

UMB Financial: Safely Navigating Through Troubled Financial Waters?

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***Abstract:** This real world case explores how UMB Financial avoided problems in the Financial Crisis of 2008. It is appropriate for undergraduate or graduate courses in bank management, financial markets and institutions, and strategic management.*

LEARNING GOALS

Upon completion of this case students should have a better understanding of the:

- (1) financial performance analysis and metrics for banks and bank holding companies
- (2) publicly available sources of banking data
- (3) relationship of risk and reward in providing bank products and services
- (4) effect on shareholder value from conservative vs. risky strategies

BACKGROUND

J. Mariner Kemper, Chairman of the Board and CEO of UMB Financial (stock ticker=UMBF) in Kansas City, Missouri appeared on CNBC to explain how his organization, the bank holding company for United Missouri Bank and its subsidiaries, has successfully navigated around problems associated with subprime mortgages and the calamities of world financial markets in 2008. Watch Mr. Kemper's interview at: <http://www.executiveinterviews.com/U12610-umbf-cnbcus/>.

Mr. Kemper, recipient of an American Bankers Association Community Banker of the Year Award for 2008, explained that UMB Financial did not apply for funds under the Capital Purchase Program of the U.S. Treasury's Troubled Asset Relief Program (TARP) because it was not needed. UMB Financial achieved over a 30% increase in earnings for the first three quarters of 2008 by continuing to do the same things that UMBF has always focused on--quality lending to customers they know and understand. In addition, the banking organization has provided ample liquidity, a safe capital cushion and an adherence to safe and sound banking principles which, among other things, includes avoiding subprime lending as well as the purchase of subprime investments.

UMB has a long history as one of the safest banks in America. The bank traces its origins to a storefront bank in Kansas City, MO in 1913. In 1919, the bank was purchased by W.T. Kemper and his son, Rufus Crosby Kemper, which began decades of ownership by the Kemper family that persists today. R. Crosby Kemper, Jr. joined the bank in 1945 and guided the bank until 2000 when he ascended to the senior chairman position of UMB Bank as well as the parent holding company. His sons, Sandy, Chris and Mariner have run the bank in recent years.

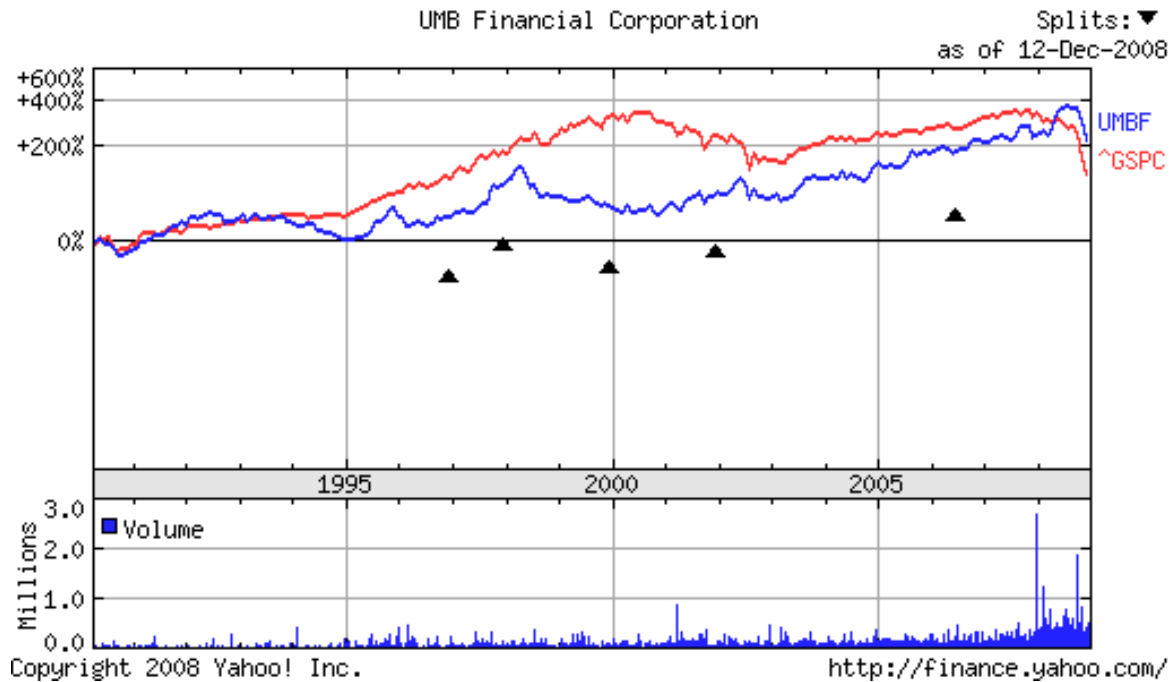
With changes in interstate banking laws in the mid-1990s, UMBF has expanded operations throughout Missouri as well as Arizona, Colorado, Kansas, Illinois, Oklahoma and Nebraska. It also has a trust

management company in South Dakota and an investment group in Wisconsin. Today, total bank holding company assets are approaching \$10 billion. UMBF stock trades on the NASDAQ market.

REVIEWING FINANCIAL PERFORMANCE

One of the primary objectives of a publicly traded company is to maximize shareholder returns as reflected by the market price of the firm's stock. UMBF has underperformed the market as measured against the returns on the Standard and Poors 500 stock index (GSPC) much of the period from 1990 until early 2008. As overall market conditions deteriorated in 2008 because of the turmoil in credit markets triggered by problems in the housing market, the market price of UMBF stock has exceeded the returns in the overall equity markets. The conservative approach that the market discounted in periods of economic growth suddenly was rewarded as the economy has entered a period of sharp contraction. Students may wish to use Yahoo Finance (<http://finance.yahoo.com>) to update data and to vary comparison indices such as the Dow Jones Industrial Average or the NASDAQ index.

Chart 1: Stock Performance 1990-2008



To provide an overview of UMBF performance versus peer institutions over time, three time periods were selected. Interested readers can find free complete detailed data for all US banks and bank holding companies from the FDIC website using the on-line Statistical Data Interchange program (<http://www2.fdic.gov/sdi/index.asp>) and from the Federal Financial Institutions Examination Council (FFIEC) at <http://www.ffiec.gov>. The latter site contains access to the Uniform Bank Performance Reports (UBPR is available directly at <http://www2.fdic.gov/ubpr/UbprReport/SearchEngine/Default.asp>) and Bank Holding Company Performance Reports (BHCPR available directly at <http://www.ffiec.gov/nicpubweb/nicweb/SearchForm.aspx>) with additional detailed performance data. The three periods include: 1) year end 2000. This is a period where the Federal Reserve held the short term target Federal Funds rate constant from May 2000 through the end of the year even as market rates declined significantly. The Presidential election in November 2000 did not produce a clear-cut winner. The Supreme Court eventually resolved the election in January 2001. Beginning in January 2001, the

Federal Reserve began a series of eleven rate cuts as the economy slipped into a brief recession; 2) year end 2002. This period experienced short term interest rates below 2% with an accompanying surge in mortgage refinancing, new mortgages and subprime lending to marginally qualified or unqualified borrowers. Some analysts suggest this marked the beginning of the subprime crisis; and 3) 2008.3, the most recent data available at the time.

During 2008 the financial markets experienced a global meltdown triggered by widespread mortgage defaults as housing prices plummeted. Credit derivatives, including credit default swaps, became difficult, if not impossible to trade as financial institutions feared counterparty risks. This created liquidity and/or solvency problems with institutions including Bear Stearns, Merrill Lynch, Washington Mutual, Lehman Brothers as well as investment banks like Goldman Sachs and Morgan Stanley. The Federal Reserve System, the US Treasury, the FDIC and foreign central banks have provided unprecedented liquidity to the global financial system as well as numerous innovative programs to avoid a complete economic and financial collapse.

During periods of extreme financial stress, financial institutions such as UMB Financial, often criticized for being too conservative in good times, become safe havens for investors. Customers that are concerned about the financial stability of their banks may choose to transfer funds to “safe” institutions like UMBF. Table 1 shows a variety of standard financial performance metrics for commercial banks. The numbers for UMBF are compared with peer institutions (a group of roughly 400 US bank holding companies that are between \$1 billion and \$10 billion in total assets. UMBF is at the upper end of this peer group in size.)

TABLE 1: Earnings and Efficiency Measures

Ratio or Measure	UMBF 2000.4	Peers 2000.4	UMBF 2002.4	Peers 2002.4	UMBF 2008.3	Peers 2008.3
Yield on earning assets	6.85%	8.48%	4.17%	6.32%	4.80%	6.19%
Cost of funding earning assets	3.25%	4.20%	1.11%	2.07%	1.55%	2.49%
Net interest margin	3.60%	4.27%	3.06%	4.25%	3.25%	3.70%
Noninterest income to earning assets	3.08%	2.55%	3.11%	2.74%	3.48%	1.54%
Noninterest expense to earning assets	5.12%	3.97%	4.89%	3.90%	4.77%	3.35%
Return on assets (ROA)	0.88%	1.27%	0.74%	1.52%	1.16%	0.38%
Return on equity (ROE)	10.57%	14.36%	8.81%	14.83%	13.44%	3.42%
Efficiency ratio (ER)	75.35%	56.18%	78.67%	54.74%	70.29%	58.38%
Assets per employee (\$millions)	2.10	3.56	2.23	3.82	3.20	4.83
Net loans and leases to deposits	52.89%	88.66%	46.37%	87.29%	58.21%	98.04%

Source: Federal Deposit Insurance Corporation

The yield on earning assets measures the returns on loans and securities. Yields on loans may be affected by the riskiness of the loans as well as the degree of market competition and the proportion of loans to total earning assets. The higher the quality of a loan, other things equal, the lower the return on the loan. A loan to a small business, for example, would be expected to carry a higher interest rate than a mortgage loan to a customer with a 700+ credit score.

The headquarters of UMBF in Kansas City, MO is located in one of the most competitive banking markets in the country. The largest market share for an institution in the geographic market currently hovers at just below 12% (Bank of America). The market share for UMBF is about 8.5%. There are over 100 banks and more than 700 offices in the Kansas City MO/KS MSA with a population of around 1.7

million. Market competition in the state of Missouri is likewise competitive including the St. Louis and Springfield MSAs.

The loan to deposit ratio for UMBF historically has been around 50%; by comparison peer institution loan to deposit ratios are in the upper 80's and in the current period approaching 100%. If UMBF is only loaning out half of the deposit funds what happens to the remainder? The simple answer is they are invested in US Treasury securities, US agency securities (like Fannie Mae, Freddie Mac, Ginnie Mae, etc.) as well as high quality state and local municipal securities. Unfortunately, the returns on these securities are generally much lower than on loans, which reduces the overall yield on earning assets. The cost of funding earning assets primarily represents the interest paid to bank depositors for a variety of different deposit vehicles including money market accounts, certificates of deposit and different types of transactions accounts. The mix of these deposits affects the cost of funds as does the competitiveness of deposit markets. Access to a variety of deposits offered by financial institutions over the Internet may also affect deposit rates.

Net interest margin is simply the difference between the yield on earning assets and the cost of funding earning assets. If the net interest margin is low compared with peers and the volume measure is also low (as approximated by the loan to deposit ratio), then total revenues from earning assets will reflect this. One possible way for a financial institution to offset at least some of the shortfall is by generating non-interest income (fee income). UMBF, with higher fee income has an edge over peers. This advantage comes from processing transactions for non-bank clients, trust income and investment services income. Unfortunately generating fee income requires incurring costs that are included as non-interest expenses. As can be seen in Table 1, non-interest expense exceeds non-interest income by a wide margin. UMB Financial is widely known for providing customer convenience. There are UMB "bricks and mortar" branches spread throughout the bank's primary markets. In addition, UMBF has negotiated an arrangement to place ATM machines in strategic locations including QuikTrip convenience stores. Customers enjoy the benefits of convenient access. While providing financial benefits to the bank, it also adds considerable costs.

The efficiency ratio (ER) is a standard measure of how well overhead cost matches against income sources (both interest income and non-interest income). A lower ratio is desirable. UMBF's efficiency ratio is historically at or above 70% while peers are generally in the 50-60% range. Another frequently used measure of productivity is assets per full time equivalent employee. Here a higher number is desirable. UMBF has improved from \$1.2 million assets per employee to \$3.2 million since 2000.4. By comparison, peer institutions have done even better, rising from \$3.56 million to \$4.83 million in assets. The bottom line numbers of interest to shareholders and market analysts are return on assets (ROA) and return on equity (ROE). These ratios are, in fact, linked by the simple mathematical relationship: $ROE = ROA * \text{leverage multiplier}$ where the leverage multiplier = $1/(\text{equity capital/assets})$ [1]

For example, a bank with an ROA=1% and an equity capital/asset ratio of 5% would have an ROE of 20%; by contrast, an ROA=1% and an equity capital/asset ratio of 10% yields an ROE of only 10%. UMBF substantially underperformed peers in both 2000.4 and 2002.4 while substantially outperforming peers in the current period. A partial explanation lies in the area of credit quality as well as in capital adequacy. These are considered in Table 2.

UMBF's return on equity of 13.44% substantially exceeds the peer average of 3.42%. This is attributable to both the higher ROA of 1.16% vs. 0.38% plus the beneficial use of leverage. The lower equity capital to asset ratio of 8.5% (compared to a peer average of 11.01%) increases the leverage multiplier to approximately 12 vs. 9 for the peer group.

TABLE 2: Asset Quality and Capital Ratios

Ratio or Measure	UMBF 2000.4	Peers 2000.4	UMBF 2002.4	Peers 2002.4	UMBF 2008.3	Peers 2008.3
Net charge-offs to loans	0.27%	0.70%	0.53%	0.89%	0.26%	0.87%
Earnings coverage of net loan charge-offs (x)	12.14	5.73	6.1	5.08	15.11	2.85
Noncurrent loans to loans	0.56%	0.93%	0.62%	1.07%	0.35%	2.45%
Equity capital to assets	7.93%	8.96%	8.28%	10.34%	8.50%	11.01%
Tier 1 risk-based capital ratio	14.13%	10.98	14.87%	12.53%	12.00%	11.15%

Source: Federal Deposit Insurance Corporation

The potential benefit of UMBF’s conservative lending strategy is seen by the measures of asset quality. In 2008.3 UMBF had a noncurrent loan ratio (loans that are 90 days or more past due or on non-accrual status) of a mere 0.35% (the lowest of the three comparison periods) compared to 2.45% for peer institutions. As a general “rule of thumb”, banks historically have experienced about a 1% noncurrent loan ratio.

Net charge-offs (actual charge-offs minus recoveries from previous periods) for UMBF are a mere 0.26% or roughly one third of the peer average. This again indicates that lending policy appears to have been directed at making high quality loans that maximize the likelihood of repayment. This is especially important in periods of financial stress. UMBF in 2008.3 has a strong earnings coverage ratio of over 15 times actual loan charge-offs. By comparison, peers have a coverage multiple of less than 3 times. According to the FDIC *Quarterly Banking Profile* for the third quarter of 2008 average banking industry ROA declined to a mere 0.05% compared to 0.92% a year earlier.

(<http://www2.fdic.gov/qbp/2008sep/qbp.pdf>) Industry noncurrent loans rose to 2.31%, the highest since the third quarter of 1993. Net charge-offs increased by 156.4% from 2007.3 with over two thirds consisting of loans secured by real estate.

A LOOK TOWARD THE FUTURE

UMB Financial has weathered the current financial turbulence up to this point by sticking to a philosophy of conservative lending focused in predominately Midwestern geographic markets. In good times this leads to underperformance and sometimes unhappy shareholders. Once the financial crisis passes and the economy emerges from recession, what management challenges lie ahead?

Can UMB Financial survive by continuing to be a conservative institution? If they decide to take more risks, especially in lending in search of greater profits, will it hurt them in the long-term? Can they maintain and extend the advantages that they currently enjoy?

The bank at nearly \$10 billion is comparatively small. Bank analysts have warned about the vulnerabilities of small regional bank holding companies. These problems may be exacerbated as former investment banks like Goldman Sachs, armed with bank holding company charters become more competitive. Likewise, Bank of America, a massive global financial institution has become even more formidable with the acquisition of Countrywide Financial as well as Merrill Lynch. These are but a few of the competitors that UMBF will face in the future.

There is also a lingering question of whether UMBF will be the hunter or the hunted. ...the acquirer or the acquired. UMBF has successfully fended off potential acquirers in the past but remains an inviting target

going forward. The financial strength and clean balance sheet also position UMBF as a potential acquirer. Decreased valuations of banks and financial institutions may make such acquisitions attractive.

UMBF has survived and prospered in the short-term by navigating through troubled waters guided by principles of conservatism and a dedication to knowing and understanding risks along with the needs of customers. The global financial landscape has changed dramatically in the past year. What lies ahead is uncertain. Will the bank seek greater rewards by assuming more risk or will it stay the conservative course as the economy recovers? A 100th birthday celebration is within sight. Will UMBF be there for the celebration?

DISCUSSION QUESTIONS

1. How does UMBF balance safety vs. profitability over time?
2. How can UMBF take advantage of the current financial crisis?
3. Does UMBF have a sustainable competitive advantage? How does UMBF fit within Porter's Five Forces Model? What does a SWOT analysis reveal?
4. Is UMBF an attractive take-over candidate by a larger institution? What factors make it appealing?

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Teaching Note/Instructor Manual available from the Journal of Business Cases & Applications.
