,581	14,810	18,961
Net interest income after provision for loan losses	150,560	148,230	449,697	459,692
NON-INTEREST INCOME				
Bank card transaction fees	43,891	39,488	123,141	112,655
Trust fees	25,318	23,681	76,221	70,328
Deposit account charges and other fees	20,197	19,873	58,511	59,184
Capital market fees	3,242	5,110	10,938	16,991
Consumer brokerage services	2,871	2,441	8,410	7,543
Loan fees and sales	1,553	1,358	4,340	4,625
Other	9,239	8,971	27,303	24,995
Total non-interest income	106,311	100,922	308,864	296,321
INVESTMENT SECURITIES GAINS (LOSSES), NET				
Impairment (losses) reversals on debt securities	(588)	5,989	508	11,579
Noncredit-related losses (reversals) on securities not expected to be sold	258	(6,546)	(1,768)	(12,806)
Net impairment losses	(330)	(557)	(1,260)	(1,227)
Realized gains (losses) on sales and fair value adjustments	980	3,737	(1,823)	9,783
Investment securities gains (losses), net	650	3,180	(3,083)	8,556
NON-INTEREST EXPENSE				
Salaries and employee benefits	91,405	89,292	271,855	266,346
Net occupancy	11,332	11,588	33,801	33,953
Equipment	4,465	4,976	13,828	15,164
Supplies and communication	5,449	5,400	16,835	16,680
Data processing and software	19,987	19,279	58,522	55,030

Marketing	3,848	4,100	11,255	12,391
Deposit insurance	2,796	2,608	8,353	7,746
Other	17,030	16,148	53,866	52,882
Total non-interest expense	156,312	153,391	468,315	460,192
Income before income taxes	101,209	98,941	287,163	304,377
Less income taxes	32,764	32,155	91,871	99,541
Net income	68,445	66,786	195,292	204,836
Less non-controlling interest expense	221	780	246	2,298
Net income attributable to Commerce Bancshares, Inc.	$68,224	$66,006	$195,046	$202,538
Net income per common share — basic	$.75	$.71	$2.14	$2.18
Net income per common share — diluted	$.75	$.72	$2.14	$2.18

See accompanying notes to consolidated financial statements.

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Commerce Bancshares, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
(In thousands)	2013	2012	2013	2012
	(Unaudited)			
Net income	$68,445	$66,786	$195,292	$204,836
Other comprehensive income (loss):				
Net unrealized gains (losses) on securities for which a portion of an other-than-temporary impairment has been recorded in earnings	(130)	3,695	887	7,592
Net unrealized gains (losses) on other securities	3,815	25,160	(112,632)	46,552
Pension loss amortization	476	453	1,426	1,358
Other comprehensive income (loss)	4,161	29,308	(110,319)	55,502
Comprehensive income	72,606	96,094	84,973	260,338
Less non-controlling interest expense	221	780	246	2,298
Comprehensive income attributable to Commerce Bancshares, Inc.	$72,385	$95,314	$84,727	$258,040

See accompanying notes to consolidated financial statements.

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Commerce Bancshares, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

	Commerce Bancshares, Inc. Shareholders						
(In thousands, except per share data)	Common Stock	Capital Surplus	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Non-Controlling Interest	Total
	(Unaudited)						
Balance January 1, 2013	$458,646	$1,102,507	$477,210	$(7,580)	$ 136,344	$ 4,447	$2,171,574
Net income			195,046			246	195,292
Other comprehensive loss					(110,319)		(110,319)
Distributions to non-controlling interest						(740)	(740)
Acquisition of Summit Bancshares Inc.	1,001	11,125		31,071			43,197
Purchase of treasury stock				(69,195)			(69,195)
Issuance of stock under purchase and equity compensation plans		(3,957)		12,111			8,154
Net tax benefit related to equity compensation plans		454					454
Stock-based compensation		4,605					4,605
Issuance of nonvested stock awards		(10,065)		10,065			—
Cash dividends ($.675 per share)			(61,536)				(61,536)
Balance September 30, 2013	$459,647	$1,104,669	$610,720	$(23,528)	$ 26,025	$ 3,953	$2,181,486
Balance January 1, 2012	$446,387	$1,042,065	$575,419	$(8,362)	$ 110,538	$ 4,314	$2,170,361
Net income			202,538			2,298	204,836
Other comprehensive income					55,502		55,502
Distributions to non-controlling interest						(1,976)	(1,976)
Purchase of treasury stock				(75,536)			(75,536)
Issuance of stock under purchase and equity compensation plans		(4,987)		14,753			9,766
Net tax benefit related to equity compensation plans		1,233					1,233
Stock-based compensation		3,705					3,705
Issuance of nonvested stock awards		(8,501)		8,501			—
Cash dividends ($.657 per share)			(60,819)				(60,819)
Balance September 30, 2012	$446,387	$1,033,515	$717,138	$(60,644)	$ 166,040	$ 4,636	$2,307,072

See accompanying notes to consolidated financial statements.

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Commerce Bancshares, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)	For the Nine Months Ended September 30	
	2013	2012
	(Unaudited)	
OPERATING ACTIVITIES:		
Net income	$195,292	$204,836
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	14,810	18,961
Provision for depreciation and amortization	31,152	32,565
Amortization of investment security premiums, net	22,840	29,989
Investment securities (gains) losses, net(A)	3,083	(8,556)
Net gains on sales of loans held for sale	—	(376)
Proceeds from sales of loans held for sale	—	22,649
Net decrease in trading securities	15,977	5,454
Stock-based compensation	4,605	3,705
Decrease in interest receivable	2,694	4,728
Decrease in interest payable	(1,319)	(1,067)
Increase (decrease) in income taxes payable	7,183	(5,571)
Net tax benefit related to equity compensation plans	(454)	(1,233)
Other changes, net	(7,086)	(10,718)
Net cash provided by operating activities	288,777	295,366
INVESTING ACTIVITIES:		
Cash received in acquisition	47,643	—
Proceeds from sales of investment securities(A)	6,624	14,931
Proceeds from maturities/pay downs of investment securities(A)	2,047,277	2,341,083
Purchases of investment securities(A)	(1,522,765)	(2,036,260)
Net increase in loans	(796,215)	(489,628)
Long-term securities purchased under agreements to resell	(125,000)	(125,000)
Repayments of long-term securities purchased under agreements to resell	175,000	125,000
Purchases of land, buildings and equipment	(18,731)	(19,243)
Sales of land, buildings and equipment	723	2,338
Net cash used in investing activities	(185,444)	(186,779)
FINANCING ACTIVITIES:		
Net increase (decrease) in non-interest bearing, savings, interest checking and money market deposits	(569,342)	554,167
Net increase (decrease) in time open and C.D.'s	81,449	(479,383)
Net increase in short-term federal funds purchased and securities sold under agreements to repurchase	726,843	1,868
Repayment of long-term borrowings	(50,961)	(8,073)
Purchases of treasury stock	(69,195)	(75,536)
Issuance of stock under stock purchase and equity compensation plans	8,154	9,766
Net tax benefit related to equity compensation plans	454	1,233
Cash dividends paid on common stock	(61,536)	(60,819)
Net cash provided by (used in) financing activities	65,866	(56,777)
Increase in cash and cash equivalents	169,199	51,810
Cash and cash equivalents at beginning of year	779,825	517,551

Cash and cash equivalents at September 30	$949,024	$569,361
(A) Available for sale and non-marketable securities		
Income tax payments, net	$84,331	$104,175
Interest paid on deposits and borrowings	$24,956	$30,198
Loans transferred to foreclosed real estate	$6,744	$7,178
Loans transferred from held for sale to held for investment category	$8,941	$—

See accompanying notes to consolidated financial statements.

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Commerce Bancshares, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2013 (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). Most of the Company's operations are conducted by its subsidiary bank, Commerce Bank (the Bank). 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 2012 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, 2013 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 2012 Annual Report on Form 10-K.

2. Acquisition

On September 1, 2013, the Company acquired Summit Bancshares Inc. (Summit). Summit's results of operations are included in the Company's consolidated financial results beginning on that date. The transaction was accounted for using the acquisition method of accounting and, as such, assets acquired, liabilities assumed and consideration exchanged were recorded at their estimated fair value on the acquisition date. In this transaction, the Company acquired all of the outstanding stock of Summit in exchange for shares of Company stock valued at $43.2 million. The valuation of Company stock was determined on the basis of the closing market price of the Company's common shares on August 30, 2013. The Company's acquisition of Summit added $261.6 million in assets (including $207.4 million in loans), $232.3 million in deposits and two branch locations in Tulsa and Oklahoma City, Oklahoma. Intangible assets recognized as a result of the transaction consisted of approximately $13.1 million in goodwill and $4.9 million in core deposit premium. Most of the goodwill was assigned to the Company's Commercial segment. None of the goodwill recognized is expected to be deductible for income tax purposes.
The fair value of core deposit premium was estimated by a third party using an after-tax cost savings method. This methodology calculates the present value of the estimated after-tax cost savings attributable to the core deposit base, relative to alternative costs of funds and tax benefit, if applicable, over the expected remaining economic life of the depositors. Based on an estimation of the expected remaining economic life of the depositors, the core deposit premium is being amortized over a 14 year period, using an accelerated method.
Historical pro forma information for the acquisition has not been presented because the effect on the Company's financial statements was not material. Acquired loans with evidence of deterioration in credit quality were not material to the consolidated financial statements of the Company. Accordingly, the provisions of ASC 310-30, which require special accounting for such loans, were not applied.
On September 3, 2013, the Company granted nonvested restricted stock awards of 42,674 shares of Company stock to various former Summit officers, which are included in the activity shown in Note 13. These awards vest over periods of 3 to 4 years and, assuming no awards are forfeited, compensation expense of approximately $1.8 million is expected to be recognized over the vesting period.

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3. Loans and Allowance for Loan Losses

Major classifications within the Company's held for investment loan portfolio at September 30, 2013 and December 31, 2012 are as follows:

(In thousands)	September 30, 2013	December 31, 2012
Commercial:		
Business	$3,634,461	$3,134,801
Real estate – construction and land	363,194	355,996
Real estate – business	2,357,894	2,214,975
Personal Banking:		
Real estate – personal	1,766,609	1,584,859
Consumer	1,489,066	1,289,650
Revolving home equity	421,569	437,567
Consumer credit card	787,215	804,245
Overdrafts	3,646	9,291
Total loans	$10,823,654	$9,831,384

At September 30, 2013, loans of $3.5 billion were pledged at the Federal Home Loan Bank as collateral for borrowings and letters of credit obtained to secure public deposits. Additional loans of $1.4 billion were pledged at the Federal Reserve Bank as collateral for discount window borrowings.

Allowance for loan losses

A summary of the activity in the allowance for loan losses during the three and nine months ended September 30, 2013 and 2012, respectively, follows:

	For the Three Months Ended September 30			For the Nine Months Ended September 30		
(In thousands)	Commercial	Personal Banking	Total	Commercial	Personal Banking	Total
Balance at beginning of period	$98,599	$67,433	$166,032	$105,725	$66,807	$172,532
Provision	(2,885)	7,031	4,146	(10,275)	25,085	14,810
Deductions:						
Loans charged off	913	12,174	13,087	3,879	36,405	40,284
Less recoveries on loans	3,144	3,297	6,441	6,374	10,100	16,474
Net loan charge-offs (recoveries)	(2,231)	8,877	6,646	(2,495)	26,305	23,810
Balance September 30, 2013	$97,945	$65,587	$163,532	$97,945	$65,587	$163,532
Balance at beginning of period	$114,671	$63,862	$178,533	$122,497	$62,035	$184,532
Provision	(2,479)	8,060	5,581	(10,125)	29,086	18,961
Deductions:						
Loans charged off	1,795	12,480	14,275	7,502	39,710	47,212
Less recoveries on loans	1,720	3,473	5,193	7,247	11,504	18,751
Net loan charge-offs	75	9,007	9,082	255	28,206	28,461
Balance September 30, 2012	$112,117	$62,915	$175,032	$112,117	$62,915	$175,032

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The following table shows the balance in the allowance for loan losses and the related loan balance at September 30, 2013 and December 31, 2012, disaggregated on the basis of impairment methodology. Impaired loans evaluated under ASC 310-10-35 include loans on non-accrual status, which are individually evaluated for impairment, and other impaired loans discussed below, which are deemed to have similar risk characteristics and are collectively evaluated. All other loans are collectively evaluated for impairment under ASC 450-20.

	Impaired Loans		All Other Loans	
	Allowance for	Loans	Allowance for	Loans
(In thousands)	Loan Losses	Outstanding	Loan Losses	Outstanding
September 30, 2013				
Commercial	$7,689	$73,698	$90,256	$6,281,851
Personal Banking	2,607	30,183	62,980	4,437,922
Total	$10,296	$103,881	$153,236	$10,719,773
December 31, 2012				
Commercial	$5,434	$80,807	$100,291	$5,624,965
Personal Banking	2,051	36,111	64,756	4,089,501
Total	$7,485	$116,918	$165,047	$9,714,466

Impaired loans

The table below shows the Company’s investment in impaired loans at September 30, 2013 and December 31, 2012. These loans consist of all loans on non-accrual status and other restructured loans whose terms have been modified and classified as troubled debt restructurings under ASC 310-40. These restructured loans are performing in accordance with their modified terms, and because the Company believes it probable that all amounts due under the modified terms of the agreements will be collected, interest on these loans is being recognized on an accrual basis. They are discussed further in the "Troubled debt restructurings" section on page 14.

(In thousands)	Sept. 30, 2013	Dec. 31, 2012
Non-accrual loans	$37,846	$51,410
Restructured loans (accruing)	66,035	65,508
Total impaired loans	$103,881	$116,918

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The following table provides additional information about impaired loans held by the Company at September 30, 2013 and December 31, 2012, segregated between loans for which an allowance for credit losses has been provided and loans for which no allowance has been provided.

(In thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
September 30, 2013			
With no related allowance recorded:			
Business	$8,444	$9,485	$—
Real estate – construction and land	7,056	14,276	—
Real estate – business	6,048	9,038	—
	$21,548	$32,799	$—
With an allowance recorded:			
Business	$18,026	$20,549	$2,740
Real estate – construction and land	22,970	24,934	2,687
Real estate – business	11,154	16,710	2,262
Real estate – personal	12,770	15,641	1,552
Consumer	4,647	4,647	134
Revolving home equity	643	643	2
Consumer credit card	12,123	12,123	919
	$82,333	$95,247	$10,296
Total	$103,881	$128,046	$10,296
December 31, 2012			
With no related allowance recorded:			
Business	$9,964	$12,697	$—
Real estate – construction and land	8,440	15,102	—
Real estate – business	5,484	8,200	—
Real estate – personal	1,166	1,380	—
Revolving home equity	510	843	—
	$25,564	$38,222	$—
With an allowance recorded:			
Business	$19,358	$22,513	$1,888
Real estate – construction and land	20,446	25,808	1,762
Real estate – business	17,115	23,888	1,784
Real estate – personal	14,157	17,304	857
Consumer	4,779	4,779	93
Revolving home equity	779	779	18
Consumer credit card	14,720	14,720	1,083
	$91,354	$109,791	$7,485
Total	$116,918	$148,013	$7,485

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Total average impaired loans for the three and nine month periods ended September 30, 2013 and 2012, respectively, are shown in the table below.

(In thousands)	Commercial	Personal Banking	Total
Average Impaired Loans:			
For the three months ended September 30, 2013			
Non-accrual loans	$32,570	$4,866	$37,436
Restructured loans (accruing)	40,881	25,163	66,044
Total	$73,451	$30,029	$103,480
For the nine months ended September 30, 2013			
Non-accrual loans	$36,656	$5,287	$41,943
Restructured loans (accruing)	40,200	25,857	66,057
Total	$76,856	$31,144	$108,000
For the three months ended September 30, 2012			
Non-accrual loans	$51,337	$7,621	$58,958
Restructured loans (accruing)	41,885	19,750	61,635
Total	$93,222	$27,371	$120,593
For the nine months ended September 30, 2012			
Non-accrual loans	$59,159	$7,399	$66,558
Restructured loans (accruing)	44,063	21,204	65,267
Total	$103,222	$28,603	$131,825

The table below shows interest income recognized during the three and nine month periods ended September 30, 2013 and 2012 for impaired loans held at the end of each respective period. This interest all relates to accruing restructured loans, as discussed in the "Troubled debt restructurings" section on page 14.

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
(In thousands)	2013	2012	2013	2012
Interest income recognized on impaired loans:				
Business	$124	$248	$372	$745
Real estate – construction and land	218	210	653	630
Real estate – business	48	72	145	216
Real estate – personal	64	22	192	65
Consumer	87	16	261	47
Revolving home equity	9	1	26	2
Consumer credit card	262	328	785	983
Total	$812	$897	$2,434	$2,688

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Delinquent and non-accrual loans

The following table provides aging information on the Company's past due and accruing loans, in addition to the balances of loans on non-accrual status, at September 30, 2013 and December 31, 2012.

(In thousands)	Current or Less Than 30 Days Past Due	30 – 89 Days Past Due	90 Days Past Due and Still Accruing	Non-accrual	Total
September 30, 2013					
Commercial:					
Business	$3,616,498	$5,837	$596	$ 11,530	$3,634,461
Real estate – construction and land	342,953	11,126	83	9,032	363,194
Real estate – business	2,310,501	35,495	—	11,898	2,357,894
Personal Banking:					
Real estate – personal	1,747,785	12,176	1,262	5,386	1,766,609
Consumer	1,473,403	14,008	1,655	—	1,489,066
Revolving home equity	419,333	1,576	660	—	421,569
Consumer credit card	769,906	10,050	7,259	—	787,215
Overdrafts	3,377	269	—	—	3,646
Total	$10,683,756	$90,537	$11,515	$ 37,846	$10,823,654
December 31, 2012					
Commercial:					
Business	$3,110,403	$10,054	$1,288	$ 13,056	$3,134,801
Real estate – construction and land	325,541	16,721	56	13,678	355,996
Real estate – business	2,194,395	3,276	—	17,304	2,214,975
Personal Banking:					
Real estate – personal	1,564,281	10,862	2,854	6,862	1,584,859
Consumer	1,273,581	13,926	2,143	—	1,289,650
Revolving home equity	433,437	2,121	1,499	510	437,567
Consumer credit card	786,081	10,657	7,507	—	804,245
Overdrafts	8,925	366	—	—	9,291
Total	$9,696,644	$67,983	$15,347	$ 51,410	$9,831,384

Credit quality

The following table provides information about the credit quality of the Commercial loan portfolio, using the Company's internal rating system as an indicator. The internal rating system is a series of grades reflecting management's risk assessment, based on its analysis of the borrower's financial condition. The "pass" category consists of a range of loan grades that reflect increasing, though still acceptable, risk. Movement of risk through the various grade levels in the "pass" category is monitored for early identification of credit deterioration. The "special mention" rating is applied to loans where the borrower exhibits negative financial trends due to borrower specific or systemic conditions that, if left uncorrected, threaten its capacity to meet its debt obligations. The borrower is believed to have sufficient financial flexibility to react to and resolve its negative financial situation. It is a transitional grade that is closely monitored for improvement or deterioration. The "substandard" rating is applied to loans where the borrower exhibits well-defined weaknesses that jeopardize its continued performance and are of a severity that the distinct possibility of default exists. Loans are placed on "non-accrual" when management does not expect to collect payments consistent with acceptable and agreed upon terms of repayment.

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Commercial Loans

(In thousands)	Business	Real Estate-Construction	Real Estate-Business	Total
September 30, 2013				
Pass	$3,534,162	$ 323,142	$2,239,654	$6,096,958
Special mention	63,931	1,636	52,241	117,808
Substandard	24,838	29,384	54,101	108,323
Non-accrual	11,530	9,032	11,898	32,460
Total	$3,634,461	$ 363,194	$2,357,894	$6,355,549
December 31, 2012				
Pass	$3,018,062	$ 297,156	$2,103,913	$5,419,131
Special mention	58,793	11,400	38,396	108,589
Substandard	44,890	33,762	55,362	134,014
Non-accrual	13,056	13,678	17,304	44,038
Total	$3,134,801	$ 355,996	$2,214,975	$5,705,772

The credit quality of Personal Banking loans is monitored primarily on the basis of aging/delinquency, and this information is provided in the table in the above "Delinquent and non-accrual loans" section. In addition, FICO scores are obtained and updated on a quarterly basis for most of the loans in the Personal Banking portfolio. This is a published credit score designed to measure the risk of default by taking into account various factors from a borrower's financial history. The Bank normally obtains a FICO score at the loan's origination and renewal dates, and updates are obtained on a quarterly basis. Excluded from the table below are certain Personal Banking loans for which FICO scores are not obtained because they generally pertain to commercial customer activities and are often underwritten with other collateral considerations. At September 30, 2013, these were comprised of $228.3 million in personal real estate loans and $60.4 million in consumer loans, or 6.5% of the Personal Banking portfolio. At December 31, 2012, these were comprised of $224.5 million in personal real estate loans and $87.4 million in consumer loans, or 7.6% of the Personal Banking portfolio. For the remainder of loans in the Personal Banking portfolio, the table below shows the percentage of balances outstanding at September 30, 2013 and December 31, 2012 by FICO score.

Personal Banking Loans

	% of Loan Category			
	Real Estate - Personal	Consumer	Revolving Home Equity	Consumer Credit Card
September 30, 2013				
FICO score:				
Under 600	1.8 %	5.5 %	2.0 %	4.0 %
600 - 659	3.2	10.5	8.2	11.8
660 - 719	9.7	24.5	15.4	33.6
720 - 779	26.6	28.2	29.5	28.2
780 and Over	58.7	31.3	44.9	22.4
Total	100.0 %	100.0 %	100.0 %	100.0 %
December 31, 2012				
FICO score:				
Under 600	2.3 %	6.7 %	2.6 %	4.4 %
600 - 659	3.2	11.3	5.3	11.7
660 - 719	10.4	24.4	15.2	32.1
720 - 779	26.6	26.4	30.0	28.2
780 and Over	57.5	31.2	46.9	23.6
Total	100.0 %	100.0 %	100.0 %	100.0 %

Troubled debt restructurings

As mentioned previously, the Company's impaired loans include loans which have been classified as troubled debt restructurings. Total restructured loans amounted to $89.1 million at September 30, 2013. Restructured loans are those extended to borrowers who are experiencing financial difficulty and who have been granted a concession. Restructured loans are placed on non-accrual status if the Company does not believe it probable that amounts due under the contractual terms will be collected, and those non-accrual loans totaled $23.1 million at September 30, 2013. Other performing restructured loans totaled $66.0 million at September 30, 2013. These are primarily comprised of certain business, construction and business real estate loans classified as

substandard. Upon maturity, the loans renewed at interest rates judged not to be market rates for new debt with similar risk and as a result were classified as troubled debt restructurings. These commercial loans totaled $44.7 million at September 30, 2013. These restructured loans are performing in accordance with their modified terms, and because the Company believes it probable that all amounts due under the modified terms of the agreements will be collected, interest on these loans is being recognized on an accrual basis. Troubled debt restructurings also include certain credit card loans under various debt management and assistance programs, which totaled $12.1 million at September 30, 2013. Modifications to credit card loans generally involve removing the available line of credit, placing loans on amortizing status, and lowering the contractual interest rate. The Company has classified additional loans as troubled debt restructurings because they were not reaffirmed by the borrower in bankruptcy proceedings. At September 30, 2013, these loans totaled $9.2 million in personal real estate, revolving home equity, and consumer loans. Interest on these loans is being recognized on an accrual basis, as the borrowers are continuing to make payments under the terms of the loan agreements.

The following table shows the outstanding balances of loans classified as troubled debt restructurings at September 30, 2013, in addition to the outstanding balances of these restructured loans which the Company considers to have been in default at any time during the past twelve months. For purposes of this disclosure, the Company considers "default" to mean 90 days or more past due as to interest or principal.

(In thousands)	September 30, 2013	Balance 90 days past due at any time during previous 12 months
Commercial:		
Business	$23,167	$7,969
Real estate - construction and land	28,631	3,507
Real estate - business	10,614	3,129
Personal Banking:		
Real estate - personal	9,306	—
Consumer	2,058	—
Revolving home equity	3,232	—
Consumer credit card	12,123	710
Total restructured loans	$89,131	$15,315

For those loans on non-accrual status also classified as restructured, the modification did not create any further financial effect on the Company as those loans were already recorded at net realizable value. For those performing commercial loans classified as restructured, there were no concessions involving forgiveness of principal or interest and, therefore, there was no financial impact to the Company as a result of modification to these loans. No financial impact resulted from those performing loans where the debt was not reaffirmed in bankruptcy, as no changes to loan terms occurred in that process. The effects of modifications to consumer credit card loans were estimated to decrease interest income by approximately $1.4 million on an annual, pre-tax basis, compared to amounts contractually owed.

The allowance for loan losses related to troubled debt restructurings on non-accrual status is determined by individual evaluation, including collateral adequacy, using the same process as loans on non-accrual status which are not classified as troubled debt restructurings. Those performing loans classified as troubled debt restructurings are accruing loans which management expects to collect under contractual terms. Performing commercial loans have had no other concessions granted other than being renewed at an interest rate judged not to be market. As such, they have similar risk characteristics as non-troubled debt commercial loans and are collectively evaluated based on internal risk rating, loan type, delinquency, historical experience and current economic factors. Performing personal banking loans classified as troubled debt restructurings resulted from the borrower not reaffirming the debt during bankruptcy and

have had no other concession granted, other than the Bank's future limitations on collecting payment deficiencies or in pursuing foreclosure actions. As such, they have similar risk characteristics as non-troubled debt personal banking loans and are evaluated collectively based on loan type, delinquency, historical experience and current economic factors.

If a troubled debt restructuring defaults and is already on non-accrual status, the allowance for loan losses continues to be based on individual evaluation, using discounted expected cash flows or the fair value of collateral. If an accruing troubled debt restructuring defaults, the loan's risk rating is downgraded to non-accrual status and the loan's related allowance for loan losses is determined based on individual evaluation, or if necessary, the loan is charged off and collection efforts begun.

The Company had commitments of $12.8 million at September 30, 2013 to lend additional funds to borrowers with restructured loans.

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The Company’s holdings of foreclosed real estate totaled $7.0 million and $13.5 million at September 30, 2013 and December 31, 2012, respectively. Personal property acquired in repossession, generally autos and marine and recreational vehicles, totaled $2.8 million and $3.5 million at September 30, 2013 and December 31, 2012, respectively. These assets are carried at the lower of the amount recorded at acquisition date or the current fair value less estimated costs to sell.

4. Investment Securities

Investment securities, at fair value, consisted of the following at September 30, 2013 and December 31, 2012.

(In thousands)	Sept. 30, 2013	Dec. 31, 2012
Available for sale	$8,577,282	$9,522,248
Trading	18,295	28,837
Non-marketable	114,520	118,650
Total investment securities	$8,710,097	$9,669,735

Most of the Company’s investment securities are classified as available for sale, and this portfolio is discussed in more detail below. Securities which are classified as non-marketable include Federal Home Loan Bank (FHLB) stock and Federal Reserve Bank stock held for debt and regulatory purposes, which totaled $45.2 million at September 30, 2013 and $45.4 million at December 31, 2012. Investment in Federal Reserve Bank stock is based on the capital structure of the investing bank, and investment in FHLB stock is tied to the level of borrowings from the FHLB. Non-marketable securities also include private equity investments, which amounted to $69.2 million at September 30, 2013 and $73.2 million at December 31, 2012.

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A summary of the available for sale investment securities by maturity groupings as of September 30, 2013 is shown below. The investment portfolio includes agency mortgage-backed securities, which are guaranteed by agencies such as the FHLMC, FNMA, GNMA and FDIC, in addition to non-agency mortgage-backed securities, which have no guarantee. Also included are certain other asset-backed securities, which are primarily collateralized by credit cards, automobiles, student loans, and commercial loans. These securities differ from traditional debt securities primarily in that they may have uncertain maturity dates and are priced based on estimated prepayment rates on the underlying collateral. The Company does not have exposure to subprime originated mortgage-backed or collateralized debt obligation instruments.

(In thousands)	Amortized Cost	Fair Value
U.S. government and federal agency obligations:		
After 1 but within 5 years	$275,088	$295,587
After 5 but within 10 years	54,421	57,489
After 10 years	72,895	62,429
Total U.S. government and federal agency obligations	402,404	415,505
Government-sponsored enterprise obligations:		
Within 1 year	25,115	25,286
After 1 but within 5 years	99,119	101,383
After 5 but within 10 years	169,727	160,947
After 10 years	146,976	137,346
Total government-sponsored enterprise obligations	440,937	424,962
State and municipal obligations:		
Within 1 year	133,539	134,734
After 1 but within 5 years	700,750	721,051
After 5 but within 10 years	535,416	524,339
After 10 years	239,264	223,187
Total state and municipal obligations	1,608,969	1,603,311
Mortgage and asset-backed securities:		
Agency mortgage-backed securities	2,755,358	2,810,261
Non-agency mortgage-backed securities	210,917	222,081
Asset-backed securities	2,893,173	2,890,646
Total mortgage and asset-backed securities	5,859,448	5,922,988
Other debt securities:		
Within 1 year	30,103	30,451
After 1 but within 5 years	46,473	46,796
After 5 but within 10 years	90,036	84,559
Total other debt securities	166,612	161,806
Equity securities	15,423	48,710
Total available for sale investment securities	$8,493,793	$8,577,282

Investments in U.S. government securities are comprised mainly of U.S. Treasury inflation-protected securities (TIPS), which totaled $415.4 million, at fair value, at September 30, 2013. Interest paid on these securities increases with inflation and decreases with deflation, as measured by the Consumer Price Index. Included in state and municipal obligations are $125.0 million, at fair value, of auction rate securities, which were purchased from bank customers in 2008. Included in equity securities is common stock held by the holding company, Commerce Bancshares, Inc. (the Parent), with a fair value of $36.5 million at September 30, 2013.

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For securities classified as available for sale, the following table shows the unrealized gains and losses (pre-tax) in accumulated other comprehensive income, by security type.

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2013				
U.S. government and federal agency obligations	$402,404	$23,567	$(10,466)	$415,505
Government-sponsored enterprise obligations	440,937	2,458	(18,433)	424,962
State and municipal obligations	1,608,969	29,756	(35,414)	1,603,311
Mortgage and asset-backed securities:				
Agency mortgage-backed securities	2,755,358	74,070	(19,167)	2,810,261
Non-agency mortgage-backed securities	210,917	12,570	(1,406)	222,081
Asset-backed securities	2,893,173	7,603	(10,130)	2,890,646
Total mortgage and asset-backed securities	5,859,448	94,243	(30,703)	5,922,988
Other debt securities	166,612	971	(5,777)	161,806
Equity securities	15,423	33,287	—	48,710
Total	$8,493,793	$184,282	$(100,793)	$8,577,282
December 31, 2012				
U.S. government and federal agency obligations	$399,971	$40,395	$(1,607)	$438,759
Government-sponsored enterprise obligations	467,063	5,188	(677)	471,574
State and municipal obligations	1,585,926	46,076	(16,295)	1,615,707
Mortgage and asset-backed securities:				
Agency mortgage-backed securities	3,248,007	132,953	(5)	3,380,955
Non-agency mortgage-backed securities	224,223	12,906	(118)	237,011
Asset-backed securities	3,152,913	15,848	(1,367)	3,167,394
Total mortgage and asset-backed securities	6,625,143	161,707	(1,490)	6,785,360
Other debt securities	174,727	3,127	(102)	177,752
Equity securities	5,695	27,401	—	33,096
Total	$9,258,525	$283,894	$(20,171)	$9,522,248

The Company’s impairment policy requires a review of all securities for which fair value is less than amortized cost. Special emphasis and analysis is placed on securities whose credit rating has fallen below A3/A-, whose fair values have fallen more than 20% below purchase price for an extended period of time, or have been identified based on management’s judgment. These securities are placed on a watch list, and for all such securities, detailed cash flow models are prepared which use inputs specific to each security. Inputs to these models include factors such as cash flow received, contractual payments required, and various other information related to the underlying collateral (including current delinquencies), collateral loss severity rates (including loan to values), expected delinquency rates, credit support from other tranches, and prepayment speeds. Stress tests are performed at varying levels of delinquency rates, prepayment speeds and loss severities in order to gauge probable ranges of credit loss. At September 30, 2013, the fair value of securities on this watch list was $202.9 million compared to $220.7 million at December 31, 2012.

As of September 30, 2013, the Company had recorded other-than-temporary impairment (OTTI) on certain non-agency mortgage-backed securities, part of the watch list mentioned above, which had an aggregate fair value of $77.4 million. The cumulative credit-related portion of the impairment initially recorded on these securities totaled $12.8 million and was recorded in earnings. The Company does not intend to sell these securities and believes it is not likely that it will be required to sell the securities before the recovery of their amortized cost.

The credit-related portion of the loss on these securities was based on the cash flows projected to be received over the estimated life of the securities, discounted to present value, and compared to the current amortized cost bases of the

securities. Significant inputs to the cash flow models used to calculate the credit losses on these securities at September 30, 2013 included the following:

Significant Inputs	Range		
Prepayment CPR	0%	-	25%
Projected cumulative default	13%	-	55%
Credit support	0%	-	15%
Loss severity	17%	-	81%

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The following table shows changes in the credit losses recorded in earnings during the nine months ended September 30, 2013 and 2012, for which a portion of an OTTI was recognized in other comprehensive income.

	For the Nine Months Ended September 30	
(In thousands)	2013	2012
Balance at January 1	$11,306	$9,931
Credit losses on debt securities for which impairment was previously recognized	1,260	1,227
Increase in expected cash flows that are recognized over remaining life of security	(59)	(93)
Balance at September 30	$12,507	$11,065

Securities with unrealized losses recorded in accumulated other comprehensive income are shown in the table below, along with the length of the impairment period.

	Less than 12 months		12 months or longer		Total	
(In thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2013						
U.S. government and federal agency obligations	$62,429	$ 10,466	$—	$—	$62,429	$10,466
Government-sponsored enterprise obligations	308,029	18,433	—	—	308,029	18,433
State and municipal obligations	560,695	20,370	79,486	15,044	640,181	35,414
Mortgage and asset-backed securities:						
Agency mortgage-backed securities	638,282	19,167	—	—	638,282	19,167
Non-agency mortgage-backed securities	53,871	1,387	1,629	19	55,500	1,406
Asset-backed securities	1,299,698	8,865	70,515	1,265	1,370,213	10,130
Total mortgage and asset-backed securities	1,991,851	29,419	72,144	1,284	2,063,995	30,703
Other debt securities	97,093	5,541	2,744	236	99,837	5,777
Total	$3,020,097	$ 84,229	$154,374	$16,564	$3,174,471	$100,793
December 31, 2012						
U.S. government and federal agency obligations	$71,464	$ 1,607	$—	$—	$71,464	$1,607
Government-sponsored enterprise obligations	102,082	677	—	—	102,082	677
State and municipal obligations	173,600	2,107	80,530	14,188	254,130	16,295
Mortgage and asset-backed securities:						
Agency mortgage-backed securities	5,874	5	—	—	5,874	5
Non-agency mortgage-backed securities	—	—	12,609	118	12,609	118
Asset-backed securities	338,007	976	78,684	391	416,691	1,367
Total mortgage and asset-backed securities	343,881	981	91,293	509	435,174	1,490
Other debt securities	39,032	102	—	—	39,032	102
Total	$730,059	$ 5,474	$171,823	$14,697	$901,882	$20,171

The total available for sale portfolio consisted of approximately 1,700 individual securities at September 30, 2013. The portfolio included 490 securities, having an aggregate fair value of $3.2 billion, that were in an unrealized loss position at September 30, 2013, compared to 144 securities, with a fair value of $901.9 million, at December 31, 2012. The total amount of unrealized loss on these securities increased $80.6 million to $100.8 million at September 30, 2013, which was mainly due to higher interest rates in the second and third quarters of 2013. At September 30, 2013, the fair value of securities in an unrealized loss position for 12 months or longer with temporary impairment totaled $152.7 million, or 1.8% of the total portfolio value, and the fair value of other securities with other-than-temporary impairment totaled $1.6 million.

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The Company's holdings of state and municipal obligations included gross unrealized losses of $35.4 million at September 30, 2013. Of these losses, $15.0 million related to auction rate securities and $20.4 million related to other state and municipal obligations. This portfolio, exclusive of ARS, totaled $1.5 billion at fair value, or 17.2% of total available for sale securities. The average credit quality of the portfolio, excluding ARS, is Aa2 as rated by Moody's. The portfolio is diversified in order to reduce risk, and information about the top five largest holdings, by state and economic sector, is shown in the table below. The Company does not have exposure to obligations of municipalities which have filed for Chapter 9 bankruptcy. The Company has processes and procedures in place to monitor its holdings, identify signs of financial distress and, if necessary, exit its positions in a timely manner.

	% of Portfolio		Average Life (in years)	Average Rating (Moody's)
At September 30, 2013				
Texas	10.2	%	5.0	Aa1
Florida	9.5		4.6	Aa2
Ohio	5.7		5.0	Aa2
Washington	5.5		5.1	Aa2
New York	5.1		6.4	Aa2
General obligation	31.4	%	4.6	Aa2
Housing	16.9		6.8	Aa1
Lease	16.4		4.7	Aa3
Transportation	13.9		4.4	A1
Limited tax	5.0		5.3	Aa1

The following table presents proceeds from sales of securities and the components of investment securities gains and losses which have been recognized in earnings.

	For the Nine Months Ended September 30	
(In thousands)	2013	2012
Proceeds from sales of available for sale securities	$2,423	$4,951
Proceeds from sales of non-marketable securities	4,201	9,980
Total proceeds	$6,624	$14,931
Available for sale:		
Gains realized on sales	$10	$342
Gain realized on donation	1,375	—
Other-than-temporary impairment recognized on debt securities	(1,260)	(1,227)
Non-marketable:		
Gains realized on sales	708	1,267
Losses realized on sales	(2,979)	(200)
Fair value adjustments, net	(937)	8,374
Investment securities gains (losses), net	$(3,083)	$8,556

At September 30, 2013, securities totaling $4.4 billion in fair value were pledged to secure public fund deposits, securities sold under agreements to repurchase, trust funds, and borrowings at the Federal Reserve Bank and FHLB. Securities pledged under agreements pursuant to which the collateral may be sold or re-pledged by the secured parties approximated $704.6 million, while the remaining securities were pledged under agreements pursuant to which the secured parties may not sell or re-pledge the collateral. Except for obligations of various government-sponsored enterprises such as FNMA, FHLB and FHLMC, no investment in a single issuer exceeded 10% of stockholders' equity.

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5. Goodwill and Other Intangible Assets

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

	September 30, 2013				December 31, 2012			
(In thousands)	Gross Carrying Amount	Accumulated Amortization	Valuation Allowance	Net Amount	Gross Carrying Amount	Accumulated Amortization	Valuation Allowance	Net Amount
Amortizable intangible assets:								
Core deposit premium	$30,620	$(22,198)	$—	$8,422	$25,720	$(20,892)	$—	$4,828
Mortgage servicing rights	3,307	(2,513)	(166)	628	3,132	(2,267)	(393)	472
Total	$33,927	$(24,711)	$(166)	$9,050	$28,852	$(23,159)	$(393)	$5,300

Aggregate amortization expense on intangible assets was $463 thousand and $594 thousand, respectively, for the three month periods ended September 30, 2013 and 2012 and $1.6 million and $1.9 million, respectively, for the nine month periods ended September 30, 2013 and 2012. 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, 2013. 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, prepayment rates and other market conditions.

(In thousands)	
2013	$1,943
2014	1,900
2015	1,516
2016	1,161
2017	845

Changes in the carrying amount of goodwill and net other intangible assets for the nine month period ended September 30, 2013 is as follows.

(In thousands)	Goodwill	Core Deposit Premium	Mortgage Servicing Rights
Balance January 1, 2013	$125,585	$4,828	$472
Summit acquisition	13,091	4,900	—
Originations	—	—	175
Amortization	—	(1,306)	(246)
Impairment reversal	—	—	227
Balance September 30, 2013	$138,676	$8,422	$628

As discussed in Note 2, the Company acquired Summit Bancshares, Inc. on September 1, 2013. As a result of the acquisition, goodwill of $13.1 million and a core deposit intangible asset of $4.9 million were established. Based on an estimation of the expected remaining economic life of the depositors, the core deposit premium is being amortized over a 14 year period using an accelerated method. Goodwill allocated to the Company’s operating segments at September 30, 2013 and December 31, 2012 is shown below.

(In thousands)	September 30, 2013	December 31, 2012
Consumer segment	$70,667	$67,765
Commercial segment	67,263	57,074

Wealth segment	746	746
Total goodwill	$138,676	$125,585

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 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, 2013 that net liability was $4.6 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 $347.3 million at September 30, 2013.

The Company periodically enters into risk participation agreements (RPAs) as a guarantor to other financial institutions, in order to mitigate those institutions' credit risk associated with 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 financial institution. These interest rate swaps are normally collateralized (generally with real property, inventories and equipment) by the third party, which limits the credit risk associated with the Company's RPAs. The third parties usually have other borrowing relationships with the Company. The Company monitors overall borrower collateral, and at September 30, 2013, believes sufficient collateral is available to cover potential swap losses. The RPAs are carried at fair value throughout their term, with all changes in fair value, including those due to a change in the third party's creditworthiness, recorded in current earnings. The terms of the RPAs, which correspond to the terms of the underlying swaps, range from 4 to 10 years. At September 30, 2013, the fair value of the Company's guarantee liabilities for RPAs was $88 thousand, and the notional amount of the underlying swaps was $44.7 million. 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.

7. Pension

The amount of net pension cost is shown in the table below:

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
(In thousands)	2013	2012	2013	2012
Service cost - benefits earned during the period	$132	$103	$395	$310
Interest cost on projected benefit obligation	1,134	1,287	3,379	3,860
Expected return on plan assets	(1,613)	(1,645)	(4,830)	(4,935)
Amortization of unrecognized net loss	767	730	2,300	2,190
Net periodic pension cost	$420	$475	$1,244	$1,425

Substantially all benefits accrued under the Company's defined benefit pension plan were frozen effective January 1, 2005, and the remaining benefits were frozen effective January 1, 2011. During 2012, the Company made a discretionary contribution of $1.5 million to its defined benefit pension plan in order to reduce pension guarantee premiums but has made no subsequent contributions to the defined benefit plan in 2013. The Company also 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 2013.

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8. Common Stock

Presented below is a summary of the components used to calculate basic and diluted income per share. The Company applies the two-class method of computing income per share, as nonvested share-based awards that contain nonforfeitable rights to dividends are considered securities which participate in undistributed earnings with common stock. The two-class method requires the calculation of separate income per share amounts for the nonvested share-based awards and for common stock. Income per share attributable to common stock is shown in the table below. Nonvested share-based awards are further discussed in Note 13.

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
(In thousands, except per share data)	2013	2012	2013	2012
Basic income per common share:				
Net income attributable to Commerce Bancshares, Inc.	$68,224	$66,006	$195,046	$202,538
Less income allocated to nonvested restricted stock	808	626	2,152	1,854
Net income allocated to common stock	$67,416	$65,380	$192,894	$200,684
Weighted average common shares outstanding	90,003	91,239	89,999	91,879
Basic income per common share	$.75	$.71	$2.14	$2.18
Diluted income per common share:				
Net income attributable to Commerce Bancshares, Inc.	$68,224	$66,006	$195,046	$202,538
Less income allocated to nonvested restricted stock	806	623	2,146	1,849
Net income allocated to common stock	$67,418	$65,383	$192,900	$200,689
Weighted average common shares outstanding	90,003	91,239	89,999	91,879
Net effect of the assumed exercise of stock-based awards - based on the treasury stock method using the average market price for the respective periods	449	313	353	316
Weighted average diluted common shares outstanding	90,452	91,552	90,352	92,195
Diluted income per common share	$.75	$.72	$2.14	$2.18

Unexercised stock options and stock appreciation rights of 131 thousand were excluded in the computation of diluted income per share for the nine month period ended September 30, 2013 because their inclusion would have been anti-dilutive. All unexercised stock options and rights were included in the computation of diluted income per share for the nine month period ended September 30, 2012.

9. Accumulated Other Comprehensive Income

The table below shows the activity and accumulated balances for components of other comprehensive income. The largest component is the unrealized holding gains and losses on available for sale securities. Unrealized gains and losses on debt securities for which an other-than-temporary impairment (OTTI) has been recorded in current earnings are shown separately below. The other component is the amortization from other comprehensive income of losses associated with pension benefits, which occurs as the losses are included in current net periodic pension cost.

	Unrealized Gains (Losses) on Securities (1)		Pension Loss (2)	Total Accumulated Other Comprehensive Income
(In thousands)	OTTI	Other		
Balance January 1, 2013	$3,245	$160,263	$(27,164)	$136,344
Other comprehensive income before reclassifications	170	(180,279)	—	(180,109)
Amounts reclassified from accumulated other comprehensive income	1,260	(1,385)	2,300	2,175
Current period other comprehensive income (loss), before tax	1,430	(181,664)	2,300	(177,934)
Income tax (expense) benefit	(543)	69,032	(874)	67,615
Current period other comprehensive income (loss), net of tax	887	(112,632)	1,426	(110,319)
Balance September 30, 2013	$4,132	$47,631	$(25,738)	$26,025
Balance January 1, 2012	$(4,321)	$136,137	$(21,278)	$110,538
Other comprehensive income before reclassifications	11,018	75,427	—	86,445
Amounts reclassified from accumulated other comprehensive income	1,227	(342)	2,190	3,075
Current period other comprehensive income, before tax	12,245	75,085	2,190	89,520
Income tax expense	(4,653)	(28,533)	(832)	(34,018)
Current period other comprehensive income, net of tax	7,592	46,552	1,358	55,502
Balance September 30, 2012	$3,271	$182,689	$(19,920)	$166,040

(1) The pre-tax amounts reclassified from accumulated other comprehensive income are included in "investment securities gains (losses), net" in the consolidated statements of income.
(2) The pre-tax amounts reclassified from accumulated other comprehensive income are included in the computation of net periodic pension cost as "amortization of unrecognized net loss" (see Note 7).

10. Segments

The Company segregates financial information for use in assessing its performance and allocating resources among three operating segments: Consumer, Commercial and Wealth. The Consumer segment includes the consumer portion of the retail branch network (loans, deposits, and other personal banking services), indirect and other consumer financing, and consumer debit and credit bank cards. The Commercial segment provides corporate lending (including the Small Business Banking product line within the branch network), leasing, international services, and business, government deposit, and related commercial cash management services, as well as merchant and commercial bank card products. The Commercial segment includes the Capital Markets Group, which sells fixed income securities and provides investment safekeeping and bond accounting services. The Wealth segment provides traditional trust and estate tax planning, advisory and discretionary investment management, and brokerage services, and includes the Private Banking product portfolio.

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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. Management periodically makes changes to methods of assigning costs and income to its business segments to better reflect operating results. If appropriate, these changes are reflected in prior year information presented below.

(In thousands)	Consumer	Commercial	Wealth	Segment Totals	Other/ Elimination	Consolidated Totals
Three Months Ended September 30, 2013						
Net interest income	$67,217	$ 72,381	$9,982	$149,580	$ 5,126	$ 154,706
Provision for loan losses	(8,656)	2,076	(33)	(6,613)	2,467	(4,146)
Non-interest income	29,695	47,500	28,868	106,063	248	106,311
Investment securities gains, net	—	—	—	—	650	650
Non-interest expense	(66,921)	(56,952)	(23,686)	(147,559)	(8,753)	(156,312)
Income before income taxes	$21,335	$ 65,005	$15,131	$101,471	$ (262)	$ 101,209
Nine Months Ended September 30, 2013						
Net interest income	$201,313	$ 212,438	$30,093	$443,844	$ 20,663	$ 464,507
Provision for loan losses	(25,537)	1,948	(173)	(23,762)	8,952	(14,810)
Non-interest income	84,825	137,111	87,201	309,137	(273)	308,864
Investment securities losses, net	—	—	—	—	(3,083)	(3,083)
Non-interest expense	(203,797)	(174,935)	(71,643)	(450,375)	(17,940)	(468,315)
Income before income taxes	$56,804	$ 176,562	$45,478	$278,844	$ 8,319	$ 287,163
Three Months Ended September 30, 2012						
Net interest income	$68,694	$ 72,649	$9,627	$150,970	$ 2,841	$ 153,811
Provision for loan losses	(8,500)	(313)	(199)	(9,012)	3,431	(5,581)
Non-interest income	29,030	45,352	27,094	101,476	(554)	100,922
Investment securities gains, net	—	—	—	—	3,180	3,180
Non-interest expense	(67,310)	(57,150)	(21,935)	(146,395)	(6,996)	(153,391)
Income before income taxes	$21,914	$ 60,538	$14,587	$97,039	$ 1,902	$ 98,941
Nine Months Ended September 30, 2012						
Net interest income	$206,348	$ 216,924	$29,092	$452,364	$ 26,289	$ 478,653
Provision for loan losses	(26,960)	(601)	(751)	(28,312)	9,351	(18,961)
Non-interest income	84,477	133,190	80,470	298,137	(1,816)	296,321
Investment securities gains, net	—	—	—	—	8,556	8,556
Non-interest expense	(200,573)	(169,201)	(66,946)	(436,720)	(23,472)	(460,192)
Income before income taxes	$63,292	$ 180,312	$41,865	$285,469	$ 18,908	$ 304,377

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.

The segment activity, as shown above, includes both direct and allocated items. Amounts in the “Other/Elimination” column include activity not related to the segments, such as that relating to administrative functions, the investment securities portfolio, and the effect of certain expense allocations to the segments. The provision for loan losses in this category contains the difference between net loan charge-offs assigned directly to the segments and the recorded provision for loan loss expense. Included in this category’s net interest income are earnings of the investment portfolio, which are not allocated to a segment.

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.

11. Derivative Instruments

The notional amounts of the Company’s derivative instruments are shown in the table below. These contractual amounts, along with other terms of the derivative, are used to determine amounts to be exchanged between counterparties and are not a measure of loss exposure. The largest group of notional amounts relate to interest rate swaps, which are discussed in more detail

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below. The Company also contracts with other financial institutions, as a guarantor or beneficiary, to share credit risk associated with certain interest rate swaps through risk participation agreements. The Company’s risks and responsibilities as guarantor are further discussed in Note 6 on Guarantees.

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. This activity increased in 2013 due to higher customer demand. Also, the Company's past practice of originating and selling fixed rate personal real estate loans to other institutions historically resulted in mortgage loan commitments and forward sales contracts. In late 2011, the Company curtailed the sales of these types of loans and did not hold such loans for sale at September 30, 2013 or December 31, 2012.

(In thousands)	September 30, 2013	December 31, 2012
Interest rate swaps	$596,025	$435,542
Interest rate caps	10,236	27,736
Credit risk participation agreements	46,565	43,243
Foreign exchange contracts	100,606	47,897
Total notional amount	$753,432	$554,418

The Company’s interest rate risk management strategy includes the ability to modify the repricing characteristics of certain assets and liabilities so that changes in interest rates 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, 2013, the Company had entered into two interest rate swaps with a notional amount of $12.3 million, included in the table above, which are designated as fair value hedges of certain fixed rate loans. Gains and losses on these derivative instruments, as well as the offsetting loss or gain on the hedged loans attributable to the hedged risk, are recognized in current earnings. These gains and losses are reported in interest and fees on loans in the accompanying statements of income. The table below shows gains and losses related to fair value hedges.

	For the Three Months Ended September 30		For the Nine Months Ended September 30	
(In thousands)	2013	2012	2013	2012
Gain (loss) on interest rate swaps	$69	$76	$299	$221
Gain (loss) on loans	(63)	(83)	(287)	(218)
Amount of hedge ineffectiveness	$6	$(7)	$12	$3

The Company’s other derivative instruments are accounted for as free-standing derivatives, and changes in their fair value are recorded in current earnings. These instruments include interest rate swap contracts sold 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 earnings. The notional amount of these types of swaps at September 30, 2013 was $583.8 million. The Company is party to master netting arrangements with many of its derivative counterparties; however, the Company does not offset assets and liabilities under these arrangements for balance sheet presentation, as the effect of offsetting is not significant. Additional information about the potential effects of offsetting and collateral amounts pledged by the Company is provided in Note 12 on Balance Sheet Offsetting.

Many of the Company’s interest rate swap contracts with large financial institutions contain contingent features relating to debt ratings or capitalization levels. Under these provisions, if the Company’s debt rating falls below investment grade or if the Company ceases to be “well-capitalized” under risk-based capital guidelines, certain counterparties can require immediate and ongoing collateralization on interest rate swaps in net liability positions or

can require instant settlement of the contracts. The Company maintains debt ratings and capital well above these minimum requirements.

The banking customer counterparties are engaged in a variety of businesses, including real estate, building materials, education, financial services, communications, consumer products, and manufacturing. At September 30, 2013, the largest loss exposures were in the groups related to education, real estate, and manufacturing. If the counterparties in these groups failed to perform, and if the underlying collateral proved to be of no value, the Company estimates that it would incur losses of $2.7 million (education), $3.0 million (real estate and building materials) and $1.7 million (manufacturing) at September 30, 2013.

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The fair values of the Company's derivative instruments, whose notional amounts are listed above, are shown in the table below. Information about the valuation methods used to determine fair value is provided in Note 14 on Fair Value Measurements.

(In thousands)	Asset Derivatives Balance Sheet Location	Sept. 30, 2013 Fair Value	Dec. 31, 2012 Fair Value	Liability Derivatives Balance Sheet Location	Sept. 30, 2013 Fair Value	Dec. 31, 2012 Fair Value
Derivatives designated as hedging instruments:						
Interest rate swaps	Other assets	$—	$—	Other liabilities	$(424)	$(723)
Total derivatives designated as hedging instruments		$—	$—		$(424)	$(723)
Derivatives not designated as hedging instruments:						
Interest rate swaps	Other assets	$12,525	$16,334	Other liabilities	$(12,526)	$(16,337)
Interest rate caps	Other assets	1	1	Other liabilities	(1)	(1)
Credit risk participation agreements	Other assets	5	9	Other liabilities	(88)	(196)
Foreign exchange contracts	Other assets	1,183	396	Other liabilities	(1,273)	(461)
Total derivatives not designated as hedging instruments		$13,714	$16,740		$(13,888)	$(16,995)
Total derivatives		$13,714	$16,740		$(14,312)	$(17,718)

The effects of derivative instruments on the consolidated statements of income are shown in the table below.

(In thousands)	Location of Gain or (Loss) Recognized in Income on Derivatives	Amount of Gain or (Loss) Recognized in Income on Derivatives			
		For the Three Months Ended September 30		For the Nine Months Ended September 30	
		2013	2012	2013	2012
Derivatives in fair value hedging relationships:					
Interest rate swaps	Interest and fees on loans	$69	$76	$299	$221
Total		$69	$76	$299	$221
Derivatives not designated as hedging instruments:					
Interest rate swaps	Other non-interest income	$777	$52	$1,071	$250
Credit risk participation agreements	Other non-interest income	51	1	176	6
Foreign exchange contracts	Other non-interest income	(109)	40	(24)	47
Mortgage loan commitments	Loan fees and sales	—	—	—	(20)
Mortgage loan forward sale contracts	Loan fees and sales	—	—	—	11
Total		$719	$93	$1,223	$294

12. Balance Sheet Offsetting

The following tables show the extent to which assets and liabilities relating to derivative instruments, securities purchased under agreements to resell (resell agreements), and securities sold under agreements to repurchase (repurchase agreements) have been offset in the consolidated balance sheets. They also provide information about these instruments which are subject to an enforceable master netting arrangement, irrespective of whether they are offset, and the extent to which the instruments could potentially be offset. Also shown is collateral received or pledged in the form of other financial instruments, which are generally marketable securities. The collateral amounts in these tables are limited to the outstanding balances of the related asset or liability (after netting is applied); thus instances of overcollateralization are not shown. Most of the assets and liabilities in the following tables were transacted under master netting arrangements that contain a conditional right of offset, such as close-out netting, upon default.

The financial collateral securing these arrangements consists of marketable securities. These are valued daily, and adjustments to amounts received and pledged by the Company are made as appropriate to maintain proper collateralization for these transactions. Collateral posted by the Company to financial institution counterparties under derivative contracts is generally subject to thresholds and transfer minimums. By contract, it may be sold or re-pledged by the secured party until recalled at a subsequent valuation date by the pledging party. Derivative transactions with customers are generally secured by non-financial collateral, such as real and personal property, which is not shown in the table below. Collateral accepted or pledged in resell and repurchase agreements with other financial institutions also may be sold or re-pledged by the secured party, but is usually delivered to and held by third party trustees. The Company generally retains custody of securities pledged for repurchase agreements with customers.

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On June 10, 2013, the Company became subject to new trade and clearing regulations authorized under the Dodd-Frank Wall Street Reform and Consumer Protection Act. After this date the new rules require derivative transactions with financial institutions to be cleared through a clearing house, which the Company accesses through a designated clearing member. Under the new rules, initial and ongoing maintenance margin, in the form of cash and marketable securities, is required of both of the original counterparties to the contract, which is maintained by the clearing house. Once the trade is cleared, the clearing house assumes the performance risk of the original counterparty. During the current quarter, the Company executed eight interest rate swaps, and at September 30, 2013 had recognized assets of $359 thousand and liabilities of $1.0 million which are subject to the new regulations and included in the table below. At September 30, 2013, collateral for these transactions, consisting of cash of $413 thousand and marketable securities totaling $2.0 million in fair value, was posted by the Company to its clearing member.

				Gross Amounts Not Offset in the Balance Sheet		
(In thousands)	Gross Amount Recognized	Gross Amounts Offset in the Balance Sheet	Net Amounts Presented in the Balance Sheet	Financial Instruments	Securities Collateral Received/Pledged	Net Amount
September 30, 2013						
Assets:						
Derivatives subject to master netting agreements	$12,670	$—	$12,670	$(912)	$ —	$11,758
Derivatives not subject to master netting agreements	1,044	—	1,044			
Total derivatives	13,714	—	13,714			
Total resell agreements, subject to master netting arrangements	1,450,000	(300,000)	1,150,000	—	(1,150,000)	—
Liabilities:						
Derivatives subject to master netting agreements	13,756	—	13,756	(912)	(10,260)	2,584
Derivatives not subject to master netting agreements	556	—	556			
Total derivatives	14,312	—	14,312			
Total repurchase agreements, subject to master netting arrangements	1,348,678	(300,000)	1,048,678	—	(1,048,678)	—
December 31, 2012						
Assets:						
Derivatives subject to master netting agreements	$16,475	$—	$16,475	$(603)	$ —	$15,872
Derivatives not subject to master netting agreements	265	—	265			
Total derivatives	16,740	—	16,740			
Total resell agreements, subject to master netting arrangements	1,500,000	(300,000)	1,200,000	—	(1,200,000)	—
Liabilities:						
Derivatives subject to master netting agreements	17,315	—	17,315	(603)	(16,017)	695
Derivatives not subject to master netting agreements	403	—	403			

Total derivatives	17,718	—	17,718			
Total repurchase agreements, subject to master netting arrangements	1,359,040	(300,000)	1,059,040	—	(1,059,040)	—

The Company is party to several agreements commonly known as collateral swaps. These agreements involve the exchange of collateral under simultaneous repurchase and resell agreements with the same financial institution counterparty. These repurchase and resell agreements have the same principal amounts, inception dates, and maturity dates and have been offset against each other in the balance sheet, as permitted under the netting provisions of ASC 210-20-45. The collateral swaps totaled $300.0 million at both September 30, 2013 and December 31, 2012. At September 30, 2013, the Company had posted collateral consisting of $319.5 million in agency mortgage-backed securities and accepted $330.0 million in investment grade asset-backed, commercial mortgage-backed, and corporate bonds.

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13. Stock-Based Compensation

The Company has historically issued stock-based compensation in the form of nonvested restricted stock, stock options and stock appreciation rights (SARs). During the first nine months of 2013, stock-based compensation was issued in the form of nonvested stock and SARs. The stock-based compensation expense that has been charged against income was $1.9 million and $1.2 million in the three month periods ended September 30, 2013 and 2012, respectively, and $4.6 million and $3.7 million in the nine months ended September 30, 2013 and 2012, respectively.

Nonvested stock awards generally vest in 4 to 7 years and contain restrictions as to transferability, sale, pledging, or assigning, among others, prior to the end of the vesting period. Dividend and voting rights are conferred upon grant. A summary of the status of the Company's nonvested share awards as of September 30, 2013, and changes during the nine month period then ended, is presented below.

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2013	882,803	$34.62
Granted	397,596	38.42
Vested	(42,125)	34.88
Forfeited	(16,609)	33.77
Canceled	(115,497)	35.32
Nonvested at September 30, 2013	1,106,168	$35.91

SARs and stock options are granted with exercise prices equal to the market price of the Company's stock at the date of grant. SARs vest ratably over 4 years of continuous service and have 10-year contractual terms. All SARs must be settled in stock under provisions of the plan. Stock options, which have not been granted since 2005, vested ratably over 3 years of continuous service and also have 10-year contractual terms. 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. The current year per share average fair value and the model assumptions are shown in the table below.

Weighted per share average fair value at grant date	$7.16
Assumptions:	
Dividend yield	2.3 %
Volatility	23.2 %
Risk-free interest rate	1.2 %
Expected term	7.3 years

A summary of option activity during the first nine months of 2013 is presented below.

(Dollars in thousands, except per share data)	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2013	768,773	$31.51		
Granted	—	—		
Forfeited	—	—		
Expired	—	—		
Exercised	(293,280)	30.57		
Outstanding at September 30, 2013	475,493	$32.09	1.0 year	$5,573

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A summary of SAR activity during the first nine months of 2013 is presented below.

(Dollars in thousands, except per share data)	Rights	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at January 1, 2013	1,787,376	$36.07		
Granted	213,721	39.03		
Forfeited	(1,521)	31.31		
Expired	—	—		
Exercised	(279,530)	36.44		
Outstanding at September 30, 2013	1,720,046	$36.38	4.2 years	$12,776

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 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 fair value accounting or write-downs of individual assets.

Fair value is 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. For accounting disclosure purposes, a three-level valuation hierarchy of fair value measurements has been established. 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, quoted prices for identical or similar assets and liabilities in markets that are not active, and inputs that are observable for the assets or liabilities, either directly or indirectly (such as interest rates, yield curves, and prepayment speeds).
- 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 observable market 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.

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Instruments Measured at Fair Value on a Recurring Basis

The table below presents the September 30, 2013 and December 31, 2012 carrying values of assets and liabilities measured at fair value on a recurring basis. There were no transfers among levels during the first nine months of 2013 or the year ended December 31, 2012.

		Fair Value Measurements Using		
(In thousands)	Total Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2013				
Assets:				
Available for sale securities:				
U.S. government and federal agency obligations	$415,505	$415,505	$—	$—
Government-sponsored enterprise obligations	424,962	—	424,962	—
State and municipal obligations	1,603,311	—	1,478,289	125,022
Agency mortgage-backed securities	2,810,261	—	2,810,261	—
Non-agency mortgage-backed securities	222,081	—	222,081	—
Asset-backed securities	2,890,646	—	2,890,646	—
Other debt securities	161,806	—	161,806	—
Equity securities	48,710	29,790	18,920	—
Trading securities	18,295	—	18,295	—
Private equity investments	64,507	—	—	64,507
Derivatives *	13,714	—	13,709	5
Assets held in trust	6,951	6,951	—	—
Total assets	$8,680,749	$452,246	$8,038,969	$189,534
Liabilities:				
Derivatives *	$14,312	$—	$14,224	$88
Total liabilities	$14,312	$—	$14,224	$88
December 31, 2012				
Assets:				
Available for sale securities:				
U.S. government and federal agency obligations	$438,759	$438,759	$—	$—
Government-sponsored enterprise obligations	471,574	—	471,574	—
State and municipal obligations	1,615,707	—	1,489,293	126,414
Agency mortgage-backed securities	3,380,955	—	3,380,955	—
Non-agency mortgage-backed securities	237,011	—	237,011	—
Asset-backed securities	3,167,394	—	3,167,394	—
Other debt securities	177,752	—	177,752	—
Equity securities	33,096	17,835	15,261	—
Trading securities	28,837	—	28,837	—
Private equity investments	68,167	—	—	68,167
Derivatives *	16,740	—	16,731	9
Assets held in trust	5,440	5,440	—	—
Total assets	$9,641,432	$462,034	$8,984,808	$194,590
Liabilities:				
Derivatives *	$17,718	$—	$17,522	$196

Total liabilities	$17,718	$—	$17,522	$196

* The fair value of each class of derivative is shown in Note 11.

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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

For available for sale securities, changes in fair value, including that portion of other-than-temporary impairment unrelated to credit loss, are recorded in other comprehensive income. As mentioned in Note 4 on Investment Securities, the Company records the credit-related portion of other-than-temporary impairment in current earnings. This portfolio comprises the majority of the assets which the Company records at fair value. Most of the portfolio, which includes government-sponsored enterprise, mortgage-backed and asset-backed securities, are priced utilizing industry-standard models that consider various assumptions, including 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. These 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 common stock and U.S. Treasury obligations.

The fair values of Level 1 and 2 securities (excluding equity securities) in the available for sale portfolio are prices provided by a third-party pricing service. The prices provided by the third-party pricing service are based on observable market inputs, as described in the sections below. On a quarterly basis, the Company compares a sample of these prices to other independent sources for the same and similar securities. Variances are analyzed, and, if appropriate, additional research is conducted with the third-party pricing service. Based on this research, the pricing service may affirm or revise its quoted price. No significant adjustments have been made to the prices provided by the pricing service. The pricing service also provides documentation on an ongoing basis that includes reference data, inputs and methodology by asset class, which is reviewed to ensure that security placement within the fair value hierarchy is appropriate.
Valuation methods and inputs, by class of security:

- U.S. government and federal agency obligations

U.S. treasury bills, bonds and notes, including TIPS, are valued using live data from active market makers and inter-dealer brokers. Valuations for stripped coupon and principal issues are derived from yield curves generated from various dealer contacts and live data sources.

- Government-sponsored enterprise obligations

Government-sponsored enterprise obligations are evaluated using cash flow valuation models. Inputs used are live market data, cash settlements, Treasury market yields, and floating rate indices such as LIBOR, CMT, and Prime.

- State and municipal obligations, excluding auction rate securities

A yield curve is generated and applied to bond sectors, and individual bond valuations are extrapolated. Inputs used to generate the yield curve are bellwether issue levels, established trading spreads between similar issuers or credits, historical trading spreads over widely accepted market benchmarks, new issue scales, and verified bid information. Bid information is verified by corroborating the data against external sources such as broker-dealers, trustees/paying agents, issuers, or non-affiliated bondholders.

- Mortgage and asset-backed securities

Collateralized mortgage obligations and other asset-backed securities are valued at the tranche level. For each tranche valuation, the process generates predicted cash flows for the tranche, applies a market based (or benchmark) yield/spread for each tranche, and incorporates deal collateral performance and tranche level attributes to determine tranche-specific spreads to adjust the benchmark yield. Tranche cash flows are generated from new deal files and prepayment/default assumptions. Tranche spreads are based on tranche characteristics such as average life, type, volatility, ratings, underlying collateral and performance, and prevailing market conditions. The appropriate tranche spread is applied to the corresponding benchmark, and the resulting value is used to discount the cash flows to generate an evaluated price.

Valuation of agency pass-through securities, typically issued under GNMA, FNMA, FHLMC, and SBA programs, are primarily derived from information from the To Be Announced (TBA) market. This market consists of generic mortgage pools which have not been received for settlement. Snapshots of the TBA market, using live data feeds

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distributed by multiple electronic platforms, and in conjunction with other indices, are used to compute a price based on discounted cash flow models.

- Other debt securities

Other debt securities are valued using active markets and inter-dealer brokers as well as bullet spread scales and option adjusted spreads. The spreads and models use yield curves, terms and conditions of the bonds, and any special features (i.e., call or put options, redemption features, etc.).

- Equity securities

Equity securities are priced using the market prices for each security from the major stock exchanges or other electronic quotation systems. These are generally classified as Level 1 measurements. Stocks which trade infrequently are classified as Level 2.

The available for sale portfolio includes certain auction rate securities. The auction process by which auction rate securities are normally priced has not functioned since 2008, and due to the illiquidity in the market, the fair value of these securities cannot be based on observable market prices. The fair values of the auction rate securities are estimated using a discounted cash flows analysis which is discussed more fully in the Level 3 Inputs section of this note. Because several of the inputs significant to the measurement are not observable, these measurements are classified as Level 3 measurements.

Trading securities

The securities in the Company’s trading portfolio are priced by averaging several broker quotes for similar instruments and are classified as Level 2 measurements.

Private equity investments

These securities are held by the Company’s private equity subsidiaries and are included in non-marketable investment securities in the consolidated balance sheets. Due to the absence of quoted market prices, valuation of these nonpublic investments requires significant management judgment. These fair value measurements, which are discussed in the Level 3 Inputs section of this note, 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 a proprietary model whose significant inputs are readily observable market parameters, primarily yield curves used to calculate current exposure. Counterparty credit risk is incorporated into the model and calculated by applying a net credit spread over LIBOR to the swap's total expected exposure over time. The net credit spread is comprised of spreads for both the Company and its counterparty, derived from probability of default and other loss estimate information obtained from a third party credit data provider or from the Company's Credit Department when not otherwise available. The credit risk component is not significant compared to the overall fair value of the swaps. The results of the model are constantly validated through comparison to active trading in the marketplace. These fair value measurements are classified as Level 2.

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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 contracts related to credit risk guarantees are valued under a proprietary model which uses unobservable inputs and assumptions about the creditworthiness of the counterparty (generally a Bank customer). Customer credit spreads, which are based on probability of default and other loss estimates, are calculated internally by the Company's

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Credit Department, as mentioned above, and are based on the Company's internal risk rating for each customer. Because these inputs are significant to the measurements, they are classified as Level 3.

Assets held in trust

Assets held in an outside 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 recorded an asset representing the total investment amount. The Company has also recorded a corresponding nonfinancial liability, representing the Company’s liability to the plan participants.

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

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)			
(In thousands)	State and Municipal Obligations	Private Equity Investments	Derivatives	Total
For the three months ended September 30, 2013				
Balance June 30, 2013	$ 126,753	$ 63,279	$ (93)	$ 189,939
Total gains or losses (realized/unrealized):				
Included in earnings	—	865	51	916
Included in other comprehensive income *	(1,772)	—	—	(1,772)
Discount accretion	41	—	—	41
Purchases of private equity investments	—	300	—	300
Capitalized interest/dividends	—	63	—	63
Sale of risk participation agreement	—	—	(41)	(41)
Balance September 30, 2013	$ 125,022	$ 64,507	$ (83)	$ 189,446
Total gains or losses for the three months included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2013	$ —	$ 865	$ 51	$ 916
For the nine months ended September 30, 2013				
Balance January 1, 2013	$ 126,414	$ 68,167	$ (187)	$ 194,394
Total gains or losses (realized/unrealized):				
Included in earnings	—	(612)	176	(436)
Included in other comprehensive income *	(656)	—	—	(656)
Investment securities called	(900)	—	—	(900)
Discount accretion	164	—	—	164
Purchase of private equity investments	—	3,950	—	3,950
Sale/pay down of private equity investments	—	(7,184)	—	(7,184)
Capitalized interest/dividends	—	186	—	186
Sale of risk participation agreement	—	—	(72)	(72)
Balance September 30, 2013	$ 125,022	$ 64,507	$ (83)	$ 189,446
Total gains or losses for the nine months included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2013	$ —	$ (612)	$ 176	$ (436)
For the three months ended September 30, 2012				
Balance June 30, 2012	$ 127,540	$ 65,766	$ (99)	$ 193,207
Total gains or losses (realized/unrealized):				
Included in earnings	—	2,774	1	2,775
Included in other comprehensive income *	3,015	—	—	3,015
Investment securities called	(3,000)	—	—	(3,000)
Discount accretion	176	—	—	176
Sale/pay down of private equity investments	—	(1,614)	—	(1,614)
Capitalized interest/dividends	—	118	—	118
Sale of risk participation agreement	—	—	(68)	(68)
Balance September 30, 2012	$ 127,731	$ 67,044	$ (166)	$ 194,609
Total gains or losses for the three months included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2012	$ —	$ 2,774	$ (37)	$ 2,737

For the nine months ended September 30, 2012				
Balance January 1, 2012	$135,621	$ 66,978	$ (123)	$202,476
Total gains or losses (realized/unrealized):				
Included in earnings	—	8,374	(3)	8,371
Included in other comprehensive income *	(1,923)	—	—	(1,923)
Investment securities called	(6,350)	—	—	(6,350)
Discount accretion	383	—	—	383
Purchase of private equity investments	—	3,275	—	3,275
Sale/pay down of private equity investments	—	(11,893)	—	(11,893)
Capitalized interest/dividends	—	310	—	310
Purchase of risk participation agreement	—	—	28	28
Sale of risk participation agreement	—	—	(68)	(68)
Balance September 30, 2012	$127,731	$ 67,044	$ (166)	$194,609
Total gains or losses for the nine months included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2012	$—	$ 6,949	$ (40)	$6,909

* Included in "net unrealized gains (losses) on other securities" in the consolidated statements of comprehensive income.

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Gains and losses included in earnings for the Level 3 assets and liabilities in the previous table are reported in the following line items in the consolidated statements of income:

(In thousands)	Loan Fees and Sales	Other Non-Interest Income	Investment Securities Gains (Losses), Net	Total
For the three months ended September 30, 2013				
Total gains or losses included in earnings	$—	$ 51	$865	$916
Change in unrealized gains or losses relating to assets still held at September 30, 2013	$—	$ 51	$865	$916
For the nine months ended September 30, 2013				
Total gains or losses included in earnings	$—	$ 176	$(612)	$(436)
Change in unrealized gains or losses relating to assets still held at September 30, 2013	$—	$ 176	$(612)	$(436)
For the three months ended September 30, 2012				
Total gains or losses included in earnings	$—	$ 1	$2,774	$2,775
Change in unrealized gains or losses relating to assets still held at September 30, 2012	$—	$ (37)	$2,774	$2,737
For the nine months ended September 30, 2012				
Total gains or losses included in earnings	$(9)	$ 6	$8,374	$8,371
Change in unrealized gains or losses relating to assets still held at September 30, 2012	$—	$ (40)	$6,949	$6,909

Level 3 Inputs

As shown above, the Company's significant Level 3 measurements which employ unobservable inputs that are readily quantifiable pertain to auction rate securities (ARS) held by the Bank and investments in portfolio concerns held by the Company's private equity subsidiaries. ARS are included in state and municipal securities and totaled $125.0 million at September 30, 2013, while private equity investments, included in non-marketable securities, totaled $64.5 million.
Information about these inputs is presented in the table and discussions below.
Quantitative Information about Level 3 Fair Value Measurements

	Valuation Technique	Unobservable Input	Range
Auction rate securities	Discounted cash flow	Estimated market recovery period	5 years
		Estimated market rate	2.1% - 4.1%
Private equity investments	Market comparable companies	EBITDA multiple	4.0 - 5.5

The fair values of ARS are estimated using a discounted cash flows analysis in which estimated cash flows are based on mandatory interest rates paid under failing auctions and projected over an estimated market recovery period. Under normal conditions, ARS traded in weekly auctions and were considered liquid investments. The Company's estimate of when these auctions might resume is highly judgmental and subject to variation depending on current and projected market conditions. Few auctions of these securities have been held since 2008, and most sales have been privately arranged. Estimated cash flows during the period over which the Company expects to hold the securities are discounted at an estimated market rate. These securities are comprised of bonds issued by various states and municipalities for healthcare and student lending purposes, and market rates are derived for each type. Market rates are calculated at each valuation date using a LIBOR or Treasury based rate plus spreads representing adjustments for liquidity premium and nonperformance risk. The spreads are developed internally by employees in the Company's

bond department. An increase in the holding period alone would result in a higher fair value measurement, while an increase in the estimated market rate (the discount rate) alone would result in a lower fair value measurement. The valuation of ARS is regularly reviewed by members of the Company's Asset/Liability Committee.

The fair values of the Company's private equity investments are based on a determination of fair value of the investee company less preference payments assuming the sale of the investee company. Investee companies are normally non-public entities. The fair value of the investee company is determined by reference to the investee's total earnings before interest, depreciation/amortization, and income taxes (EBITDA) multiplied by an EBITDA factor. EBITDA is normally determined based on a trailing prior period adjusted for specific factors including current economic outlook, investee management, and specific unique circumstances such as sales order information, major customer status, regulatory changes, etc. The EBITDA multiple is based on management's review of published trading multiples for recent private equity transactions and other judgments and is derived for each individual investee. The fair value of the Company's investment (which is usually a partial interest in the investee company)

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is then calculated based on its ownership percentage in the investee company. On a quarterly basis, these fair value analyses are reviewed by a valuation committee consisting of investment managers and senior Company management.

Instruments Measured at Fair Value on a Nonrecurring Basis

For assets measured at fair value on a nonrecurring basis during the first nine months of 2013 and 2012, and still held as of September 30, 2013 and 2012, the following table provides the adjustments to fair value recognized during the respective periods, the level of valuation inputs used to determine each adjustment, and the carrying value of the related individual assets or portfolios at September 30, 2013 and 2012.

		Fair Value Measurements Using			
(In thousands)	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses) Recognized During the Nine Months Ended Sept. 30
September 30, 2013					
Collateral dependent impaired loans	$9,683	$—	$—	$ 9,683	$(3,132)
Private equity investments	675	—	—	675	(325)
Mortgage servicing rights	628	—	—	628	227
Foreclosed assets	1,115	—	—	1,115	(168)
September 30, 2012					
Collateral dependent impaired loans	$24,749	$—	$—	$ 24,749	$(7,669)
Mortgage servicing rights	515	—	—	515	37
Foreclosed assets	538	—	—	538	(277)
Long-lived assets	5,622	—	—	5,622	(3,428)

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 and nonfinancial instruments measured at fair value on a nonrecurring basis.

Collateral dependent impaired loans

While the overall loan portfolio is not carried at fair value, the Company periodically records nonrecurring adjustments to the carrying value of loans based on fair value measurements for partial charge-offs of the uncollectible portions of those loans. Nonrecurring adjustments also include certain impairment amounts for collateral dependent loans when establishing the allowance for loan losses. Such amounts are generally based on the fair value of the underlying collateral supporting the loan. In determining the value of real estate collateral, the Company relies on external and internal appraisals of property values depending on the size and complexity of the real estate collateral. The Company maintains a staff of qualified appraisers who also review third party appraisal reports for reasonableness. 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. Values of all loan collateral are regularly reviewed by credit administration. Unobservable inputs to these measurements, which include estimates and judgments often used in conjunction with appraisals, are not readily quantifiable. These measurements are classified as Level 3. Changes in fair value recognized for partial charge-offs of loans and loan impairment reserves on loans held by the Company at September 30, 2013 and 2012 are shown in the table above.

Loans held for sale

Loans held for sale are carried at the lower of cost or fair value. In recent periods, this portfolio consisted of student loans. Most of the portfolio was under contract to an agency which was unable to consistently purchase loans under existing contractual terms. Such loans were evaluated using a fair value measurement method based on a discounted cash flows analysis, which was classified as Level 3.

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Private equity investments and restricted stock

These assets are included in non-marketable investment securities in the consolidated balance sheets. They include certain investments in private equity concerns 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 as determined by review of available information, most of which is provided as monthly or quarterly internal financial statements, annual audited financial statements, investee tax returns, and in certain situations, through research into and analysis of the assets and investments held by those private equity concerns. Restricted stock consists of stock issued by the Federal Reserve Bank and FHLB and is held by the bank subsidiary as required for regulatory purposes. Generally, there are restrictions on the sale and/or liquidation of these investments, and they are carried at cost, reduced by other-than-temporary impairment. Fair value measurements for these securities are classified as Level 3.

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.

Goodwill and core deposit premium

Valuation of goodwill to determine impairment is performed on an annual basis, or more frequently if there is an event or circumstance that would indicate impairment may have occurred. The process involves calculations to determine the fair value of each reporting unit on a stand-alone basis. A combination of formulas using current market multiples, based on recent sales of financial institutions within the Company’s geographic marketplace, is used to estimate the fair value of each reporting unit. That fair value is compared to the carrying amount of the reporting unit, including its recorded goodwill. Impairment is considered to have occurred if the fair value of the reporting unit is lower than the carrying amount of the reporting unit. The fair value of the Company’s common stock relative to its computed book value per share is also considered as part of the overall evaluation. These measurements are classified as Level 3.

Core deposit premiums are recognized at the time a portfolio of deposits is acquired. Core deposit premiums are recognized using valuation techniques which calculate the present value of the estimated after-tax cost savings attributable to the core deposit base, relative to alternative costs of funds and tax benefits, if applicable, over the expected remaining economic life of the depositors. Subsequent evaluations are made when facts or circumstances indicate potential impairment may have occurred. The Company uses estimates of discounted future cash flows, comparisons with alternative sources for deposits, consideration of income potential generated in other product lines by current customers, geographic parameters, and other demographics to estimate a current fair value of a specific deposit base. If the calculated fair value is less than the carrying value, impairment is considered to have occurred. This measurement is classified as Level 3.

Foreclosed assets

Foreclosed assets consist of loan collateral which has been repossessed through foreclosure. This collateral is comprised of commercial and residential real estate and other non-real estate property, including auto, marine and

recreational vehicles. Foreclosed assets are recorded as held for sale initially at the lower of the loan balance or fair value of the collateral less estimated selling costs. Subsequent to foreclosure, valuations are updated periodically, and the assets may be marked down further, reflecting a new cost basis. Fair value measurements may be based upon appraisals, third-party price opinions, or internally developed pricing methods. These measurements are classified as Level 3.

Long-lived assets

In accordance with ASC 360-10-35, investments in branch facilities and various office buildings are written down to estimated fair value, or estimated fair value less cost to sell if the property is held for sale. Fair value is estimated in a process which considers current local commercial real estate market conditions and the judgment of the sales agent and often involves obtaining third party appraisals from certified real estate appraisers. The carrying amounts of these real estate holdings are regularly monitored by real estate professionals employed by the Company. These fair value measurements are classified as Level 3. Unobservable inputs to these measurements, which include estimates and judgments often used in conjunction with appraisals, are not readily quantifiable.

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15. Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments held by the Company are set forth below. Fair value estimates are made at a specific point in time based on relevant market information. They do not reflect any premium or discount that could result from offering for sale at one time the Company’s entire holdings of a particular financial instrument. Because no market exists for many of the Company’s financial instruments, fair value estimates are based on judgments regarding future expected loss experience, risk characteristics and economic conditions. These estimates are subjective, involve uncertainties, and cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The methods and inputs used in the estimation of fair value for the financial instruments in the table below are discussed in the preceding Fair Value Measurements note and in the Fair Value of Financial Instruments note in the Company's 2012 Annual Report on Form 10-K. There have been no significant changes in these methods and inputs since December 31, 2012.

The estimated fair values of the Company’s financial instruments and the classification of their fair value measurement within the valuation hierarchy are as follows:

(In thousands)	Fair Value Hierarchy Level	September 30, 2013 Carrying Amount	September 30, 2013 Estimated Fair Value	December 31, 2012 Carrying Amount	December 31, 2012 Estimated Fair Value
Financial Assets					
Loans:					
Business	Level 3	$3,634,461	$3,615,226	$3,134,801	$3,144,989
Real estate - construction and land	Level 3	363,194	365,500	355,996	352,547
Real estate - business	Level 3	2,357,894	2,370,219	2,214,975	2,240,796
Real estate - personal	Level 3	1,766,609	1,786,727	1,584,859	1,642,820
Consumer	Level 3	1,489,066	1,500,998	1,289,650	1,309,403
Revolving home equity	Level 3	421,569	426,408	437,567	441,651
Consumer credit card	Level 3	787,215	802,582	804,245	823,560
Overdrafts	Level 3	3,646	3,646	9,291	9,291
Loans held for sale	Level 2	—	—	3,017	3,030
Loans held for sale	Level 3	—	—	5,810	5,810
Investment securities:					
Available for sale	Level 1	445,295	445,295	456,594	456,594
Available for sale	Level 2	8,006,965	8,006,965	8,939,240	8,939,240
Available for sale	Level 3	125,022	125,022	126,414	126,414
Trading	Level 2	18,295	18,295	28,837	28,837
Non-marketable	Level 3	114,520	114,520	118,650	118,650
Federal funds sold	Level 1	87,167	87,167	27,595	27,595
Securities purchased under agreements to resell	Level 3	1,150,000	1,151,727	1,200,000	1,215,234
Interest earning deposits with banks	Level 1	267,548	267,548	179,164	179,164
Cash and due from banks	Level 1	594,309	594,309	573,066	573,066
Derivative instruments	Level 2	13,709	13,709	16,731	16,731
Derivative instruments	Level 3	5	5	9	9
Financial Liabilities					
Non-interest bearing deposits	Level 1	$6,185,098	$6,185,098	$6,299,903	$6,299,903
Savings, interest checking and money market deposits	Level 1	9,680,816	9,680,816	9,817,943	9,817,943
Time open and certificates of deposit	Level 3	2,351,850	2,354,675	2,230,807	2,239,595
Federal funds purchased	Level 1	711,715	711,715	24,510	24,510

Securities sold under agreements to repurchase	Level 3	1,048,678	1,048,294	1,059,040	1,057,462
Other borrowings	Level 3	105,928	116,423	103,710	117,527
Derivative instruments	Level 2	14,224	14,224	17,522	17,522
Derivative instruments	Level 3	88	88	196	196

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16. Legal Proceedings

In the third quarter of 2012, Visa announced a proposed settlement (in conjunction with Mastercard) regarding certain interchange litigation affecting member banks, and among many provisions the settlement included a reduction in credit card interchange income by 10 basis points over an eight month period beginning September 2013. Accordingly, at that time the Company established a liability of $5.2 million for the estimated effect of this reduction in interchange income. During the third quarter of 2013, the Company's payments to Visa related to this reduced interchange income totaled $643 thousand, and the Company’s remaining liability at September 30, 2013 was $4.5 million.

As described more fully in Note 18 of the Company’s 2012 Annual Report on Form 10-K, in December 2011, the Bank reached a class-wide settlement in a class action lawsuit regarding overdraft fees charged on certain debit card transactions and as a result paid $18.3 million into a class settlement fund. The Bank also agreed to post debit card transactions in chronological order, which was implemented on February 21, 2013. As a result of the change in the posting order of debit card transactions, the Company currently estimates that overdraft income will be reduced on an annual basis by $3.5 million to $5.5 million.

On January 4, 2013, the Company was named in a petition by Patrick J. Malloy III, Bankruptcy Trustee for the Bankruptcy Estate of George David Gordon Jr. (“Gordon”). The petition was filed in the District Court in and for Tulsa County, State of Oklahoma and removed to the United States District Court for the Northern District of Oklahoma, and subsequently remanded back to the District Court on May 7, 2013. On May 10, 2013, the Company was served with an amended petition in the case. The amended petition alleges that Gordon was involved in securities fraud and that Bank South, an Oklahoma bank that was subsequently acquired by the Company, together with a lending officer employed by Bank South, are jointly and severally liable, as aiders and abettors of the fraudulent scheme, for losses suffered by defrauded investors. The losses suffered by investors who have assigned their claims to the Trustee are alleged to be in excess of $9 million. The claim alleges that the Bank is liable as a successor by merger to Bank South. Based on facts available to the Company and after discussion with outside counsel handling the matter, the Company believes it has substantial defenses to this matter but has established a loss contingency of $1.0 million on this matter. This matter will continue to be evaluated on an ongoing basis.

The Company has various other lawsuits pending at September 30, 2013, arising in the normal course of business. While some matters pending against the Company specify damages claimed by plaintiffs, others do not seek a specified amount of damages or are at very early stages of the legal process. The Company records a loss accrual for all legal matters for which it deems a loss is probable and can be reasonably estimated. Some legal matters, which are at early stages in the legal process, have not yet progressed to the point where a loss amount can be estimated.

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Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF 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 2012 Annual Report on Form 10-K. Results of operations for the three and nine month periods ended September 30, 2013 are not necessarily indicative of results to be attained for any other period.

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", variations 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 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, failure of litigation settlement agreements to become final in accordance with their terms, and competition with other entities that offer financial services.

Critical Accounting Policies

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. A discussion of these policies can be found in the sections captioned "Critical Accounting Policies" and "Allowance for Loan Losses" in Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's 2012 Annual Report on Form 10-K. There have been no changes in the Company's application of critical accounting policies since December 31, 2012.

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Selected Financial Data

	Three Months Ended September 30		Nine Months Ended September 30	
	2013	2012	2013	2012
Per Share Data				
Net income per common share — basic	$.75	$.71	$2.14	$2.18
Net income per common share — diluted	.75	.72	2.14	2.18
Cash dividends	.225	.219	.675	.657
Book value			23.90	25.08
Market price			43.81	38.41
Selected Ratios				
(Based on average balance sheets)				
Loans to deposits [1]	58.33 %	56.89 %	56.56 %	55.89 %
Non-interest bearing deposits to total deposits	32.77	33.30	32.62	32.18
Equity to loans [1]	20.41	24.00	21.32	23.97
Equity to deposits	11.91	13.65	12.06	13.40
Equity to total assets	9.90	11.06	9.93	10.88
Return on total assets	1.26	1.28	1.20	1.32
Return on total equity	12.69	11.57	12.05	12.13
(Based on end-of-period data)				
Non-interest income to revenue [2]	40.73	39.62	39.94	38.24
Efficiency ratio [3]	59.72	59.99	60.38	59.14
Tier I risk-based capital ratio			13.65	14.92
Total risk-based capital ratio			14.89	16.25
Tangible common equity to assets ratio [4]			9.10	10.47
Tier I leverage ratio			9.43	10.00

(1) Includes loans held for sale.
(2) Revenue includes net interest income and non-interest income.
(3) The efficiency ratio is calculated as non-interest expense (excluding intangibles amortization) as a percent of revenue.
(4) The tangible common equity to assets ratio is a measurement which management believes is a useful indicator of capital adequacy and utilization. It provides a meaningful basis for period to period and company to company comparisons, and also assists regulators, investors and analysts in analyzing the financial position of the Company. Tangible common equity is a non-GAAP measure and represents common equity less goodwill, core deposit premium and non-controlling interest in subsidiaries. Tangible assets, also a non-GAAP measure, represents total assets less goodwill and core deposit premium.

The following table is a reconciliation of the GAAP financial measures of total equity and total assets to the non-GAAP measures of total tangible common equity and total tangible assets.

	September 30	
(Dollars in thousands)	2013	2012
Total equity	$2,181,486	$2,307,072
Less non-controlling interest	3,953	4,636
Less goodwill	138,676	125,585
Less core deposit premium	8,422	5,289
Total tangible common equity (a)	$2,030,435	$2,171,562
Total assets	$22,452,297	$20,878,769
Less goodwill	138,676	125,585

Less core deposit premium	8,422	5,289
Total tangible assets (b)	$22,305,199	$20,747,895
Tangible common equity to assets ratio (a)/(b)	9.10 %	10.47 %

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Results of Operations

Summary

(Dollars in thousands)	Three Months Ended September 30			Nine Months Ended September 30		
	2013	2012	% change	2013	2012	% change
Net interest income	$154,706	$153,811	.6 %	$464,507	$478,653	(3.0)%
Provision for loan losses	(4,146)	(5,581)	(25.7)	(14,810)	(18,961)	(21.9)
Non-interest income	106,311	100,922	5.3	308,864	296,321	4.2
Investment securities gains (losses), net	650	3,180	(79.6)	(3,083)	8,556	N.M.
Non-interest expense	(156,312)	(153,391)	1.9	(468,315)	(460,192)	1.8
Income taxes	(32,764)	(32,155)	1.9	(91,871)	(99,541)	(7.7)
Non-controlling interest expense	(221)	(780)	(71.7)	(246)	(2,298)	(89.3)
Net income attributable to Commerce Bancshares, Inc.	$68,224	$66,006	3.4 %	$195,046	$202,538	(3.7)%

For the quarter ended September 30, 2013, net income attributable to Commerce Bancshares, Inc. (net income) amounted to $68.2 million, an increase of $2.2 million, or 3.4%, compared to the third quarter of the previous year, and an increase of $2.4 million, or 3.7%, compared to the previous quarter. For the current quarter, the annualized return on average assets was 1.26%, the annualized return on average equity was 12.69%, and the efficiency ratio was 59.72%. Diluted earnings per share was $.75, an increase of 4.2% compared to $.72 per share in both the third quarter of 2012 and the previous quarter.

Compared to the third quarter of last year, net interest income increased $895 thousand, or .6%, mostly due to a $1.9 million decrease in deposit interest expense. This decline in interest expense was partially offset by a decrease of $1.1 million in interest income on loans. The provision for loan losses totaled $4.1 million for the current quarter, representing a decrease of $1.4 million, or 25.7% from the third quarter of 2012. Non-interest income increased $5.4 million, or 5.3%, due to continued growth in bank card and trust fee income. Non-interest expense for the third quarter increased $2.9 million, or 1.9%, compared to the same quarter last year, largely due to an increase of $2.1 million, or 2.4%, in salaries and benefits expense. Net investment securities gains decreased $2.5 million, or 79.6%, in the current quarter compared to the third quarter last year. The decrease in investment securities gains reflects lower gains recorded in the Company's private equity securities portfolio during the current quarter compared to the previous period.

Net income for the first nine months of 2013 was $195.0 million, a decrease of $7.5 million, or 3.7%, from the same period last year. Diluted earnings per share was $2.14, a decrease of 1.8% compared to $2.18 per share in the same period last year. For the first nine months of 2013, the annualized return on average assets was 1.20%, the annualized return on average equity was 12.05% and the efficiency ratio was 60.38%. Net interest income decreased $14.1 million, or 3.0%, from the same period last year due to lower earnings on the loan and investment securities portfolios of $9.2 million and $13.3 million, respectively. These declines were partially offset by an increase of $3.0 million in interest income on long-term resell agreements and a decline of $5.4 million in deposit interest expense. The provision for loan losses was $14.8 million for the first nine months of 2013, down $4.2 million, or 21.9%, from the same period last year. Non-interest income increased $12.5 million, or 4.2%, over the first nine months of last year largely due to continued growth in both bank card and trust fee income. Non-interest expense increased $8.1 million, or 1.8%, due to increases in salaries and benefits expense and data processing and software costs. Net investment securities losses totaled $3.1 million in the first nine months of 2013 compared to net investment securities gains of $8.6 million in the first nine months of 2012. The increase in losses occurred in the private equity securities portfolio, and resulted mainly from lower gains in fair value. In addition, a $2.6 million loss was recorded in the previous quarter, resulting from an interest recovery upon the sale of a private equity investment.

As mentioned in Note 2 to the consolidated financial statements, the Company acquired Summit Bancshares Inc. (Summit) on September 1, 2013. Summit's results of operations are included in the Company's consolidated financial results beginning on that date. The Company acquired all of the outstanding stock of Summit in exchange for shares of Company stock valued at $43.2 million. The Company's acquisition of Summit added $261.6 million in assets (including $207.4 million in loans), $232.3 million in deposits and two branch locations in Tulsa and Oklahoma City, Oklahoma.

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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

	Three Months Ended September 30, 2013 vs. 2012	Nine Months Ended September 30, 2013 vs. 2012
	Change due to	Change due to
(In thousands)		