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Editor's Note

A key ingredient for a sound and efficient financial system is an adequately capitalised banking system. Capital provides a bank with a buffer against unexpected losses and also serves as a basis for its medium-term growth. But how much capital should banks hold?

In 1988, the Basel Committee on Banking Supervision – a committee established by the central bank governors of the G10 countries – developed the Basel Capital Accord, now widely known as Basel I. Basel I defined capital for the purposes of bank capital adequacy, and proposed a minimum capital requirement for banks of 8 per cent of total assets – assets being measured in such a way as to account for their relative risk. The Basel I framework has been widely followed in many countries, including New Zealand.

Over time, as financial markets and instruments have evolved and become more complex, banks and other institutions have adopted more sophisticated methods to measure and manage risk. In response, last year the Basel Committee released a new capital adequacy framework known as Basel II.   In the first article of this issue, Andrew Yeh, James Twaddle, and Mike Frith of the Bank's Financial Stability Department provide an introduction to the Basel II framework and outline the Reserve Bank's plans to adopt the framework here in New Zealand.

The foreign exchange market plays a crucial role in the functioning of the New Zealand economy, enabling international trade flows as well as a channel to foreign capital markets. In our second article, Nick Smyth from the Financial Stability Department examines recent trends in foreign exchange market turnover, drawing on information from a three-yearly survey published by the Bank of International Settlements. Nick finds that trading of the New Zealand dollar has increased significantly over the past few years, and by more than many other currencies. Of note, is the extent to which trading of the New Zealand dollar now occurs offshore rather than in the domestic market.

The third article, by David Drage of the Financial Stability Department and Anella Munro and Cath Sleeman from the Economics Department, provides an update on the market for offshore issues of New Zealand dollar denominated bonds, commonly known as Eurokiwis and Uridashis. Issuance of these bonds has been very strong over the past two years, with domestic interest rates high relative to the rest of the world. The article explains the incentives to issue and purchase these bonds, and the role that these bonds play in enabling New Zealand to access the foreign capital market.

In our final article, Mike Wolyncewicz of the Bank's Financial Services Group discusses the rationale underpinning the five-yearly funding agreements for the financing of the Reserve Bank's operating expenditures. The article looks at the processes by which these agreements are reached and the accountability measures in place to monitor the use of resources.   The article looks at the funding agreement that has been put in place for 2005-2010 against the backdrop of previous Funding Agreements.

This issue also contains a recent speech by the Governor on the New Zealand payments system – the complex infrastructure in place to transfer money of all types around the economy in order to settle obligations. The speech emphasises that ensuring a sound and efficient payments system is an important part of the Bank's financial stability role.

As always, I trust that readers will find this issue of the *Bulletin* interesting and informative.

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