Does the closing of Minority Depository Institutions Affect Credit Supply within their Communities?

Noara Razzak *

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Abstract

The number of Minority Depository Institutions (MDIs) peaked in the year 2008, reaching 215 according to a recent report by the Federal Deposit Insurance Company(FDIC). However over the following years their numbers decreased considerably and 146 such institutions exist as of 2018. From 2013 to 2018 about 122 MDI branches were sold while 349 branches were closed. I want to use a Difference in Difference Method to study whether the closure of a MDI branch in a community results in decreased credit supply within the community when compared to another community with a similar demographic and income composition that still had functioning MDI branches. I use Community Reinvestment Act (CRA) data and Home Mortgage Disclosure Act (HMDA) data to build estimates of small business loans and mortgage lending by census tracts. I then compare census tracts where an MDI branch closed to a similar census tract which did not have any branches closed. Information on census tracts are collected from the American Community Survey.

Keywords: Minority Depository Institution, Financial Inclusion

*John E. Walker Department of Economics, School of Business, Clemson University, Clemson, South Carolina, 29634-1309, USA; email nrazzak@clemson.edu.

1 Introduction

In 1865, the first minority bank, Freedmen's Savings Bank and Trust Company, was established. African American-owned banks have existed in the U.S. since mid nineteenth century with their numbers steadily increasing in the early decades of the twentieth century. These banks were initially set up to provide credit to communities in the U.S. that could not readily access credit as discussed in **?** and Gerena (2009). According to Gerena (2009), their numbers severely decreased during the Great Depression and in the 1930s only nine African American-owned banks remained. Moreover, only five African American-owned banks opened in the years between 1934 and 1951. The early 1970s saw a resurgence of African American-owned banks, characterized by both loans issued and deposits received by African American-owned banks as shown in Bates and Bradford (1980). However, the Community Reinvestment Act (CRA) enacted in 1977 saw increasing competition from other banks in communities traditionally served by minority owned banks and Gerena (2009) writes that this resulted in several African American-owned banks closing because of increased competition. The 1960s saw the establishment of the first Asian-American owned bank and the first Hispanic owned bank. **?** writes that in 1962, Los Angeles-based Cathay Bank became the first bank recognized as Asian American and in 1969 Centinel Bank of Taos, New Mexico, became the first U.S. mainland-based Hispanic bank.

Banks that were primarily owned by minority groups eventually became designated as Minority Depository Institutions (MDIs). The Federal Deposit Insurance Corporation (FDIC) defines MDIs as banks in which: 1) at least 51 percent of the voting stock is owned by minority individuals, or 2) the majority of the board of directors are minority individuals and the communities that these institutions serve are primarily populated by minority individuals. However, other kinds of institutions may also be classified MDIs. For example, The Office of the Comptroller of the Currency(OCC) (2021) states that it may consider additional factors when evaluating institutions and it can also consider a mutual institution an MDI if women comprise a majority of the board of directors and hold a significant percentage of senior management positions. Furthermore, Toussaint-Comeau and Newberger (2017) write that the OCC may continue to designate any national bank or federal savings association previously nominated as an MDI, even if that institution no longer meets the ownership criteria as long as the institution primarily serves the credit and other economic needs of its original community where the majority of the population are minorities.

MDIs increased in numbers in the first years of the twenty-first century reaching 215 right before the Great Recession in 2008; since then the number of MDIs decreased to 149 as of December 31, 2018 according to Eberley et al. (2019). More than half of all MDIs at year-end 2018 were headquartered in the four most populous U.S. states: California, Texas, New York, and Florida. By far, California hosts the largest number of MDIs, with 36 MDIs headquartered in the state. California also has the largest number of MDI offices, with 349, or nearly one-quarter of all U.S. MDI offices. Texas hosts 22 MDIs operating 306 banking offices. Interestingly, while Puerto Rico hosts only five MDIs it has 301 MDI banking offices, representing 20 percent of all U.S. MDI offices at year-end 2018. Out of the 149 MDIs, the number of MDI charters located in metropolitan areas were 126 (about 85 percent of all MDI charters) and together they operated about 1363 (about 89.4 percent of all MDI branch offices) office branches within these metropolitan areas. Eberley et al. (2019) show that from 2013 to 2018, while the number of offices or bank branches operated by all FDIC-insured institutions declined by 9 percent, the number of offices operated by community banks declined by 12 percent and the number of offices operated by MDIs declined by 14 percent. Office closures, acquisitions by non-MDI financial institutions, and redesignations resulted in a net loss of 258 MDI offices between 2013 and 2018.

The impact of the 2008-2009 Great Recession on the performance of African American-owned and other minority owned banks have been studied by Lepley et al. (2015). They show that prior to 2008, African-American owned banks held a significant advantage over minority-owned banks from other ethnic groups in net interest income as a percentage of average assets. However, these banks had relatively weak loan portfolios and failed to contain costs. The 2008-2009 crisis worsened the vulnerabilities of African-American banks while their positive differences essentially disappeared. As a result, Eberley et al. (2019) show that in 2018, African-American banks operated 18 percent fewer branches than they did in 2013. Hispanic-owned bank branches also faced a steep decline and fell by about 23 percent in the same time period. Barth and Xu (2020) write that although minority share of the population stands at 38 percent and they operate 19 percent of all businesses in the U.S., the proportion of MDIs is considerable meagre and stands at 2.8 percent.

Research on whether the presence of MDIs reduce discriminatory lending have been mixed. The presence of minority-owned banks and their lending practices have been studied by Dahl (1996) who looks at lending patterns of 34 commercial banks during alternate periods of minority and non-minority ownership in the 1980s and early 1990s and shows that loan growth is slower when the banks are owned by non-minorities. However, Black et al. (2001) find no sign of discrimination when they study whether African-American mortgage applications are more likely to be rejected than those of white Americans when controlling for Metropolitan Statistical Areas (MSAs) as geographical delineations. Finally, Berger et al. (2022) show that borrowers and lenders sharing minority characteristics reduce informational asymmetries via tacit understandings, engage in better moral behavior through mutual trust and community reinforcement and this in turn leads to better lending practices in minority communities.

According to the Federal Deposit Insurance Corporation(FDIC) (2021), an estimated 4.5 percent of U.S. households (approximately 5.9 million) were “unbanked” in 2021, meaning that no one in the household had a checking or savings account at a bank or credit union. There have also been a considerable body of literature that look at the presence of bank branches and its relationship with financial inclusion. Hegerty (2019) study bank branch density in Chicago and finds that the number of banks decreases with population density and percentage of African American and Hispanic residents, although he does not investigate financial inclusion of the residents in communities with lower number of bank branches.

Célerier and Matray (2019) show that an exogenous expansion of bank branches increases financial inclusion in low-income households by using the U.S interstate branching deregulation between 1994 and 2005. Similarly, Joassart-Marcelli and Stephens (2010) investigate the spatial relationships between immigrant settlement patterns in Greater Boston in 2000 and accessibility to various types of financial institutions.

Presence of bank branches do influence the decision of "unbanked" households to own bank accounts. Boel and Zimmerman (2022) show that when the 2019 FDIC Survey of Household Use of Banking and Financial Services asked households about their reasons for not having a bank account, about 14 percent mention that bank branches locations are inconvenient for them. At the same time, 48 percent and 36 percent of those surveyed mention their inability of maintaining the minimum fees and lack of trust in banks respectively as reasons of not owning a bank account. Berre et al. (2021) write that during the 1980s and 1990s, advanced computing systems led banks to price discriminate between deposit accounts holding higher balances and those holding lower balances. As a result, banks instituted higher fees and relatively high account minimums on lower balance customers to ensure break-even for this new product. This in turn left communities who are more likely to be "unbanked" in more precarious situations and as a result increased the unbanked population.

There have also been research on the impact of distance to bank branches on lending. Herpfer et al. (2022) study the causal impact of the distance between bank branches to corporate lending. Yogo et al. (2021) show that geographic variation in financial participation relates to income rather than racial composition as they study the universe of U.S. households with a member aged 50 to 59 in the administrative tax data. Hogarth et al. (2005) carry out one of the early studies in financial inclusion and explore factors that influence account ownership between 1989 and 2001, a time of substantial economic growth as well as substantial public policy development relating to low-middle income families in the U.S. Finally, Stein and Yannelis (2020) perform a historical analysis of the Freedman's Savings Bank and show that families with accounts were more likely to have children in school, be literate, work, and have higher occupational income, business ownership, and real estate wealth.

Banks within communities have been a unique feature of the U.S banking, that have seen the proliferation of community banks since the early days of the republic. However, the number of community banks have also decreased in recent decades. Hanauer et al. (2021) write that over the past twenty years, spanning from 2000 to 2020, the total number of commercial banks declined by almost 50 percent, changing the circumstances of their local communities. Hein et al. (2005) suggests that community banks concentrate their activities on local communities, gathering deposits and lending within a specific and regional trade area rather than operating in regional or national markets. Cole (1998) studies the importance of personal relationships when firms need to access credit. Similarly Avery and Samolyk (2004) find that consolidation activity involving big banks is related with lower loan growth, whereas community bank consolidations and a greater concentration of community banks in the commune are related with higher loan growth. Nguyen and Barth (2020) also support the previous finding and show that community banks are still providing 30 percent more small business funding than non-community banks, especially after the Great Recession. Similarly, Allen and Whitledge (2022) show that during the first week of available Paycheck Protect Program (PPP) loans, community banks issued almost three times as many loans as large non-community banks, small firms in non-metro areas were more likely to borrow during the first week and the phenomenon is largely driven by community bank lending.

Hein et al. (2005) argue that while many large banks have tried to eliminate much of the human interaction in banking in an effort to minimize transaction costs, many community banks attempt to build and exploit deposit relationships as well as relationship lending. A study of the performance of smaller community banks by Bassett and Brady (2001) show that after adjusting for mergers, assets and deposits grew faster in the smaller banks than in the large banks every year from 1985 to 2005 even though the number of community banks decreased. Similar to commercial banks, MDIs play an important role supplying credit to their communities. There is extensive literature on the impact of bank failures, including mission oriented banks on the supply of small business credit as shown by Berger et al. (2001), Nguyen (2019) and Toussaint-Comeau et al. (2020). According to the Federal Deposit Insurance Corporation(FDIC) (2014), MDIs also originated a larger share of their mortgages to borrowers to live in Lower-Middle Income (LMI) census tracts and to minority borrowers than did non-MDI community banks. Furthermore, qualitative information from U.S Government Accountability Office (GAO) (2006) show that MDIs have higher costs because MDIs often provide financial literary services and serve customers who prefer to do banking in person than through other less costly alternatives such as mobile phones or internet. As a result, closing of a branch within the primary local market should in theory affect credit supply more intensely in tracts where these MDIs operate.

This paper studies how closing of MDI branches in their primary local markets (i.e census tracts) affects both small business loans and mortgages within their immediate communities.

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