**Regulation of the Reserve of Commercial Banks**

In terms of the provisions of Section 93 of the MLA, LCBs operating in Sri Lanka are required to maintain reserves against all deposit liabilities denominated in Sri Lanka rupees. This is called Statutory Reserve Requirement (SRR). The SRR consists of a certain percentage (SRR ratio) of total liabilities of demand, time & savings and other deposits denominated in Sri Lanka rupees. The SRR ratio is determined from time to time by the Central Bank.

For the purpose of reserve calculation and maintenance by LCBs, each calendar month is divided into two periods (i.e. Period A and Period B):

1. Period A from the 1st to the 15th (both inclusive); and
2. Period B form the 16th the last day (both inclusive) of each month.

The reserves required to be maintained by LCBs for the reserve maintenance Period A of any month should be based on the average daily deposit liabilities of the Period A of the preceding month, while for the reserve maintenance period B of any month, such reserve should be based on the average daily deposit liabilities of the Period B of the preceding month.

LCBs may maintain an amount over and above two per centum of the average deposit liabilities mentioned above but not exceeding four per centum thereof as a part of its required reserves in the form of Sri Lanka currency notes and coins. Such amount should be the average holding of Sri Lanka currency notes and coins calculated for the respective computation period.

LCBs are not required to maintain 100 per cent of their reserve requirement at all times and are allowed to reduce their daily reserve requirement upto a certain level of SRR as determined from time to time by the Central Bank. However, at the end a two week reserve maintenance period, the average amount of reserve maintained should be 100 per cent or above.

If any LCB is failed to maintain 100 per cent of SRR at the end of a reserve maintenance period, such LCBs should pay CBSL interest at the rate of one tenth of one per centum (0.1%) on the amount of the deficiency in reserves, as a penalty.

CBSL can inject liquidity to the market or absorb liquidity from the market by changing SRR ratio. When the CBSL increases SRR ratio, commercial banks are required to keep more rupee deposit liabilities with the CBSL limiting the ability of credit creation. This decreases the excess market liquidity. The reverse of this materializes if the CBSL reduces SRR ratio. If the market is in the excess liquidity position, CBSL can increase the SRR to absorb liquidity from the market and vice versa.