Chapter 1. Financial Sector Trends in EMDEs: Divided Risk Outlook and Development Progress

While financial sector risks for most higher-income EMDEs are low to moderate, some lower-income countries analyzed in this report face high risks in the next 12 months. *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 in the next 12 months. However, risks are high in some, mostly low- and lower-middle income countries. In many of these countries global risks related to the monetary policy and economic growth outlook in advanced economies, as well as geopolitical conflicts, compound domestic risks. In most countries, domestic risks result from government debt sustainability challenges and a high sovereign-bank nexus, lagged effects of high interest rates on private sector debt-service capacity, and challenges related to bank asset quality. One striking outcome of this backdrop has been the exclusion of Sub-Saharan African countries from international debt markets for most of 2022 and 2023.*

Banks in EMDEs appear generally sound and resilient, but there are pockets of weakness, mostly in lower-income countries. *Despite various macroeconomic and geopolitical shocks over the past few years, banks in EMDEs have maintained sound capital and liquidity buffers and saw a boost in their profitability. Analysis suggests that most EMDE banks can handle sizable credit and sovereign shocks. These buffers are welcome as around one-third of listed firms in EMDEs, accounting for a fifth of total outstanding debt, face interest payments that exceed their profits. However, around 20 percent of sample banks in lower-income EMDEs would be undercapitalized if confronted with a significant but plausible 5-percentage-point increase in the nonperforming loan ratio. Several banks—mostly in the Middle East and North Africa, Sub-Saharan Africa, and South Asia regions—are also highly vulnerable to risks of "haircuts" on government bonds resulting from possible debt restructurings, which could affect their financial stability and viability.*

Reforms in more resilient EMDEs have shown the importance of sound supervision and strong financial sector safety nets; however, almost 70 percent of EMDEs facing high financial sector risks are not prepared to handle financial stress. *Measures should be taken to enhance the independence and powers of banking supervisors and to strengthen supervision. To reduce the likelihood of financial stress and mitigate spillovers to the economy, steps should be taken to bolster financial safety nets, including crisis management frameworks and deposit insurance systems. Remaining COVID-19-era forbearance measures should be phased out, while gaps in regulatory definitions of problem assets, provisioning requirements, and supervisory enforcement should be addressed to ensure that bank balance sheets are transparent and accurately reflect asset quality.*

While progress towards many financial development goals has been relatively weak, improvements have been seen in financial inclusion for individuals and in efforts to green the financial sector. *This chapter identifies six priorities for financial sector development and documents how recent progress has been mixed. Advances have been made on greening the financial sector and increasing financial inclusion for individuals, where account ownership for individuals increased by almost 30 percentage points in a decade to reach 71 percent of adults in EMDEs by 2021. However, access to finance for smaller firms and capital market development remains challenging, despite growth in the assets of domestic institutional investors. Many EMDEs continue to struggle to strike the right balance between the state's influence in the financial sector and promotion of market-based competition. The concentration of EMDE banking assets in the three largest banks per country rose from 57 percent to 64 percent on average between 2013 and 2022. Policy makers should continue to embrace the safe adoption of digital financial services, which support competition, innovation, and financial inclusion for both individuals and small firms.*