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Hip to Be Square

BY ALAN KLINE

Frost Bank has a reputation for never wavering from its mission of building long-term relationships. It achieves this goal by providing top-notch service, putting principles before profits and giving customers a fair deal. "Our culture is our value proposition," says Phil Green, its chairman and CEO. PHOTO BY GABE HERNANDEZ ©2018 SAN ANTONIO BUSINESS JOURNAL. ALL RIGHTS RESERVED. REPRINTED WITH PERMISSION.

Investors hate surprises, so when Frost Bank revealed on an earnings conference call last July that it had increased the rates it was paying on customers' deposits, the stock market reacted unkindly.

Shares of the bank's parent company, Cullen/Frost Bankers, plunged 5% that day on fears that the higher deposit costs would suppress the net interest margin and eat into future profits.

What surprised investors most was that San Antonio-based Frost would be among the first regional banks in the country to meaningfully boost what it pays on deposits in response to the Federal Reserve rate hikes. Frost already had ample low-cost deposits to fund its lending activities – its 49% loan-to-deposit ratio is well below the industry average – and shareholders questioned why it would pay up to bring in money it didn't seem to need, said Brett Rabatin, a senior banking analyst at Piper Jaffray.

"Their minds were blown a little bit because if you look at the balance sheet, you would think Frost would be the bank dragging its feet" on raising deposit rates, Rabatin said. "Yet here it was getting in front of the market, and it left everyone really confused."

But to Phil Green, the chairman and chief executive of the $31.5 billion-asset Frost, the decision to increase rates was less about attracting new deposits to the bank and more about "providing a square deal" to existing customers. At that point the Fed had raised its rates by 100 basis points over the previous 18 months and Green believed that those banks still paying next to nothing on consumer deposits would soon face a reckoning.

"The industry will ultimately have to respond with higher rates to compete with offerings from nonbank alternatives," such as money market funds, Green told analysts on that second-quarter earnings call. "It can either respond in a timely manner or risk being too late and losing relationships and trust along the way."

The move to raise rates on deposit accounts well before competitors did and over the concerns of many investors goes a long way toward explaining why one of Texas' oldest banks is also one of its most admired.

While many banks say that they put their customers' needs first, Frost demonstrates this better than most, industry observers say. Its strategy of emphasizing relationships, not compromising its principles to make quarterly numbers and putting a high premium on convenience is apparent in its actions. Not many other banks its size offer live customer support 24 hours a day, seven days a week, have a network of more than 1,200 ATMs and continue to add, rather than close, branches.

Its service earns high marks from customers. For nine consecutive years now, Frost has placed No. 1 in J.D. Power's annual customer satisfaction rankings for the Texas region, and for the past two years it has won more excellence awards from Greenwich Associates than any other bank in the country, based on the service it provides to small and middle-market businesses.

Frost is also well-respected for being one of Texas' best corporate citizens.

"It's just as important to us how you treat your co-workers as it is how you treat your customers," says Candace Wolfshohl, Frost's executive vice president for culture and people development. PHOTO BY GABE HERNANDEZ ©2018 SAN ANTONIO BUSINESS JOURNAL. ALL RIGHTS RESERVED. REPRINTED WITH PERMISSION.

After Hurricane Harvey ravaged southeast Texas last summer, its charitable foundation decided to give an unprecedented $1 million to nonprofits aiding hurricane victims. Last year it won a first-ever citizenship award from the Federal Home Loan Bank of Dallas for the investments it has made in affordable housing projects over the last two decades. And in honor of its 150th anniversary this year, the bank is committed to performing 150 good deeds in the markets it serves, from sponsoring arts festivals to sending volunteers to help at animal shelters to hosting small-business and financial literacy seminars.

This devotion to the people part of doing business – building relationships and helping its communities – is a big reason Frost enjoys a strong reputation in the markets it serves.

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This holds true with both customers and noncustomers, as measured by the American Banker/Reputation Institute Survey of Bank Reputations. Of the 40 banks included in the survey this year, Frost placed second, behind only USAA Bank, in the noncustomer ranking, with a score of 71.1 on a scale of 1 to 100. It came in at No. 12 in the customer ranking, with a score of 77.9.

Frost received industry-leading scores from noncustomers in two categories that are considered reputation drivers, citizenship and workplace culture. It ranked second in the five other categories, including products and services, financial performance and governance. (For this survey, governance is essentially a measure of how ethical people think a bank is, with the score being based on perceptions of transparency and fairness.)

Customer scores also landed it among the top five banks in all seven categories.

Frost's reputation has been bolstered by a conservative credit culture that has allowed the bank to weather the most severe of economic downturns. It famously refused to accept funds from the government's Troubled Asset Relief Program at the onset of the financial crisis in 2008 because it didn't need the money, and many people in Texas remember that it was the only one of the state's 10 largest banks to survive the oil and real estate busts of the late 1980s and early 1990s.

What happened in the '80s and '90s might not be significant to millennials, but it matters a lot to older generations who want to know that their bank is not making risky bets with their money, said Curtis Carpenter, managing director at Sheshunoff Investment Banking in Austin. "A lot of gold-star banks went down in the '80s. Frost is the only one that didn't," he said. "For people who are in their mid-50s or older, that is still very much a thing."

Frost's banking philosophy is guided by what it calls the "blue book" – a manual written 20 years ago by Green's predecessor, Richard Evans. The book itself builds on a mission statement written by Evans' predecessor, Thomas Frost, a few years earlier that reads: "We will grow and prosper, building long-term relationships based on top-quality service, high ethical standards, and safe, sound assets."

Green, who has been Frost's chairman and CEO since early 2016, said that the words in the book are not merely "aspirational," they are the core values by which all employees must abide. The book is thin, but it is packed with details on how employees are expected to treat customers and each other, while setting expectations for shareholders and outlining the bank's commitments to the communities it serves.

"Our culture is our value proposition," Green said. "We have to make sure, as best we can, that we are doing the things that are documented in that book."

Still, even the best banks have to work at maintaining their cultures, so when Green took over as CEO, one of his first orders of business was naming longtime human resources executive Candace Wolfshohl to the newly created position of executive vice president for culture and people development.

Under Wolfshohl, Frost has put an even greater emphasis on development, coaching and leadership training and it undertook its first-ever employee survey to gauge workers' attitudes toward the company.

While the survey found that employees generally feel good about how they are helping customers, it also showed that Frost had some room for improvement in the work environment. The online survey included an open-ended comment section that produced more than 1,200 comments – 161 pages' worth – the results of which were sent only to Green, who read every word. In response to those comments, the company last year implemented a series of worker-friendly changes, such as increasing wages, adding more vacation days and extending its maternity and paternity leave.

"We do a fantastic job creating great customer experiences that make people's lives better, but we needed to do better creating great employee experiences," Green wrote in his annual letter to shareholders.

This is not to suggest that employees are unhappy or frustrated. Nearly 500 employees, including Green and Wolfshohl, have been with the company for at least 25 years, and most wouldn't have stayed if they didn't find it to be a welcoming work environment.

"In the blue book we say that 'technical competence is no substitute for personal character' and we mean that," Wolfshohl said. "It's just as important to us how you treat your co-workers as it is how you treat your customers."

That continuity, particularly within the ranks of lenders, is also one of the bank's key competitive advantages, said Brady Gailey, an analyst at Keefe, Bruyette & Woods. "At some banks it's like a revolving door, lenders will come and go every three or four years, but Frost has bankers who have been there for decades," Gailey said. "When you have the consistency of bank officers, it translates to a consistency of customers. A lot of Frost's customers are multigenerational."

'Most bankers around the state will tell you that it's just really hard to steal a Frost customer,' says Curtis Carpenter of Sheshunoff Investment Banking.

Carpenter, who has been following the Texas banking scene for 35 years, said that Frost's ability to retain customers – in some of the nation's most desirable and fiercely competitive markets – is unmatched.

"One of the things Frost is known for is its tremendous customer loyalty," he said. "Most bankers around the state will tell you that it's just really hard to steal a Frost customer."

Frost's loyalty to its customers is sometimes at odds with the short-term demands of shareholders, though it typically pays off for all parties in the end. The decision to raise rates on deposits is a case in point.

Growth in Frost's money market deposit accounts had slowed since the Fed began raising interest rates in late 2015 and bank officials suspected it was because some customers had already moved their money to nonbank funds. Then in July Frost substantially increased rates on high-yielding money market funds and certificates of deposit, and by the end of the third quarter, money market deposits had grown to their highest levels since the third quarter of 2015.

Frost's stock price, meanwhile, more than recovered from its midsummer swoon. Since falling to as low as $81.09 in early September, the stock had climbed more than 40%, to about $116, as of early June.

Piper Jaffray's Rabatin said he was skeptical of the decision to boost deposit rates, but then he put together an analysis of how peer banks' funding costs would be affected once they got around to raising rates and found that Frost's would still be lower. That's because its percentage of low-cost core deposits to total assets is roughly 84.5%, far higher than peer averages, according to Federal Deposit Insurance Corp. data.

"There was good logic to the bank getting out in front of their competitors," Rabatin said. "Its cost of funds is still half that of most banks."

Green came up on the finance side of the bank and he admits that there was a time early in his career when he would have been concerned about the impact a decision like raising rates on deposits would have on the bottom line or the stock price. But in working for leaders such as Evans, the author of that blue book, and Frost, the writer of that mission statement – who at 90 is still the bank's chairman emeritus – Green began to change his thinking.

"I used to believe that the objective was to create a successful business and that you got there by making a correct series of business decisions," said Green. "I've come not to believe that anymore. What I believe today is that the objective is to create a successful institution and you get there by making a correct series of institutional decisions, and they aren't always the same thing."

An example of this institutional thinking was a decision in the early 2000s to exit the mortgage business. Mortgage lending was profitable, but management began to view it as a commodity business that did not jibe with its stated mission of building long-term, sustainable relationships.

"We got out of the mortgage business not because we saw trouble ahead – we weren't that smart – but because it wasn't based on a relationship, it was based on price," Green said. "If you are dealing with someone just on the basis of price, that's not going to be a quality relationship.

"Our shareholders understand," he continued, "that the bank will make decisions in the interest of the long term and consistent with its culture."