Executive Summary

The financial sector risk outlook for emerging market and developing economies (EMDEs) is largely divided along income lines, with lower-income countries facing much higher risks than higher-income countries. The good news is that an analysis of 50 EMDEs, which represent 93 percent of total bank assets in EMDEs, found that 70 percent of sample countries face low to moderate financial sector risks over the next 12 months. However, risks are high in some, mostly lower-income countries.[1] In many of these countries, domestic risks are compounded by global risks related to the monetary policy and economic growth outlook in advanced economies (AEs), as well as geopolitical conflicts.

Most banks in EMDEs weathered the pandemic shock well and appear relatively sound and resilient, but pockets of weakness exist. Most EMDE banks have sufficient buffers to withstand sizable credit and sovereign risk shocks. Yet some sample banks in lower-income EMDEs would be undercapitalized if confronted with a significant but plausible increase in the nonperforming loan ratio. Several banks—mostly in the Middle East and North Africa, Sub-Saharan Africa, and South Asia regions—face elevated risks of "haircuts" on sovereign bonds should there be a domestic debt restructuring, a situation that could trigger an adverse feedback loop between the sovereign and domestic banks, as described below.

A majority of the countries facing high financial sector risks (including many lower-income African countries) are currently not well prepared to handle financial stress. Important weaknesses in regulatory and supervisory frameworks hamper the ability of some high-risk EMDEs to ensure the soundness of the financial sector, and essential components of crisis management frameworks and financial sector safety nets are often missing or inadequate.

These vulnerable countries should take urgent steps to remedy critical policy and institutional gaps in order to improve the resilience of their financial sectors. Strong interagency crisis management coordination mechanisms, operational emergency

1. See appendix A for the list of all EMDEs. "Lower-income EMDEs" refers to low- and lower-middle income EMDEs. "Higher-income EMDEs" refers to upper-middle- and high-income EMDEs. See appendix B for the 50 countries covered in the financial risk and development analysis in this report. The 50 countries analyzed represent 93 percent of total banking system assets and 85 percent of total GDP of all EMDEs.

liquidity assistance, robust resolution frameworks, and credible deposit insurance systems are examples of essential tools that can reduce the impact and likelihood of financial stress and mitigate spillovers to the real economy. In addition, it is important to bolster the operational independence and powers of banking sector authorities, clarify that their financial stability mandate takes precedence over financial sector development objectives, and ensure effective supervision of financial institutions and strong financial sector safety nets.

Although progress has been slow for many financial sector development priorities, there have been improvements in financial inclusion for individuals and in efforts to green the financial sector. Developing the financial sector is critical to promoting sustainable economic growth and ending poverty. So far, advances in key priorities such as broadening access to finance for smaller firms and supporting capital market development have been relatively weak. In addition, many EMDEs continue to struggle to achieve the right balance between the state's influence in the financial sector and the promotion of market-based competition. Policy makers should continue to embrace the safe adoption of digital financial services that has supported competition, innovation, and financial inclusion for both individuals and small firms. Continued efforts to mobilize climate finance could in turn broaden capital market development.

EMDE banks have substantially increased their holdings of government debt over the past decade, which can pose risks to financial stability when exposures are very large. The close link between the banking sector and the government is a situation known as the sovereign-bank nexus. Between 2012 and 2023, the exposure of banks to government debt in EMDEs rose by over 35 percent as governments borrowed more, partly to deal with the COVID-19 pandemic. The exposure rose even more—by over 50 percent—in debt-distressed countries. A moderate increase in government debt holdings by banks can reflect healthy financial sector deepening and development. However, these exposures currently stand at a decade high and subject the financial sector to additional risks through elevated government debt and fiscal pressures. Countries with a high sovereign-bank nexus also tend to be less prepared to deal with financial stress, which can amplify adverse feedback loops. This heightened potential for financial stress contagion could threaten macroeconomic and financial sector stability. Even a 5 percent loss on banks' government debt would render one-fifth of sample banks in debt-distressed countries undercapitalized, potentially precipitating a banking crisis. Such crises—especially joint banking-government debt crises—have been very costly throughout history.

Regulatory standards designed to capture the risks that banks take fail to account for the tail risk of a government debt default (including restructuring), which is significant in some EMDEs. These standards do not impose limits on banks' exposures

to the government or apply capital charges to sovereign exposures in local currency, a situation that does not foster prudent risk taking by banks. Furthermore, standards require only limited disclosure of such exposures by banks and this can render their balance sheets less transparent. Large accumulations of government debt by EMDE banks could also curtail lending to the private sector and hinder economic growth.

EMDE banking authorities should foster more prudent risk taking by banks and strengthen financial sector resilience. Banking authorities cannot resolve the sovereign-bank nexus risks alone. First and foremost, sound fiscal and other policies to preserve public debt sustainability and macroeconomic stability are required. However, banking authorities could introduce granular disclosure requirements for banks' exposures to the government in order to strengthen market discipline. To mitigate excessive buildup of government debt holdings in banks that lack adequate capital buffers, authorities could carefully consider the benefits and drawbacks of capital charges on government debt exposures in local currency, particularly if these exposures exceed certain thresholds. Considering capital charges is particularly relevant for jurisdictions that have experienced past episodes of sovereign debt distress, or that currently face significant risks of debt distress, and that have bank-dominated financial sectors—these tend to be lower-income EMDEs. Authorities could further encourage stronger bank buffers well in advance of potential crises, implement effective financial safety nets and crisis management frameworks, and conduct regular stress-testing for banks that also considers possible impacts of sovereign debt stress.

EMDEs face higher climate-related financial sector risks and larger climate financing gaps than advanced economies. These challenges are amplified in countries that already face high financial risks. Climate risks have the potential to significantly reduce output in several EMDEs, with current forecasts likely underestimating both the economic toll and the risks to financial stability. For example, climate-related financial sector risks may adversely interact with heightened fiscal and other financial sector risks, including through a high sovereign-bank nexus, as described earlier. Excluding China, EMDEs represent a quarter of global gross domestic product but only account for 14 percent of reported global climate finance flows. Over 50 percent of EMDE climate finance comes from public sources, with the private sector playing a smaller role compared to AEs. Only 16 percent of climate financing in EMDEs (ex China) goes to adaptation and nearly all of that financing (98 percent) also comes from public sources. In contrast to advanced economies and China, other EMDEs raise less than half of their climate finance at home. Despite being the largest source of finance, the banking sector in EMDEs supplies only limited climate finance, with 60 percent of banks allocating 5 percent or less of their lending portfolios to it.

To address these dual challenges, banking authorities are adopting novel approaches

to managing climate-related financial risks and enabling climate finance. But banking authorities must not compromise on their primary financial stability objective and must continue to support financial inclusion. Most progress to date has been in middle-income EMDEs, where authorities are deploying regulatory tools to address climate risk in a sequenced and proportional manner. For example, some banking authorities have customized climate risk assessments to local extreme weather patterns involving droughts, floods, and typhoons. Approaches tested to mobilize climate finance range from adjusting interest rates on lending facilities to requiring banks to direct lending to green activities. However, most of these approaches are new, their suitability and effectiveness are still unproven, and they may produce unintended consequences. Banking authorities must take care to prioritize financial stability and continue to promote financial inclusion as they adopt regulatory tools and supervisory approaches that support the mobilization of climate finance and management of climate risks in the financial sector.

Banking authorities on their own will not be able to meet climate financing needs. If EMDEs are to successfully tackle climate change and its many impacts, they will need broader policy support and financing from beyond the banking sector, in addition to defining "green" more clearly. Governments often look to central banks and banking authorities for support, particularly in EMDEs where banks dominate the financial sector, but they should not compromise on these institutions' operational independence. Prudential and central bank measures should not interfere with core institutional mandates, and they cannot substitute for broader government interventions that are necessary to tackle climate change—including carbon pricing, fiscal policies, and market-based regulations. In the financial sector, the adoption of green and sustainable taxonomies, which define and classify investments and activities that support climate targets, will be essential. Yet today such taxonomies cover only 10 percent of EMDEs compared with 76 percent of advanced economies. Over the longer term, well-functioning capital and insurance markets—often absent in EMDEs—need to be developed to provide access to long-term funding for new green technologies as well as critical climate infrastructure and resilience instruments. Well-governed development banks and credit guarantee institutions can play a major part in raising more climate finance if deployed judiciously and in a targeted fashion.