

## LIQUIDITY RISK MANAGEMENT IN BANKS AND ITS ROLE IN MAINTAINING FINANCIAL RESILIENCE

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**Annotation:** Liquidity risk management has emerged as a critical component of financial stability, especially following the vulnerabilities exposed during past banking crises. The ability of banks to effectively manage their liquidity is paramount to ensuring not only their survival but also the resilience of the broader financial system. Recent studies reveal that liquidity shocks can precipitate rapid deposit outflows, leading to systemic crises when coupled with weaknesses in interbank lending mechanisms (Rajendra P et al., 2025). Furthermore, in exploring the delicate interplay between credit and liquidity risks, it becomes evident that while these risks may not directly interact contemporaneously, each independently affects bank stability, thereby necessitating a strategic approach to their joint management (Ghenimi A et al., 2017). This essay will delve into the intricacies of liquidity risk management, highlighting its pivotal role in enhancing financial resilience in contemporary banking practices.

**Keywords:** Liquidity risk management, Bank liquidity, Financial resilience, Asset–liability management (ALM), Basel III regulations, Liquidity coverage ratio (LCR), Net stable funding ratio (NSFR)

### Definition and Importance of Liquidity Risk Management in Banks

Liquidity risk management in banks refers to the processes and strategies employed to ensure that a financial institution can meet its short-term obligations without incurring unacceptable losses. This aspect of risk management is critical due to the potential for sudden liquidity shocks, which can precipitate severe operational disruptions and undermine overall financial stability. Recent studies highlight the channels through which liquidity stress can propagate, emphasizing the need for robust defenses against such shocks to preserve the integrity of the banking system (Rajendra P et al., 2025). Furthermore, the interplay between liquidity risk and credit risk reveals that while they may not have a direct reciprocal relationship, their separate influences can significantly impact bank stability (Ghenimi A et al., 2017). Therefore, effective liquidity management is indispensable for maintaining resilience in an increasingly volatile financial landscape.

### Key Components of Liquidity Risk Management

Effective liquidity risk management involves several key components that collectively ensure a banks stability and resilience against financial shocks. Central to this framework is the establishment of robust liquidity buffers, which act as a safeguard during periods of market stress, particularly in light of historical crises that have exposed vulnerabilities in banking institutions (Rajendra P et al., 2025). Furthermore, liquidity risk assessment tools must be employed to monitor potential liquidity stress events, enabling timely responses to sudden market changes. Additionally, the interaction between liquidity risk and credit risk cannot be overlooked, as both risks independently affect bank stability while their interplay can exacerbate fragilities (Ghenimi A et al., 2017). Consequently, an integrated approach that combines consistent liquidity monitoring, risk mitigation strategies, and regulatory compliance is imperative for maintaining financial resilience in the face of an increasingly volatile economic landscape.



## **Tools and Techniques Used to Monitor and Control Liquidity Risk**

In the realm of liquidity risk management, banks employ a myriad of tools and techniques to monitor and control potential vulnerabilities effectively. Notably, the liquidity mismatch index (LMI) has emerged as a vital instrument, assessing the disparity between asset market liquidity and funding liquidity for bank holding companies. Across the years leading up to the 2008 financial crisis, the LMI reflected a significant decline, illustrating systemic fragility in the banking sector (Bai J et al., 2017). Furthermore, empirical studies underline critical mechanisms that exacerbate liquidity stress, demonstrating the necessity for robust stress testing and regulatory reforms designed to fortify banks against liquidity shocks. By integrating such methodologies, financial institutions can enhance their resilience and effectively safeguard against future economic turmoil (Rajendra P et al., 2025).

## **Role of Liquidity Risk Management in Maintaining Financial Resilience**

The management of liquidity risk is fundamental to enhancing financial resilience within banks, particularly in the face of evolving market challenges. Financial institutions are continuously exposed to potential liquidity shocks, which can stem from rapid deposit withdrawals or diminished access to wholesale funding (Rajendra P et al., 2025). Such vulnerabilities, highlighted by recent banking crises, point to the pressing need for robust liquidity risk management strategies. The interplay between liquidity and credit risks further complicates this landscape; while they may not exhibit a direct contemporaneous relationship, their separate impacts can significantly undermine bank stability (Ghenimi A et al., 2017). Consequently, an effective liquidity risk management framework not only safeguards individual institutions but also fortifies the stability of the financial system as a whole, fostering a more shock-resilient environment that can better absorb unforeseen liquidity fluctuations.

## **Impact on Bank Stability and Crisis Prevention**

The impact of liquidity risk management on bank stability and crisis prevention is profound, as evidenced by recent studies highlighting the intricate relationship between various risks. Notably, banks face fragility from both credit and liquidity risks, which have been shown to influence bank stability independently, often leading to detrimental outcomes during financial crises. By understanding these interactions, financial institutions can adopt more effective risk management strategies. For instance, the findings indicate that while liquidity risk contributes a premium to bank performance through net interest margins, it can also impair stability when not managed appropriately (Chen Y-K et al., 2017). Thus, implementing robust liquidity risk frameworks is essential for fostering resilience and ensuring that banks can withstand economic shocks and the pressures of market dynamics (Ghenimi A et al., 2017).

## **Conclusion**

In conclusion, effective liquidity risk management is fundamental to the financial resilience of banks, particularly in mitigating vulnerabilities exposed during crises. The ability of financial institutions to manage liquidity stress is critical, as evidenced by recent episodes where rapid deposit outflows and interbank lending failures have severely tested banks stability (Rajendra P et al., 2025). The interaction between liquidity and credit risks also highlights how these factors contribute to banking instability, underlining the need for a comprehensive approach to risk management that addresses both areas simultaneously (Ghenimi A et al., 2017). As financial landscapes continuously evolve, adopting robust liquidity management strategies, alongside regulatory frameworks, is essential for safeguarding against future shocks. Ultimately, resilient



banks are better equipped not only to withstand liquidity crises but also to support the broader economy during turbulent periods, fostering overall financial stability.

### **Summary of the Importance of Effective Liquidity Risk Management in Ensuring Financial System Stability**

Effective liquidity risk management is a cornerstone of financial system stability, particularly in the banking sector. By ensuring that banks maintain an adequate level of liquid assets, institutions are better positioned to withstand financial shocks and avoid insolvency during crises. Evidence from studies emphasizes that both credit risk and liquidity risk, while not inherently intertwined, independently influence bank stability; their interaction can exacerbate vulnerabilities within the financial system (Amara et al., 2019). This elucidates the need for banks to adopt robust liquidity management frameworks that address both risks comprehensively. Enhanced regulatory efforts aimed at joint risk management strategies further underscore the critical role liquidity risk management plays in fortifying banks against potential failures, thereby promoting overall financial resilience (Ghenimi A et al., 2017).

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