



air Alliance for
Innovative
Regulation

THE SURVIVAL OF MINORITY DEPOSITORY INSTITUTIONS REQUIRES A JOURNEY TO DIGITIZATION

This is not just a challenge; it is a crisis, and the stakes could not be higher





INTRODUCTION

The heartbeat of any thriving community lies in the interplay of its people, businesses, institutions, and culture—each contributing to the lifelines of opportunity, equity, and growth. In underserved and marginalized areas throughout the United States, Minority Depository Institutions (MDIs) serve as arteries in these systems, providing vital financial support, and fostering economic resilience. An analysis by the National Bankers Association found that 62% of MDI branches are located in zip codes with poverty rates higher than the national average, compared to 38% of non-MDI branches. The median MDI branch is in a zip code that is 49% nonwhite, compared to 21% of non-MDI branches.

Today, MDIs face an existential threat from the technological transformation underway in the financial industry. These banks and credit unions — most of which are very small — are unlikely to survive if they cannot keep pace with new technology. The number of MDIs declined from 215 in 2008 to 149 in 2018. This decline occurred mostly through voluntary mergers, but MDIs were 2.5 times more likely to fail than other banks.

The Alliance for Innovative Regulation (AIR) has conducted a [two year initiative](#) assessing this challenge and helping MDIs undertake the tech modernization journey. **The learnings from this work indicate the need for concerted action by a wide range of actors across a broad spectrum of issues.** The project has yielded three critical observations:



At the same time, there is every reason to believe that, with timely action, these institutions can not only survive, but flourish, in a digital financial marketplace.



WHAT'S AT STAKE

People living in marginalized and underserved communities often face higher costs for goods and services, paying more for credit, food, and other essentials due to limited access to better options. MDIs are crucial in addressing these disparities, providing the financial support needed for homeownership, entrepreneurial growth, and economic stability in these communities. As James Baldwin once said, "Anyone who has ever struggled with poverty knows how extremely expensive it is to be poor." MDIs are on the front lines of addressing this struggle, offering vital services that help break the cycle of poverty and address the racial wealth gap.

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James Baldwin

If MDIs cannot survive in a digital marketplace, the loss would be profound, perpetuating economic disparities, exclusion, cycles of poverty and the racial wealth gap.

MDI CHALLENGES

MDIs are at a disadvantage in the rapidly advancing digital era, facing a growing gap between their capabilities and those of larger institutions—a gap that was exacerbated by the COVID-19 pandemic. These institutions are contending with eight profound challenges:

- **Customer Expectations:** There is growing customer demand for seamless, digital-first experiences that many MDIs struggle to provide.
- **Fintech Competition:** The rise of fintech companies offering superior digital services increases pressure on MDIs to innovate.
- **Vendor Dependence:** Most MDIs rely heavily on external vendors for core banking systems, which are often outdated and difficult to integrate with modern technology.
- **Contractual Constraints:** Lengthy contracts with core service providers also limit MDIs' ability to switch or upgrade systems.
- **Data Access and Utilization:** Difficulties in accessing their own historical customer data hampers data analysis and digital banking strategies.
- **Disproportionate operating costs:** Outdated technology imposes high operating and compliance costs in comparison to those incurred by both large banks and to fintech firms.



- **Technology skill limitations:** Most MDIs do not employ personnel with the skills needed to select, install, maintain, and leverage newer types of technology.
- **Capital and liquidity constraints:** MDIs tend to have lower profits than other institutions, resulting in limitations on their financial ability to purchase new technology infrastructure and to hire the technology talent they need.

THE PATH AHEAD

Ensuring the survival and success of MDIs will require bold action from a range of entities. Public and private sectors must come together, often through strategic partnerships and with the support of regulatory bodies, in a concerted effort to strengthen MDIs' digital capabilities.

The following recommendations outline actionable strategies that can assist MDIs in overcoming their challenges:

1. **Prioritize Targeted Capital Infusions:** Funding is needed from government and/or philanthropic entities to provide MDIs with the financial resources needed to invest in modern digital infrastructures. Assistance could take the form of grants, tax incentives, and low-interest loans to ensure that MDIs can access cutting-edge technology without incurring unsustainable debt. Tech and financial services companies could also invest in MDIs by providing financial resources or in-kind contributions such as technology platforms or infrastructure.

While specific figures can vary depending on the needs of individual institutions, it is estimated that MDIs would require \$15-\$25 billion in capital over the next five years to modernize their technology infrastructures and remain competitive in the digital era. This capital would be necessary for investments in digital banking platforms, core system upgrades, cybersecurity, and the integration of fintech solutions, all of which are critical to MDIs' ability to continue serving their communities effectively. Policymakers and philanthropic organizations should assess the adequacy of current initiatives in relation to the need and consider methods for expanding resources.

For most institutions, an initial conversion to modern digital infrastructure will require a short term capital investment. Because digital technology is designed to be more agile and efficient than older systems, the initial conversion should enable reduced costs over time for maintenance and continuous upgrades.



2. **Facilitate Strategic Partnerships with Fintechs:** Regulators and industry leaders should proactively encourage and support business arrangements between MDIs and fintech companies that offer digital solutions, such as online banking platforms, mobile apps, data analytics tools, and regtech capabilities. These collaborations are essential to enhancing MDIs' service offerings, streamlining operations, improving customer experience, and improving risk management and operating efficiency. Several entities are working on establishing standard-setting organizations (SSOs) that could advance this goal by reducing the burdens and risks that banks and credit unions face in selecting technology vendors and partners.
3. **Implement Regulatory Support Mechanisms:** Policymakers should consider making regulatory adjustments that specifically reduce the compliance burden on MDIs, particularly in areas critical to digital transformation. This might include streamlining reporting requirements, such as reducing the frequency and complexity of mandatory financial reports and regulatory filings, which often overwhelm MDIs with limited resources. They could consider reducing or restructuring regulatory fees, such as those associated with examinations, deposit insurance, and licensing. They could also provide tailored technical assistance to help MDIs navigate complex regulatory landscapes. Additionally, regulators should consider simplifying the third-party risk management process, which often presents significant challenges when MDIs consider adopting fintech solutions.
4. **Expand Access to Digital Talent:** To ensure MDIs have the skilled workforce needed for digital transformation, initiatives should be led by the private sector, with strong support from regulators. The private sector, particularly technology firms and financial institutions, should spearhead efforts to connect MDIs with skilled technology professionals. This could include utilizing secondments through which employees temporarily work with MDIs to share their expertise. It is also possible that major fintechs that work with MDIs could establish a talent or technical support resource. This could include offering subsidies or incentives for hiring tech talent, as well as partnering with educational institutions to create training programs that upskill existing MDI employees in digital and technological competencies. Legislators can play a crucial role by providing tax incentives, expanding the Community Reinvestment Act (CRA) credits, and other financial support mechanisms to encourage private-sector participation and ensure the long-term success of these initiatives.
5. **Encourage Collaborative Technology Development:** A consortium of MDIs, potentially in concert with other partners, could focus on building a shared, sustainable platform for providing core banking services, secure cloud-based



solutions for data management, and streamlined compliance tools that reduce regulatory burdens. Additionally, it could offer integrated fintech solutions for mobile banking, payment processing, and customer relationship management, allowing MDIs to compete with larger institutions. The platform should also facilitate access to data analytics and customer insights, enabling MDIs to better serve their communities. This effort should include securing long-term funding commitments and partnerships with established tech firms to provide the necessary expertise and infrastructure. Additionally, clear governance structures must be established to manage the platform effectively, ensuring it evolves with the needs of MDIs without placing undue burden on individual institutions.

6. **Strengthen Community Engagement Through Digital Channels:** Public and private entities could support MDIs in developing robust digital outreach programs that maintain and enhance their deep community ties. This includes funding for digital marketing initiatives, community-focused mobile banking apps, and online financial education resources that bridge the gap between traditional and digital banking.
7. **Innovate Core Banking Systems:** MDIs must move beyond simply upgrading outdated core banking systems and instead embrace innovative, future-proof solutions. Regulators, fintech partners, and private investors should collaborate to provide not only financial support but also access to cutting-edge cloud-based and modular core systems that offer scalability and flexibility.

Leveraging a platform-based approach, MDIs should aim to adopt composable banking architectures—modular systems where components can be updated independently, quickly and at low cost, allowing for continuous technological advancements without overhauling the entire system. This would empower MDIs to easily integrate new features like mobile banking, data analytics, and AI-driven customer services, all while reducing operating costs. By embracing this strategy, MDIs can not only improve operational efficiency but also future-proof their systems for ongoing innovation, ensuring they can meet the demands of a modern, digital-first financial environment.

Key features of a platform-based approach include:

- **Modularity:** Banks can add or replace services as needed, creating a flexible system that can evolve with changing business needs and technological advancements.



- **Scalability:** Platforms can scale up or down easily to accommodate growth, making them ideal for smaller institutions like MDIs, which may need to expand or adapt over time.
- **Interoperability:** A platform-based system allows seamless integration with third-party applications, such as fintech services or cloud-based solutions, fostering innovation and enhancing customer experiences.
- **Efficiency:** By consolidating multiple services onto a single platform, banks can streamline operations, reduce costs, and improve the speed at which new products or updates are rolled out.
- **Continuous Innovation:** New technologies or regulatory changes can be integrated into the platform incrementally, allowing banks to stay ahead of trends and requirements without a complete system overhaul.

THE NEED FOR HOLISTIC SOLUTIONS: A CALL TO ACTION

The challenge facing MDIs is already the focus of numerous efforts, with strategic programs already playing a crucial role. Many of the financial regulatory agencies have dedicated personnel who focus on these issues. There are also federal and state programs that are helpful to Community Development Financial Institutions, or CDFIs, and many MDIs carry CDFI status. Other public sector initiatives provide resources or problem-solving, such as Project REACH, spearheaded by the OCC.

Similarly, the private sector has undertaken a range of initiatives. One example is MDI ConnectTech, funded by Visa, Citi and JP Morgan Chase, and led by the Alliance for Innovative Regulation (AIR), the National Bankers Association (NBA), the National Bankers Association Foundation (NBAF), and Inclusiv. Another is the Mission Driven Bank Fund with anchor investors, Microsoft and Truist Financial Corporation. Such efforts are examples of strategic partnerships that combine resources, expertise, and shared goals to empower MDIs, enabling them to modernize their operations, bridge the digital divide, and continue serving their communities with enhanced financial services.

Nevertheless, it is unlikely that current efforts, at the current scale, will suffice. Solving any one, or even several, of the challenges facing MDIs will not enable them to maintain viability. These institutions need solutions that address all of their critical needs, simultaneously. They need external funding from public or private sources to support conversion to new technology platforms. They need access to affordable technology talent, perhaps through a shared services arrangement or platform. They need



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the ability to change core processing vendors and/or to make their core systems interoperate easily with other technology solutions via APIs. They need full, ready access to their own data. They need clear standards and practical, low-risk ways to vet and partner with

technology firms, including fintech and regtech companies. Finally, they need a regulatory environment that fosters development and adoption of solutions.

While MDIs are working individually and collectively on this full range of challenges, it is not within their own power to meet all of them. Constructive engagement is necessary with industry partners, government programs, philanthropic entities, advocacy organizations, regulators, and policymakers.

AIR'S MDI INITIATIVE AND WHITE PAPER

AIR will soon release a [white paper](#), “A Purposeful Journey into Digitization Lessons Learned from the MDI Digital Modernization Pilot and ConnectTech Programs,” that details the insights and outcomes from our [MDI initiative](#). The paper highlights the critical challenges MDIs face in the digital age and the collaborative efforts that have been undertaken to address these issues, offering a roadmap for future digital transformation of the MDI sector. Through detailed case studies and analysis, the white paper underscores the importance of continued support and innovation to ensure that MDIs can thrive and continue to serve their communities effectively.





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About AIR

AIR is a nonprofit, non-membership organization working to make the financial system fully inclusive, fair and resilient through responsible use of new technology. By connecting regulation, finance, technology and society, AIR drives global innovation and collaboration to overcome the system's legacy shortcomings and prepare it for rapid technology change.

Learn more at regulationinnovation.org.

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