

## LIQUIDITY RISK AND ASSET–LIABILITY DYNAMICS IN SRI LANKAN LICENSED COMMERCIAL BANKS

Tharshiga, P\* and Subramaniam, V. A.

*Department of Financial Management, University of Jaffna, Sri Lanka*

*\*tharshiga@univ.jfn.ac.lk*

The study examines the relationship between asset–liability structure and liquidity risk in Sri Lankan commercial banks. Unlike prior South Asian banking studies, this study specifically focuses on Sri Lanka’s licensed commercial banking sector, leveraging its monthly data frequency and extended sample period to capture both post-global financial crisis and post-Easter Sunday attack structural dynamics, thereby offering a differentiated empirical contribution. Liquidity management is a critical aspect of banking sector stability, particularly in economies where banks play a dominant role in financial intermediation. The primary objective of this study is to analyse how lending behaviour, funding structure, and balance-sheet adjustments influence liquidity risk over time. For analysis purposes, it employs monthly balance sheet data from commercial banks spanning January 2010 to December 2023, covering a long observation period. Liquidity risk is measured using the loan-to-deposit ratio as the primary balance-sheet-based indicator, capturing funding liquidity risk. This measure is preferred over regulatory proxies such as the LCR and NSFR, given data availability over the full sample period. Key explanatory variables include the loan-to-deposit ratio, borrowing dependence, and loan growth. An autoregressive distributed lag modelling framework is adopted to capture both short-run dynamics and long-run equilibrium relationships among the variables. ARDL is selected over VAR/VECM given the mixed order of integration among variables, confirmed by unit root tests. Seasonality and structural breaks in the monthly data are addressed through appropriate dummy variables. The potential for reverse causality between loan growth and liquidity risk is acknowledged and addressed through the ARDL framework's lag structure and robustness checks. The empirical findings reveal that liquidity risk exhibits strong persistence, indicating gradual adjustment following shocks. Lending expansion and rapid credit growth are found to exert immediate pressure on liquidity conditions, while subsequent adjustments reflect banks’ balance-sheet rebalancing. Borrowings are shown to provide short-term liquidity support; however, their lagged effects indicate increased vulnerability, suggesting that reliance on borrowing as a liquidity management strategy is not sustainable in the long run. The long-run results confirm the existence of a stable equilibrium relationship between liquidity risk and bank balance-sheet characteristics. The study highlights the importance of prudent asset–liability management in maintaining banking sector liquidity. The findings provide policy-relevant insights for bank managers and regulators, emphasising the need for balanced credit growth and stable funding structures to enhance financial stability in Sri Lanka.

**Keywords:** Bank liquidity risk, Asset–liability management, Commercial banks, Balance-sheet dynamics, Financial stability, Sri Lanka