Financial System Report

Summary

October 2025

Bank of Japan

Note: This document presents a summary of the October 2025 issue of the *Financial System Report*.
See the *Report* for more details of the analyses as well as notes and sources of the charts.

Stability assessment of Japan's financial system

- Japan's financial system has been maintaining stability on the whole.
- Financial intermediation has continued to function smoothly.
  - In the loan market, firms' demand for loans has continued to rise and banks' lending stance has remained active. Under such circumstances, no major financial imbalances have been seen in current financial activities.
- Japanese banks have sufficient capital bases and stable funding bases to withstand various stress events, such as those equivalent to the global financial crisis that would cause major corrections in financial markets and the real economy at home and abroad.
  - Uncertainties remain high regarding the formulation of economic policies in each jurisdiction, geopolitical risks, and developments in global financial markets. Financial institutions need to be vigilant against materialization of various risks.
  - From a long-term perspective, if structural factors remain, such as a decline in firms' loan demand reflecting the shrinking population and other factors, banks' profitability and loss-absorbing capacity could decline, depending on the supply and demand balance in the loan market, and this could lead to a contraction of financial intermediation activities or an overheating, such as excessive search for yield.
  - It is necessary to ensure the stability of Japan's financial system into the future by analyzing risks and potential vulnerabilities of the financial system, and by addressing them appropriately.

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(Conclusion) Stability assessment and caveats

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Box 1: Developments in the interest burden of housing loans

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Box 3: Deposit trends during rising interest rates: Japan-U.S. comparisons using principal component analysis

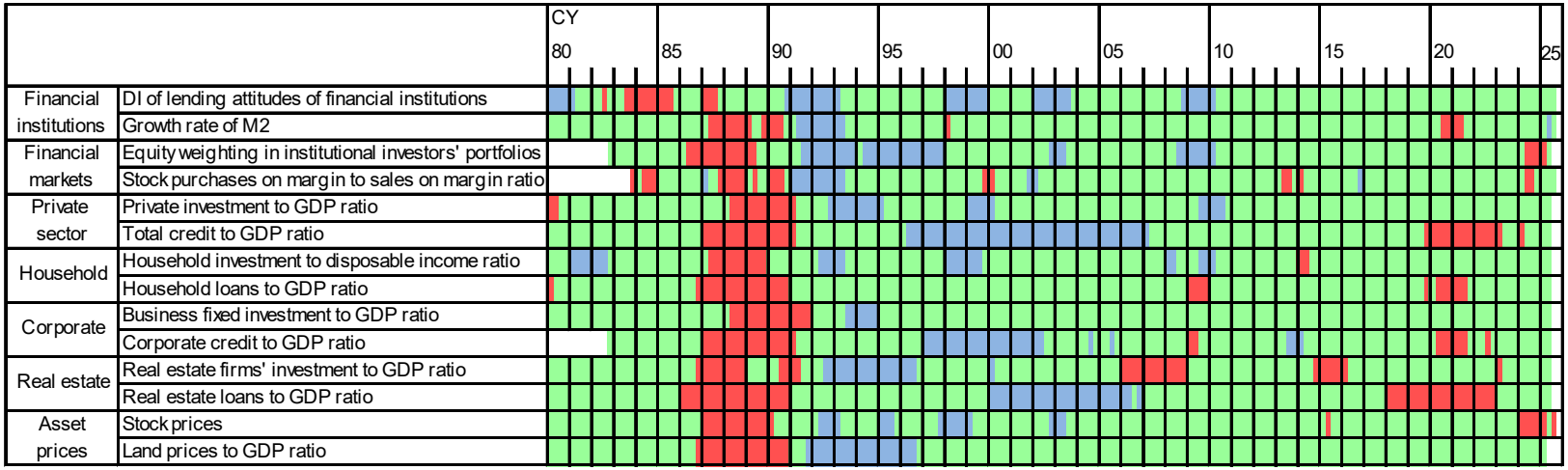
1. Financial cycle and developments in asset prices

- Financial cycle
- Stock market
- Real estate market

Financial cycle

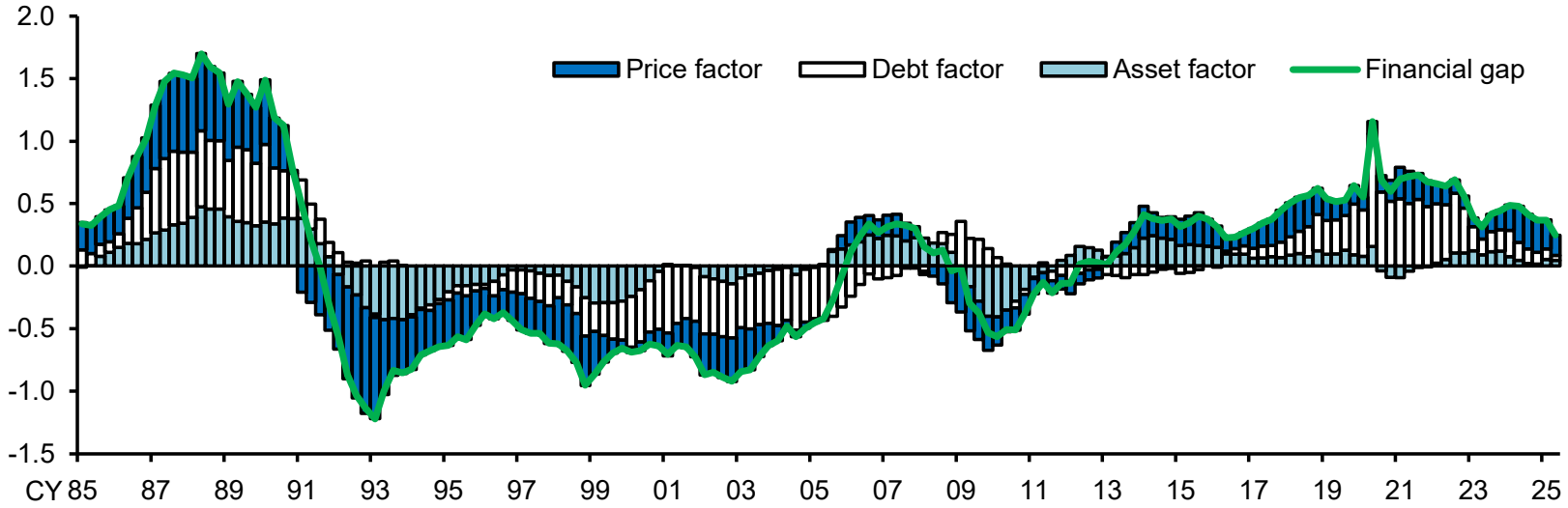
- No major financial imbalances have been seen in current financial activities based on the heat map and the financial gap.
  - The latest heat map shows that, although stock prices is "red," 13 out of the 14 FAIXs are "green," which signals neither an overheating nor a contraction.
  - The financial gap has narrowed compared to a while ago.

Heat map



Note: See Chart V-1-1.

Financial gap

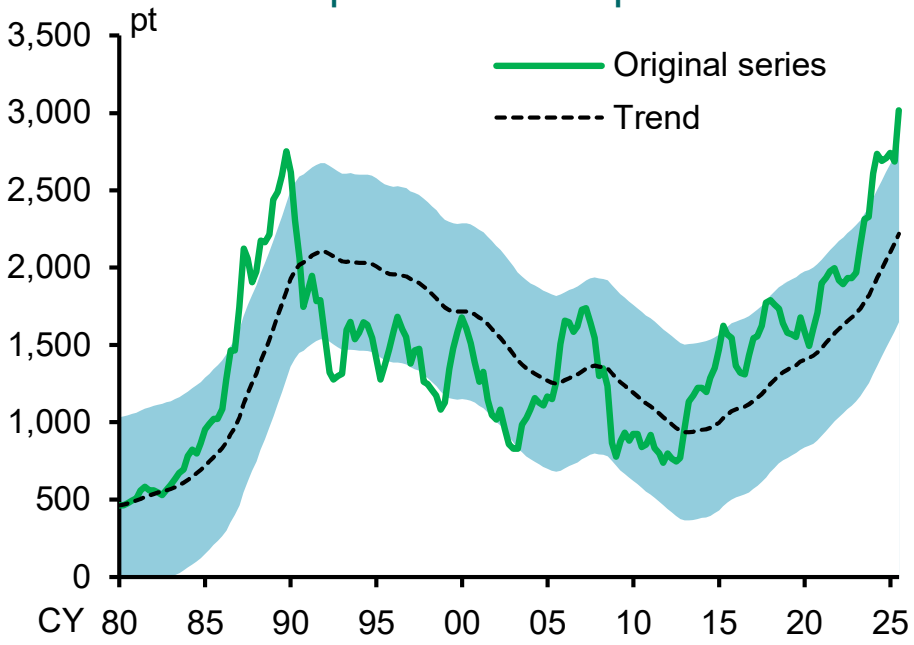


Note: See Chart V-1-2.

Asset prices: Japan's stock market

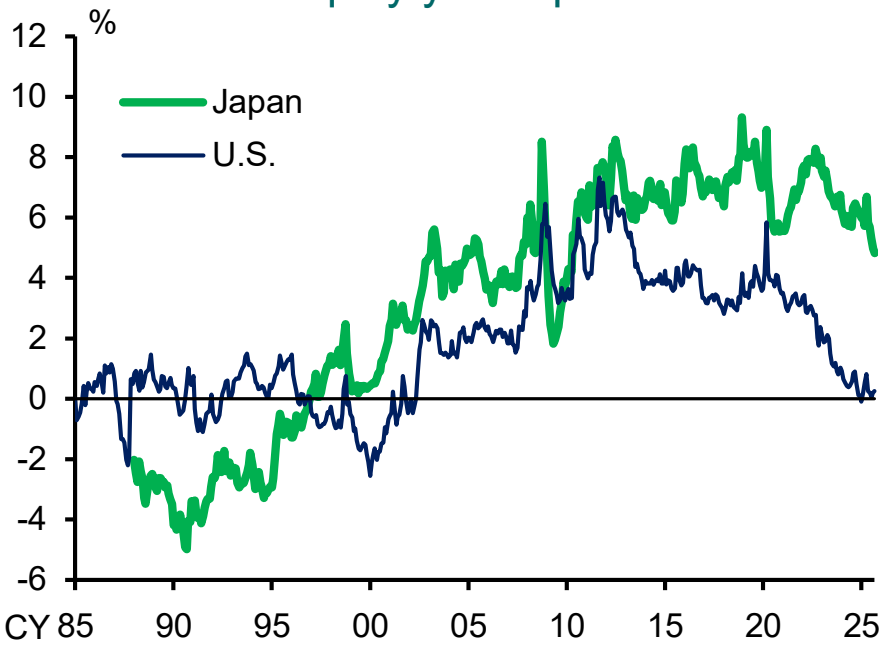
- In global financial markets, stock prices fell substantially at the beginning of April as market sentiment became significantly cautious, reflecting the heightened uncertainties regarding trade policy in each jurisdiction. Since then, prices of risky assets have risen, with progress in trade negotiations and improvements in market sentiment.
- The heat map shows that *stock prices* has been "red," which signals an upward deviation from the trend.
- Price-earnings (P/E) ratios remain generally at historical average levels. Equity risk premiums in terms of yield spreads have declined somewhat.

Japanese stock prices



Note: Latest data as of 2025/Q3 (July-September average). "Trend" is calculated using the one-sided HP filter. See Chart V-1-3.

Equity yield spreads



Note: Latest data as of end-September 2025. Calculated by subtracting 10-year government bond yields from expected returns based on expected EPS for the next 12 months. See Chart V-1-3.

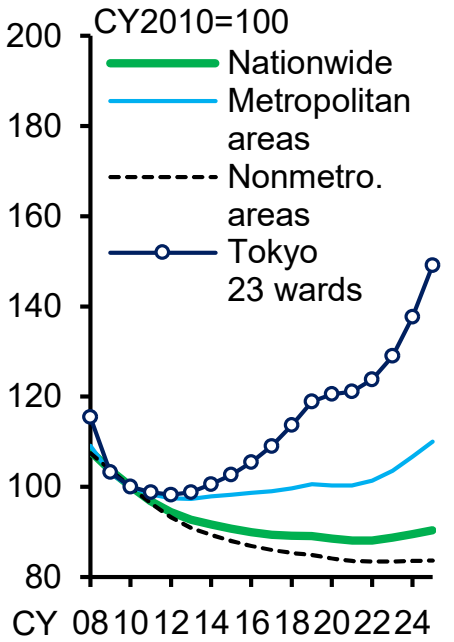
Asset prices: Japan's real estate market (1)

- Real estate prices have continued to rise, particularly in major metropolitan areas.
  - Condominium prices for residential real estate transactions and office building prices for commercial real estate transactions have continued their rising trend.

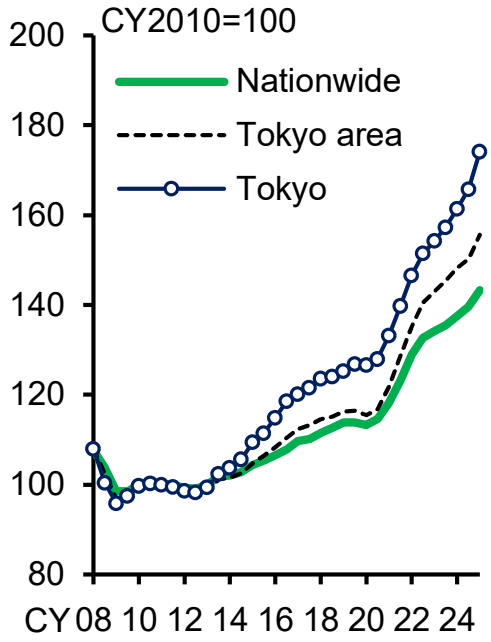
Real estate prices

Residential real estate

(Land prices)

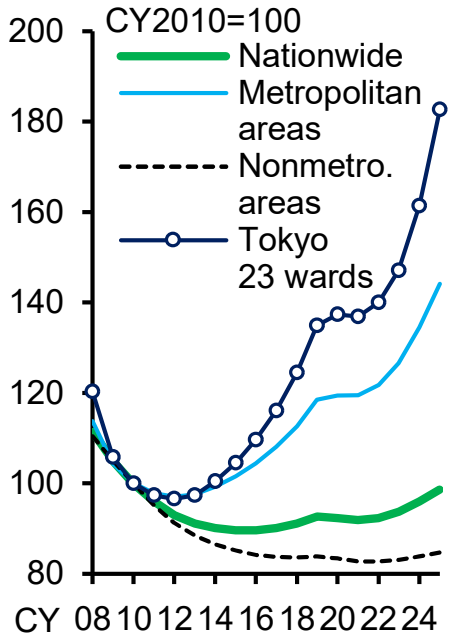


(Real estate transaction prices)

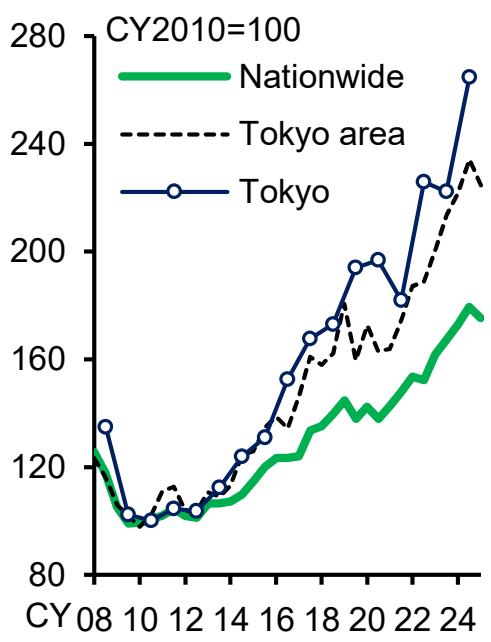


Commercial real estate

(Land prices)



(Real estate transaction prices)



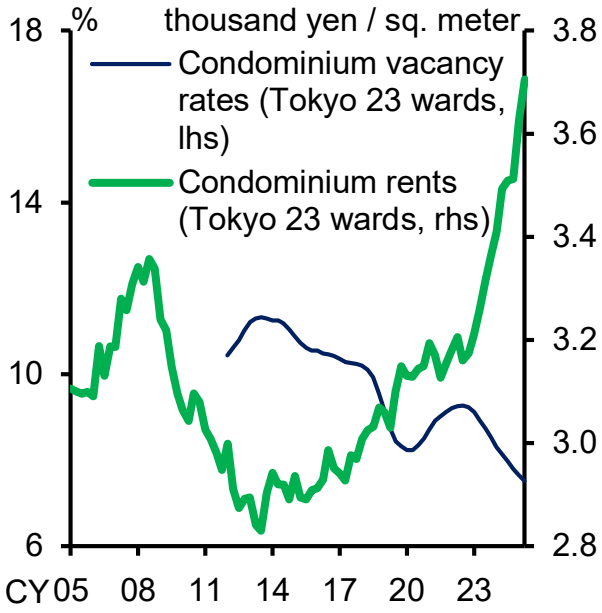
Note: Data for land prices are based on "Publication of market values of standard sites by prefectural government." Transaction prices are based on "Japan Property Price Index." The residential property index is used for residential real estate, and the office index is used for commercial real estate. See Chart V-1-7.

Asset prices: Japan's real estate market (2)

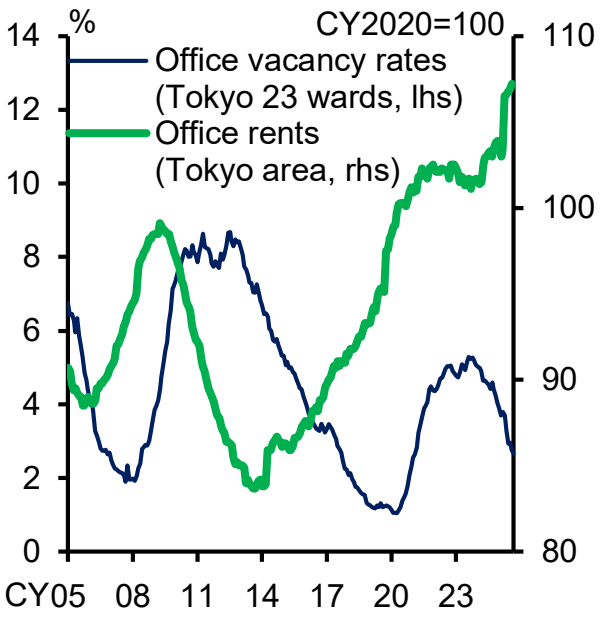
- On the demand side, a decline in vacancy rates and a rise in rents have been seen amid the moderate economic recovery.
- On the supply side, construction costs for condominiums have risen and construction schedules have been delayed, reflecting the rise in material costs and labor shortages.

Vacancy rates and rents

Condominiums

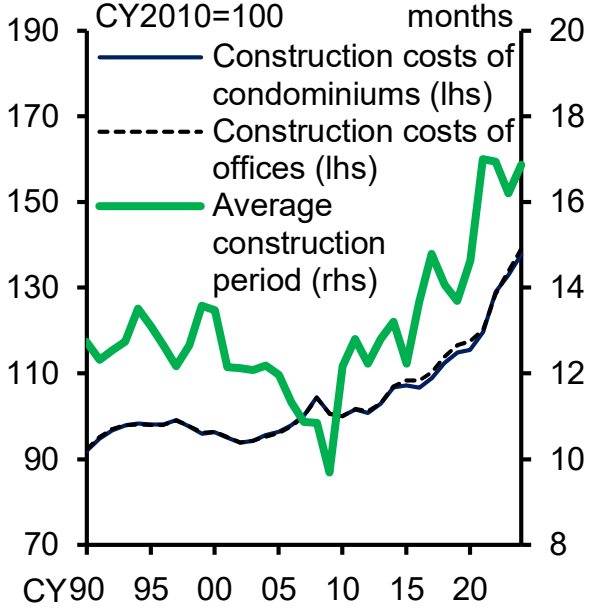


Office



Note: See Chart V-1-8 and V-1-12.

Construction costs and average construction period

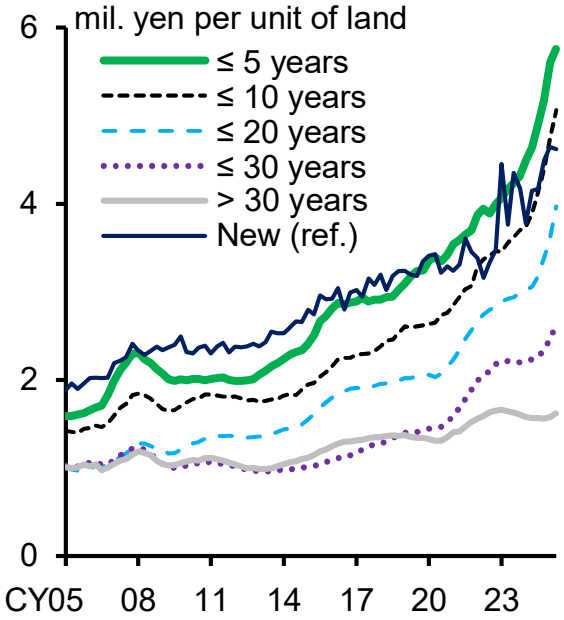


Note: See Chart V-1-8.

Asset prices: Japan's real estate market (3)

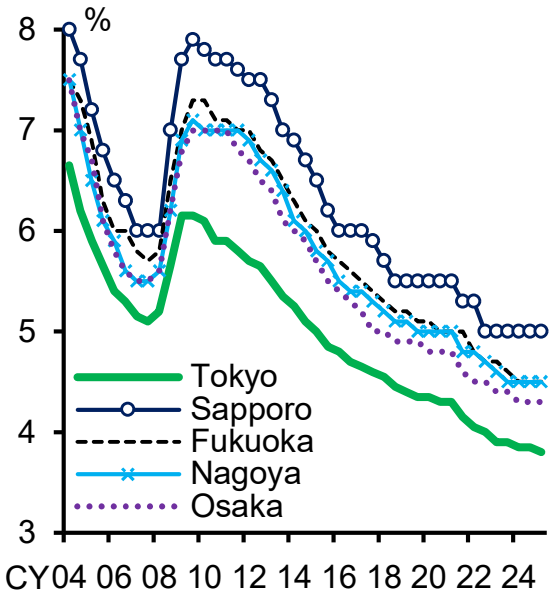
- The prices of both newly constructed condominiums and existing condominiums in the Tokyo metropolitan area have risen substantially. The downtrend of the expected return on condominium investment has been continuing.
  - Supply factors have been a major factor driving the condominium price increase.

Condominium prices by age



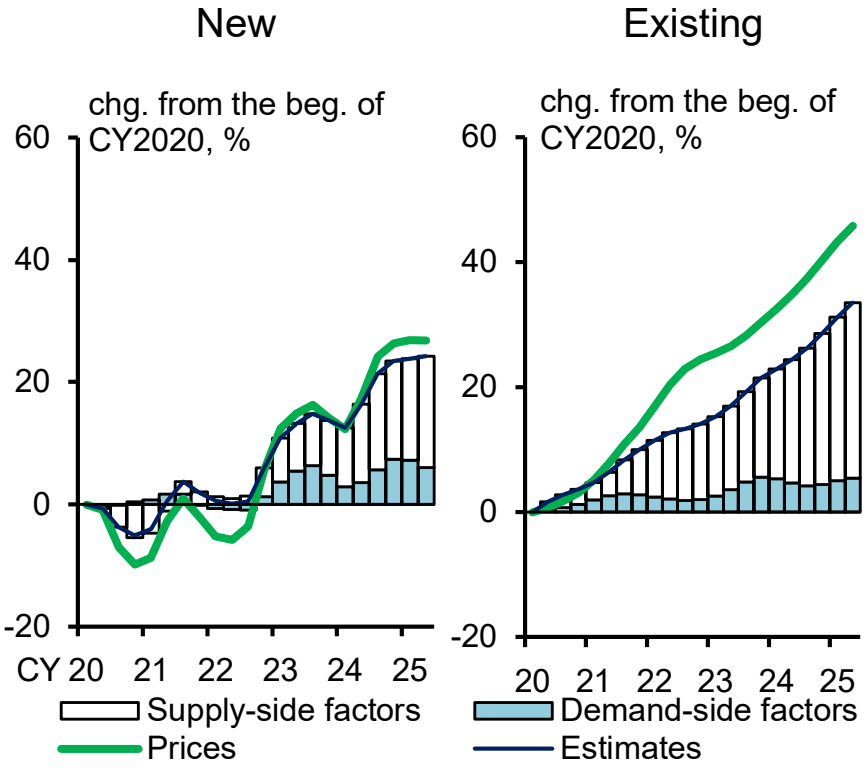
Note: Prices in the Tokyo metropolitan area. See Chart V-1-10.

Expected returns on condominium investment



Note: See Chart V-1-10.

Factors affecting condominium prices

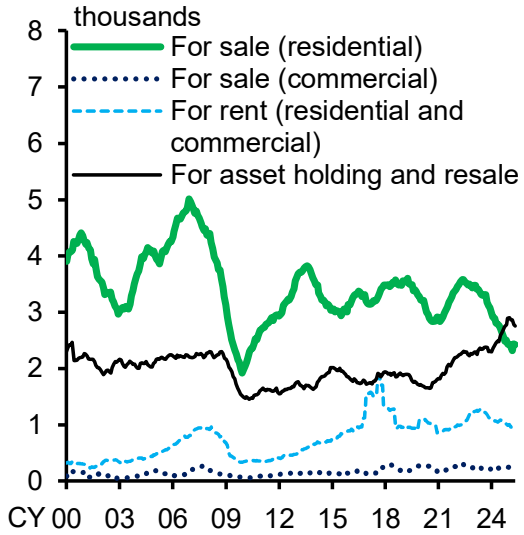


Note: Shows the decomposition based on the estimates of a structural VAR with 4 variables; newly constructed and existing condominium prices, sales of new condominiums, and construction costs. See Chart V-1-11.

Asset prices: Japan's real estate market (4)

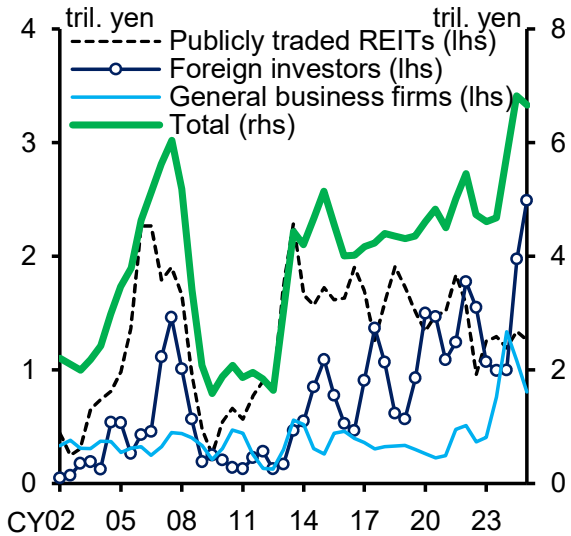
- The rise in office prices in the Tokyo metropolitan area is primarily driven by the continuing rise in construction costs and delays in construction (supply-side factors), while the rise in rent pulled by demand has been observed as well.
- Real estate prices also reflect expectations about the pace of future rent increases and investment demand in anticipation of price rises. Recently, large-scale land transactions for asset-holding and resale purposes are on the rise, acquisitions by investors in projects with low yields are increasing with higher demand by foreign investor, and real estate risk premiums (property yields minus 10-year government bond yields) have declined.

Number of large land transactions by use



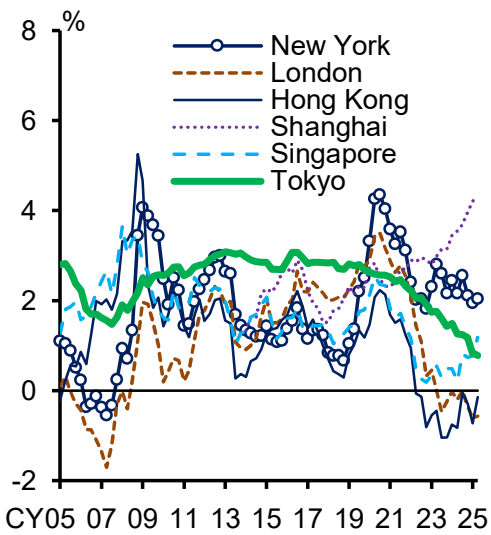
Note: See Chart V-1-9.

Commercial real estate acquisitions



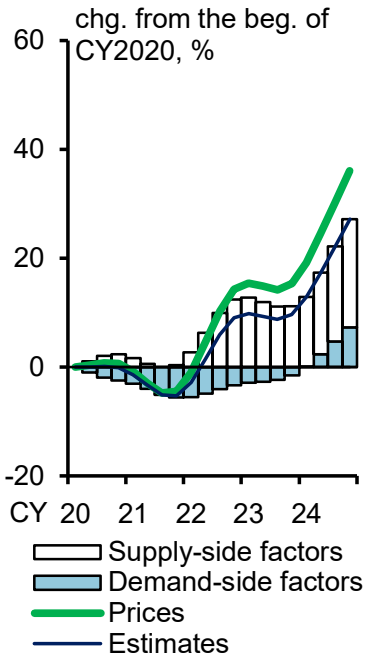
Note: See Chart V-1-12.

Real estate yield gap



Note: Yield gaps are calculated as cap rates of Grade-A office buildings in each city minus 10-year government bond yields. See Chart V-1-13.

(Ref.) Factors affecting office prices

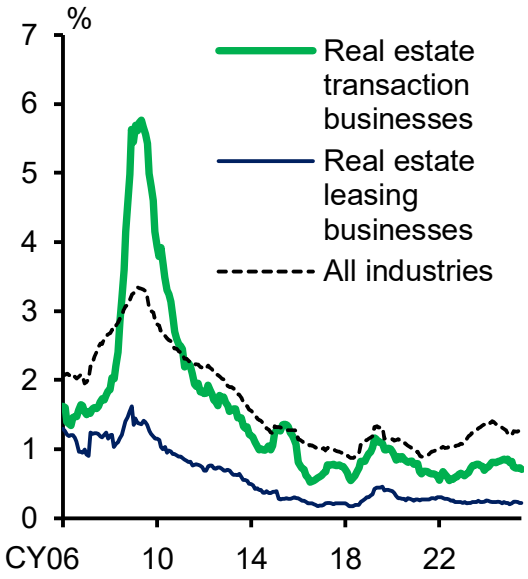


Note: See Chart V-1-12 in the April 2025 issue of the *Report* for details.

Real estate-related lending

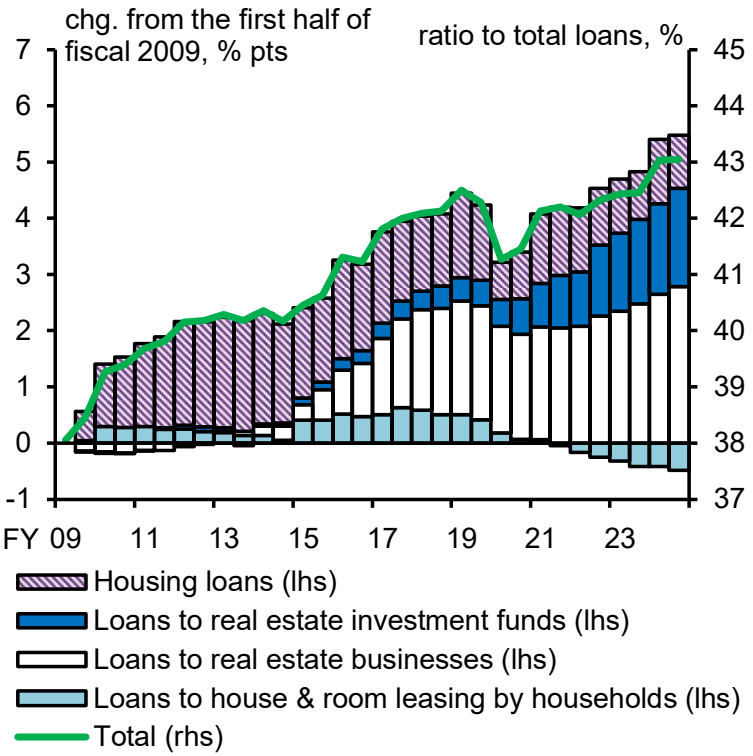
- Banks' real estate-related lending has been on an uptrend, and the composition of their lending has gradually shifted to that consisting of loans to real estate funds and real estate businesses other than house and room leasing by households. Some lenders have seen an increase in large exposures amid the rise in real estate transaction prices.
- Although default rates of real estate-related businesses have remained low, banks need to manage risks, while bearing in mind the changes in risk profile of real estate-related lending.

Default rates of real estate businesses

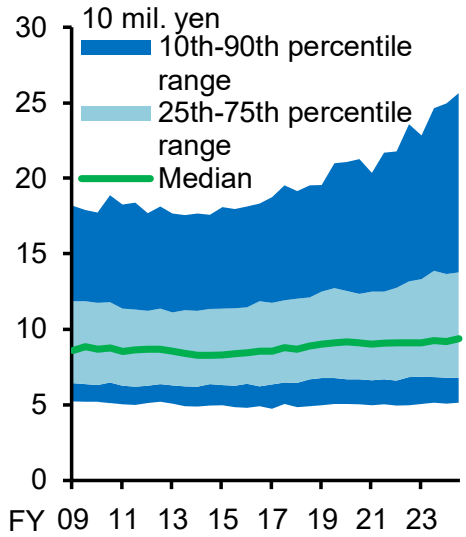


Real estate-related loans

Share of real estate-related loans in total loans



Loan amount per loan (Loans to real estate businesses)



Note: See Chart V-1-17.

Note: "Loans to house and room leasing by households" are loans for construction or purchase of rental housing for individuals, such as apartment loans etc. "Loans to real estate businesses" in the left-hand chart excludes "Special purpose companies for real estate," which is included in "Loans to real estate investment funds." See Chart V-1-18.

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Box 1: Developments in the interest burden of housing loans

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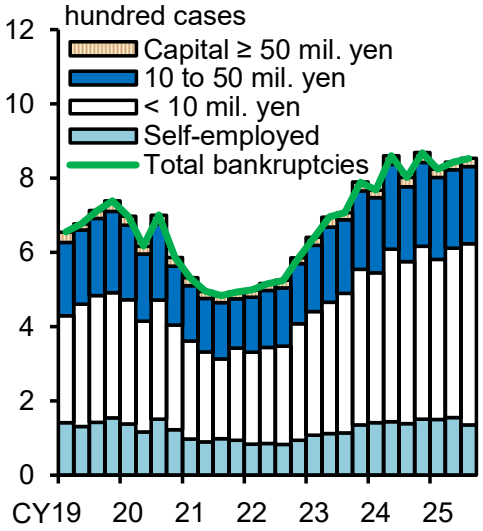
2. Firms' financial resilience

- Corporate bankruptcies and defaults
- Effects of changes in trade policy
- Foreign credit risks

Corporate bankruptcies and defaults

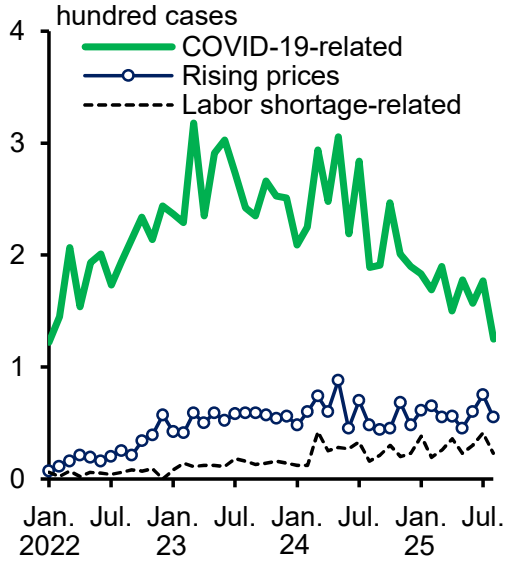
- Corporate bankruptcies and defaults have been more or less unchanged, albeit with fluctuations.
- Although the ratio of operating profits to sales of SMEs has been on an improving trend, there are a considerable number of firms whose profit recovery has been more moderate than the overall trend.
  - Rises in raw material prices, labor shortages, and rising labor costs may be adding further downward pressure particularly among such firms.

Bankruptcies by firm size



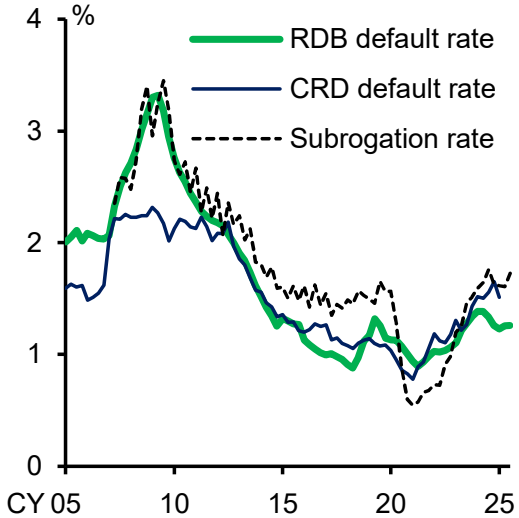
Note: See Chart IV-1-4.

Bankruptcies by cause



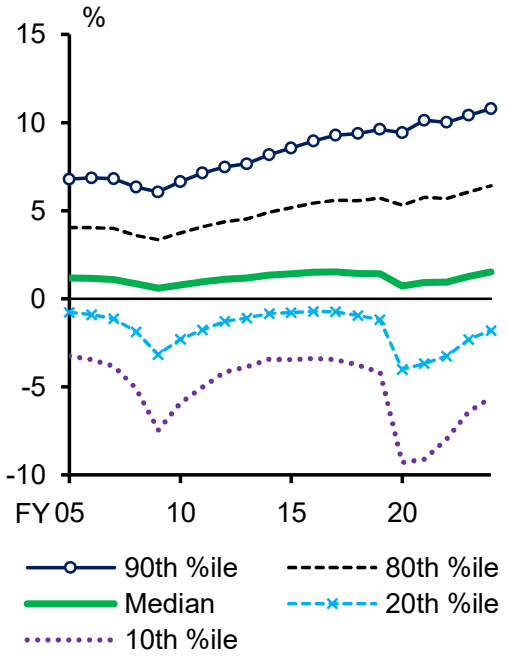
Note: See Chart IV-1-4.

Default rates and subrogation rates



Note: See Chart IV-1-4.

SMEs' ratio of operating profits to sales

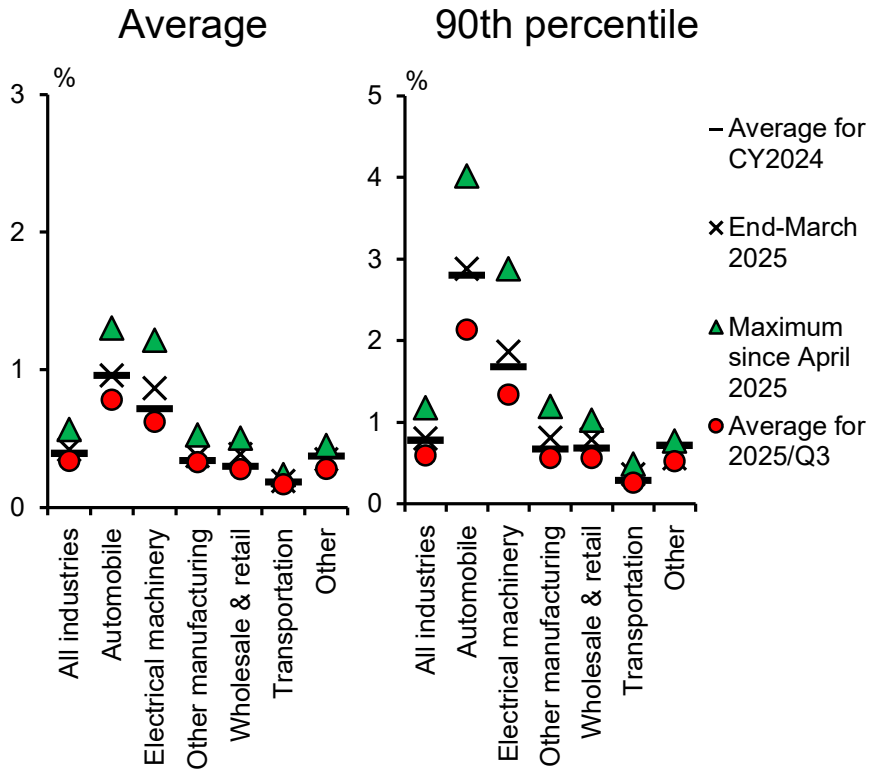


Note: See Chart IV-1-5.

Impact of changes in trade policy: large firms' profit projections

- Although large Japanese firms' expected default frequencies (EDFs), according to Moody's, rose temporarily following the announcement of reciprocal tariffs at the beginning of April, they have largely returned to levels comparable to the 2024 average.
- Based on the profit projections by large firms, while firms in the non-manufacturing sector are expecting increases in profits, those in the manufacturing sector are forecasting a decline.

Expected default frequency (EDF) of large firms



Profit forecasts and loan share by industry

	Operating profits (y/y % chg.)		Share among corporate loans as of end-June 2025 (%)	
	FY2025 forecasts	(ref.) FY2008	Major banks	Regional banks
All industries	-3.3	-45.9	—	—
Manufacturing	-6.3	-63.5	26.1	18.3
Basic materials manufacturing	7.2	-44.3	10.5	6.2
Iron, steel & non-ferrous metals	-10.1	-48.4	3.6	1.5
Processing manufacturing	-10.7	-71.6	15.5	12.2
Transportation equipment	-27.4	-102.3	3.4	2.0
General machinery	-3.2	-46.8	3.7	2.5
Electrical machinery	-0.6	-90.1	4.0	1.6
Non-manufacturing	0.8	-16.0	73.9	81.7
Construction	-1.1	-20.3	2.4	6.8
Real estate	8.6	-36.5	27.1	23.1
Wholesale & retail	6.8	-3.1	13.5	15.7
Transportation	-9.5	-24.8	5.4	7.7
Food, accommodation & consumer services	7.7	-11.2	4.2	10.8
Other non-manufacturing	-0.8	-16.3	21.3	17.5

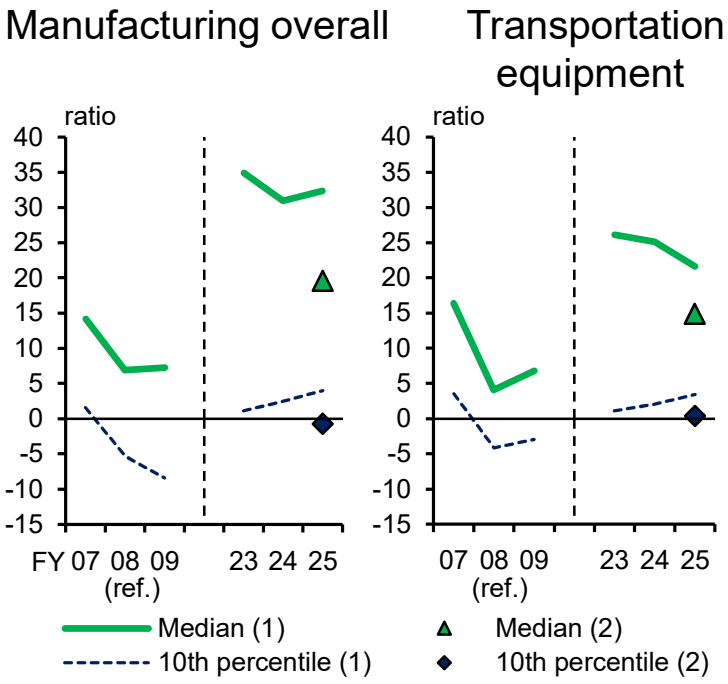
Note: Shows 1-year EDF by Moody's. See Chart IV-1-3.

Note: Figures for "FY2025 forecasts" are forecasts by individual listed firms. See Chart IV-1-6.

Impact of changes in trade policy: large firms' credit risks

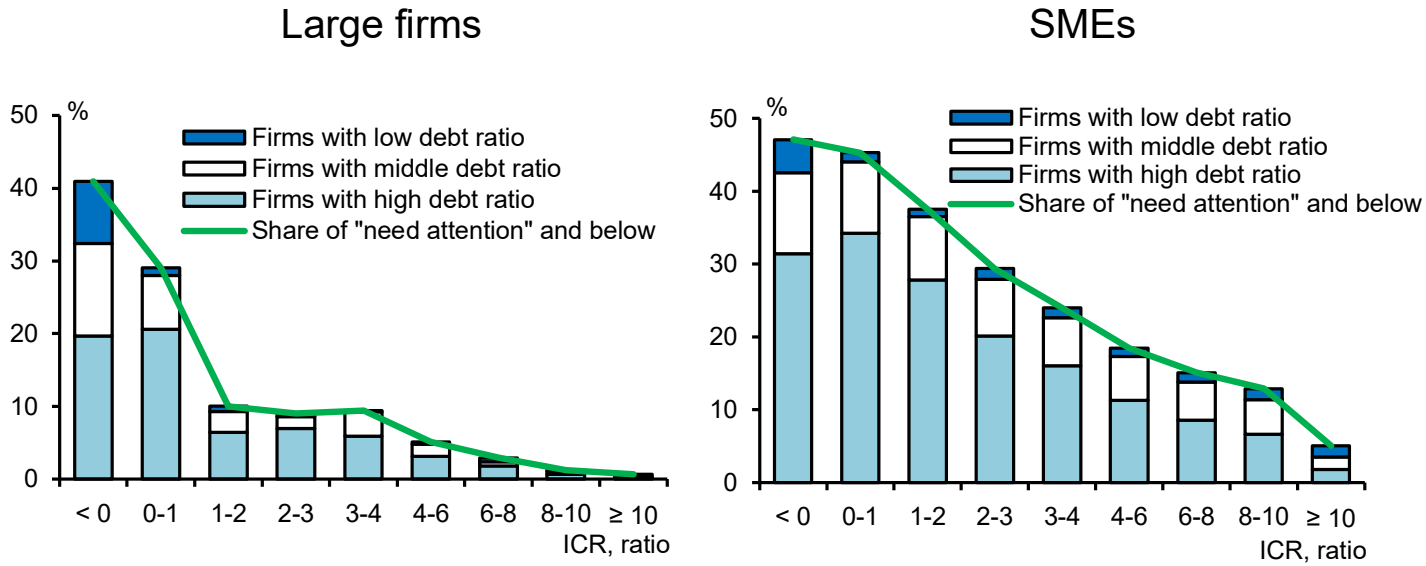
- Based on large firms' projections for fiscal 2025, their interest coverage ratios (ICRs) would remain high even for firms which expect to see a decline in profits (case 1 in the left-hand chart).
- Although large firms' financial positions have been generally sound and the credit risk is likely to be minor based on the firms' own projections, attention is warranted to the fact that for large loans the impact of downgrading of individual borrowing firms on credit costs can be large.

Simulation of large firms' ICR



Note: Figures for fiscal 2025 are estimates. Case (1) shows the estimates when profit forecasts are realized, and case (2) shows the estimates when profits decrease by 2 standard deviations relative to case (1). See Chart IV-1-7.

Relationship between ICR and borrower classification

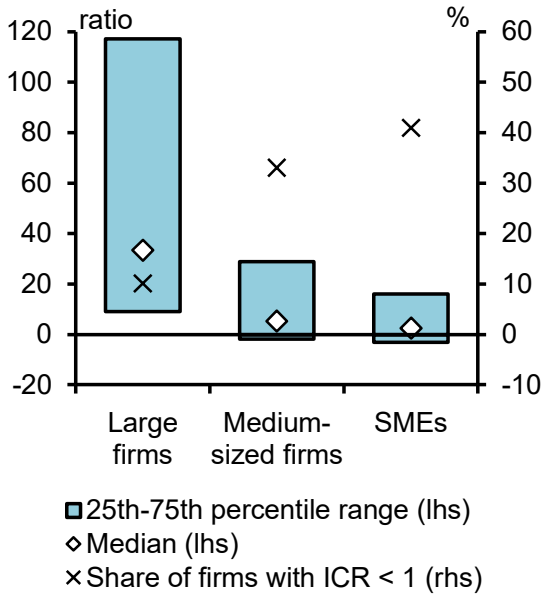


Note: See Chart IV-1-8.

Impact of changes in trade policy: effects from large firms to SMEs

- The effects of the tariff hike on SMEs as a whole are likely to be limited (cases 1 and 2 in the charts below), although they could vary depending on certain assumptions.
  - If profits of large firms in the manufacturing sector come in far below their projections due, for example, to the drop in trade volume, the default rates of small and medium-sized supplier firms will rise somewhat accordingly (case 3 in the charts below).

Borrowers' ICR



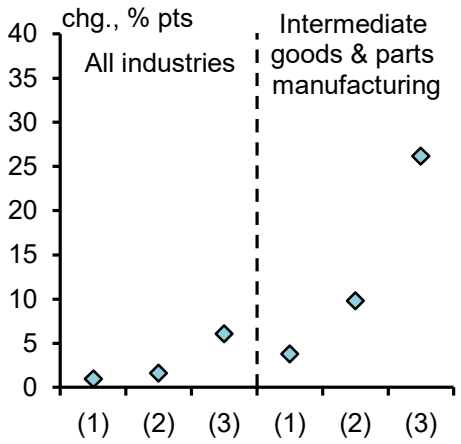
Impact of trade policies on SME's financial positions

Assumptions for the simulation of the impact on SMEs

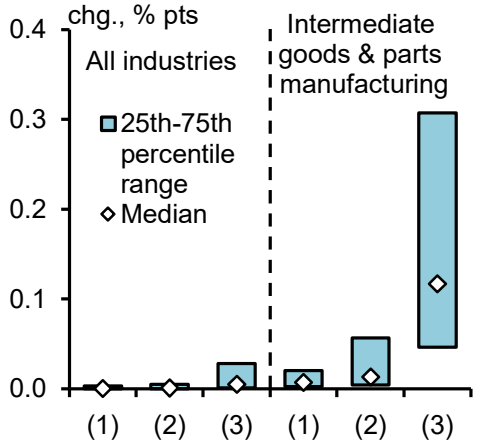
	Transportation equipment			Iron, steel & non-ferrous metals, Transportation
	Export price	Input price	Volume	Volume
(1)	➡	➡	⬇	⬇
(2)	⬇	⬇	➡	

(3) In addition to the case (2), operating profits for large manufacturing firms decrease by 30% pts.
Volume ⬇

Estimates of share of firms with ICR falling below 1



Estimates of probability of default



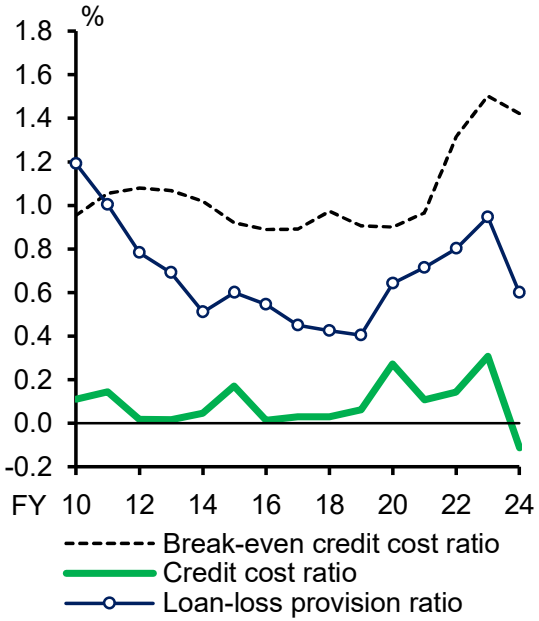
Note: See Chart IV-1-9.

Note: The middle and right-hand charts show the estimates for each case, (1), (2) and (3), in the left-hand chart. The estimates in both charts show the change from baseline values calculated using data for fiscal 2024. See Chart IV-1-11.

Foreign credit risks

- Japanese banks' foreign credit risk has remained low.
- The break-even credit cost ratio of banks' international business remains relatively high, indicating that even if considerable credit costs were to be incurred, they could be absorbed by net interest income.
- While ICRs of major banks' large foreign borrowers have declined due to past increases in interest rates, they overall remain financially sound. Given that uncertainties regarding trade and other policies remain high, careful credit management continues to be warranted.

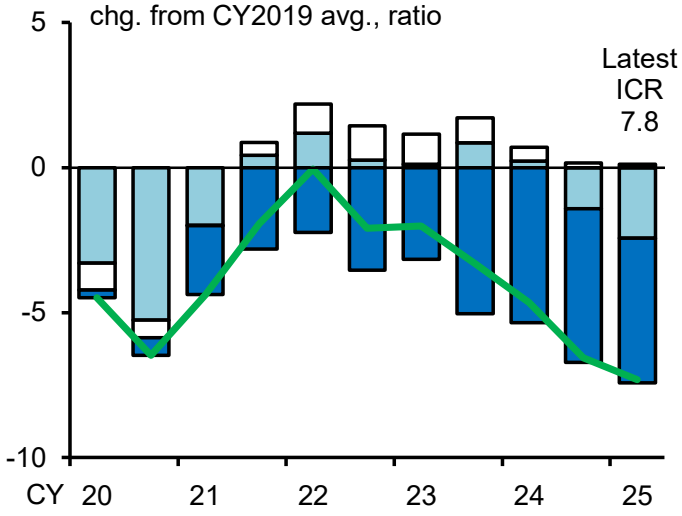
Credit costs of foreign loans



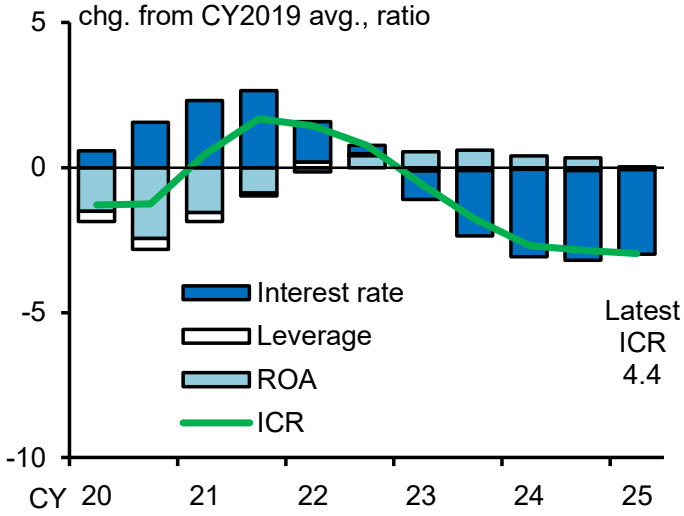
Note: See Chart IV-1-13.

ICR of foreign large borrowers

Manufacturing



Non-manufacturing



Note: See Chart IV-1-18.

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Chapter III. Financial intermediation

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- B. Financial intermediation by the NBFI sector

Chapter IV. Risks faced by financial institutions

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- **B. Market risk associated with securities investment**
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Chapter V. The financial cycle and challenges following changes in the business environment

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Box 2: Hedge funds' growing presence in global bond markets

Box 3: Deposit trends during rising interest rates: Japan-U.S. comparisons using principal component analysis

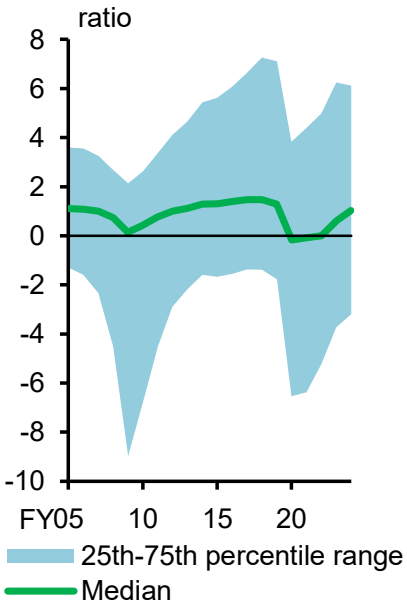
3. Banks', firms', and households' resilience to rising interest rates

- Firms' borrowings
- Housing loans
- Banks' interest rate risk and developments in deposits

Firms' resilience to rising interest rates

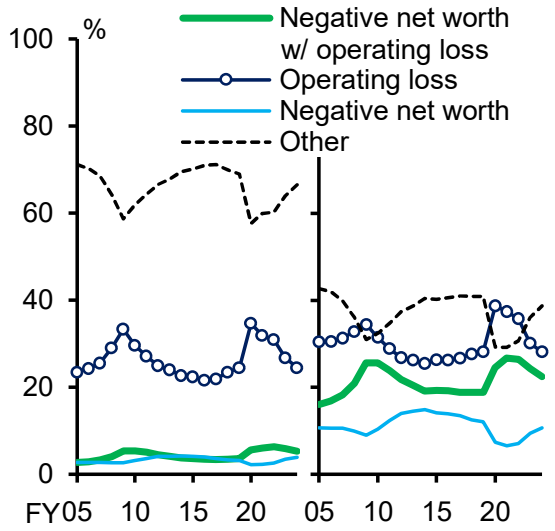
- ICRs of SMEs have improved as a whole.
- Based on the simulation analysis that assumes interest rates to be raised mechanically, default probabilities of firms with high leverage or insufficient on-hand liquidity tend to be more sensitive to higher interest rates. However, default probabilities of SMEs as a whole would be little affected by higher interest rates.

ICR of firms with net borrowings



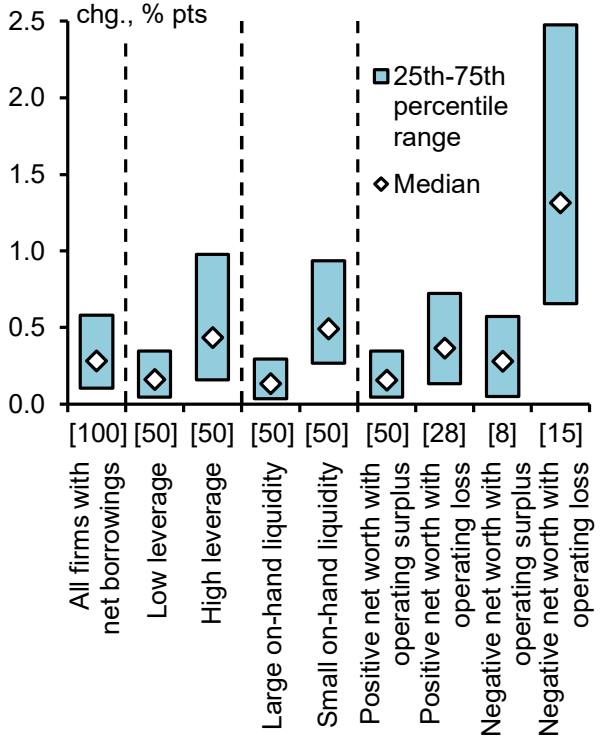
Note: Firms with net borrowings are those with a positive amount of interest-bearing debt less holdings of cash and deposits. See Chart IV-1-12.

Composition by financial characteristic of firm profitability



Note: See Chart IV-1-5.

Sensitivity of probability of default to interest rates

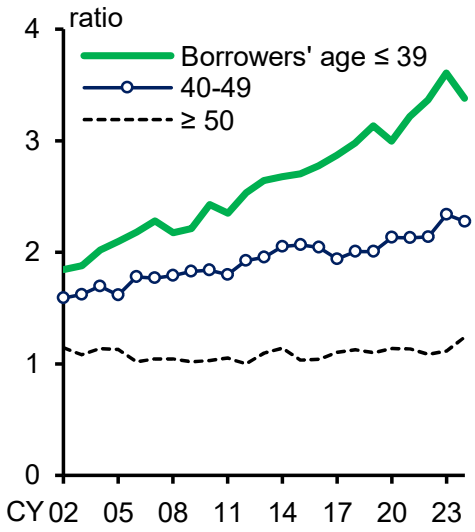


Note: A probability of default (PD) model is estimated for each firm category, and sensitivity (change in the PD) to a 1.0 percentage point increase in long- and short-term interest rates is estimated for each firm. "High" and "Low" leverage is based on the median debt ratio. "Large" and "Small" on-hand liquidity is based on the median ratio of on-hand liquidity to total assets. Figures in brackets indicate the shares of respective firm categories. See Chart IV-1-12.

Households' resilience to rising interest rates

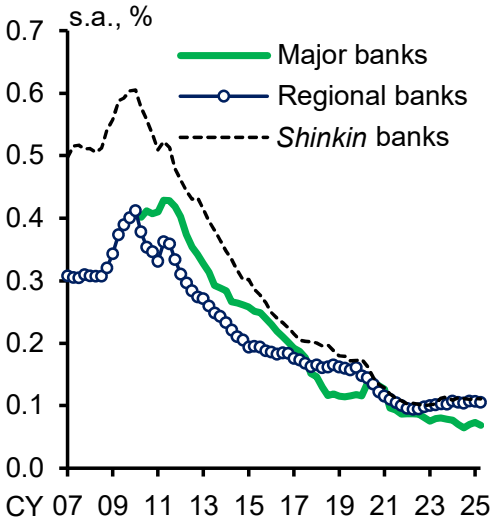
- The loan amount per housing loan has been on an increasing trend, and applied interest rates on floating-rate housing loans have been rising somewhat. Even in this condition, delinquency rates on housing loans have remained essentially unchanged at low levels.
  - Increases in the monthly payment for housing loans among regional banks have been limited so far partly because floating-rate housing loans are subject to the "5-year rule." The number of housing loans with increased monthly payment will likely increase with the gradual renewals of the repayment amount.

LTI of housing loans



Note: LTI is the ratio of borrowers' loans outstanding to their annual income. See Chart B1-1.

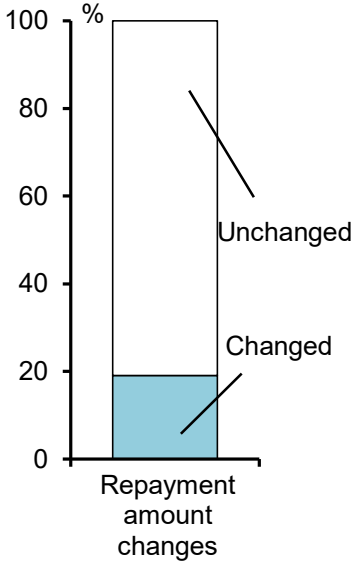
Delinquency rates of housing loans



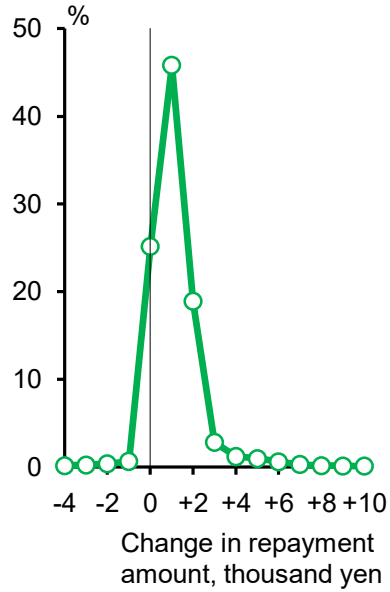
Note: See Chart B1-2.

Repayment amount for floating-rate housing loans

Proportion of repayment amount changes



Distribution of change in repayment amount

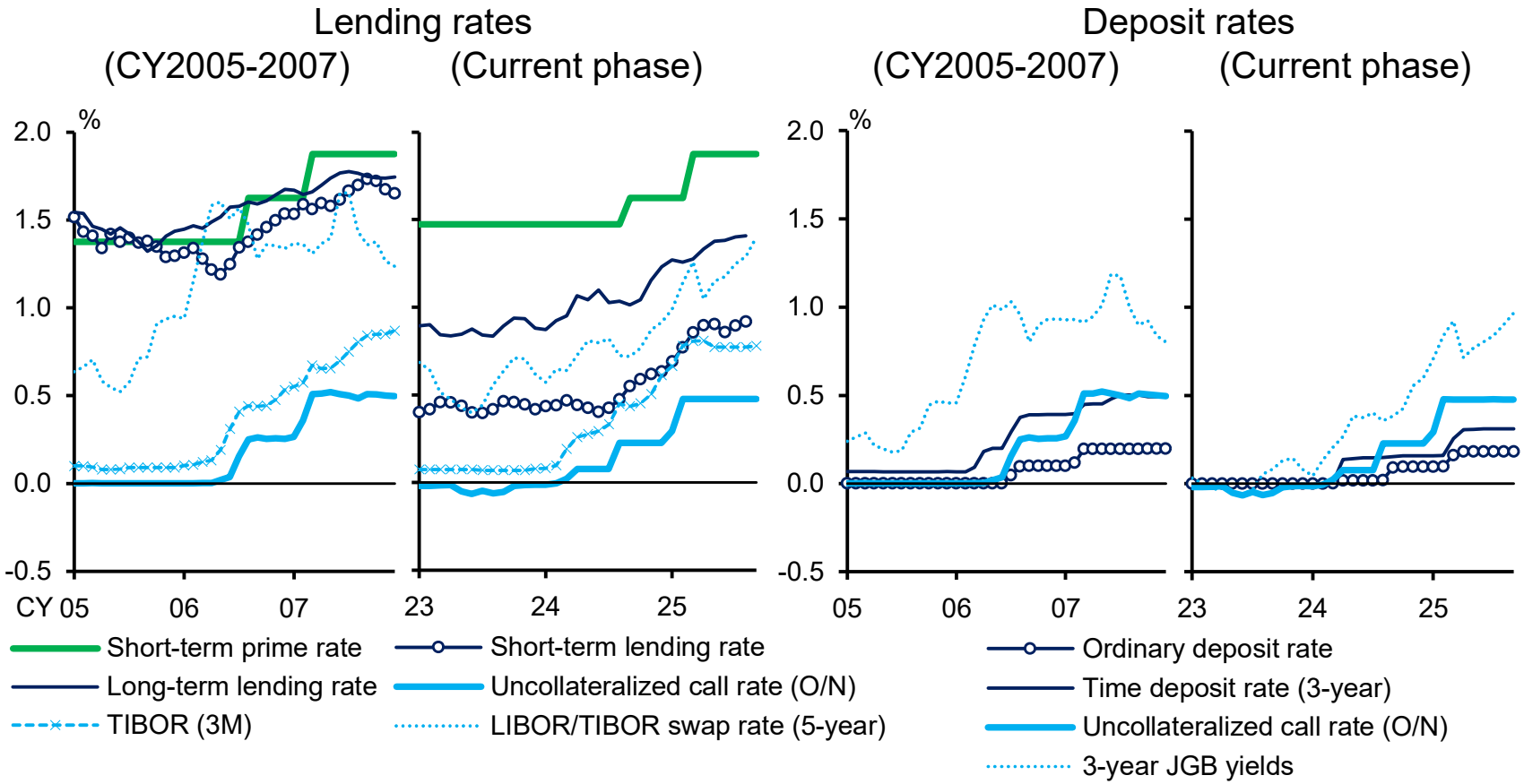


Note: The data cover floating-rate housing loans that remained on the books of the sample banks from March 2024 to March 2025, for which applied interest rates have changed. The right-hand charts show the percentage of loans for which the repayment amount has changed and the amount by which repayment has changed. See Chart B1-5.

Lending and deposit rates

- Lending rates have risen moderately since the last *Report* in April 2025.
- Many banks have recently raised their interest rates on ordinary deposits to around 0.2 percent. Interest rates on time deposits have also seen a moderate increase.
- Increases in lending rates in response to an increase in market interest rates have tended to exceed increases in deposit rates. Therefore, over a somewhat longer term, rising interest rates are likely to increase banks' profits.

Lending and deposit rates (compared to the previous phase of policy rate hikes)



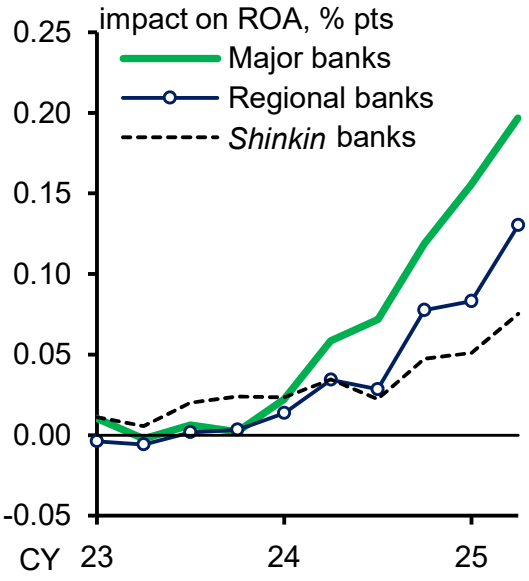
Note: 1. Lending rates indicate average contract interest rates on new loans and discounts (3-month backward moving averages). Deposit rates indicate the typical rates posted at banks.
2. The latest data for market rates, short-term prime rates, and deposit rates are as of September 2025. Those for lending rates are as of August 2025. See Chart VI-1-6.

Banks' resilience to rising interest rates (1)

- Banks' profits have improved as interest rates on assets held by banks (loans and securities) are being renewed and interest margins of loans and securities are improving.
  - Downward pressure on banks' profitability from structural factors such as a decline in domestic loan demand has continued in recent years, and this warrants attention.

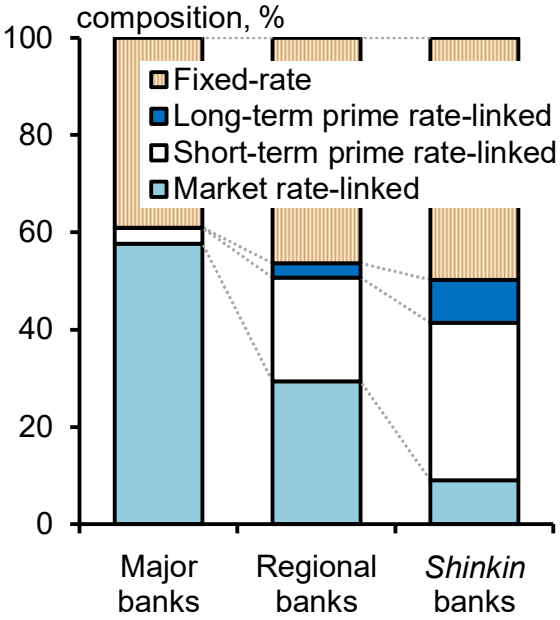
Impact of rising domestic interest rates on banks' profits

Estimated impact on profits



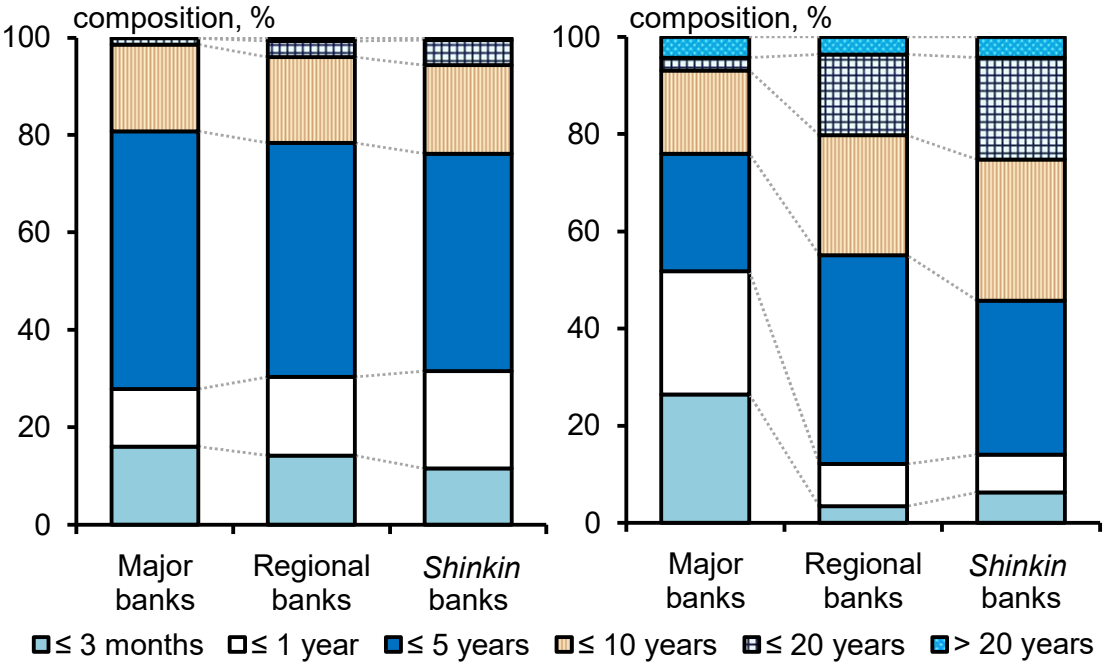
Note: Shows an estimate of the impact of changes in yields from 2022/Q4 on ROA based on PPNR excluding trading income, using data on balances and yields of yen interest rate assets and liabilities (by instrument) at the end of each quarter. See Chart VI-1-8.

Corporate loans outstanding by interest rate type



Note: See Chart III-1-12.

Asset outstanding by interest rate renewal period (Fixed-rate corporate loans) (Securities)

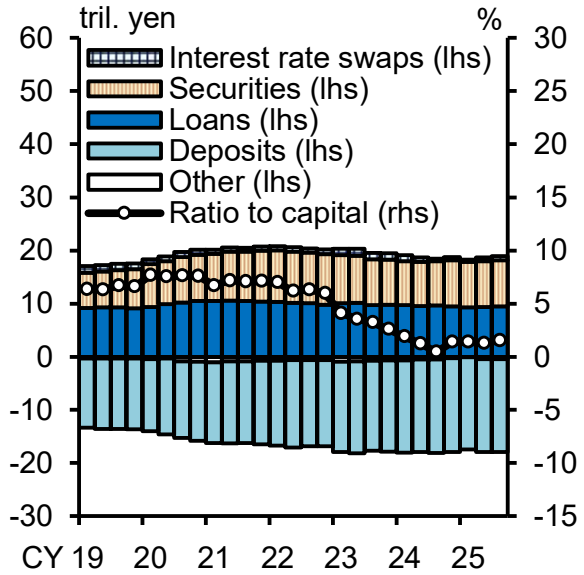


Note: See Chart VI-1-8.

Banks' resilience to rising interest rates (2)

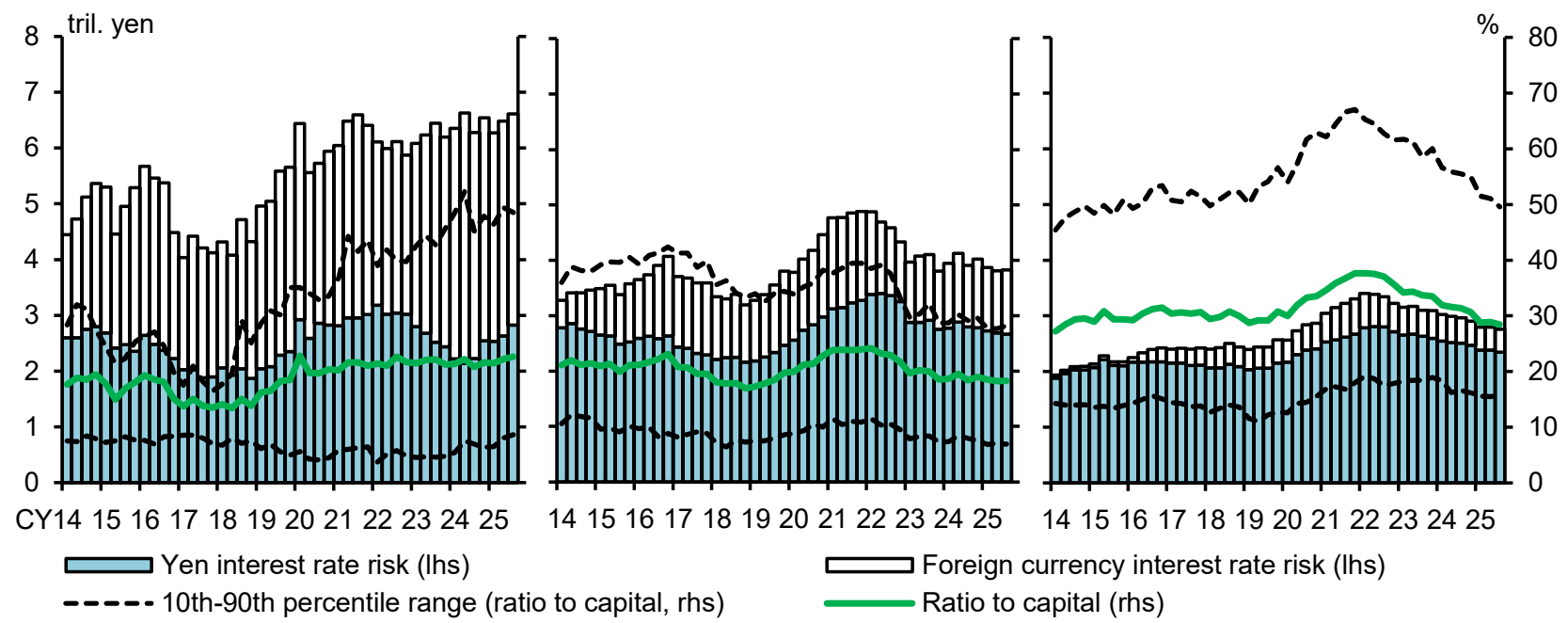
- The amount of yen interest rate risk in the banking book on the asset side and the liability side is more or less in balance and has remained low.
- Banks' interest rate risk on yen-denominated bonds as a whole has been suppressed compared to before, and the risk-to-capital ratio has generally been unchanged for major banks, while it has been on a somewhat declining trend for regional and *shinkin* banks when the risk on foreign-currency-denominated bonds is included.
  - There are banks with large interest rate risks associated with securities investment. Such banks need to continue to manage interest rate risks carefully.

Interest rate risk in the banking book



Note: Shows yen interest rate risk in terms of the 100 BPV. See Chart IV-2-3.

Interest rate risk of securities holdings



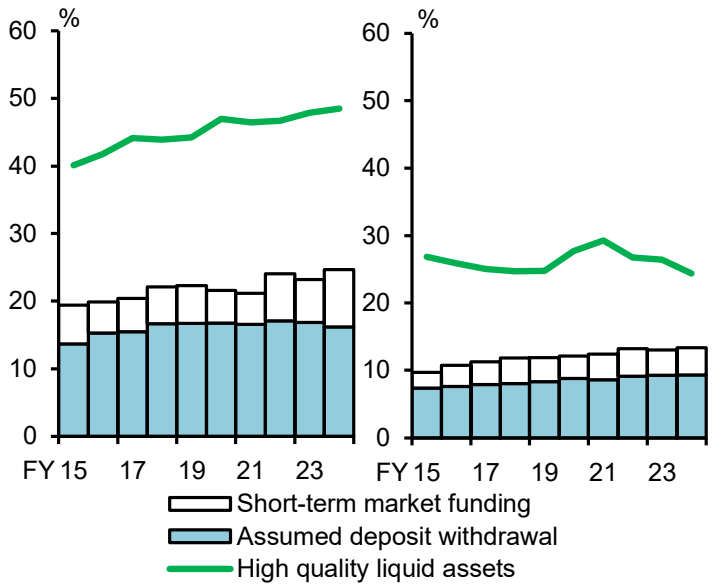
Note: Shows interest rate risk in terms of the 100 BPV for yen and 200 BPV for foreign currency. See Chart IV-2-1.

Developments in deposits (1)

- Banks have stable funding bases, mainly backed by small, sticky retail deposits, and have ample liquidity. Deposits have continued to grow, although the pace of increase has decelerated recently.
  - The factors behind the slowdown in the increase in corporate deposits include the withdrawal of fiscal support measures taken during the pandemic and the increase in corporate tax payments. The growth rate in retail deposits has also slowed down, reflecting increases in investments in stocks and stock investment trusts.

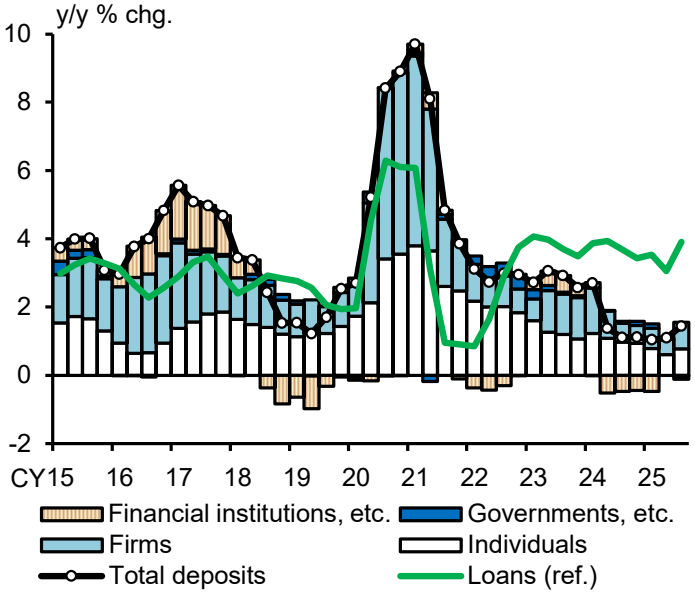
HQLA coverage

Major banks | Regional and *shinkin* banks



Note: Shows ratios to total assets. See Chart IV-3-2.

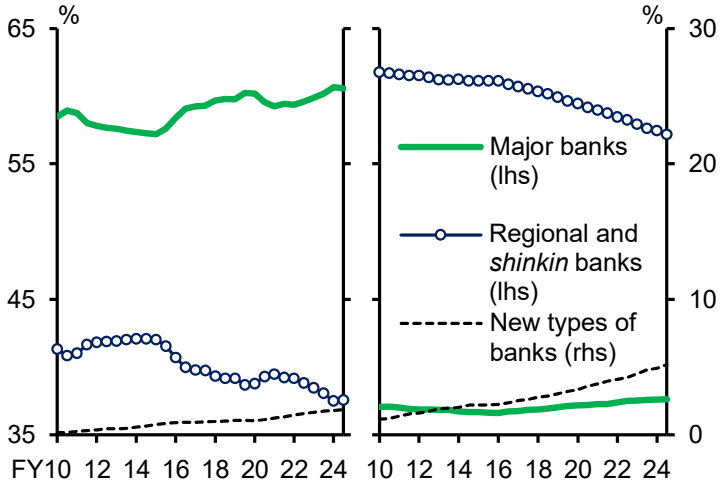
Deposit growth by type of depositor



Note: Covers domestically licensed banks and *shinkin* banks. See Chart IV-3-3.

Share of deposits by type of bank

Corporate deposits | Retail deposits

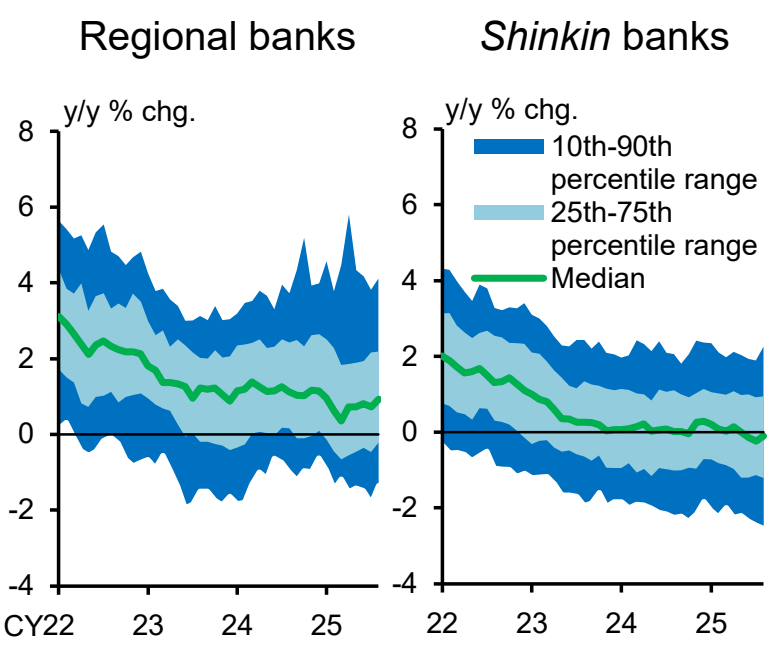


Note: See Chart IV-3-5.

Developments in deposits (2)

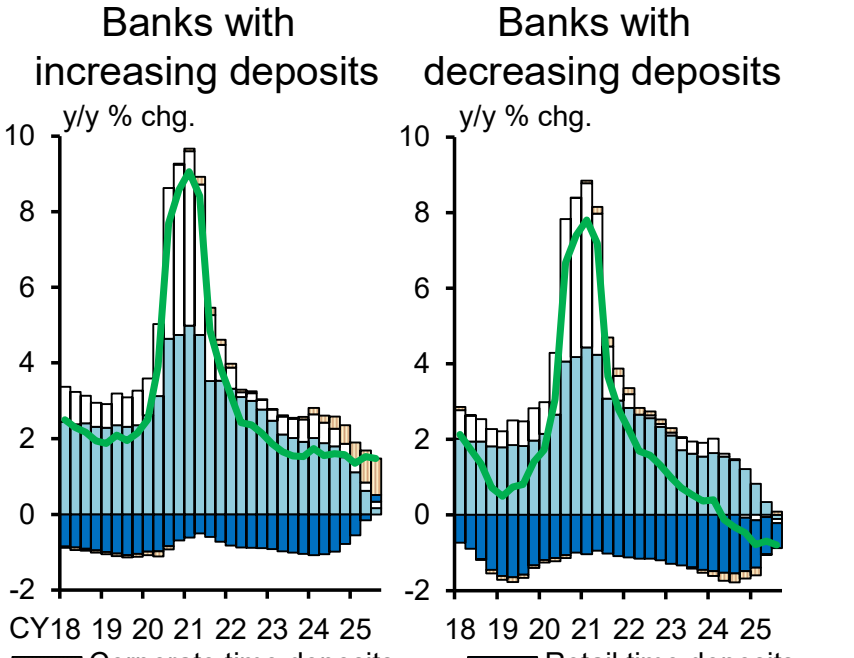
- The distribution of deposit growth at regional and *shinkin* banks has generally been stable. However, since the latter half of 2023, when upward pressure on yen interest rates began to emerge, differences in growth rates have arisen, particularly for time deposits.
- With a focus on short-term fluctuations in deposits, analyzing the variations of deposit growth by banks since the beginning of this year reveals that those offering higher interest rates tend to see relatively stronger deposit growth, and loan-to-deposit ratio is positively associated with deposit growth.

Distribution of deposit growth



Note: See Chart IV-3-7.

Deposit growth by bank characteristic



Note: "Banks with increasing deposits" and "Banks with decreasing deposits" are classified based on the year-on-year change in deposits during the period from January to June 2025. Covers regional and *shinkin* banks. See Chart IV-3-8.

Factors determining recent developments in deposit growth

Dependent variable: Year-on-year change in deposits (the first half of 2025)		
Explanatory variables	Constant	-2.10 (0.42) ***
	Time deposit rate	11.15 (1.83) ***
	Change in population	0.00 (0.24)
	Loan-to-deposit ratio	0.01 (0.01) **
	Year-on-year change in loans	0.20 (0.04) ***
Adj. R^2		0.23
Sample size		344

Note: Covers regional and *shinkin* banks. Figures in parentheses are standard errors. ***, **, and * indicate statistical significance at the 1 percent, 5 percent, and 10 percent levels, respectively. See the model 2 in Chart IV-3-10.

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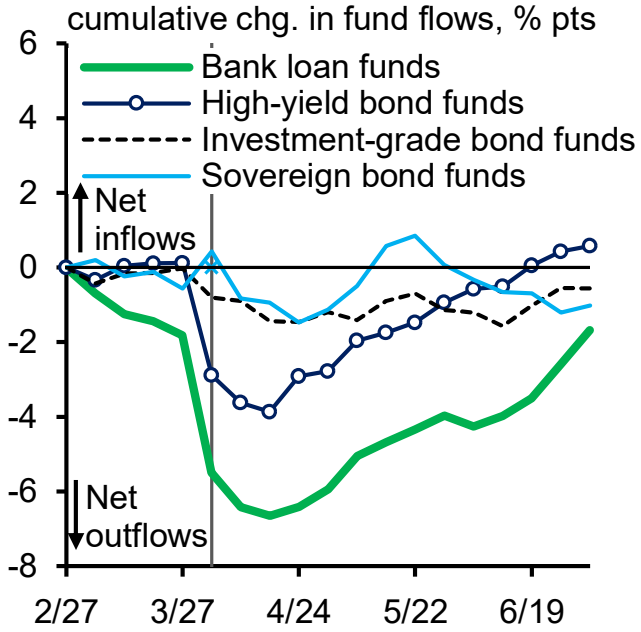
4. Developments in foreign NBFIs and banks' exposures

- Investment in domestic and foreign financial markets by the foreign NBFI sector
- Domestic banks' exposure to the foreign NBFI sector

Foreign open-end funds

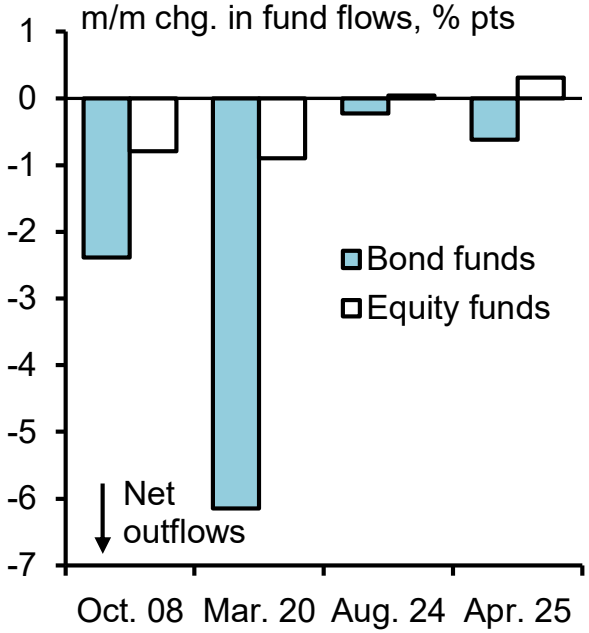
- Attention is warranted on the possibility that a global large-scale stress, such as was the case in March 2020, could also propagate to Japan, while foreign open-end funds often invest in multiple regions, including Japan.
- To accommodate large-scale redemptions, open-end funds generally also hold liquid assets. However, because there is substantial variation in redemption rates across investment asset types and funds, redemptions could amplify market volatility through the sale of securities, depending on the type and scale of stress.

Outflows from bond funds primarily investing in U.S (current phase)



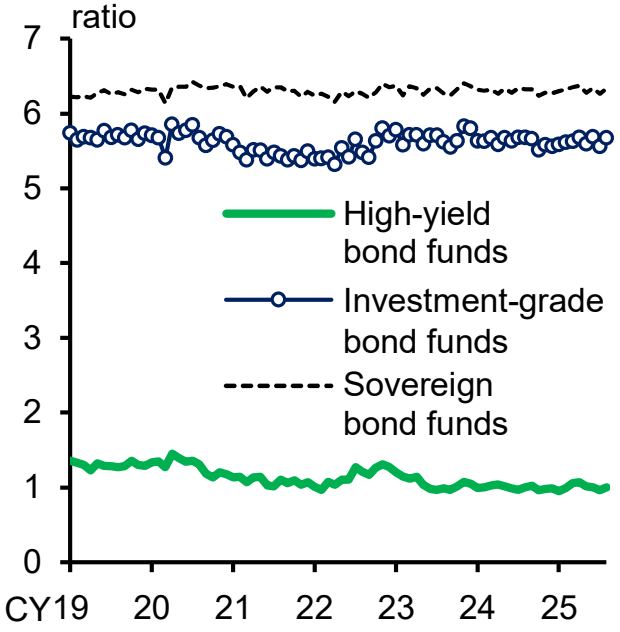
Note: Shows the ratio to the total asset size as of the week starting February 27. See Chart V-2-5.

Outflows from foreign funds investing in Japan (comparison with past shock periods)



Note: See Chart V-2-5.

Liquidity buffer against redemptions for foreign funds investing in Japan

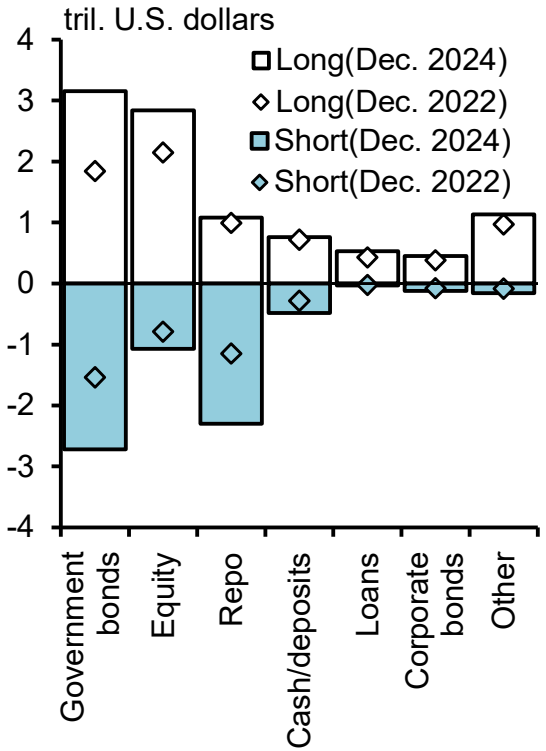


Note: Shows the liquidity coverage ratio for each fund when large-scale redemptions occur (assuming the 5th percentile value of fund-type-specific outflow rates). Median value of each fund type. See Chart V-2-7.

Foreign hedge funds

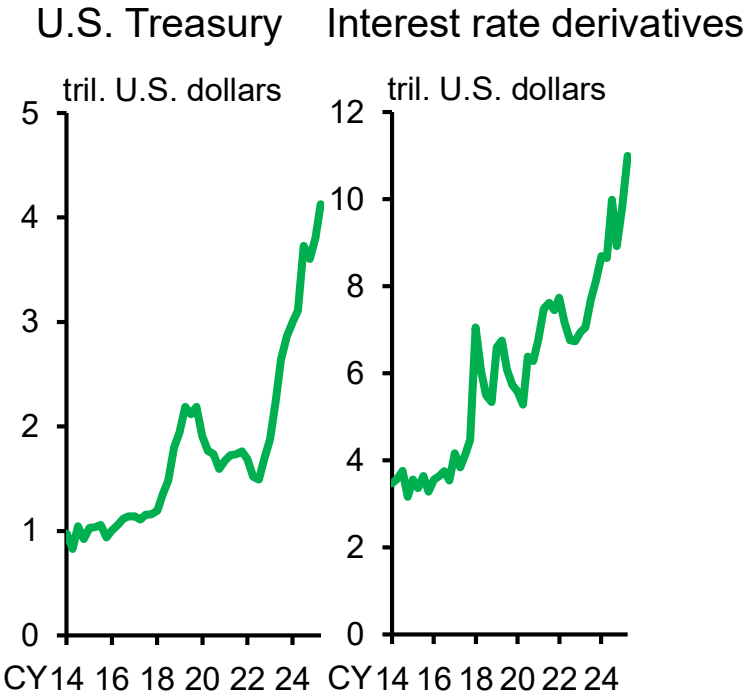
- It is pointed out that hedge funds have contributed to the increased market volatility in the U.S. government bond market last April.
  - It appears that hedge funds had been building up positions (buying U.S. Treasuries and paying interest rate swaps) before the announcement of reciprocal tariffs. When long-term interest rates rose, after the announcement, causing swap spreads to widen into negative territory, hedge funds are said to have sold U.S. Treasuries to avoid large-scale losses, contributing to the further rise in yields.

U.S. hedge funds' exposure by asset type



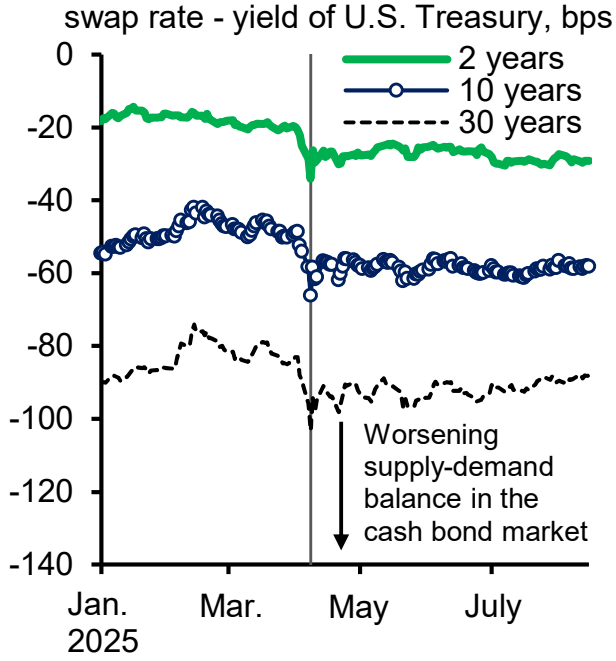
Note: See Chart B2-1.

Fixed income positions of U.S. hedge funds



Note: Shows gross exposure (the sum of long and short positions). See Chart V-2-2.

U.S. swap spreads

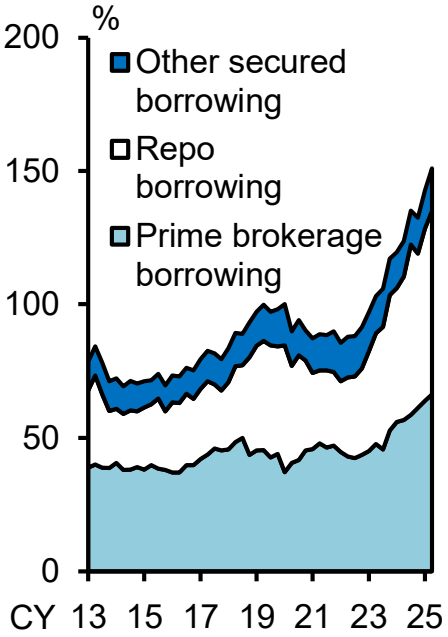


Note: See Chart V-2-2.

Leverage of hedge funds

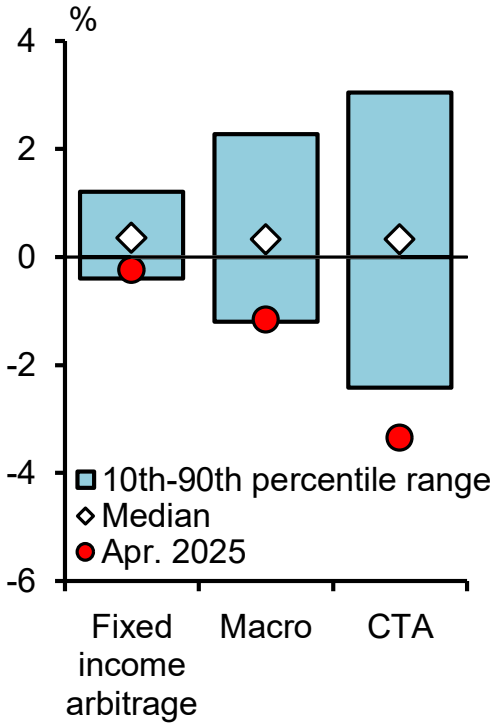
- The leverage of hedge funds has continued to rise recently.
- It has been pointed out that the presence of fixed income arbitrage strategies has been increasing.
- Hedge funds' transaction share in the overall U.S. repo market activity is now rising rapidly. While the returns of fixed income arbitrage hedge funds are generally not volatile, rapid position adjustments resulting from deleveraging in the event of unexpected market movements can amplify market volatility in the bond market.

Financial leverage of U.S. hedge funds



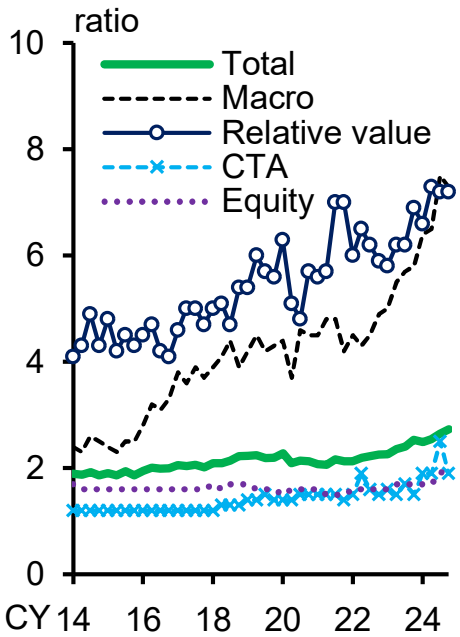
Note: See Chart V-2-4.

Distributions of monthly returns by strategy



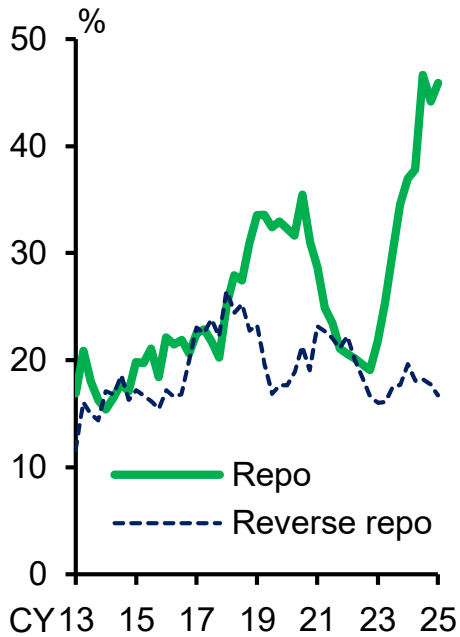
Note: See Chart B2-2.

Leverage by type of strategy



Note: See Chart V-2-4.

U.S. repo transaction share of hedge funds

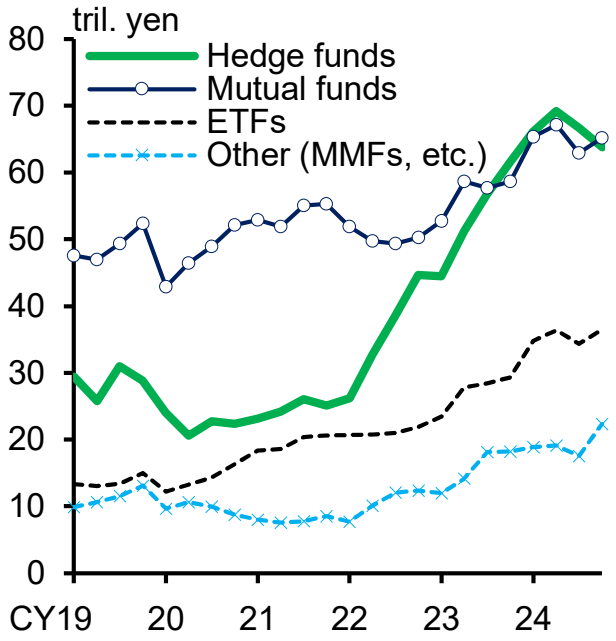


Note: Shows a share of repo outstanding. See Chart B2-3.

Foreign hedge funds in the JGB market

- The transaction volume in the JGB market of foreign investors, including hedge funds, has been on an uptrend, and the presence of hedge funds engaging in arbitrage trading appears to be growing.
  - It appears that some hedge funds use fair amount of leverage, primarily through repo financing. In many cases, Japan-based branches and subsidiaries of U.S. and European financial institutions are acting as the intermediaries for repo transactions with hedge funds, rather than Japanese financial institutions.

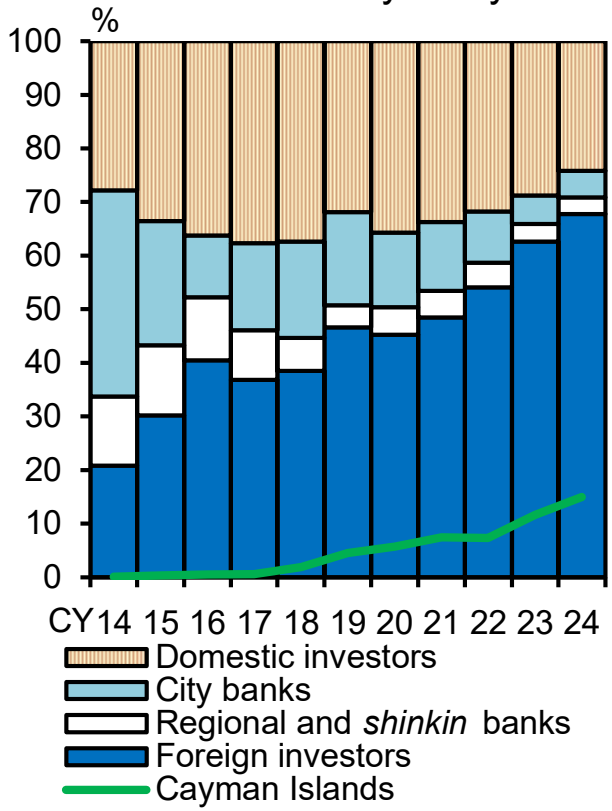
Investments to Japan by U.S. investment funds



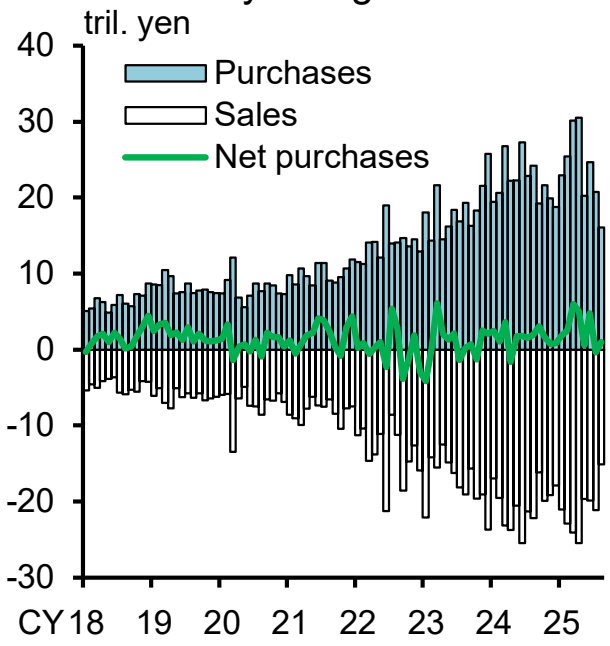
Note: See Chart V-2-3.

Developments in JGB transactions of foreign investors

Transaction volume share of cash JGBs by entity



Purchases and sales of cash JGBs by foreign investors

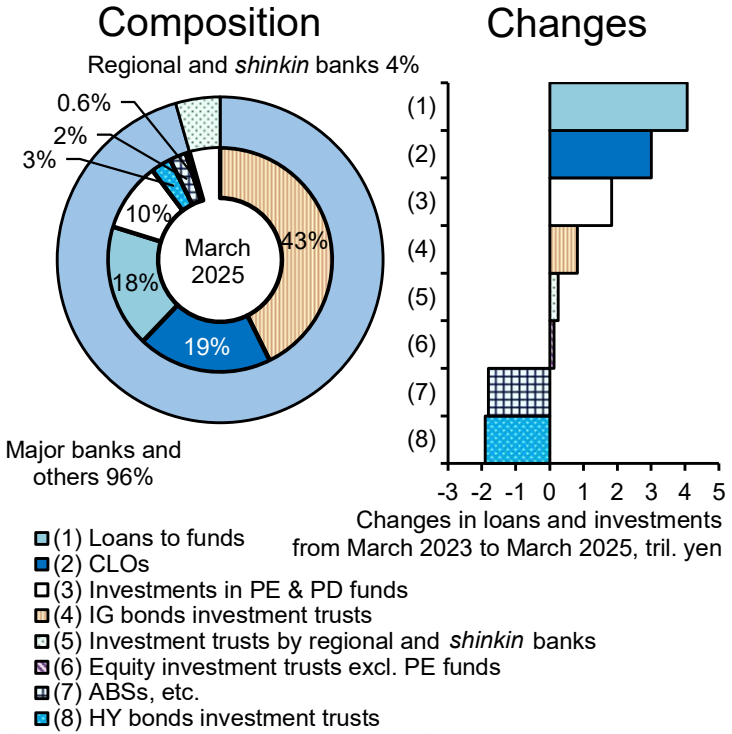


Note: Transaction volume refers to dealer-to-client cash JGB transactions, including both purchases and sales. It excludes treasury discount bills. See Chart B2-4.

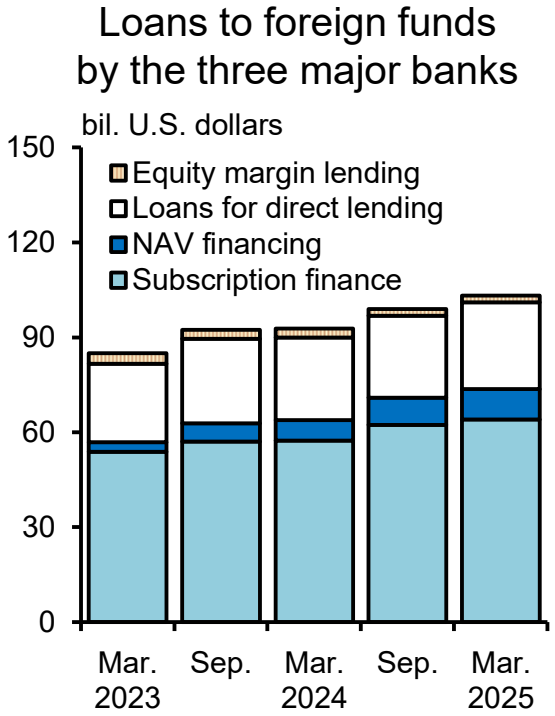
Domestic banks' exposure to the foreign NBFI sector

- Major banks have been increasing loans to PE and PD funds.
- Although the share of loans to PE and PD funds in total lending is small, major banks in particular have been performing subscription financing and NAV financing, which is secured by the cash flows of PE funds' portfolio firms.
- Given the high uncertainty regarding the economic and financial situation, some PE funds have postponed their selling of portfolio firms, and the growth in assets under management has been decelerating somewhat. Among PD funds, it is pointed out that loans with relaxed lending terms have been increasing.

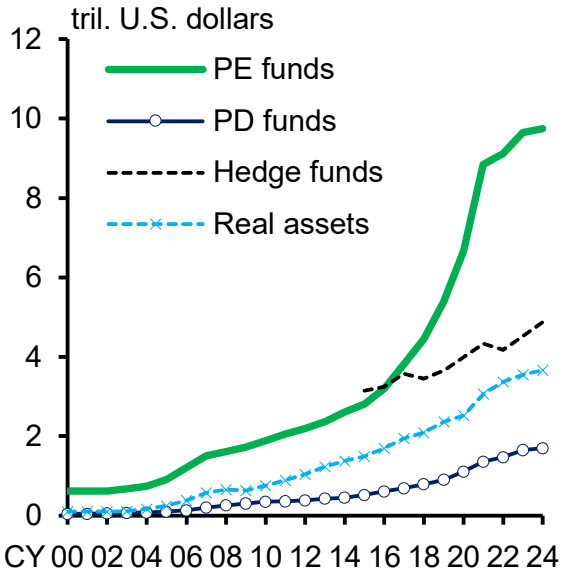
Loans and investments of Japanese financial institutions to the foreign NBFI sector



Loans to foreign funds by the three major banks



Assets under management in private funds



Note: Covers loans and investments to the foreign NBFI sector by major banks and others, excluding trust banks, and foreign investment trusts by regional and *shinkin* banks. "Loans to funds" is loan exposures (including credit lines) to private funds in the Americas. See Charts V-2-8 and V-2-9.

Note: Based on Preqin data. See Chart V-2-10.

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5. Macro stress testing

- Financial stress scenario
- Rises in foreign interest rates scenario plus

Macro stress testing: Overview of scenarios

- Macro stress testing in this *Report* is conducted to examine the resilience of the financial system under (1) the baseline scenario, (2) a "financial stress scenario," and (3) a "rises in foreign interest rates scenario plus."

  (1) The baseline scenario is based on forecasts for economic variables by private research institutions and international organizations as of early August 2025. It assumes that domestic and foreign interest rates will move in line with the forward rate curve as of early August 2025.

  A sensitivity analysis on yen interest rates assumes a parallel upward shift of 1 percentage point in yen interest rates, compared to the baseline scenario.

  (2) The financial stress scenario assumes adjustments of the same magnitude as that observed at the time of the global financial crisis and a significant deterioration in domestic and foreign economies.

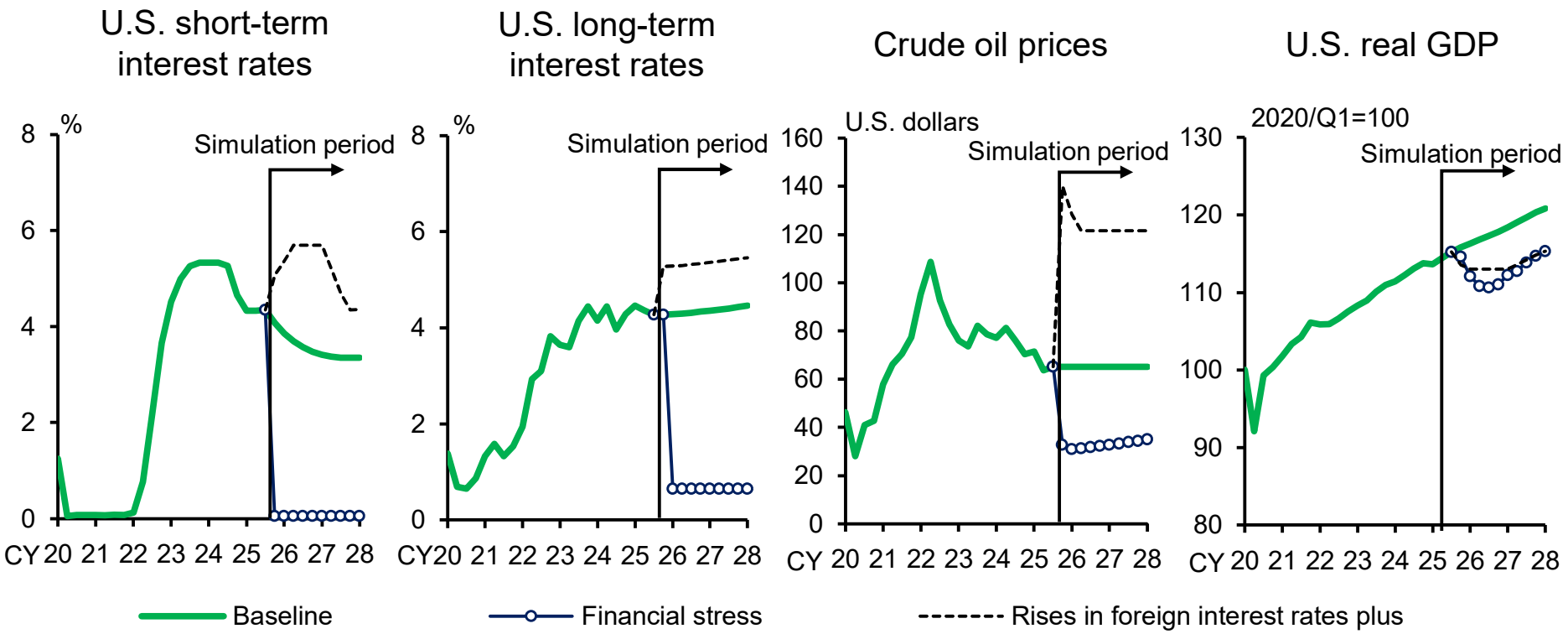
  (3) The rises in foreign interest rates scenario plus assumes a slowdown in foreign economies and rises in foreign interest rates, which reflect a global surge in prices triggered by the materialization of geopolitical risks and other factors.

  Compared to the "rises in foreign interest rates scenario" in the previous *Report*, a more severe stress is assumed regarding increased policy uncertainty and a fall in global trade volume in this scenario.

Assumptions on foreign financial markets and foreign economies

- In the financial stress scenario, foreign economies decelerate to the same extent as in the global financial crisis. Foreign interest rates will decline significantly.
- In the rises in foreign interest rates scenario plus, the U.S. federal funds rate is assumed to be 2 percentage points higher than the baseline scenario, and remains high for one year. U.S. long-term interest rates are assumed to be 1 percentage point higher than the baseline scenario and remain high throughout the simulation period.

Foreign financial and economic variables assumed in macro stress testing

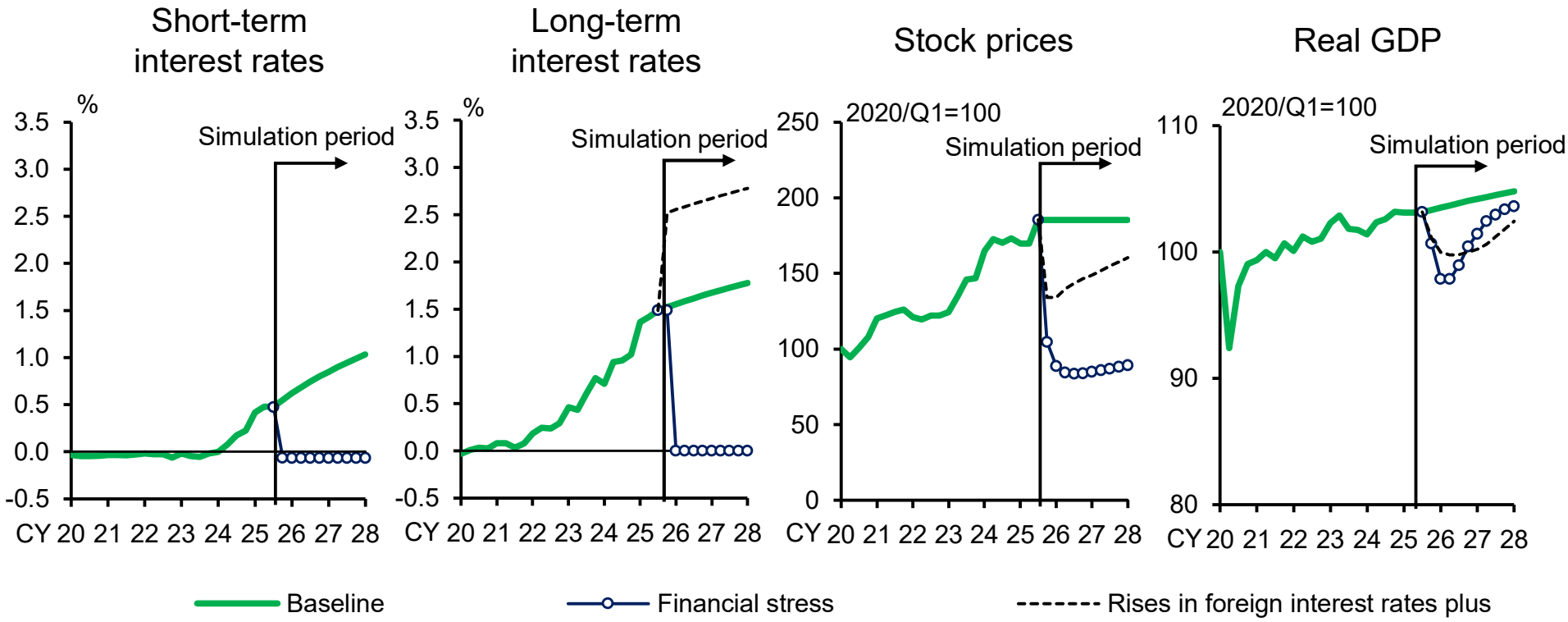


Note: "Short-term interest rates" refers to the overnight rate, and "long-term interest rates" refers to the 10-year yield. See Chart VI-2-1, Chart VI-2-2, and the "Scenario Tables."

Assumptions on domestic financial markets and Japan's economy

- In the financial stress scenario, Japan's economy decelerates significantly, as in foreign economies. Domestic interest rates will decline significantly, while prices of risky assets plummet.
- In the rises in foreign interest rates scenario plus, Japan's long-term interest rates are assumed to be 1 percentage point higher and remain at that elevated level. Japan's economy is also assumed to slow down.
  - The scenario also assumes the negative effects mainly fall on manufacturing industry, with global trade volume falling significantly and policy uncertainty increasing.

Japanese financial and economic variables assumed in macro stress testing

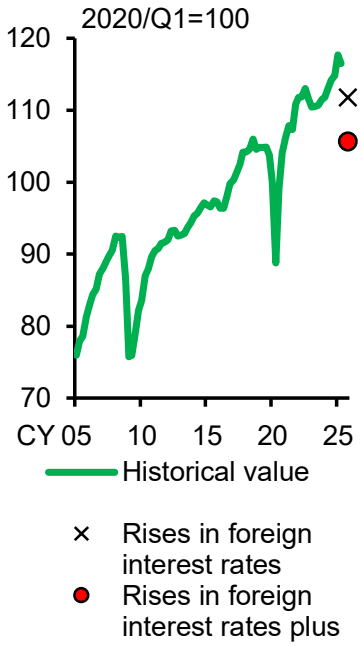


Note: The paths of Japanese short-term interest rates in the rises in foreign interest rates scenario plus are the same as in the baseline scenario.
"Short-term interest rates" refers to the overnight rate, and "long-term interest rates" refers to the 10-year yield. See Chart VI-2-1, Chart VI-2-2, and the "Scenario Tables."

Assumptions in the rises in foreign interest rates scenario plus

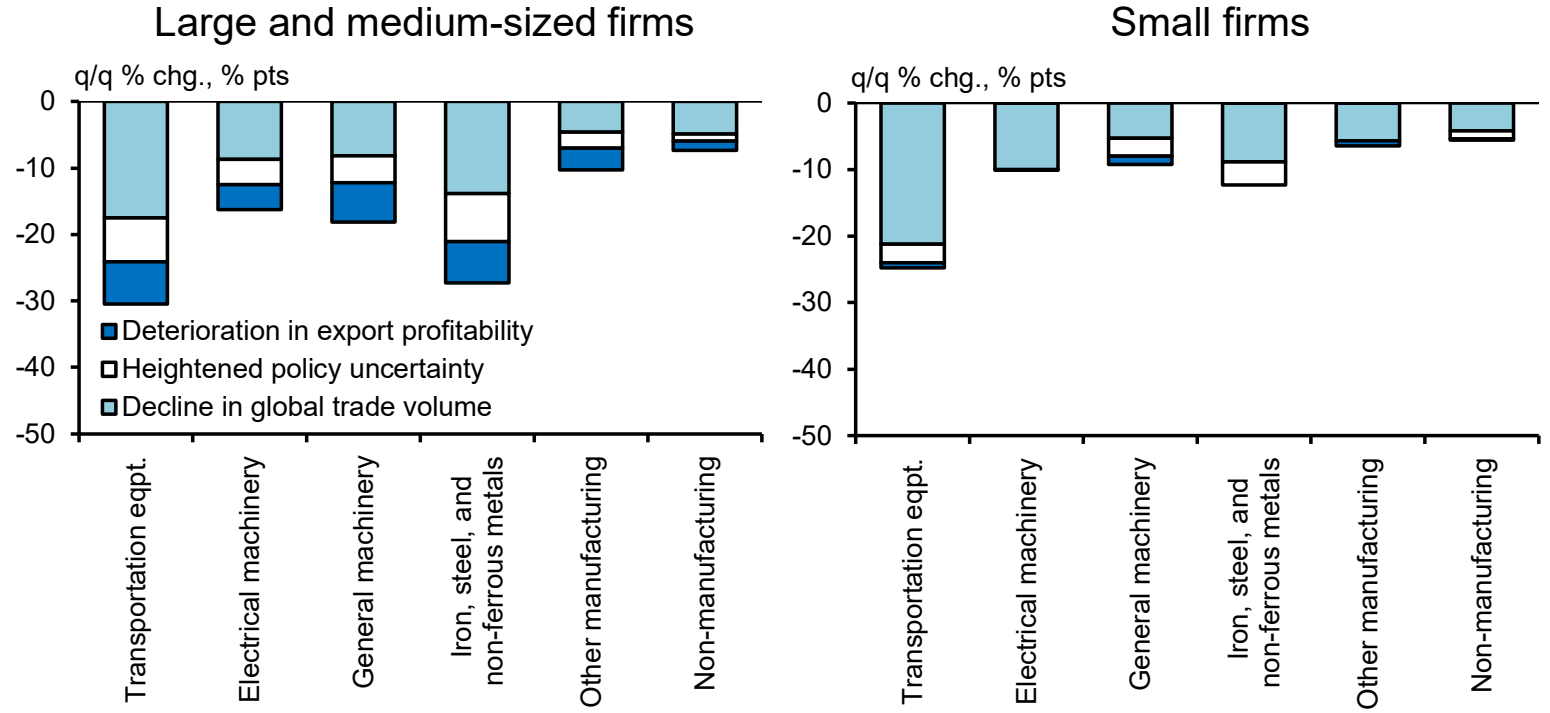
- The rises in foreign interest rates scenario plus assumes the following three additional shocks: (1) a deterioration in export profitability, (2) a fall in global trade volume, and (3) heightened policy uncertainty. These shocks are assumed to exacerbate the fall in risky asset prices and impact corporate profits in various ways, depending on the firm's size and the type of industry.

Assumption on global trade volume



Note: See Chart VI-2-7.

Effects on value-added by industry (assumptions)

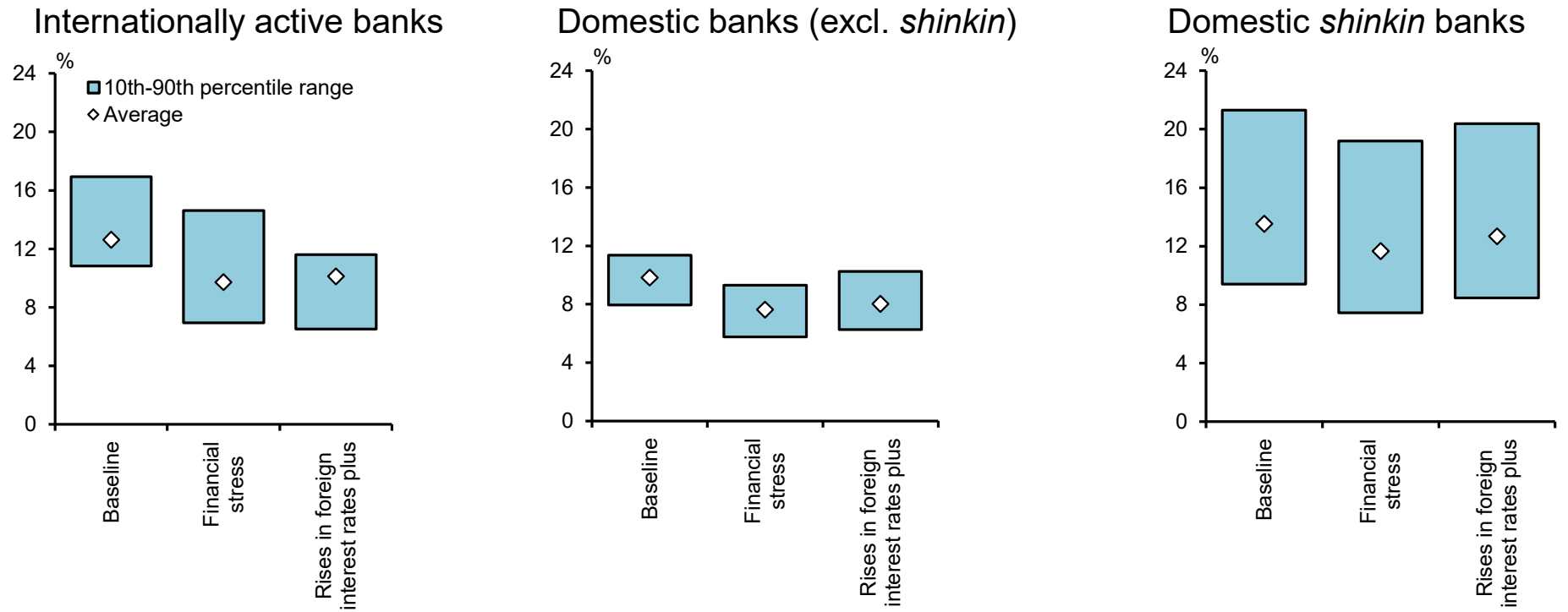


Note: Shows the decline in value-added (quarter-on-quarter change) in response to each shock. The values are based on estimates from a structural VAR model with the following variables: Japanese export price index, global trade volume, global economic policy uncertainty index, real GDP of foreign countries, Japanese real GDP, and value-added by industry and size. See Chart VI-2-8.

Results of macro stress testing

- In the financial stress scenario, capital adequacy ratios are pushed down by the decrease in net interest income, an increase in credit costs, and a deterioration in both valuation and realized gains/losses on securities holdings.
- In the rises in foreign interest rates scenario plus, the capital adequacy ratios are pushed down by a decrease in net interest income due to rising foreign currency funding costs and a further deterioration in both valuation and realized gains/losses on securities holdings, mainly among internationally active banks.
- In both downside scenarios, the simulation results indicate that capital adequacy ratios are lower than in the baseline scenario, but they remain above the regulatory requirements on average. It can therefore be assessed that banks have sufficient capital to withstand such stress.

Distribution of capital adequacy ratios under each scenario



Note: Shows capital adequacy ratios at the end of the simulation period (as of end-fiscal 2027). See Chart VI-2-12.

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6. Opportunities and risks posed by changes in the business environment

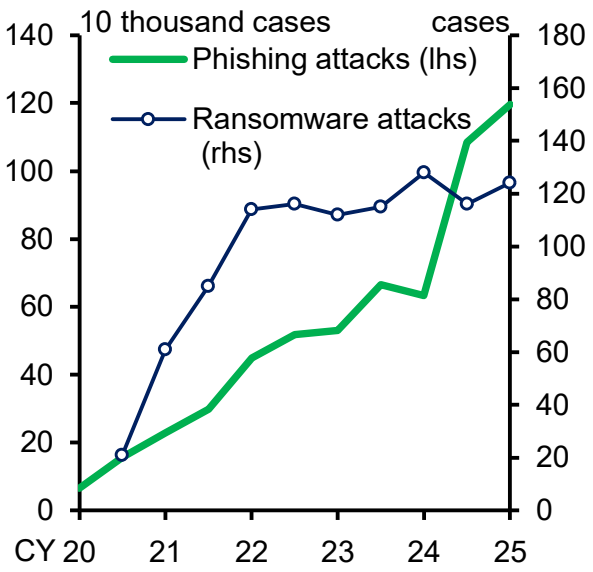
- The threat of cyberattacks
- Adaptation to new technologies

The threat of cyberattacks

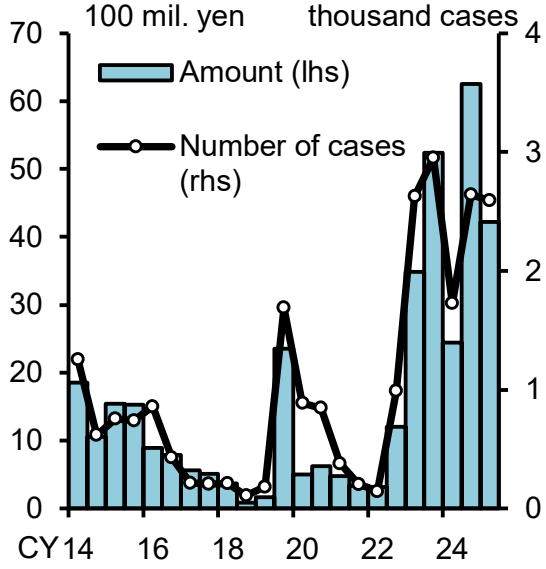
- The spread of digital technologies is an opportunity for financial institutions to enhance the efficiency of their business operations and to provide new financial services. However, at the same time, it can be the cause of new risks.
  - The number of ransomware attacks in Japan has been at a high level. Unlawful money transfers through online banking have been increasing significantly. Since early 2025, there has been a surge in cases of unauthorized access to customer accounts at securities companies.
  - Financial institutions need to enhance their IT resilience by reinforcing their governance and organizational structures, investing in necessary resources, and continuing efforts in human resource development -- with the involvement of top management -- based on the recognition that incidents can occur even when cyberattack countermeasures are in place.

Number of cyber-related attacks in Japan

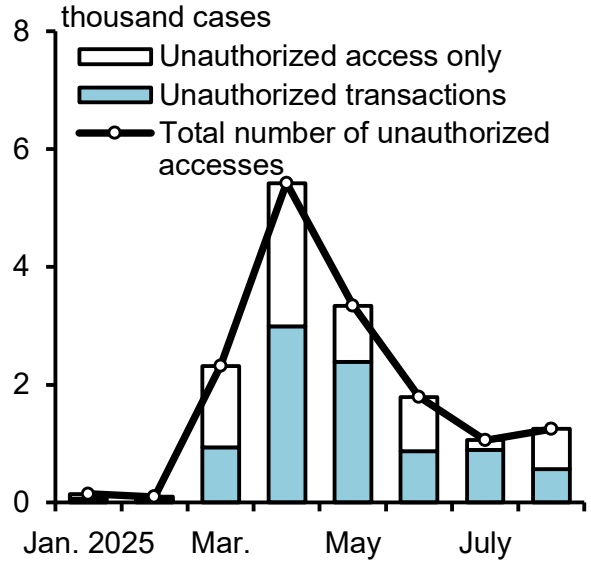
Cyberattacks



Unlawful online money transfers



Unauthorized access to and transactions in securities accounts



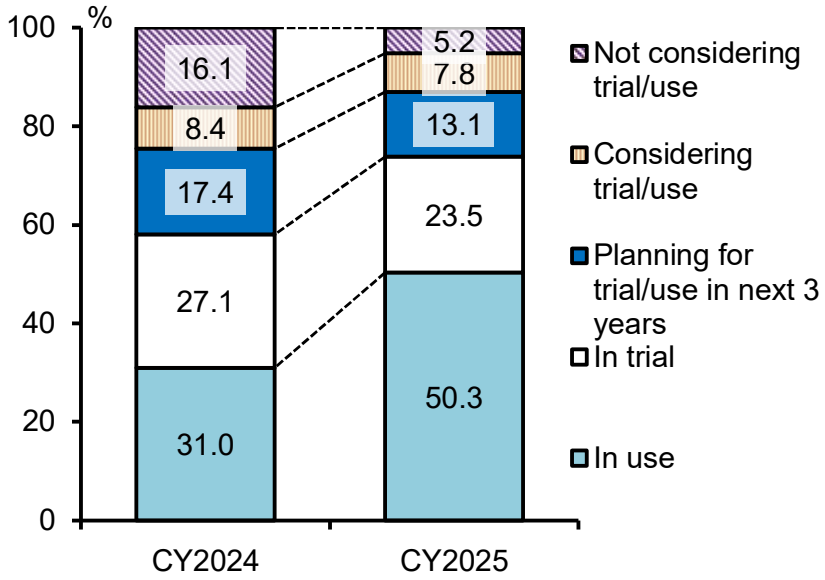
Note: See Chart V-3-1.

Adaptation to new technologies

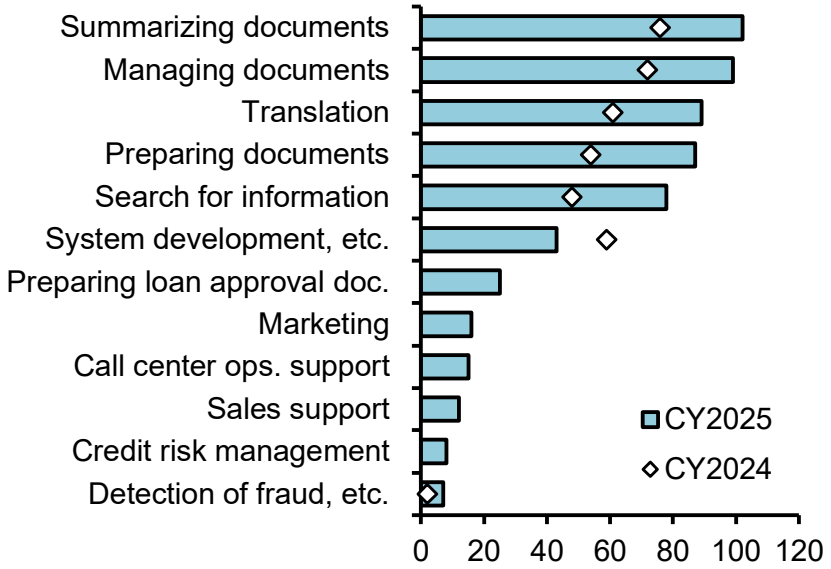
- In recent years, the use of generative artificial intelligence (AI) has rapidly become widespread, and its adoption is also progressing among banks in Japan, primarily to improve the efficiency of existing business operations.
  - According to a survey of financial institutions conducted by the Bank of Japan in 2025, about 50 percent responded that they were using generative AI.
  - When using generative AI, banks must remain alert to risks such as biased or false answers (i.e., AI may "hallucinate") and risks originating from third parties. Banks must also pay attention to the heightened threat of cyberattacks generated by the misuse of generative AI.
  - It is necessary to continue to keep in mind both the benefits and risks of using generative AI.

Usage status and application areas of generative AI

Use of generative AI



Application areas of generative AI



Note: For details, see "Use and Risk Management of Generative AI by Japanese Financial Institutions -- Based on the Results of FY2025 Survey --," *Financial System Report Annex Series*, September 2025 and Chart V-3-2.

Conclusion: Stability assessment and caveats

- Japan's financial system has been maintaining stability on the whole.
- Financial intermediation has continued to function smoothly, and no major financial imbalances have been seen in the financial intermediation activities.

Risks faced by financial institutions

- The quality of banks' domestic and foreign loan portfolios has been maintained. With corporate profits being on an improving trend on the whole, bankruptcies have been more or less unchanged, albeit with fluctuations. The quality of banks' foreign loan portfolios has continued to be maintained as banks have been selective in their foreign lending.
- With the links between (1) the domestic banking sector and financial markets and (2) the foreign NBFI sector strengthening, Japan's financial system may have become more susceptible to fluctuations in global financial markets and the influence of foreign investment funds. Keeping these points in mind, banks need to identify and manage risks associated with securities holdings.
- Banks have sufficient yen funding liquidity. As for foreign currency, they have maintained stable funding. Banks need to continue to work toward establishing stable funding bases.
- Banks need to continue to properly manage risks related to digital technologies and climate-related financial risks.

Resilience of the financial system

- Regarding banks' loss-absorbing capacity, their capital well exceeds regulatory requirements.
- Banks' amount of yen interest rate risk relative to their capital has remained low with that on the asset and liability sides being more or less in balance.
- Based on the results of the macro stress testing, it can be judged that the stability of Japan's financial system is maintained even under stress equivalent to the global financial crisis and compound stresses where foreign interest rates rise and global trade volume falls.
- Uncertainties remain high regarding economic policies in each jurisdiction, geopolitical risks, and global financial markets, including their future developments and impact. If stress materializes, globally active NBFIs could amplify negative shocks. Banks must remain vigilant against the materialization of various risks and implement effective measures to manage such risks.