

Daiwa's Economic View

BOJ's *Financial System Report* (Apr 2026)

- What is occurring in new "world with interest rates"?
- Declining deposit stickiness, shorter debt durations

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Summary

The BOJ released its latest [Financial System Report](#) (*FSR*) on 21 April. As was the case with the October 2025 *FSR*, the report stated that, "Japan's financial system has been maintaining stability on the whole." The key issues addressed in the latest *FSR* include: (1) impact of overseas non-bank sector on domestic financial market, (2) lending stance of financial institutions and credit provided to the real estate sector, and (3) impact of rising interest rates on bank balance sheets. As part of the stress test, scenario analyses were conducted on an ad hoc basis, taking into account the escalating tensions in the Middle East and the surging real estate prices. One notable feature of the April report is that a significant portion of the content is devoted to trends involving financial institutions' real estate exposure.

This *FSR* is the first to be compiled since the BOJ raised its policy interest rate to 0.75%. One key point of interest is [the degree of impact on the real economy, financial intermediation, and bank balance sheets](#) after the policy interest rate reached virtually uncharted territory.

Looking at the credit conditions of financial institutions, while there have been no significant changes in bankruptcy trends or default rates, lending to the real estate sector continues to grow at a higher rate vs all industries. There have also been suggestions that risks could materialize during real estate price adjustments or refinancing.

Also, against the backdrop of intensifying competition for deposits, as deposit stickiness declines and the liability-side of bank balance sheets becomes increasingly shorter, it was reaffirmed that banks are covering these risks by shortening their asset-side durations. On this point, through their conduct regarding JGB holdings, banks can influence yield formation, particularly the term premium on long-term bonds.

Furthermore, this *FSR* also touched on the growing presence of foreign investors in the JGB market and trends among multi-strategy hedge funds. This again highlights the channels through which fluctuations in global equity and bond markets amplify volatility in the domestic bond market.

From the bond market's perspective, the April *FSR* confirms financial system stability. Meanwhile, this has once again highlighted the impact that the transition to a "world with interest rates" has on the bond market through banks' ALM operations. Along with the increase in real estate-related loans and changes in the deposit structure, shifts in banks' stances toward holding government bonds also have significant implications for the formation of term premiums.

Assessment of financial system stability

The assessment of Japan's financial system was, "Has been maintaining stability on the whole." This was the same wording as in the October 2025 report. As demand for corporate loans continues to rise, financial institutions are maintaining their proactive lending stance, specifically, "No major financial imbalances have been seen in current financial activities."

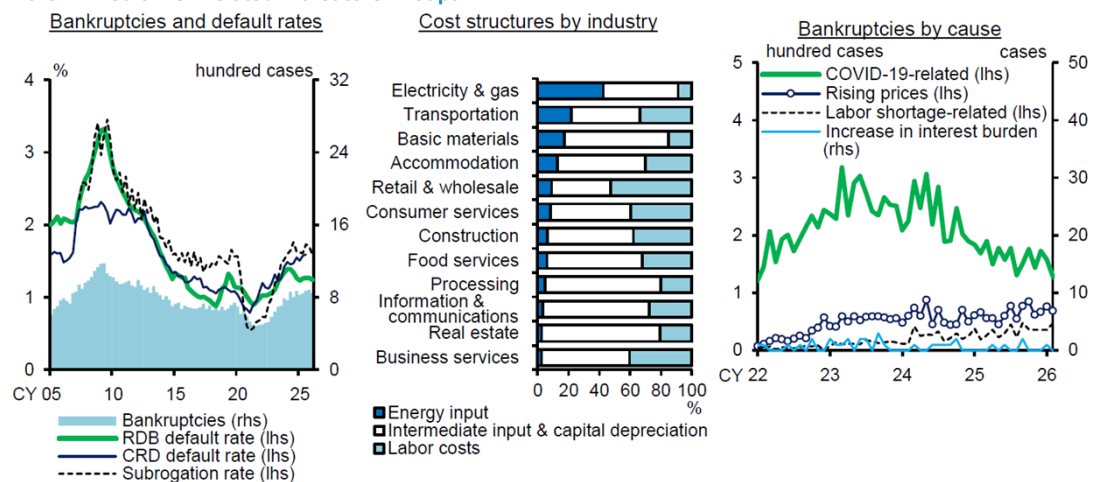
However, as we will discuss in a later section, loans to the real estate sector continue to grow at a faster pace than overall lending. Combined with soaring real estate prices, the risks associated with real estate-related exposure are a focus of this *FSR*.

Domestic credit risk

As lending rates continue to rise, the number of corporate bankruptcies has remained flat compared to levels seen just after the coronavirus outbreak. The same is true for the default rate, which has been rising at a slower pace recently. This is mostly due to improving corporate performance. Indeed, even when looking at the reasons for corporate bankruptcies, very few companies cite "increasing interest burdens" as a direct cause. At this juncture, the impact of interest rate hikes on corporate finance appears to be limited.

However, the full impact of the US/Iran conflict, which erupted on 28 February, on corporate management remains unknown. Looking at cost structures by industry, electricity/gas, transportation, materials-based manufacturing, and others account for a high proportion of costs attributable to energy inputs. Even though crude oil prices remain elevated, the extent to which these industries can pass on higher costs to their prices will likely impact cash flows at some companies, in our view.

Chart 1: Credit Risk-related Indicators in Japan

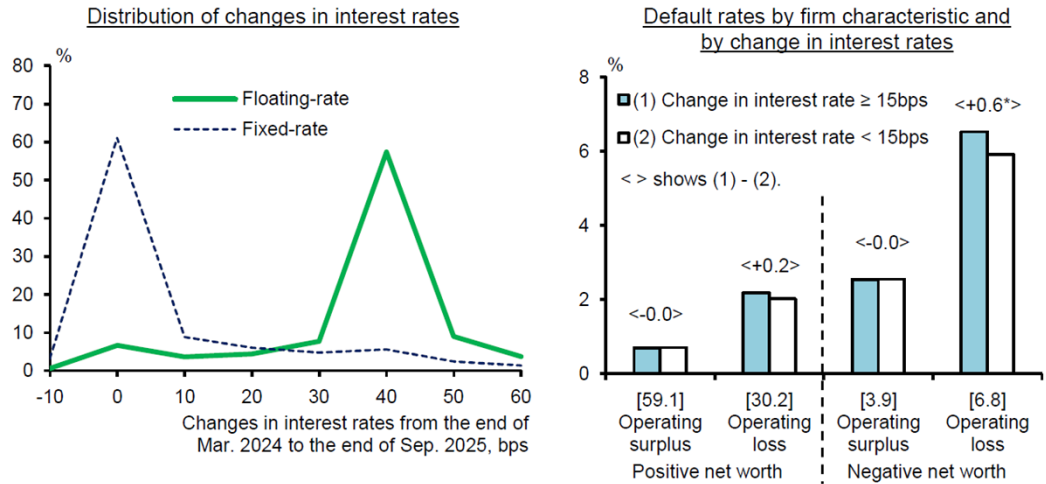


Source: Reprinted from BOJ "Financial System Report" (Apr 2026).

Relationship between rising lending rates and default rates

The relationship between rising lending rates and default rates can vary significantly depending on a company's earnings situation and the type of interest rate on its loans (fixed or floating). In this regard, the latest *FSR* report again presents the distribution of changes for lending rates since the BOJ ended negative interest rates, as well as default rates by magnitude of change (targeting SMEs). Looking at the distribution of interest rate changes, floating-rate loan rates rose by about 40bp for roughly 60% of borrowers, while fixed-rate lending rates remained unchanged for about 60% of borrowers. Looking at how default rates respond to the amount of interest rate changes, while the default rate is slightly higher among borrowers who experienced larger interest rate increases, the difference is small, ranging from 0.2 to 0.6ppt. In other words, we confirmed that for the Japanese economy to date, the impact of interest rate changes on default rates has been limited.

Chart 2: Changes in Lending Rates and Response of Default Rates Amid Rising Interest Rates



Source: Reprinted from BOJ "Financial System Report" (Apr 2026).

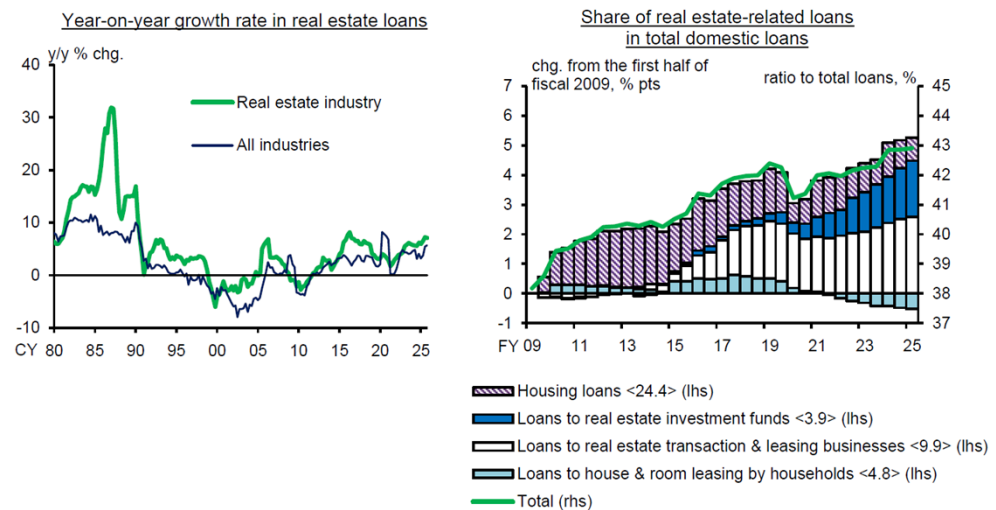
◆ Minutes of Monetary Policy Meeting on 22-23 Jan 2026

Some members expressed the recognition that, while not much time had passed since the policy interest rate hike in December 2025, financial conditions continued to be accommodative, considering factors such as firms' and other entities' demand for funds, financial institutions' lending attitudes, and issuance conditions for CP and corporate bonds.

Real estate-related loans

The pace of growth for bank lending has been accelerating over the past year. In particular, "Real estate-related lending in particular has continued to grow at a faster pace than overall lending." The share of real estate-related loans within total domestic loans has continued to rise, reaching approximately 43% recently. Looking at the more detailed content of real estate-related loans, we can see that the increase in lending over the past few years has been driven by, "Loans to real estate investment funds" and "loans to real estate transaction & leasing businesses."

Chart 3: Real Estate-related Loans



Note: In the right-hand chart, figures in brackets indicate the share of real estate-related loans to total loans as of end-September 2025. See Charts V-1-7 and V-1-9.

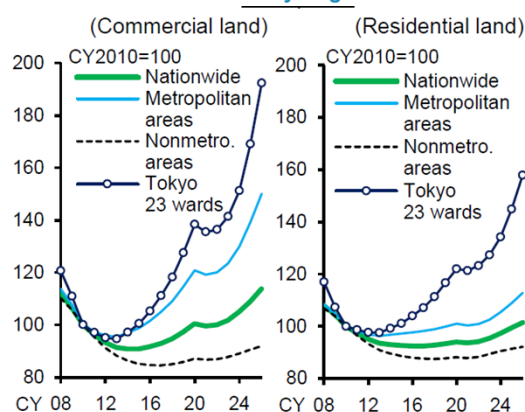
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One characteristic of non-recourse loans, including loans to real estate investment funds, is that they have, "Their source of repayment limited to the cash flows generated by the underlying real estate and its sale value, and such loans are therefore likely to be directly affected by changes in real estate prices and rents." In this regard, this FSR also points out that many of the properties

managed by real estate investment funds are concentrated in major metropolitan areas where real estate prices are rising sharply.

By business type, lending to real estate funds has been increasing, particularly among major banks, and so is expected to provide sufficient loss-absorbing capacity even in the event of shocks. That said, each financial institution likely, “Needs to manage risks by also paying due attention to the risk of fluctuations in real estate prices and to the possibility that the transmission channels of stress may differ from those in the past.” As evidenced by the stress tests in the April *FSR*, which are based on the assumption of a significant deterioration in the real estate market, financial authorities are paying close attention to real estate finance.

Chart 4: Real Estate Prices by Region



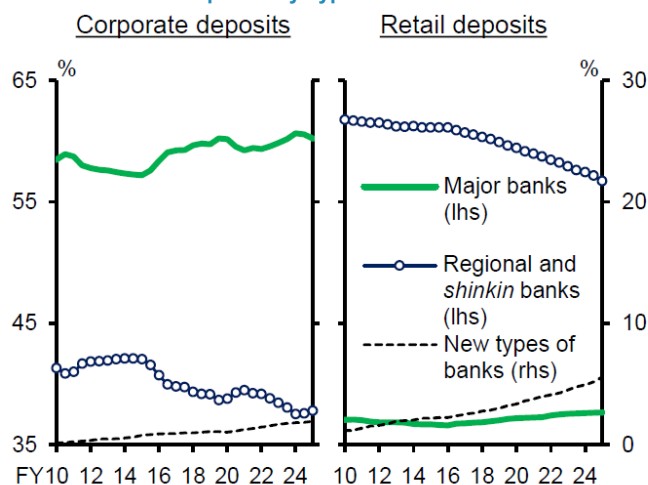
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Funding liquidity risk and shorter debt durations

Amid this transition to a “world with interest rates,” as well as more intense competition for deposits, the liquidity risk associated with deposits is increasing compared to the past. The impact of increased money market liquidity on bank balance sheets is one of the key points to check in this *FSR*. With regard to overall domestic liquidity, financial institutions are “sufficiently resilient.”

However, the y/y growth rate for deposits has slowed compared to lending growth rates. In particular, regional financial institutions are seeing a decline in their share of deposit balances due to factors such as the “movement of inherited deposits, given the significant regional disparities in aging and population decline.”

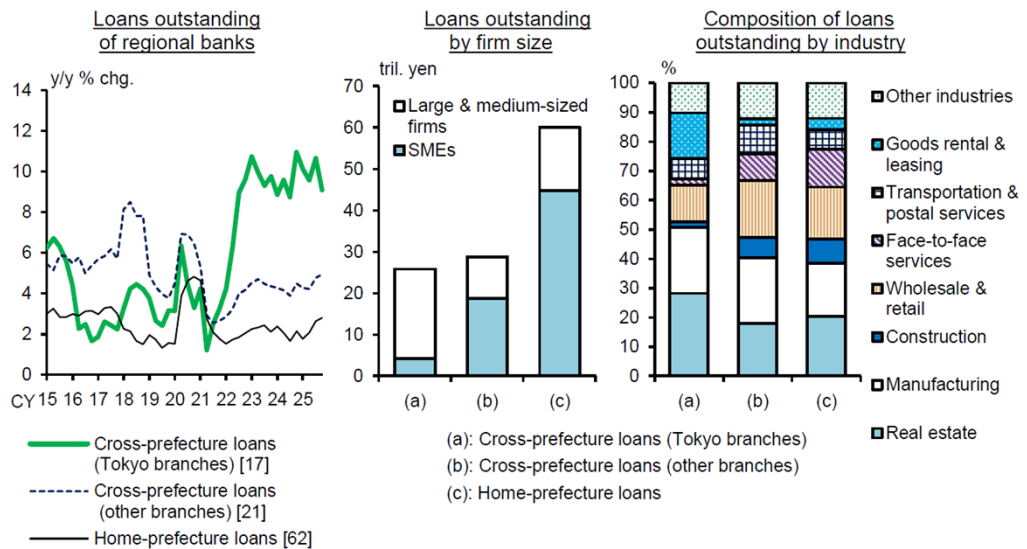
Chart 5: Share of Deposits by Type of Bank



Source: Reprinted from BOJ “Financial System Report” (Apr 2026).

The declining share for deposits is not unrelated to the increase in cross-prefecture lending by regional banks. It has been pointed out that cross-prefecture lending tends to result in loan funds that are difficult to retain as deposits to a lesser extent than local lending within the same area. It was also noted that among the cross-prefecture lending, those loans made by bank branches in Tokyo include a high proportion of loans to the real estate sector.

Chart 6: Characteristics of Cross-prefecture Loans



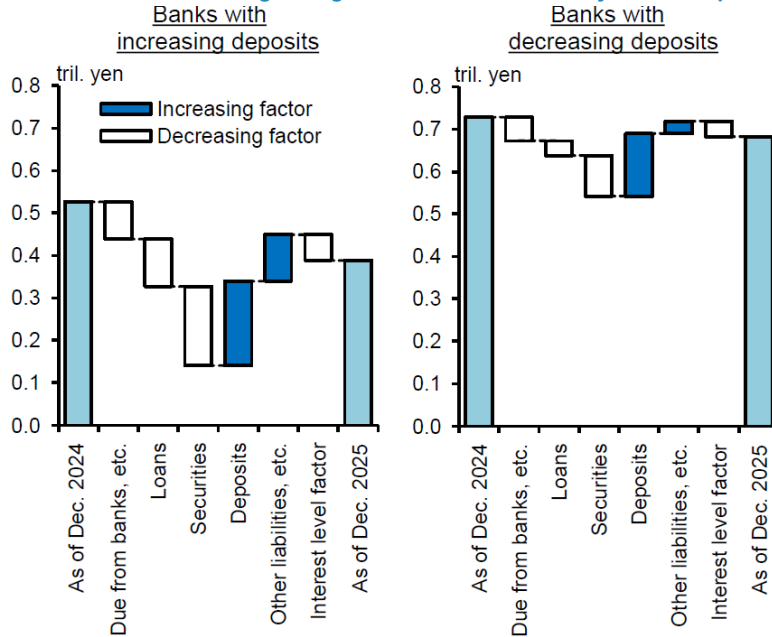
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Among regional financial institutions, while 50% of *shinkin* banks are facing a y/y decline in deposits, the corresponding ratio for regional banks is only around 30%. There is considerable variation across individual banks in terms of deposit inflows and outflows. On this point, "among banks with increasing deposits, deposits have been growing due primarily to large time deposits that are highly sensitive to interest rates, given the relatively high rates at which time deposits are priced."

What is important here is that "large deposits acquired based on high deposit rates may exhibit high sensitivity to interest rates and economic developments and consequently could be less sticky." A decline in deposit stickiness implies a shortening of liability duration on banks' balance sheets, which becomes a major concern from an ALM management perspective. Time deposits gathered through high-rate deposit campaigns are not necessarily classified as stable time deposits or stable deposits under the LCR framework.

That said, "thus far, the interest rate risk of loans and securities at banks with increasing deposits has shown a decline due to factors such as a shortening of durations, even as their loans and securities outstanding has risen." In other words, the shortening of liabilities is being offset by a shorter duration on the asset side, namely in loans and securities holdings. From a market perspective, this shortening of the duration of banks' JGB holdings contributes to a rise in the term premium on long-term bonds.

Chart 7: Factors Affecting Changes in Interest Rate Risk by Banks' Deposit Characteristic

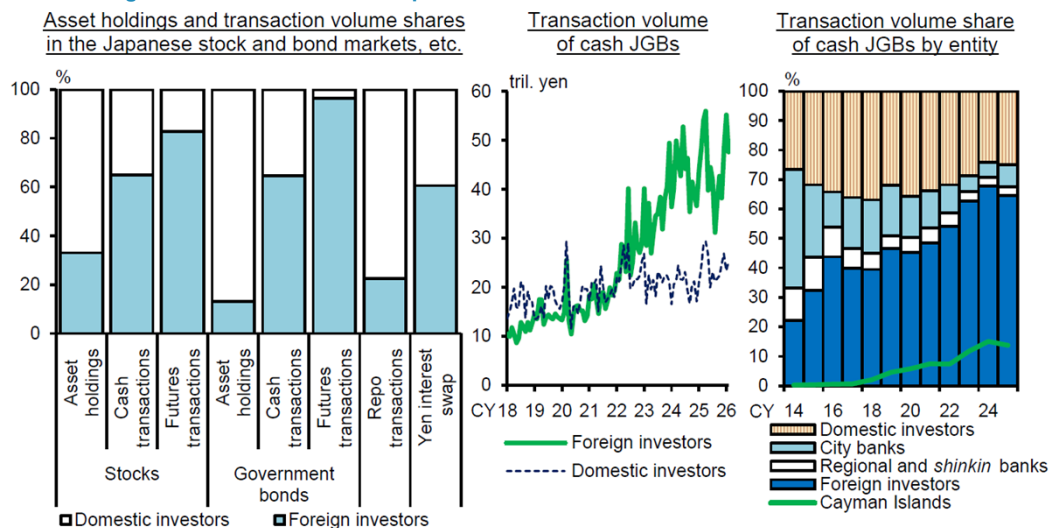


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Presence of overseas investors in the Japanese bond market

Another issue with implications for the JGB market is the increasing presence of overseas investors. In the JGB market, overseas investors account for 60% of trading in cash bonds and as much as 90% in futures. In the latest *FSR*, as in the previous issue, the BOJ pointed out that as linkages across global markets deepen, interest-rate moves in a particular country can be transmitted through channels such as "reduced liquidity in bond markets." According to JSDA statistics, overseas investors are net buyers of JGBs in normal times, but "they switch to net sellers in periods of heightened volatility," with the result that yield volatility tends to be amplified.

Chart 8: Foreign Investors' Presence in Japanese Markets



Source: Reprinted from BOJ "Financial System Report" (Apr 2026).

The report also newly examines the behavior of multi-strategy and macro hedge funds using multiple investment strategies. Because many of these funds invest in both equities and bonds, and because they use repo and equity-backed loans for funding, the latest report also highlights the risk that deleveraging triggered by corrections in AI-related equities could spill over into the bond market. If not only international linkages within bond markets but also cross-asset

correlations continue to strengthen, insight into multi-asset dynamics is likely to become increasingly important for JGB investment going forward.

Risk scenarios incorporating worsening Middle East tensions and corrections in AI-related stocks

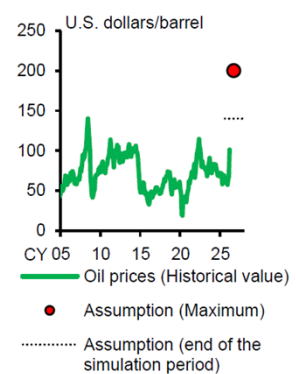
In addition to its regular scenario analysis, the latest *FSR* conducts a stress test that updates the “the rises in foreign interest rates scenario plus” analysis from [the previous FSR](#) to reflect heightened tensions in the Middle East. In the current scenario, overseas interest rates rise and overseas economic growth slows against a backdrop of materializing geopolitical risks and a global rise in prices—in other words, stagflation is assumed. A distinctive feature of this scenario is that it also factors in corrections in AI-related stocks and deterioration in credit costs for private credit.

Specifically, the assumptions include a maximum 1.5ppt rise in long-term interest rates in Japan and the US, a decline of as much as 40%-50% in Japanese and US equity prices, and a deterioration in credit costs for loans to data centers and to private credit funds. As for crude oil prices, WTI crude futures are assumed to rise temporarily to \$200/bbl before remaining elevated at \$140/bbl.

Chart 9: Assumptions in The Rises in Foreign Interest Rates Scenario Plus
Assumption on main variables

Main variables		Estimation methods	Maximum deviation rate
Financial variables	U.S. and Japanese long-term interest rates	Assuming an additional 0.5ppt widening relative to the rises in foreign interest rates scenario plus in the October 2025 issue	+1.5%pts
	U.S. stock prices	AI-related shocks assumed to decline sharply in line with the dot-com bubble collapse, with others based on the real GDP	About -50%
	Japanese stock prices		About -40%
	Fund prices	Based on the asset price related to each fund price	About -30%
Real economic variables	U.S. real GDP		About -5%
	Japanese real GDP	VAR model for the U.S. and value-added, and FMM for Japan	About -4%
	Value-added by industry		About -15%
Foreign loans	Loans to data centers	Based on the default rates of high-yield bonds during the dot-com bubble collapse	About -10%pts
	Loans to PC funds	Based on the PC funds' investment share to information technology firms, and the default rates of high-yield bonds during the dot-com bubble collapse	About -2%pts

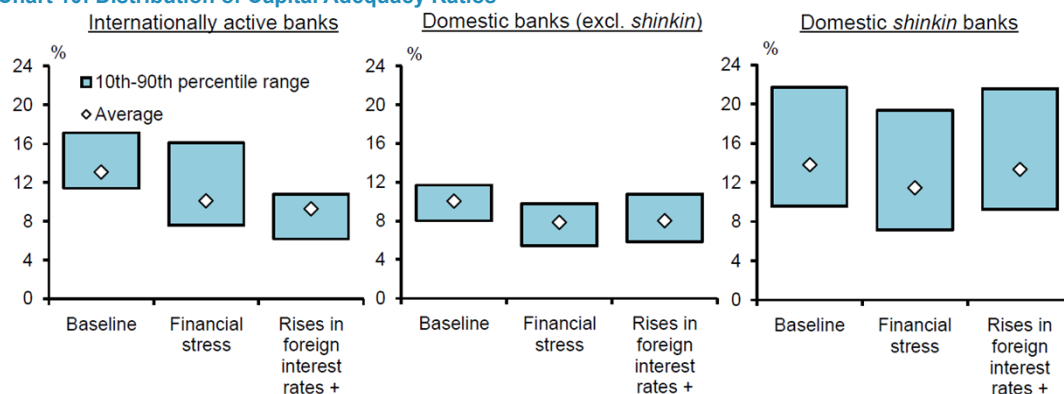
Assumption on oil prices



- Note: 1. "Maximum deviation rate" for each variable represents the maximum difference between the values under the baseline scenario and the rises in foreign interest rates scenario plus in each quarter. For the interest rates, "maximum deviation rate" indicates the maximum difference in the value of the long-term interest rates. For value-added by industry, "maximum deviation rate" is the average rate of the maximum deviation across industries and firm sizes. For foreign loans, "maximum deviation rate" indicates the maximum difference in the credit cost ratio.
2. "AI-related stocks" are defined as stocks classified in the "Information Technology" sector of the S&P 500 in the U.S., and in the "Electric Appliances," "Information & Communication," "Machinery," or "Precision Instruments" sectors of the TOPIX in Japan.
3. The oil prices in the right-hand chart show WTI crude oil futures. Latest data for the "Historical value" is as of end-March 2026.

Source: Reprinted from BOJ "Financial System Report" (Apr 2026).

The simulation results suggest that the drag from domestic credit costs would be greater than that under the scenario assuming the Global Financial Crisis. This scenario assumes that the initial downside risk to the Japanese economy is limited. However, the result was that “there is an absence of mitigating effect from lower interest rates on debt repayment burdens in this scenario. Under these circumstances, credit costs increase for financially vulnerable small and medium-sized enterprises that are likely to be affected by rising crude oil prices, as well as for sectors that are heavily affected by a fall in AI-related investment.” Nevertheless, “capital adequacy ratios overall remain above regulatory requirements throughout the simulation period.” Thus, it was judged that “the stability of the financial system as a whole is maintained.”

Chart 10: Distribution of Capital Adequacy Ratios


Source: Reprinted from BOJ "Financial System Report" (Apr 2026).

Conclusion

According to a *Nikkei* article on the evening of 21 April, the market was reminded that an April rate hike would be skipped. This itself was in line with previous reporting and therefore came as no surprise. What stands out, however, is the wording in the headline—"The BOJ will assess Middle East developments and decide in June whether a hike is warranted." This is similar to Governor Kazuo Ueda's phrasing in his 1 December 2025 speech—"we will consider the pros and cons of raising the policy interest rate and make decisions as appropriate"—which triggered a rapid repricing of expectations for a December hike at last year's December meeting. As such, the wording appears intended to make the market strongly aware of the possibility of a June rate hike. In fact, the probability of a hike by June in the OIS market rose to around 66%.

Of course, whether policy action is warranted will also depend on how the Middle East situation unfolds. Meanwhile, if the policy rate is raised to 1% in the near future, there can be little doubt that the environmental changes associated with a "world with interest rates," as discussed in this report, will accelerate. Specifically, we expect a shift from ordinary deposits into time deposits and securities investment, a decline in deposit stickiness, a shortening of bank liability durations, and shorter durations for loans and securities investment through ALM management.

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