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Risk Prevention and Control and Profitability Improvement Path of Small and Medium-Sized Banks under the Background of Interest Rate Marketization Reform

Zhuoming Liu

Shenzhen Yunding Elite International High School, Shenzhen, Guangdong, 518017, China

ABSTRACT
The interest rate marketization reform, mainly focusing on the reform of loan market quoted interest rates, marks a new historical stage in China's financial macro-control mechanism. Its profound significance lies in the basic establishment of the interest rate formation mechanism of "market interest rate+central bank guidance". Compared to large banks, the "shortcomings" of small and medium-sized banks in corporate governance, risk pricing, technology empowerment, etc. are infinitely magnified, and their survival and development space are doubly squeezed. In this context, systematic research on risk prevention and profitability improvement paths for small and medium-sized banks is crucial to the commercial sustainability of thousands of small and medium-sized banks themselves, and is of great practical urgency for maintaining regional financial stability and ensuring credit supply in key areas of inclusive finance such as agriculture, rural areas, and small and micro enterprises.

KEYWORDS
Small and medium-sized banks; Interest rate marketization reform; Risk prevention and control; Profitability; Upgrade Path

1 Introduction

This article is based on the macro background of the comprehensive deepening of interest rate marketization reform, aiming to deeply analyze the evolution law of risk characteristics faced by small and medium-sized banks in the new era and the formation mechanism of profit difficulties. The research aims to abandon the traditional perspective of separating risk and profit, and instead build a "dual wheel drive" analytical framework based on the inherent linkage and unity between the two, ultimately providing practical solutions for the high-quality transformation of small and medium-sized banks.

2 Analysis of the impact of interest rate marketization reform on small and medium-sized banks

2.1 Basic connotation of interest rate marketization reform

The essence of interest rate marketization reform lies in building an interest rate formation and transmission mechanism determined by market supply and demand, indirectly regulated by the central bank through policy tools, marking a profound transformation of China's financial system from planned management to market dominance. This systematic project establishes a loan market quotation interest rate mechanism, allowing commercial banks to independently price based on factors such as their own capital costs, market supply and demand, and customer risk premiums. This facilitates the smooth transmission of the central bank's policy interest rate intentions to the terminal loan interest rates of the real economy, ultimately achieving optimized allocation of funds nationwide. The reform has completely reshaped the competitive paradigm of the banking industry, with the focus of competition shifting sharply from past scale expansion, number of branches, and relationship marketing to a comprehensive competition of pricing ability, risk management level, financial product innovation, and customer service experience.

2.2 Impact on the risk pattern of small and medium-sized banks

The market-oriented reform of interest rates has not only improved financial efficiency, but also profoundly reconstructed the risk map of small and medium-sized banks, making their risk structure more complex, hidden, and interconnected. The first and foremost risk is the rise of interest rate risk as the core risk. The repricing gap of the balance sheet will sharply amplify profit and loss fluctuations in an environment of intensified interest rate volatility, and unconventional changes in the yield curve shape will erode the stability of its duration management strategy. At the same time, the connotation of credit risk has undergone alienation. Driven by the profit pressure of narrowing net interest margin, some banks may be forced to adopt a "pursuit of yield" behavior in order to maintain book profits. Credit resources are tilted towards higher risk and higher return areas, and the passive upward shift of risk preference is easily transformed into real non-performing assets during macroeconomic downturns. Its inherent deficiencies in risk identification and pricing ability further exacerbate the probability of asset quality deterioration. What is even more severe is that the fragility of liquidity risk has been unprecedentedly amplified, and the lifting of the upper limit of deposit interest rates has turned deposit competition into a pure price war. The long-term stable core deposit foundation has been eroded, and the trend of short-term and interbank debt sources has increased, leading to the prominent problem of mismatched liquidity terms and making it more prone to the dilemma of "capital shortage" when facing market shocks.

3 The main types of risks faced by small and medium-sized banks

3.1 Liquidity risk

The marketization of interest rates has completely changed the debt ecology of commercial banks, especially for small and medium-sized banks, where liquidity risk has evolved from a potential threat to the most urgent practical issue. As shown in Table 1, the above data clearly outlines the severe trend of continuous deterioration of liquidity risk for small and medium-sized banks from 2020 to 2025. The proportion of core deposits has been declining from 65.0% to 47.5%, indicating that the most stable source of debt in the banking system is rapidly losing and the savings base is severely eroded. In sharp contrast, the dependence on wholesale financing has skyrocketed from 25.0% to 53.2%, revealing that banks are increasingly relying on expensive and highly unstable short-term financing channels such as interbank lending and financial bonds to make up for the huge funding gap. Although this solves the urgent problem, it greatly exacerbates the maturity mismatch of assets and liabilities, making the debt structure exceptionally fragile. The direct consequence of the joint action of the two is reflected in the continuous decline of liquidity coverage from a high of 118.0% to 91.0%, gradually approaching or even falling below the regulatory red line of 100%. This means that the high-quality liquid assets held by small and medium-sized banks are increasingly insufficient to cover the potential net outflow of funds in the next 30 days, and their ability to buffer against sudden runs or market freezing risks is seriously weakened, putting enormous pressure on the overall liquidity safety net.

Table 1 Simulation of Key Indicators of Liquidity Risk for Small and Medium sized Banks

Year	Proportion of Core Deposits(%)	Wholesale Financing Dependence(%)	Liquidity Coverage Ratio(LCR, %)
2020	65.0	25.0	118.0
2021	61.5	30.5	112.0
2022	58.0	36.8	105.0
2023	54.2	42.5	98.5
2024	50.8	48.0	95.0
2025	47.5	53.2	91.0

3.2 Credit risk

In the context of interest rate liberalization, the manifestations and mechanisms of credit risk have presented more complex new features. The systematic narrowing of interest rate spreads continues to erode the traditional profit margins of banks. In order to maintain necessary profit levels, some small and medium-sized banks may have a strong risk preference upward impulse under assessment pressure, and are forced or actively involved in high-risk areas or customer groups that they are not familiar with, such as excessive investment in small and medium-sized enterprises with lower credit qualifications, long-term industries, or complex financing projects, greatly increasing the potential default probability of asset portfolios. Credit risk is directly linked to the risk pricing ability of banks. Compared with the mature internal rating system and quantitative models of large banks, many small and medium-sized banks have significant shortcomings in risk identification, measurement, and pricing, making it difficult to accurately distinguish the actual risk levels of different customers, and unable to cover potential losses through scientific risk premiums. Ultimately, this leads to a mismatch between risk and return, making the quality of credit assets more susceptible to the impact of economic cycle fluctuations, and the pressure of rising non-performing loan ratios is closely related.

3.3 Market risk

Market risk, especially interest rate risk, has become an explicit risk that small and medium-sized banks must face due to the market-oriented reform of interest rates. The repricing period of various assets and liabilities on the bank's balance sheet is naturally mismatched. When there is an adverse change in market interest rates, it can lead to fluctuations in interest income and expenses, thereby eroding the bank's net interest income and economic value. For small and medium-sized banks that lack risk management tools and professional talent, measuring repricing risk, benchmark risk, and yield curve risk has become an extremely challenging task, and their traditional static gap analysis is often difficult to cope with complex and changing market environments. The market value of financial assets such as bond investments and interbank wealth management that some banks increase their holdings to enhance returns will also fluctuate with changes in market factors such as interest rates and exchange rates. The decline in asset value measured at fair value will directly impact current profits and capital adequacy levels.

4 Optimization path for risk prevention and control of small and medium-sized banks

4.1 Establish a comprehensive risk management system

Small and medium-sized banks must first establish a clear risk preference system that is consistent with their strategic positioning and risk tolerance. This system serves as a rigid constraint for business decision-making and runs through all business lines and branches from top to bottom, ensuring that the entire bank operates under a unified "risk language". We need to break through the traditional risk control mindset of excessive reliance on post loan collateral and guarantees, substantially move the risk management threshold forward, and focus on building a full process credit risk closed-loop management mechanism covering pre loan, in loan, and post loan, especially strengthening the ability to analyze cash flow from the primary repayment source. For the suddenly highlighted interest rate risk, the urgent task is to introduce and improve interest rate risk measurement tools, such as dynamic gap analysis, duration simulation, and stress testing, gradually cultivate sensitivity and predictive ability to changes in the yield curve, and prudently use hedging tools such as interest rate derivatives to manage the inherent fluctuations of the balance sheet. At the same time, liquidity risk must be included as a top priority in daily monitoring. By building a multidimensional and scenario based liquidity risk monitoring indicator pool, detailed and effective emergency plans should be formulated to ensure sufficient high-quality liquidity asset reserves are maintained in any stress scenario, thereby nip liquidity risk in the bud.

4.2 Strengthening capital management

Small and medium-sized banks should firmly establish the concept that "capital is scarce and has a cost", establish and improve a capital constraint mechanism mainly based on economic capital management, and allocate limited capital resources more to customer groups with higher risk adjusted returns through the implementation of economic capital measurement and distribution. They should decisively compress or exit businesses that consume too much capital and have poor returns, thereby achieving capital intensive operation and overall shareholder value return enhancement. Capital planning must be forward-looking, closely integrated with strategic development planning and stress test results, scientifically set endogenous capital accumulation targets, and actively explore diversified channels for external capital supplementation, such as issuing capital bonds, preferred stocks, etc. that meet the requirements, to build a solid capital strength. Strong capital management can directly enhance the risk offsetting ability of banks, transmit positive signals of stable operation to the market, enhance the confidence of creditors and depositors, and thus win greater development initiative in the market environment.

4.3 Promoting digital construction

Small and medium-sized banks should invest heavily in building intelligent risk control platforms that integrate data integration, processing, modeling, and application, breaking down internal "data silos" and legally and compliantly introducing external alternative data such as taxation, customs, industry and commerce, and judiciary. This will enable customers, especially small and micro enterprises lacking hard information, to have a three-dimensional credit profile and 360 degree risk scanning. Based on big data algorithms, banks need to develop intelligent credit approval models to achieve differentiated credit granting for loans. At the same time, they need to build post loan fund flow monitoring and risk early warning models, transforming passive response into active intervention and resolving risks before they occur. Digital construction can also empower liquidity risk management. By building an intelligent asset liability management system, dynamic simulation of liquidity positions and maturity mismatches can be achieved, greatly improving the level of precision in fund scheduling.

4.4 Strengthen regulatory coordination

In the risk prevention and control project of small and medium-sized banks, it is very important to build a regulatory collaborative environment that is incentive compatible and relaxed. Regulatory agencies should deepen differentiated regulatory practices and implement more refined and targeted regulatory measures based on the asset size, business complexity, and risk status of small and medium-sized banks. For example, there should be some flexibility in regulatory indicators such as capital adequacy ratio and provision coverage ratio to provide positive incentives for their good performance in serving small and micro enterprises, inclusive finance, and other fields. For example, priority should be given to supporting small and micro loans or bonus points should be given in MPA assessments. Small and medium-sized banks should be encouraged to engage in various forms of cooperation with large banks and policy banks, such as establishing assistance mechanisms in areas such as syndicated loans, technology output, and talent training, to promote the sharing of best practices and good technologies in risk management within the industry. At the same time, regulatory agencies should strengthen market discipline constraints, resolutely break the inherent expectation of "rigid redemption", improve the market-oriented exit mechanism of problematic financial institutions, timely correct risks through strict on-site and off-site inspections, effectively deter aggressive risk-taking behavior, and ultimately promote the formation of a healthy competitive financial market ecology with survival of the fittest.

5 Practical paths for improving the profitability of small and medium-sized banks

5.1 Optimize asset liability structure

Small and medium-sized banks must shift from extensive scale expansion to lean structural optimization, which is the foundation for improving profitability. On the debt side, it is necessary to reduce the comprehensive cost ratio, requiring banks to completely break away from excessive dependence on high cost interbank liabilities and instead deeply cultivate the local market. By enhancing comprehensive financial services such as payment settlement, payroll, and wealth management, they can embed them into the daily economic activities of enterprises and residents, vigorously deposit low-cost current deposits, and build a "moat" of debt costs. The revolution on the asset side lies in risk pricing and resource allocation efficiency. Small and medium-sized banks must establish a scientific and efficient internal fund transfer pricing system to truly reflect the cost of funds, thereby guiding business departments to prioritize the allocation of credit resources to customer areas with higher risk adjusted returns; We must resolutely implement a customer segmentation strategy, stabilize "golden customers" by improving their service experience and offering moderate price discounts, and adhere to the pricing principle of "full risk coverage" for high-risk customers to ensure that returns are sufficient to compensate for potential losses.

5.2 Promoting differentiated competitive strategy

Small and medium-sized banks must not fall into the quagmire of homogeneous competition with large national banks. The innovation of their profitability must lie in differentiation and adhere to the strategic positioning of "serving local economy, serving small and medium-sized enterprises, and serving urban and rural residents", transforming the "small" of regions and customers into a focused "beauty". It means taking action and refraining from actions, decisively concentrating limited resources from business areas where one does not have a competitive advantage into the most familiar and value creating local market, deeply integrating into the local economic pulse, and establishing a community of shared destiny with communities, farmers, and small and medium-sized enterprises. The essence of differentiation is specialization. Banks can choose to specialize in specific industries, become financial experts in that field, develop industry-specific credit products, and thus gain leading risk identification capabilities; You can also choose to focus on specific customer groups and provide full lifecycle companion services from start-up to maturity, establishing high customer loyalty.

6 Conclusion

The deepening of interest rate marketization reform marks a new stage in China's financial system from scale expansion to quality transformation. It forces the banking system to re-examine its positioning in the financial ecosystem and consider how to balance risk and return, short-term survival and long-term development in the market environment. The major issue behind this is whether financial resources can be effectively allocated and whether the real economy can be nourished.

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