A Shared-Services Model to Address MDIs' Digital Needs

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Introduction

Earlier this year, three nonprofit organizations began work on a shared-services platform to improve the digital capability of Minority Depository Institutions (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 and will facilitate implementation of plug-and-play solutions.[2]

Small financial institutions experience a plethora of disadvantages when it comes to competing against larger banks and nonbank fintech firms. The megabanks' vastly superior scale, revenue, retail footprint, talent pool and technology infrastructure allow them to expand their dominance to an exponential degree.[3] Large banks' advantage is particularly evident in their accelerated pace of offering in-demand digital products and services. Meanwhile, newer fintech players are changing the competitive landscape by bringing digital products to market faster and attracting customers not served by mainstream financial institutions.

Like other small financial institutions, MDIs face structural technology disadvantages in offering front-end services, like digital onboarding and seamless digital user experience, that today's customers expect. They must also contend with the back-end inefficiency of older technology, which results in higher operating costs compared to rivals. The competitive imbalances tied to the rapid digitization of financial services threatens the ability of MDIs, in particular, to fulfill their mission.

As the banking industry undergoes continued consolidation, the number of MDIs serving underserved communities has dwindled, falling 31% over the decade ending 2018.[4] This is despite their integral role in serving populations historically left on the sidelines of the banking system through more than a century of racial oppression and segregated economies.

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[2] MDI Digital Modernization Project, https://regulationinnovation.org/mdi-digital-modernization-project/

[3] "Bigger Banks Are Good for Bankers but Not Customers," *Chicago Booth Review*, Sept. 16, 2021, https://www.chicagobooth.edu/review/bigger-banks-are-good-bankers-not-customers

[4] 2019 Minority Depository Institutions Report, FDIC, https://fdic.gov/regulations/resources/minority/2019-mdi-study/full.pdf

The difficulty of MDIs to modernize 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 on their own.

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 shared-services platform customized for the unique business model and digital needs of minority depository institutions.[5] The goal is to create a digital modernization roadmap and a "middleware" framework of digital 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 can help community banks and credit unions maintain a competitive edge in the face of multiple headwinds.[6] The digital modernization project presents a new testing ground for that approach to solve the digital challenges of institutions that cater to underserved communities.

A Widening Digital and Economic Gap

MDIs have filled a vital need since just after the Civil War, when emancipated Blacks were excluded as customers by white-owned banks. The first MDI, Freedman's Bank, pioneered the model of catering to those left out of the mainstream financial services system.[7] Nearly 160 years later, MDIs remain the primary or sole banking option for many business owners and households with restricted access to banking branches and other services in their communities. Even in majority-minority neighborhoods where large banks operate, many customers will not bank with them because of deep-seated mistrust of white-owned institutions.[8] MDIs are a

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[5] AIR helps equip regulators and financial institutions with digital tools to bring about a fairer, more inclusive financial system. The NBA is the nation's trade group representing minority-owned and -operated banks. Inclusiv is a network of nearly 500 community development credit unions (CDCUs) serving underserved communities.
https://regulationinnovation.org/
https://www.nationalbankers.org/
https://www.inclusiv.org/

[6] "Community Banks and the Opportunity to Benefit From Resource Sharing," *Stout Insights*, May 6, 2020, https://www.stout.com/en/insights/article/community-banks-opportunity-benefit-resource-sharing

[7] http://freedmansbank.org/

[8] "FDIC has tough task persuading unbanked to deposit stimulus checks," *American Banker*, April 11, 2021, https://www.americanbanker.com/news/fdic-has-tough-task-persuading-unbanked-to-deposit-stimulus-checks

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.

Banks designated as MDIs — meaning 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 — totaled 144 as of the first quarter of 2022, according to the Federal Deposit Insurance Corporation.[9] Meanwhile, the National Credit Union Administration — which defines credit union MDIs 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 June 28, 2022.[10]

In a 2019 report, the FDIC discussed the downward trend in the number of MDIs by noting that as recently as 2008, the number of MDI banks was as high as 215. By 2018, that number had dropped to 149, and the number of Black-owned or -operated banks declined by more than half during this period.[11] There are now only 19 Black-owned banks in the country, down from 48 in 2001.

Not only did the biggest banks dramatically expand market share during the past decade and a half, but fintech firms accounted for a bigger chunk of consumer lending in the years after the 2008-10 financial crisis.[12] Analysis by the Federal Reserve Bank of St. Louis — citing data from TransUnion — said fintech firms were responsible for 5% of U.S. personal loans in 2013, but that figure skyrocketed to 38% by 2018, which was larger than banks' share of the market.[13] Personal loans made by banks fell from 40% to 28% during that period, according to the St. Louis Fed. The share of personal loans made by credit unions dropped 10 percentage points to 21%.

Some researchers and public policy officials have lauded the role that MDIs play in providing minority communities with dedicated services. MDIs' branches and deposits tend to be located

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[9] Minority Depository Institutions Program, https://www.fdic.gov/regulations/resources/minority/2022q1.xlsx
[10] https://www.ncua.gov/support-services/credit-union-resources-expansion/resources/minority-depository-institution-preservation/mdi
[11] Federal Deposit Insurance Corporation, 2019 Minority Depository Institutions Report, https://www.fdic.gov/regulations/resources/minority/2019-mdi-study/full.pdf
[12] Bank Market Share by Size of Institution, 1994 to 2018, ILSR, https://ilsr.org/bank-market-share-by-size-of-institution/
[13] "Banks See Challenges from Fintech Disruption," Federal Reserve Bank of St. Louis, April 29, 2021, https://www.stlouisfed.org/on-the-economy/2021/april/banks-challenges-fintech-disruption#authorbox
"Fintechs help boost US personal loan surge to a record $138 billion," CNBC, https://www.cnbc.com/2019/02/21/personal-loans-surge-to-a-record-138-billion-in-us-as-fintechs-lead-new-lending-charge.html

in counties considered "socially vulnerable" by the Centers for Disease Control and Prevention, according to a February 2022 report by the Federal Reserve Bank of Dallas.[14]

They also account for a relatively large chunk of home loans to borrowers in those counties. Not surprisingly, some experts have expressed concern about the impact of declining MDI numbers, particularly in Black communities.[15] A report published last year by the Brookings Institution cited data showing that the rates for unbanked and underbanked consumers in 2019 were highest among Black adults. While small, MDIs remain a critical component in efforts to expand financial inclusion.

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, but 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 is unfamiliar with digital processes; and 5) struggles with outdated and outsourced legacy core systems.

To be clear, MDIs' difficulty in keeping up with rapid digital changes isn't unique to institutions serving minority communities. Most small financial institutions rely on the "big three" core processors for their technology infrastructures — FIS, Fiserv, and Jack Henry & Associates — and face acute challenges regarding cost, human resources and expertise when it comes to modernizing their digital infrastructure.

At MDIs, the impact of not meeting their customers' needs to get ahead economically in the digital age 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% more likely to receive higher-cost loans.[16] Similarly, only 40% of minority small businesses receive the full loan amount that they request compared to 68% of non-minority businesses.[17] These disparities have been worsened by the COVID-19 pandemic.

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[14] "Minority Depository Institutions Have Vital Role Serving Vulnerable Communities," https://www.dallasfed.org/research/economics/2022/0201.aspx

[15] "An analysis of financial institutions in Black-majority communities: Black borrowers and depositors face considerable challenges in accessing banking services," Brookings Institution, https://www.brookings.edu/research/an-analysis-of-financial-institutions-in-black-majority-communities-black-borrowers-and-depositors-face-considerable-challenges-in-accessing-banking-services/

[16] "Empowering Communities and Their Banks," https://milkeninstitute.org/sites/default/files/reports-pdf/Minority%20Depository%20Institution%20Capacity-update-Feb-14__0.pdf

[17] 2016 Small Business Credit Survey: Report on Minority-Owned Firms, Federal Reserve, https://www.fedsmallbusiness.org/survey/2017/report-on-minority-owned-firms

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.

Benefits of Collective Goals and Shared Services

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.[18]

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.[19] 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. 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 in partnership with The Venture Center, is intended to help community banks identify partnership opportunities with potential fintech vendors.[20] 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

[18] 2021 Trends in Community Banking, Fiserv, https://www.fiserv.com/en/about-fiserv/the-point/2021-trends-in-community-banking.html

[19] Shared Resource Arrangements: An Alternative to Consolidation, Conference of State Bank Supervisors, Sept. 2016, https://www.csbs.org/sites/default/files/shared_resource_arrangements_whitepaper_final_0.pdf

[20] https://www.icba.org/solutions/innovation/accelerator

the Alliance for Innovative Regulation (AIR) during the COVID pandemic. These events focused on fintech approaches to the Small Business Administration's Paycheck Protection Program (PPP) loan forgiveness process.[21]

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), a cyber intelligence sharing platform with member institutions totaling $100 trillion of assets.[22] Another is the Cybersecurity Assessment Tool created by the Federal Financial Institutions Examination Council (FFIEC).[23] 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.[24] 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 and most experts believe that the government would never let one of the megabanks fail, 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.

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[21] https://www.icba.org/newsroom/news-and-articles/2020/06/02/icba-air-and-the-venture-center-gear-up-for-second-ppp-solutions-sprint
[22] https://www.fsisac.com/
[23] FFIEC Cybersecurity Assessment Tool, https://www.ffiec.gov/pdf/cybersecurity/ffiec_cat_may_2017.pdf
[24] https://www.alloylabs.com/
https://thefinancialbrand.com/news/banking-innovation/banking-innovation-collaboration-fintech-alliance-84029/

Such services include reciprocal deposit networks, certificate of deposit registries and deposit listing services.[25]

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.[26] The alliance is owned and managed by 30 state bank associations. 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 CU's location.[27]

A Digital Modernization Hub for MDIs

The MDI Digital Modernization Project is intended to be another exhibit of the potential for shared-services platforms 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 techstack, 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

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[25] Podcast: How Community Banks Can Take Advantage of Reciprocal Deposits, *ABA Banking Journal*, https://bankingjournal.aba.com/2018/08/podcast-community-banks-reciprocal-deposits/

[26] https://compliancealliance.com/

[27] https://www.co-opfs.org/Solutions/Engage/Shared-Branching-Network.html

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-services programs that have already made a difference, the MDI Digital Modernization Program 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.

Funded in part by VISA