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A shared-technology model to address MDIs' digital needs

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Synopsis

Minority Depository Institutions (MDIs) have long maintained a unique position in the financial services industry as the institutions that understand and can serve their communities better than any other financial institution segment. Recent financial shocks have increased the challenges these important institutions are already facing. In this paper, we assess recent trends in an important sector of US community banks and propose some collective actions solutions for enhancing their competitiveness.

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Introduction

Recent shocks in the US financial sector have spurred concerns about economic growth in the United States and globally. The impact of the crisis could have ripple effects on small banks and community owned financial institutions as many customers consider moving their funds to presumably safer and larger banks. Deposit flight could have significant implications for funding that is necessary for the economic growth of minority communities. Recent data from the Federal Reserve shows that deposits have dropped during the first quarter of 2023. In this paper we assess recent trends in an important sector of US community banks and propose some solutions for enhancing their competitiveness.

Minority Depository Institutions (MDIs) are widely lauded as important community institutions recognized for serving underserved clients. Commercial banks, credit unions, and community savings banks are designated as MDIs if minority investors own over half of the voting stock, or a majority of a bank's board are people of color and the community it serves is predominantly minority. Publicly available data from the Federal Deposit Insurance Corporation (FDIC, 2022) show that, as of the fourth quarter of 2022, 147 MDIs served communities across the United States and its territories. As the banking industry undergoes continued consolidation and increasing competition, however, the number of MDI charters has dwindled, falling nearly 20 percent over the decade ending in 2022. This is despite the integral role they play in the communities they serve.

The size of MDIs tends to be smaller than the average for US financial institutions, and their branches and deposits tend to be located in areas considered socially vulnerable (Cetina et al., 2022) and low-income (FDIC, 2019). MDIs also tend to operate within relatively small and concentrated geographic areas. These characteristics give them the strength and ability to empower their communities and client base but also represent challenges, particularly in an increasingly competitive landscape. As smaller—and often under-resourced—financial institutions, MDIs face a disproportionate burden in providing the sort of technological tools (e.g., mobile banking) that customers increasingly expect. They must also contend with the back-end inefficiency of older technology, which results in higher operating costs compared to larger banks with which MDIs may compete. The competitive imbalances tied to the rapid digitization of financial services threatens the ability of MDIs, in particular, to fulfill their mission.

Small financial institutions may also experience other disadvantages when it comes to competing against larger banks and nonbank fintech firms. Larger firms' greater scale, revenue, retail footprint, talent pool, and technology infrastructure allow them to much more easily expand their reach (Kissi, 2021) and allow an accelerated ability to offer in-demand digital products and services. Meanwhile, newer fintech players are changing the competitive landscape by bringing digital products quickly to market and attracting customers that may not be sufficiently served by mainstream financial institutions.

The barriers MDIs face to modernizing their technology relative to other financial institutions reinforces a growing digital divide that exacerbates the nation's economic inequities along racial lines. Community banks and credit unions focused on disadvantaged and underserved communities face an existential dilemma. On one hand, they must improve their digital capability to fulfill their mission and offer the products that Black and Brown consumers and minority-owned small businesses need in order to advance. On the other hand, MDIs lack the resources and experience to undergo a risky digital modernization of their own.

In 2022, three nonprofit organizations began work to improve the digital capability of MDIs. They initiated the MDI Digital Modernization Project, a multistep program that will assess the technology needs of small financial institutions catering to underserved communities of color. This initiative—developed jointly by the Alliance for Innovative Regulation (AIR), National Bankers Association (NBA), and Inclusiv, and funded by Visa—aims to provide a digital modernization roadmap for solutions developed by fintech third parties and other vendors that multiple MDIs can plug into without incurring prohibitive costs.

A review of other programs addressing the needs of small financial institutions, including MDIs, suggests that the collective power and strength of a shared-services approach—one in which multiple financial institutions can access and utilize a shared set of digital solutions—can help community banks and credit unions maintain a competitive edge in the face of multiple headwinds (Stout, 2020). The Digital Modernization Project presents a new testing ground for that approach to solve the digital challenges of institutions that cater to underserved communities.

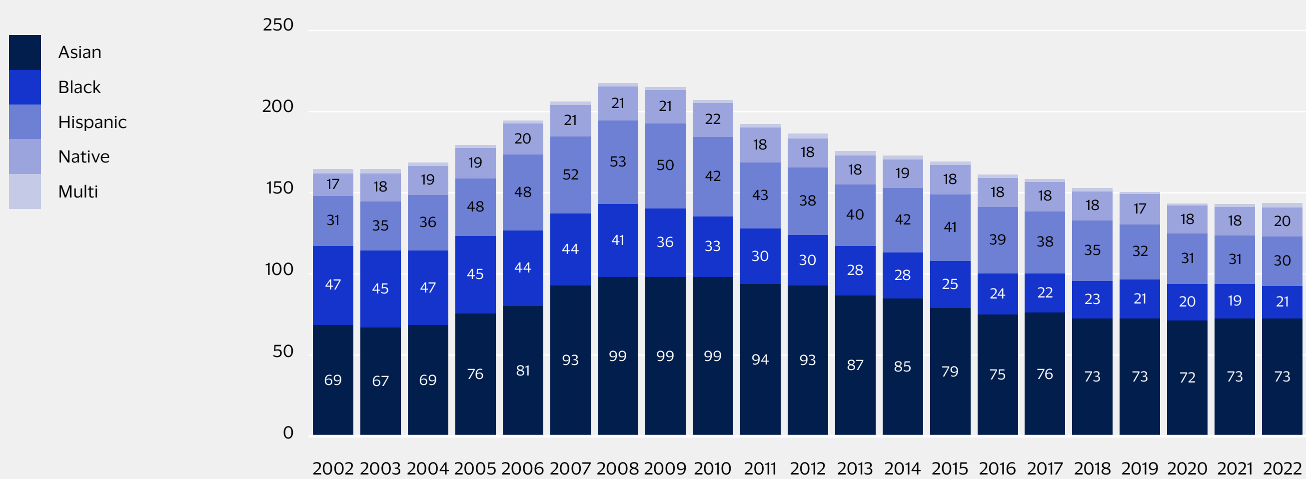
The digital and economic gap is widening

MDIs have filled a vital need across communities for many decades. For example, the first MDI, Freedman's Bank, pioneered the model of catering to those historically excluded by mainstream financial services system (Operation Hope, n.d.). Nearly 160 years later, MDIs remain the primary or sole banking option for many business owners and households with limited banking branches and services in their communities. MDIs are a critical node in the financial inclusion ecosystem because of the depth of their understanding of and experience with the risks and opportunities unique to this segment.

But despite their importance in the drive for a more equitable financial system, the number of MDIs has declined over the past two decades—along with the broader decline of community banks—in the face of persistent competitive imbalances.

As shown in Figure 1, the total number of MDI banks operating in the US peaked at 215 in 2008. During the 14 years since this peak, the number of MDI banks has declined by nearly one third. During the same period, the number of Black-owned or Black-operated banks declined by more than half. There are now only 21 Black-owned banks in the country, down from 47 in 2002.

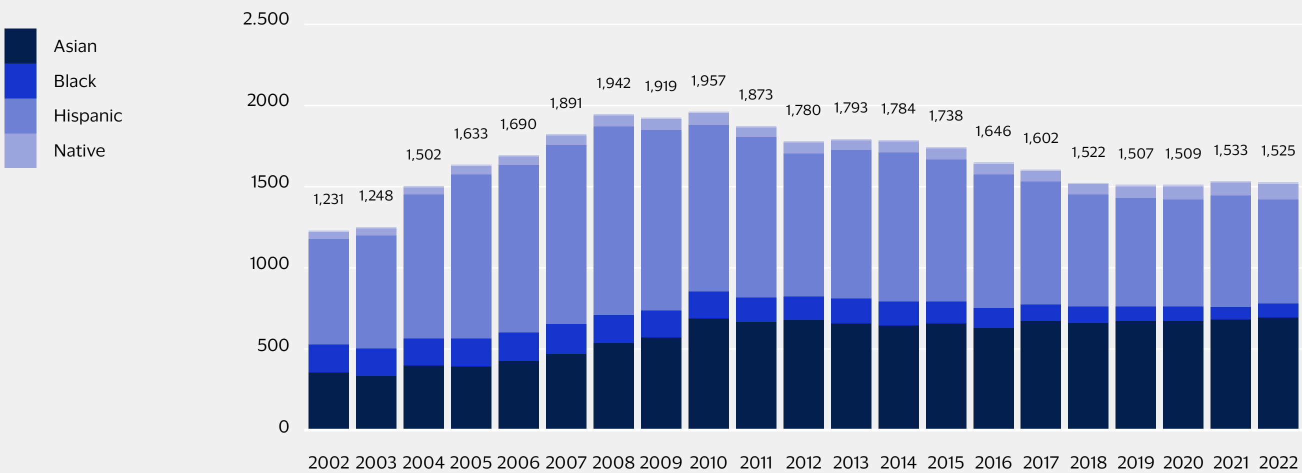
Figure 1: Number of MDI banks, 2002-2022



Source: FDIC, VEEI, Oxford Economics

Although consolidation accounts for much of the recent decline in the number of MDI banks, FDIC data also show a decline in the number of MDI bank branches during the same period (see Figure 2). This decline mirrors industry-wide trends. The number of FDIC-insured banks halved between 2002 and 2022 (FDIC, 2022a), a trend largely attributed to consolidation and mergers in the financial sector. But the decline in MDIs is especially concerning, as these community banks "often serve customers who prefer to do business in person at bank branch locations" (Toussaint-Comeau & Newberger, 2017). The total number of branches in the US peaked at 1,957 in 2010. During the 12-year period since this peak, the number of MDI branches has declined by 22 percent. And once again, the decline is even steeper among branches of Black-owned or Black-operated MDIs. In 2022, there were 86 total branches of Black-owned banks in the US—a decline of nearly 47 percent from 2010, and a decline of over 50 percent from the peak of 174 branches in 2007.

Figure 2: Number of MDI bank branches, 2002-2022

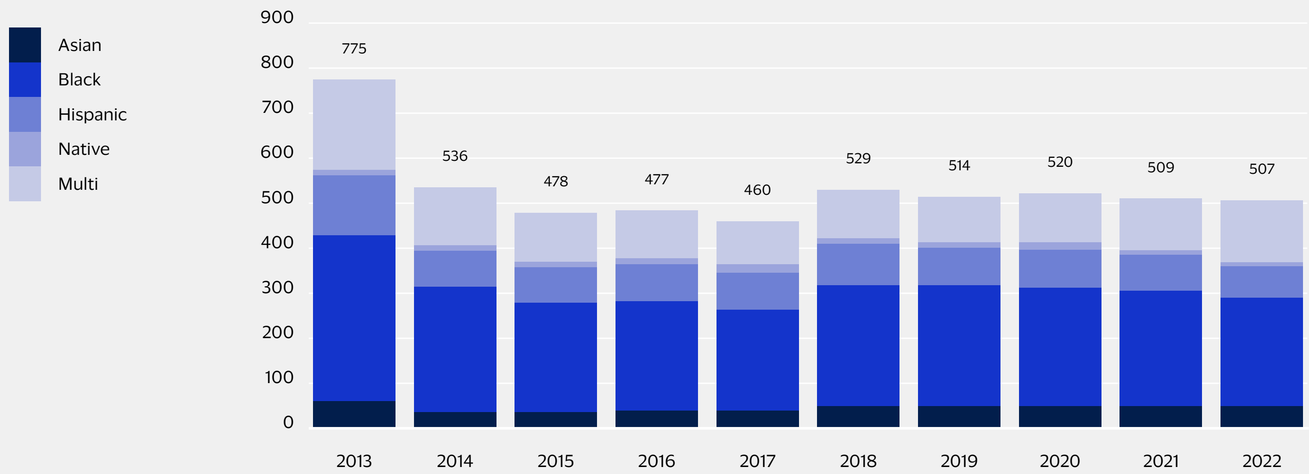


Source: FDIC, VEEI, Oxford Economics

Meanwhile, the National Credit Union Administration (NCUA)—which defines MDI credit unions as those where a majority of current members, board members, and the community served belong to a minority group—counted 507 such institutions as of December 2022, representing a decline of nearly 35 percent over the past decade (see Figure 3). During the same period, the number of Black-operated MDI credit unions declined by just over 34 percent, while the number of Hispanic-operated institutions declined by nearly half.

Not surprisingly, many experts have expressed concern about the impact of declining MDI numbers, particularly in Black and Brown communities. A recent report published by the Brookings Institution showed that the rates for unbanked and underbanked consumers in 2019 were highest among Black adults (Broady et al., 2021). While small in size, MDIs remain a critical component in efforts to expand financial inclusion.

Figure 3: Number of MDI credit unions, 2013-2022



Source: FDIC, VEEI, Oxford Economics

As MDIs have fallen in number, the competitive landscape has also become more challenging. Following the global financial crisis of 2008, the banking sector has seen a significant consolidation. This trend has been paired with the rise of fintech firms as an increasingly significant source of consumer lending. The Federal Reserve Bank of St. Louis—using TransUnion data—has found that fintech firms handled 38 percent of U.S. personal loans as of 2018 (White, 2021). During this period, personal loans made by banks fell to 28 percent. Credit unions made up 21 percent.

In order to thrive in this increasingly competitive landscape, there is broad agreement that MDIs (as well as other community banks and credit unions) must undergo extensive technology improvements in order to be more competitive. Unfortunately, that is easier said than done. According to a survey compiled as part of the Digital Modernization Project, MDIs reported five main challenges in their attempt to strengthen their digital capabilities on their own:

1. A lack of sufficient capital for technology investment;
2. The high cost of implementing new technology for small institutions;
3. Limited human capital with technology expertise;
4. An employee base that may be unfamiliar with digital processes; and
5. Outdated and outsourced systems.

At MDIs, the impact of not meeting customer needs is magnified on society at large. Structural barriers in the financial system have long created and worsened profound racial inequalities. According to research by the Milken Institute, non-white credit applicants with similar credit profiles are over 62 percent more likely to receive higher-cost loans (Betru et al., 2019). Similarly, only 40 percent of minority-operated small businesses receive the full loan amount that they request, compared to 68 percent of non-minority-operated businesses (Federal Reserve Bank of Cleveland, 2017). These disparities have gotten worse during the COVID-19 pandemic.

If people of color in underserved areas rely on their local MDI for credit needs, deposit account and payments services, and other financial services tools—and if that institution is not innovating at the pace of recent technological change—consumers in minority areas will fall further behind economically. This exacerbates inequalities that have come into greater focus since the 2020 police murder of George Floyd.

Collective goals and shared services have many benefits

Despite the headwinds faced by MDIs and other community-focused financial institutions catering to underserved populations, smaller financial providers do have several advantages over banking organizations with a regional, national, or global reach. For one thing, community banks are arguably better aware of their customers' needs at a personal level—including their financial challenges and successes—because of closer relationships with the people they serve. This allows them to operate from a position of strength and serve a vital need during times of local and global stress, such as the 2020 economic downturn triggered by the COVID-19 pandemic.

Another key advantage for MDIs and smaller financial institutions across the spectrum is their strength in numbers and shared purpose. Collective goals set by community banks and credit unions have given rise to several shared-services programs in recent years, some focusing on MDIs and others focused more broadly. Such programs are seen by their advocates as an alternative to persistent industry consolidation (Conference of State Bank Supervisors [CSBS], 2016). In addition, other initiatives by regulators and private-sector vendors have focused on common tools and products that are of particular benefit to financial institutions, regardless of size. These arrangements provide resources for smaller financial institutions to implement changes that will enable them to compete in a more digital and globally connected financial world, with new risks and opportunities. These programs have addressed everything from digital innovation initiatives, to strengthening cybersecurity defenses, to small-business lending ventures, to pandemic responses. Here are a few examples.

ICBA's ThinkTECH Accelerator Program

The ThinkTECH Accelerator, launched in 2019 by the Independent Community Bankers of America (ICBA, n.d.) in partnership with The Venture Center, is intended to help community banks identify partnership opportunities with potential fintech vendors. According to the ICBA, more than 150 community banks have participated in the program. Among the program's convenings were a series of TechSprints—hackathon-style competitions to encourage development of digital solutions for specific problems—held in partnership with AIR during the COVID pandemic. These events focused on fintech approaches to the Small Business Administration's Paycheck Protection Program (PPP) loan forgiveness process.

Cybersecurity tools

Data breaches and other cyber intrusions remain one of the most immediate persistent threats facing the financial sector. The largest banks can commit tremendous resources toward data security, threat monitoring and crisis response planning. Some newer fintech firms have digitally native tech that can be highly effective in combating cyber threats. By contrast, smaller financial institutions are limited by the costs that they can incur to establish cybersecurity programs.

Organizations in the public and private sectors have developed information-sharing and threat assessment tools that can be utilized by financial institutions of all sizes. One such resource is the Financial Services Information Sharing and Analysis Center (FS-ISAC, n.d.), a cyber intelligence sharing platform with member institutions totaling $100 trillion of assets. Another is the Cybersecurity Assessment Tool created by the Federal Financial Institutions Examination Council (FFIEC, 2017). The tool provides financial institutions with a "repeatable and measurable process" for management to assess vulnerabilities and the company's ability to respond to threats.

Alloy Labs Alliance

The Alloy Labs Alliance is a consortium formed by FinTech Forge in 2018 with 12 founding bank members (Nicols, 2018). The group provides a venue for similar banks to work together on digital areas of common interest, such as customer onboarding, following the principle that they can accomplish more together than alone. The alliance formed a strategic partnership with the American Bankers Association.

Deposit networks

Because small financial institutions lack the name recognition of the largest financial companies, community banks and credit unions have a built-in disadvantage when trying to grow their deposit base. To address this challenge, third-party vendors have developed solutions allowing community banks to attract deposits that exceed the FDIC's $250,000 limit but are still insured. Such services include reciprocal deposit networks, certificate of deposit registries, and deposit listing services (Sparks, 2018).

Compliance Alliance

The Compliance Alliance was established in 2011 to provide community banks with a suite of compliance services, including a hotline for compliance-related questions and access to shared compliance personnel. The alliance is owned and managed by 30 state bank associations (Compliance Alliance, n.d.). Among its services are reviews of bank marketing, policies, disclosures, and new products.

Co-op Shared Branch Network

The Shared Branch Network, developed by a credit union-owned technology vendor, offers a fee-based service for credit unions to tap into a network of branches at other institutions. Members can transact at any of the thousands of participating branches in the network as if they were at their own credit unions' location (Co-op Solutions, n.d.).

Sharing tech solutions is key to giving MDIs a much-needed digital boost

The Digital Modernization Project is intended to be another exhibit of the potential for shared-technology programs to give a leg up to financial institutions that cater to underserved populations. It aims to be the first technology accelerator focused on the unique demands of minority-backed banks and credit unions.

The program is being launched through a pilot with an initial group of MDIs—including banks, credit unions, and community development financial institutions (CDFIs)—that will be assisted in conducting deep-dive assessments of their existing tech stack, individual innovation goals, strategic priorities, and technology gaps. The assessments will help formulate a blueprint for each MDI to implement a third-party digital solution.

A resulting development of stronger partnerships between MDIs and fintech vendors could be mutually beneficial for both parties. For one thing, fintech partners have the digitally native tech and strong innovation cultures that could help MDIs expand their offerings. But those firms are challenged on acquiring customers and lack access to government-backed deposits as a source of funding, both of which MDIs have.

In the fall of 2021, AIR partnered with the NBA to conduct a technology needs assessment and gap analysis for member banks. MDIs reported that their key technology gaps were P2P payments, digital onboarding for new customers, and online loan applications with automated underwriting. From an operations perspective, MDIs focused on the need for shared services and a centralized process to identify, review, select for, and integrate third-party vendors. MDIs also reiterated their need to partner closely with regulators, since infrastructure investments could reduce bank profitability. In subsequent phases of the initiative, the program partners will identify potential third-party vendors, consulting volunteers and other resources.

The pilot will put into motion a multi-year "test and learn" collaboration between MDIs, fintech innovators, and other technology experts. The program partners will release publicly the results of the pilot test as well as a road map to inspire MDIs—and other small financial institutions—across the ecosystem to modernize their digital infrastructure. The result will be a digital strategy for MDIs to strengthen competitiveness, expand product offerings, improve customer experience, lower costs, and improve profitability.

Conclusion

The digital transformation of the financial system continues to accelerate unabated. Both consumers and small businesses need the latest financial technology to benefit from the economy. The financial institutions that can provide their customers with easy access to these tools will be in the best position to compete and grow in the digital age.

MDIs have long maintained a unique position in the financial services industry as the institutions that understand and can serve their communities better than any other financial institution segment. In many communities of color all across the country, the local MDI is the only financial institution that can serve the local customer base. Unfortunately, competitive forces and the outsized costs required to undergo digital modernization have led to new hurdles for MDIs in maintaining this critical role.

However, collective action and strength in numbers are a key strategy in helping community banks and credit unions compete. Like the shared-technology programs that have already made a difference, the Digital Modernization Project can help MDIs take the much-needed steps to implement technology upgrades and offer their customers the digitally relevant services and products that will help them succeed in the economy, thereby contributing to national efforts to narrow the racial wealth gap.

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