Simple, resilient and proportional: revisiting regulation for small banks[1]

Executive summary

Small banks differ significantly from large banks in terms of their roles, activities, geographic reach and operational complexity. While there is no uniform definition for "small banks," they typically focus on lending and deposit-taking to households and small businesses, relying on local ownership and specialised knowledge of their communities. In contrast, large banks serve a diverse customer base, operate across national and international markets and engage in a broader range of activities such as specialised lending, wealth management and trading. Their diversified business models and advanced risk management systems result in more complex structures and risk profiles.

To account for these differences, the Basel Committee on Banking Supervision (BCBS) provides for the proportional application of global banking standards. First, the core principles for effective banking supervision, which set the minimum standard for the sound regulation and supervision of banks, applies to all banks in all jurisdictions. To enable broad application, these principles embed a proportionate approach by emphasising that prudential requirements and supervisory practices align with banks' systemic importance and risk profiles. Second, while other aspects of the Basel Framework, including Basel III, are intended for internationally active banks, they can be tailored to other banks based on their size, complexity and risk profile. To support this, the BCBS has issued high-level guidance on proportionality, emphasising that effective approaches should be conservative and simple to implement.

Proportionality practices for non-internationally active banks vary significantly across jurisdictions. This includes variation in terms of the criteria and thresholds used to determine the scope of banks subject to specific rules and the regulatory standards that are subject to proportional application. In non-BCBS jurisdictions, proportionality often involves a mix of simplifying some regulatory standards while imposing stricter requirements in specific areas.

Recent efforts to modernise regulatory frameworks in some jurisdictions, often driven by pro-growth objectives of national governments, have reignited the debate on proportionality. As some jurisdictions review regulatory requirements to mitigate undue compliance burden on smaller banks, it is important to design proportionate approaches that reduce complexity for smaller banks while still accounting for the risks posed by banks of varying risk profiles.

This paper explores the design of regulatory regimes for small banks and identifies key features that advance the BCBS's twin proportionality objectives of being "conservative yet simple." Based on a stock-take of small bank regulatory regimes in six jurisdictions, it identifies eligibility criteria and regulatory requirements for small banks. Unlike earlier Financial Stability Institute studies, which explored proportionality strategies for all non-internationally active banks, this paper focuses exclusively on the regulatory regimes applicable to a subset of small banks that meet specified eligibility criteria.

The criteria for defining small banks differ significantly across surveyed jurisdictions. While asset size is the only common criterion across all sampled jurisdictions, the thresholds applied vary substantially. Other criteria include measures for complexity and domestic activity requirements, though the underlying proxies differ across sampled jurisdictions. Financial resilience metrics, such as minimum leverage ratios, are sometimes applied as an entry requirement, but the requisite levels and methodologies vary. In some cases, information from supervisory assessments is also used as eligibility criteria.

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Proportionality in regulatory requirements varies widely, reflecting differing simplification methods and the trade-offs made between streamlining requirements and fostering resilience. The European Union (EU) prioritises reducing compliance burden through simplified reporting templates and market disclosures while applying broadly similar capital, leverage and liquidity requirements across all banks. Other jurisdictions focus on streamlining specific elements of their prudential regulations that are viewed as overly complex for small banks. These efforts may target either particular components or the entirety of the risk-based capital (RBC) regime and the Pillar 1 liquidity requirements.

These differences manifest in varying capital requirements across jurisdictions. The United States (US) and Switzerland replace RBC requirements with leverage ratios higher than those prescribed under Basel III, though their calculation methodologies differ. Other jurisdictions, such as China and the United Kingdom (UK), retain RBC ratios but either simplify or exempt certain RBC components. For instance, the UK, beginning on 1 January 2027, will allow eligible banks to consolidate multiple capital buffer requirements with a single capital buffer and simplify market risk-weighted asset calculations for banks with small trading book exposures. China eliminates both the capital buffers and market risk capital requirements but requires small banks to maintain a higher minimum Common Equity Tier 1 (CET1) ratio than Basel standards. In Brazil, the RBC regime for small banks includes limited simplifications.

Liquidity standards also differ. Approaches to liquidity requirements include requiring small banks to (i) comply with both the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR); (ii) adhere to the LCR only, while allowing exemptions from the NSFR if certain requirements are met; and (iii) meet simplified proxies for the LCR and NSFR. In two jurisdictions, small banks are exempt from quantitative liquidity requirements altogether.

While most jurisdictions apply large exposure standards to small banks with minimal adjustments, significant simplifications are made to Pillar 3 disclosures and supervisory reporting. Some jurisdictions tailor Pillar 3 disclosures based on whether small banks are publicly listed, while others implement broad simplifications regardless of listing status. Supervisory reporting is widely streamlined through simplified templates, reduced reporting frequencies and targeted exemptions. Brazil distinguishes between market disclosures and supervisory reporting, applying targeted Pillar 3 simplifications while keeping supervisory reporting requirements largely unchanged.

To define small banks, authorities can adapt the BCBS' "size, complexity and risk profile" criteria to their local conditions. While the BCBS deliberately never defined these criteria, authorities often use them as the basis to tailor the Basel Framework to smaller banks. Consequently, authorities need to develop jurisdiction-relevant proxies and thresholds for each criterion to ensure local relevance. Transitional rules are essential to prevent firms from frequently entering or exiting the small bank category.

- **size:** This is the simplest to define, typically based on balance sheet size; but decisions on appropriate thresholds – whether static or variable – require careful consideration.
- **complexity:** Proxies fall into two categories: (i) operational, market and trading complexity, such as limits on trading book size; and (ii) cross-border complexity, which includes proxies that limit cross-border exposures and require a minimum threshold for domestic activity.
- **risk profile:** Proxies include (i) supervisory metrics – that is, various supervisory assessment indicators that may be used as part of the eligibility criteria; and (ii) financial metrics, such as minimum leverage and liquidity requirements, to demonstrate firms' financial resilience.

Designing prudential requirements for small banks requires a holistic approach that balances simplicity and resilience. Regulatory simplifications observed across jurisdictions offer different pathways for authorities to rationalise prudential standards. Such simplifications include (i) replacing RBC ratios with higher leverage requirements; (ii) simplifying aspects of the RBC ratio; (iii) streamlining liquidity requirements; and (iv) reducing supervisory reporting and disclosures. Any simplifications should be paired with relevant safeguards that are embedded in eligibility criteria to foster banks' overall resilience.