Future trends in UK banking

Analysis and projections

A Cebr report for Fiserv
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Executive Summary

The key findings from this report are given below:

- Smaller SMEs typically have a worse relationship with their bank, and have less knowledge of alternative sources of finance. This is important as credit conditions have worsened recently, reducing the ability of Britain’s army of small businesses to borrow and invest for growth.

- However, new sources of finance such as peer-to-business lending are taking off very quickly, with an estimated £1.2 billion in new lending to in 2014, up from just £90 million in 2011. This market could grow to over £10 billion by the end of the decade, representing £14,000 for every small business that applied for credit this year.

- Credit unions are another alternative source of funding for SMEs, having only been allowed to give membership to businesses since 2012. This sector is small in the UK compared to other countries, but is projected to have up to £130 million of financing available for small firms by the end of the decade, often at favourable rates.

- The Bank of England and the Financial Conduct Authority have been working to reduce barriers to entry to the financial services and banking market. The number of firms applying for banking licenses has increased as a result – with the regulators holding 47 pre-application meetings in the year to March 2014 and authorising five new banks. This compares to 48 meetings in the full three years from 2010 to 2012. Other measures to introduce more competition look successful; including a 22% increase in the number of current account switches since the new switching service came in.

- However, the cost of compliance for small banks is often proportionally much greater than at larger banks, suggesting more could be done to help. In addition, some applicants maintain that applying for a banking authorisation remains difficult and costly.
1 Introduction

This Cebr report, commissioned by Fiserv, looks at changing trends in the UK banking sector, and the ways in which this different environment is positive for both potential new entrants and for consumers.

The rise of new technology brings with it new challenges for banks, particularly in the rise of alternative finance. The internet makes it much easier for small and medium-sized businesses to access funding through crowd-based solutions, such as peer-to-business lending. While this is a tiny proportion of the overall lending market for now, it is seeing very rapid growth. Regulatory change also makes it easier for SMEs to get funding through other channels, such as credit unions. These trends are important, as SMEs are often unsatisfied with their banking relationship, and as such provide a real threat to banks retaining small businesses as customers.

Additional regulatory change has come through that aims to make it easier for new banks to enter the market. While there are signs that this is having some positive effect, there are concerns that more may need to be done to break the hold that the biggest banks have on market share. In addition, regulation following the financial crisis that aims to reduce systemic risk hits smaller banks disproportionately, making it more difficult to do business.

These aspects are looked at in turn, and the structure of this report is as follows:

- Section 2 studies SME relationships with banking and finance
- Section 3 looks at the rise of alternative financing options for business
- Section 4 reports on recent changes in the regulatory environment
- Section 5 provides conclusions
2 SMEs: access to finance and banking attitudes

This section investigates the issues being faced by the UK’s small and medium-sized business population with regards to banking. The key findings are given below:

- The smaller a business, typically the worse a relationship it has with its main bank. Despite this, smaller firms are more likely to solely rely on their bank for their financing needs, rather than looking further afield.
- The most frequently applied for credit products were bank loans and overdrafts.
- SMEs generally have low levels of knowledge about alternative sources of finance, with more than half saying that they don’t know how to access any.
- This is important as finance availability levels remain relatively weak, limiting the extent to which SMEs can contribute to investing for growth in the UK economy.

2.1 SME banking relationships

Small and medium sized business are a significant part of the UK economy, comprising as they do over 99% of the total business population, as well as supporting over half of all private sector employment and generating 43% of all private sector turnover.

However, the sector is a highly fluid one, with 350,000 new businesses created and 240,000 business ‘ deaths’ (active companies becoming inactive) in 2013 alone. As such, SMEs represent a riskier investment than larger firms and so it is generally held that the sector is under-served.

Despite this, the majority of UK SMEs (60%) describe their working relationship with their bank as ‘good’, with a third (33%) even reporting that it’s ‘very good’. However, these figures (for 2012) are down from two years previously, where 64% of SMEs reporting a good banking relationship – a trend that comes alongside a worsening of credit conditions.

In addition, banking relationships appear to worsen the smaller the business. More than one in six (17%) micro firms (i.e. those with fewer than 10 employees) report having a poor rapport with their banking institution, compared to just 9% of medium sized companies (those with between 50 and 249 employees). This suggests that more could be done to help the smallest UK businesses gain the financial advice and access that they need.
For most small and medium sized enterprises, the bank is their main port of call for any financing that they need, with many not of being aware of other sources of external finance. In 2012, almost half of small businesses (48%) sought a bank loan, and 35% looked for a bank overdraft – a much greater proportion than those seeking finance from any other source, as shown in Figure 2 below. However, within this headline figure, micro-sized businesses were the most likely to go to their bank – at 50%, compared to 41% and 44% for small and medium-sized firms respectively. The same pattern is true for bank overdrafts. This means that those companies that are most likely to go to their bank are the most likely to report having a poor working relationship with the bank.

Medium-sized firms meanwhile are more likely to use asset based finance or leasing / hire purchase than their micro-sized counterparts, and are also more likely to seek investment from a venture capitalist.
The reason that so many SMEs, and in particular micro-sized firms, go to the bank as their first port of call for financing is that the knowledge for what options there are and where else there is to go is not widespread enough. A third of SMEs report that they’re unaware of any of the most frequently used sources of external finance, given in Figure 3 below. Even fewer firms would know where to go to find these options, with 58% of SMEs reporting they wouldn’t know where to find any of these sources of finance. This is mainly the case for micro sized firms, with 61% reporting this compared to a still notable 31% of medium-sized companies. This suggests that better financial education for small business owners may help to meet the financial needs of SMEs and in particular, micro sized firms.

Figure 3: Types of external finance: which are you aware of / know where to go to find?
In addition, UK small businesses are still finding it difficult to get approved for finance even among the institutions that they do know. According to the Q3 2014 Federation of Small Businesses Voice of Small Business report, 35% of firms that had applied for credit within the past three months were turned down in their application. Although this is down from a figure of 47% at the same point a year before, it still represents a significant proportion of firms being unsuccessful.

Looking further ahead, lenders responding to the Bank of England’s ‘Credit Conditions Survey’ report on average that the availability of credit to small businesses contracted in Q4 2014. In addition, it is likely to do so even more sharply in the first three months of 2015, as illustrated in Figure 4 below. This takes credit availability back towards levels seen in the first half of 2013. This decline in credit availability among the main market lenders highlights the need for alternative lending solutions for the UK’s small business population.

Figure 4: Change in availability of credit to small businesses, by quarter, net balances of lenders reporting positive change

Source: Bank of England Credit Conditions Survey Q3 2014

2.3 What are the implications for the finance sector?

As has been highlighted in this section, SMEs and micro-sized businesses in particular rely heavily on their bank for their financing needs. Despite this dependence, many small firms are not happy with their banking relationship. Although the Current Account Switching Service (CASS) covers businesses as well as consumers, only a relatively small number of SMEs have moved provider since the introduction of CASS. However, rather than this being due to no desire to switch, the Federation of Small Businesses believes that this low take-up has been due to a failure among banks to reach out to firms, with most of the marketing direction aimed at the consumer. This suggests that there is significant scope for banks to more specifically target SMEs and to offer a service with which they are happier than currently – new challenger banks may find themselves able to gain market share through this avenue.
3 The rise of alternative finance for business

Various initiatives have been introduced by the government since the financial crisis to boost lending conditions for businesses, including the Enterprise Finance Guarantee, Project Merlin and Funding for Lending. However, despite these schemes, the credit environment remains difficult for SMEs, as this report has previously shown. Indeed, lending to SMEs under Funding for Lending has contracted since it began.

This section of the report looks at several rapidly growing alternative sources of finance for UK SMEs that lie outside the traditional banking sector. The key findings are highlighted in bullet points below:

- Credit unions in the UK were allowed to let businesses join as members for the first time in 2012. This is a quickly growing sector with potentially more favourable lending conditions than commercial alternatives, and one which could be worth £130 million in available financing to SMEs by 2020.
- Peer lending and crowd funding are an even more rapidly growing, although very new, source of credit to SMEs. Peer-to-business lending is estimated to be worth £850 million in new flows of credit in 2014, an enormous increase from just £20m in 2011. This source of finance could be worth £12.3 billion a year by 2020, a figure that would represent a £14,000 loan for every small business applying for credit.

3.1 Credit unions

Credit unions, non-profit cooperatives whose members can borrow from pooled deposits at often comparatively low rates, are a source of finance that is relatively underused in the UK compared to other countries. Until recently, membership of credit unions was limited to private individuals, but even then membership was low compared to other economies. Figures from the World Council of Credit Unions show that membership was just under 3% of the population at the end of 2013 in the UK, compared to 46% in the US and as high as 75% in Ireland.

However, new legislation was introduced on 8th January 2012 that allows corporate bodies to join and gain access to the funding pool. This is a positive step for SME financing, although only a maximum of 10% of the members of a union can be non-individuals and can only be granted a maximum of a total of 10% of the union’s loans.

Perhaps reflecting the difficulty of credit conditions in recent years, membership of credit unions in Great Britain has been on a sharp and sustained upward trend. In 2014 there were just over 1 million members, with £1.2 billion in total assets and supporting £680 million in loans to members. This is significantly up from 500,000 members ten years before, with £430 million in total assets and supporting £300 million in loans to members. These findings are all illustrated in Figure 5 below. This rapid growth has also helped to support a sustained increase in the level of employment supported by the sector, with roughly 1,500 staff members in 2014, up from close to 750 in 2004.

This shift towards credit unions over the years since the financial crisis is expected to hold its momentum over the rest of the decade, as the financial options offered look favourable compared to other sources of finance. This trend may well be exacerbated by the likely future increases in the Bank of England’s base rate, which will push up the cost of monthly mortgage payments on house values that have grown faster than average earnings around much of the UK in recent years. In addition, as awareness of the option of joining a credit union slowly spreads around UK SMEs, more are likely to take the opportunity of membership.

With these trends in mind, the number of credit union members is projected to rise to over 1.7 million members by 2020, as penetration increases alongside increases in the UK population. These members
are projected to have total credit union assets of £2.2 billion by the end of the decade, which is able to support an estimated £1.3 billion in loans to members in total – including lending to both businesses and individuals. With 10% of the total amount of union lending allowed to go to businesses under present legislation, this gives a potential source of £130 million of financing available for SMEs by the end of the decade. Although this is a relatively small pot compared to other sources such as private equity and asset finance (as illustrated later in Figure 7), the generally more favourable lending terms that credit unions impose may be preferable to the more established routes to funding.

Figure 5: Characteristics of Credit Unions in Great Britain by year

![Graph showing characteristics of credit unions over the years](image)

Source: Bank of England Credit Union Statistics, Cebr analysis

3.2 Peer-to-peer lending and crowd funding

Other alternative sources of finance that have really gathered momentum since the financial crisis are peer-to-peer lending and crowd funding. A combination of very low returns on investments, and a reticence among banks to lend, helped to spur on these new channels of access to finance. Now the much strengthened popularity of the sector will likely enable it to remain as a permanent feature of the financial landscape even after financial conditions return to more normal levels.

Total new ‘peer-to-business’ lending stood at over £1.2 billion in 2014, bringing the cumulative total lent to businesses to £2.1 billion. This is a significant increase from 2013, where an estimated £460 million new lending took place. To further illustrate the rapid expansion of this market, total new peer-to-business lending in 2011 is estimated at just £90 million, as can be seen in Figure 6 below.

The crowd funding market is even newer than peer-to-business lending, and is split into a few different channels. The largest section of the crowd funding market is that based on donations and fund raising,

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1 Peer to Peer Finance Association
where the donors gain no financial or material returns from the recipient. This part of the market is estimated to be worth £310 million in 2013. Crowd funding for donors with more of an interest in their investment is a smaller sector. In 2013, £20 million was raised through rewards-based crowd funding, where the donor receives a product or similar in return for their investment. In addition, £28 million was raised through equity-based crowd funding, where the donor receives some security in return for their investment. These two channels both grew significantly from 2012, where each was worth less than £5 million.

**Figure 6: UK peer-to-business lending figures, by year**

Source: Cebr estimates based on Peer 2 Peer Finance Association data

These alternative sources of finance represent a strong opportunity for UK SMEs to raise finances when they may be unable to do so from other channels, such as regular banks. Although as stated earlier in the report, UK SMEs have relatively little knowledge of where to find alternative funding, the peer-to-business and crowd funding sectors are engaging in a concerted marketing push, which is likely to raise awareness significantly.

The relatively young nature of these markets means that there is massive scope for growth over the rest of the decade. As shown in Figure 7, these new sources of finance would need to go a long way before being anything like as large as more traditional financing options.

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2 The Rise of Future Finance, December 2013, Nesta
Although peer-to-business lending and crowd funding are largely reliant on households and private individuals for providing cash, the potential size of this market is very large. Survey results suggest that roughly half of people have used peer-to-peer lending before or would be open to doing so in the future. With median household net financial wealth of £8,400 in in the 2010 to 2012 period, if half of households lent just a tenth of their savings through peer-to-business schemes, this would give a total pool of available lending of £11 billion. Alternative estimates put total potential peer-to-business lending as high as £12.3 billion a year, a figure that given current growth rates in the market could easily be reached by 2020.

An estimated 17% of small businesses have applied for any sort of credit during 2014, which is equivalent to 871,000 firms. This means that for each of these companies looking for finance, more than £14,000 would be available on average through this financing channel alone.

This rise of alternative sources of finance is likely to have a positive effect on UK growth in the future. According to the Federation of Small Businesses, roughly 40% of small firms that have applied for credit have been turned down in 2014, but many would use this finance to invest for expansion. Peer-to-business lending could help to fund this growth, helping to drive the UK economy and create more employment.

3.3 Impacts on the banking environment

As noted earlier in the report, small firms tend to rely on their bank for their financing needs. However, this is likely due to in large part to a lack of knowledge about alternative solutions. Many of these

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alternatives have been around for a long time – such as venture capital or asset based lending – but others are a new phenomenon. Improved technology is allowing the rapid take-off of new avenues such as peer-to-business lending, and with these new market entrants comes a significant marketing presence, a factor that must raise awareness among firms. In addition, new peer-to-business lending software is designed to be as user-friendly as possible to attract new users, a feature that some small businesses may find as a welcome departure from their previous searches for alternative finance. With this sector on the rise, further new entrants are likely – potentially providing additional competitive forces to improve the quality or cost of the service.

As highlighted, the scale of credit gained by SMEs in the alternative finance sector is likely to climb sharply over the years to 2020 and beyond. This is not necessarily at the expense of more traditional banks, as the economy is projected to expand relatively robustly over the medium term, increasing demand for credit in absolute terms. In addition, new regulations on capital requirements may mean that banks are not able to fulfil SMEs’ credit needs, and so alternative providers are welcome news for the economy. However, it is likely that the introduction of these new, user-friendly and well-advertised financing options will provide some competitive pressure on incumbent and challenger banks, who may need to react accordingly to prevent losing market share in the SME space.

A further significant finding is that access to finance among the UK’s small businesses remains relatively poor or too expensive. Despite a focus of the government in recent years to try to improve access, many firms are still being turned down for new credit. This is important to the economy as a whole, as more limited financing options may stymie capital investment spending among small firms – investment that could be used to help boost productivity and living standards. However, it is also important to the financing sector. As illustrated above, a notable proportion of small businesses wish to gain access to credit but are being turned down – representing a sizable number of potential customers that, for whatever reason, are deemed too risky to lend to. The introduction of new platforms for lending may go some way towards remedying this, benefitting both small businesses through investment-led growth and financiers through gaining new customers. The Department for Business, Innovation and Skills has previously recommended that a platform is established for small businesses to issue bonds, by aggregating the issues from a large number of SMEs and financing them through the established corporate bond markets. This would solve the problem of the riskier nature of lending to small firms, as well as bringing the size of a bond issue towards the level more normally expected by the markets.
4 The changing regulatory environment

4.1 Background

The global financial crisis and economic downturn sparked significant regulatory reforms in financial services around the world, including in the UK. One of the most recent shake ups of the banking market in the UK is the Financial Services (Banking Reform) Act 2013, which received Royal Assent at the end of 2013, although is still to be fully implemented.

This Act will help consumers by introducing the retail ring-fence, where the deposits of banks’ retail customers and taxpayers are protected from the activities of investment banking. The Act also brings the introduction of a new ‘bail-in’ policy, whereby if a bank faces insolvency, it is the creditors that face a write-down, rather than the government and the taxpayer. A further significant new regulatory change is the greater accountability that it brings to the management of banks – if wrongdoing is found to happen at the bank, it is those in charge of the processes that will be held to blame, to a much greater extent than before.

Changes to the capital requirements are also a key part of banking reform to reduce the risk to worldwide economy. The Financial Stability Board, a global collection of financial regulators, has recommended that key large lenders be required to set aside capital worth 15-20% of their risk-adjusted assets by 2019. This is a higher capital requirement than is typically currently required, and would allow banks to absorb more of their own losses in the event of failure.

4.2 Changes to reduce barriers to entry in banking sector

The above regulatory changes aim to generally improve the health of the banking sector and to reduce the risk of catastrophic damage to the economy in the event of a financial crisis. However, regulators have also been looking at specific measures to reduce barriers to entry in banking.

In March 2013, the Financial Services Authority (FSA) and the Bank of England set out a review of requirements for firms newly entering or expanding in the banking sector. A notable number of these changes have already come into place, although some still have yet to do so.

One change that helps to remove barriers to entering the market is a significant reduction in the initial minimum capital requirement for a small specialist bank. These institutions are now required to hold an absolute minimum level of capital of £1 million (or €1 million, whichever is higher), plus a capital planning buffer, down from a previous level of €5 million. New banks then have a time frame of up to three years to comply with the rules for existing banks. Liquidity requirements have also been reduced, so that these for a newly authorised bank are now in line with incumbent banks, with no automatic premium being added simply due to being newly authorised. In addition, the regulators have looked to make it easier at the pre-application stage, engaging more and providing access to specialists. The number of pre-application meetings has increased sharply recently, to 47 meetings in the year to March 2014, with 25 applicants. This is up from a total of 48 meetings in the 36 months between 2010 and 2012. In addition, five new banks were granted authorisation in the year to March 2014, generally up on the average per year since the financial crisis.

Aside from the capital side of things, changes have also been made to try to promote competition in the marketplace. One of the non-capitalisation barriers to entry was found to be attracting new customers and encouraging them to switch from their existing provider – as such, the Current Account Switching Service was implemented, making it much easier for banking customers to move their activities to a new provider. This aims both to help new entrants to the market but also to promote competition among incumbents. There are signs that this new scheme has helped significantly, as new data show that more
than 1.2 million used the service in the twelve months to end of September 2014. This is a full year since the scheme went live, and represents an increase of 22% on the number of accounts that were moved during the previous 12 months. It will remain to be seen in the coming years if this is the start of more switching activity, or whether the introduction of the new scheme simply helped encourage all those that had been meaning to switch for a while to do so, however as an initial result it is very encouraging.

The FCA and the Bank of England also note the fact that off-the-shelf IT systems can have “a significant difference to some applicants” in terms of cost and ease of use, compared to developing an IT system from scratch. The regulators plan to work with suppliers of these systems to ensure that the potential for these to reduce barriers to entry and boost competition is fully exploited.

The Office for Fair Trading’s 2013 review of current accounts also found that the lack of an established brand network and brand name were barriers to entry and as a result, Lloyds Banking Group divested TSB, and the Royal Bank of Scotland is also scheduled to make a divestment. These moves are intended to help reduce the power of the existing big brands, making it easier for new ones to establish a foothold.

There is ongoing work at the FCA in helping small firms and those with innovative business models to enter financial services. The first part of this is launching the new organisation ‘Project Innovate’, which aims to help both regulated and unregulated firms to bring new products to the financial services market by giving access to expert advice.

A further step that could well help to encourage further competition in the banking sector and remove barriers to entry is the Competition and Markets Authority (CMA) launching a large scale investigation into the hold of the big four banks on the market. Currently, these biggest banks account for more than three quarters of personal and small business current accounts. The CMA is expected to look at the incumbent system of free in-credit bank accounts, to see if a more heterogeneous pricing approach would improve customer outcomes. Any recommendations coming out of the review could well help to boost competitiveness in the market and allow for easier access for new entrants.

4.3 Effectiveness and implications of these changes

In general, the loosening of regulation for new entrants appears to be having positive effects, with more applicants for banking authorisation. In addition, some of those seeking authorisation have noted that doing so is much easier now than a few years ago. However there are signs that more could still be done to help bring down barriers to new entry, as other applicants point to it still being very difficult and costly to go through the application stage.

In addition, while the Bank of England and the FCA have done much to try to help new entrants, the overall banking regulation climate is much tighter than before the financial crisis. Although these reforms are aimed at reducing systemic risk, it sharply increases the cost to banks of doing business, through the holding of relatively unproductive capital and through the cost of complying with new regulation. Large banks will face the greatest costs in absolute terms, but the cost of compliance could end being higher in relative terms for small and medium sized banks. The British Bankers Association highlight this threat, pointing out that these new overheads will reduce the ability of small banks to provide competitive alternatives in the UK small business and retail market.

Overall, the regulators appear to be encouraging first steps towards improving the ease of entry to the banking sector and to improving market conditions for small banks. However, although it may be easier to start up a new bank than before, the difficulty is in transitioning from a small provider to a medium-sized or large one. The reduced capital requirements and other allowances for new entrants typically only last for three to five years, at which point the bank is must meet the same requirements as the current incumbents. Given that the big four lenders control over three quarters of the current account market, their scale is vastly different from any bank just a few years into its development. As such, the cost of compliance with new regulation is spread over a wider number of customers, making them more
cost efficient and harder to compete with. The advantage that new banks have is not being lumbered with older IT infrastructure in need of an overhaul and may be able to adapt more quickly to changing market conditions. However, the question remains over whether these benefits outweigh the proportionally greater cost of complying with regulations. It is often held that the mid-sized business sector in the UK is overlooked by government – with tends to focus measures more on the small business population – and the same may be true more specifically within banking.
5 Conclusions

The banking sector has seen much change over the past decade, with significant disruption coming of course from the financial crisis, but also from the rise of new consumer technologies, devices and communications networks. Some of the most notable trends affecting the industry have been analysed in this report, from which the following conclusions and implications for banking providers have been drawn.

Threats to banks’ traditional SME customer base come from the rise of alternative finance providers. Typically, small and micro businesses have relied heavily on their bank for their credit needs, but this appears to be largely due to a lack of knowledge around other sources of credit, rather than due to being happy with their banking relationship. Improving technology has recently given rise to peer-to-business lending and crowdfunding as alternatives to banks. With an emphasis on user-friendliness and a concerted marketing drive, this sector is likely to grow rapidly over the years to 2020. Partly this will be come naturally through economic growth, but will also likely be due to these new businesses taking SME lending market share lending from banks. Credit unions are a further potential source of credit – one that has only been allowed to accept businesses as members since 2012. Historically, the UK has had a low penetration of credit union membership internationally, but this has recently been on the up and is expected to rise further, gaining greater funds to lend to their new SME members.

In addition, much regulatory change has come about since the financial crisis. Much of this has centred on trying to reduce levels of systemic risk to prevent a similar occurrence, including introducing or increasing minimum capital requirements. These regulations can affect smaller banks proportionally more than larger ones, as the fixed cost of compliance is spread over fewer holdings. However, the Bank of England and the regulators have also been working towards reducing barriers to entry for new challenger banks. There are signs that this is working, with more applications for authorisation, with many likely to progress into new banks. This is likely to provide more competitive pressure for the existing banks, although there are questions on whether a larger number of banks will fundamentally change the banking experience for the customer.

Overall, the changes being seen in the banking sector are encouraging for new entrants and for consumers. However, it is increasingly apparent that incumbent banks will need to look not just at the threat from challenger banks, but also from more diverse sources of competition – with crowdfunding, payment providers, and even technology providers moving deeper into banks’ traditional territory.