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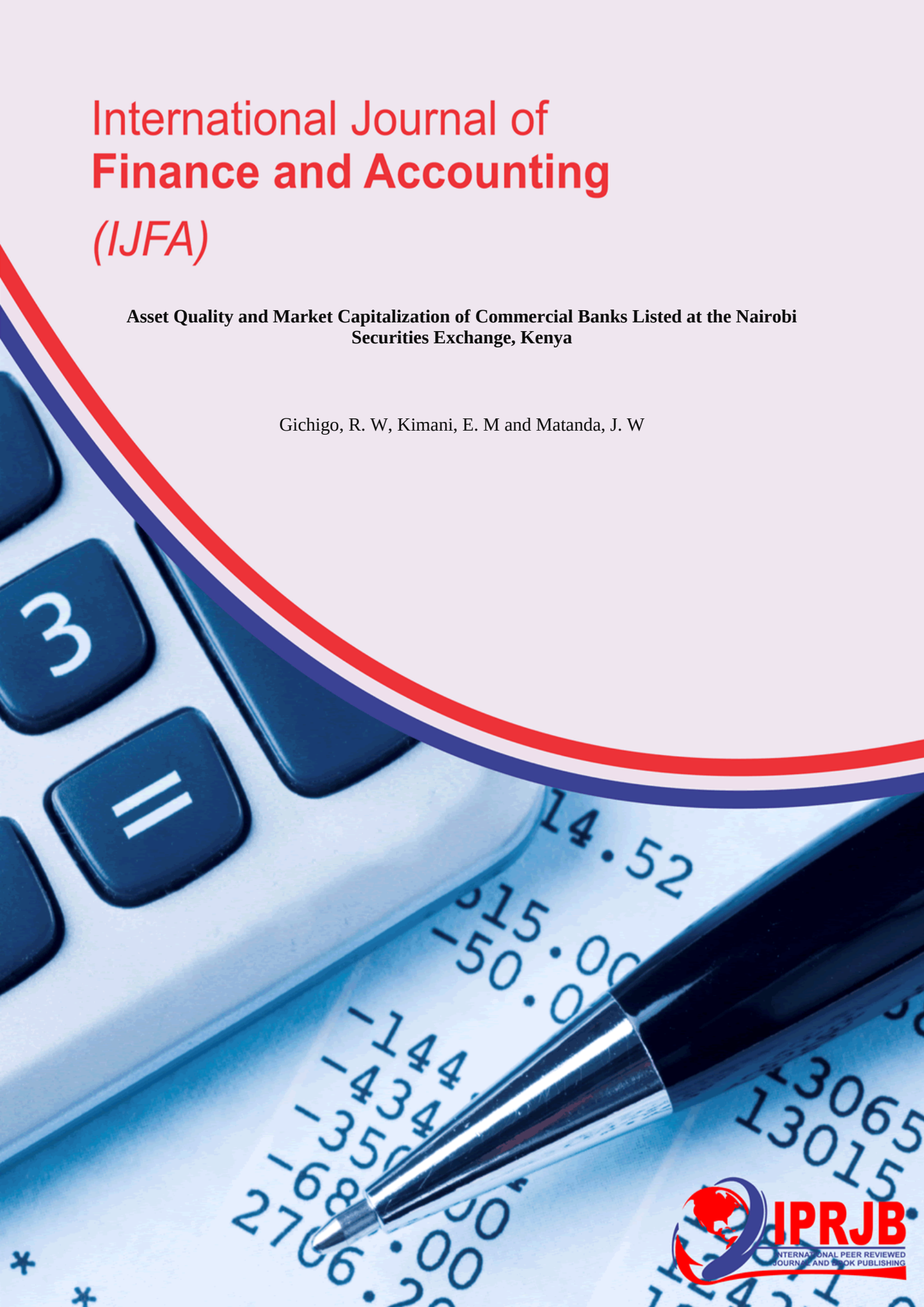

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Asset Quality and Market Capitalization of Commercial Banks Listed at the Nairobi Securities Exchange, Kenya

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Abstract

Purpose: Commercial banks listed on the NSE have recorded fluctuating market capitalization over the past decade, raising concerns over their solvency and long-term viability. From 2013 to 2024, ROA declined from 4.8% to 3.7%, while ROE fell from 33% to 22%, indicating inconsistent bank performance. Fluctuations in these metrics, including a ROE low of 23% in 2020 and a recovery to 28% in 2022, weaken investor confidence and reduce market efficiency. The objective of the study was to establish the effect of asset quality on the market capitalization of commercial banks listed at the Nairobi Securities Exchange. The theoretical foundation was grounded in Portfolio

Methodology: Theory. This study adopted a causal research design. The target population for this study consists of all 11 commercial banks listed on the Nairobi Securities Exchange from 2018 to 2024. Since the population is fairly small, below 100, a census method was employed. The study used secondary data collected using a secondary data collection schedule. The data was analyzed using both descriptive and inferential analysis. Descriptive statistics involved determining the mean, the standard deviation, skewness, and kurtosis of each variable under study. The data was analyzed using panel data techniques, which are particularly suitable for handling data that involves multiple entities over several time periods. STATA 15 was employed for data analysis purposes.

Findings: The study established that asset quality significantly influences market capitalization of commercial banks listed at the NSE by explaining 63.38 % of the bank variations in market capitalization. The findings conclude that asset quality is a critical determinant of market capitalization, enhancing investor confidence, stability, and long-term market performance of banks.

Unique Contribution to Theory, Practice and Policy: The study recommends that commercial banks strengthen asset quality through effective management of non-performing loans. Regulators should also encourage prudent risk management practices. These strategies will improve investor confidence, stabilize earnings, and significantly boost market capitalization at the NSE.

Keywords: *Asset Quality, Market Capitalization, Commercial Banks, Nairobi Securities Exchange, Kenya*

INTRODUCTION

Market capitalization reflects the total value of a banking institution's outstanding shares and serves as a key indicator of its financial performance and investor confidence. It encapsulates market perceptions of risk, profitability, and operational efficiency, influenced by interest rate fluctuations, macroeconomic conditions, and the quality of financial disclosures (Mwangi & Kamau, 2022). A declining market capitalization may signal weakening investor trust, possible financial instability, or speculative uncertainty. On the other hand, a consistently growing market capitalization suggests strong financial fundamentals, efficient management, and a resilient banking sector, thereby attracting long-term investors (Kariuki & Omondi, 2023). Regulatory interventions such as stringent disclosure rules and prudent monetary policies enhance market confidence by sustained capital market growth (Chen, Liu, & Zhao, 2021).

The introduction of the Interest Rate Cap through the Banking (Amendment) Act significantly altered credit market dynamics in Kenya between 2016 and 2019 by limiting lending rates to four percentage points above the Central Bank Rate and setting a floor on deposit rates. The cap constrained risk-based pricing, prompting banks to shift lending away from SMEs and higher-risk borrowers toward government securities and top-tier corporates, thereby slowing private sector credit growth (CBK, 2017; CBK, 2018). During this period, asset quality pressures intensified as non-performing loans increased across key sectors, while net interest margins and profitability declined, particularly among small and mid-tier banks (IMF, 2018; World Bank, 2019). The regulatory distortion also affected investor perceptions, contributing to subdued bank valuations on the Nairobi Securities Exchange and elevating perceived regulatory risk within the sector.

Statement of the Problem

Market capitalization is a fundamental measure of the sustainability, competitiveness, and value generation capacity of commercial banks. It reflects a bank's ability to generate earnings relative to expenses and other relevant costs, and is critical in maintaining investor confidence, attracting deposits, and ensuring macroeconomic stability (Wang, Yang & Yang, 2023). Listed banks are especially held to higher performance standards to assure investors, depositors, and regulators of their financial health and governance integrity. However, listed banks in Kenya are facing persistent challenges in sustaining and maintaining consistent market capitalization. These structural weaknesses have translated into volatile and declining market capitalization. Weak market capitalization affects shareholder returns, limits banks' lending capacity, and undermines their role in financial intermediation and economic development. These fluctuations and gradual declines undermine investor confidence, distort market valuations, and erode capital market efficiency. The broader implications of poor market capitalization are already visible in the form of bank failures and erosion of public trust. Between 2018 and 2024, market capitalization for listed commercial banks in Kenya showed a fluctuating trend. In 2018, MCAP was KES 71.85 billion, rising to KES 78.97 billion in 2019. However, it declined to KES 70.16 billion in 2020 and further dropped to KES 68.33 billion in 2021. The downward trend continued in 2022, reaching a low of KES 62.55 billion. A modest recovery was observed in 2023 with MCAP at KES 64.33 billion, followed by a strong rebound to KES 76.33 billion in 2024, representing 18.7% increase. However, in 2024, the market capitalization of all firms listed at NSE reached 1.939 trillion shillings, representing a 35% increase compared to the previous year. Although global research by Le and Ngo (2020) and Dima, Izzeldin, and Soliman (2022) confirms that asset quality significantly influences market capitalization, most

of these studies are based on banking systems in developed economies or broader emerging markets. Their findings may not be fully applicable in the Kenyan context.

Objectives of the Study

The objective of the study was to establish the effect of asset quality on the market capitalization of commercial banks listed at the Nairobi Securities Exchange.

Research Hypotheses

H_{O1}; Asset quality has no effect on the market capitalization of commercial banks listed at the Nairobi Securities Exchange

Significance of the Study

The findings of this study offer valuable insights for the management of commercial banks listed on the NSE by highlighting how asset quality affects market capitalization. These insights enable managers to make informed strategic decisions aimed at enhancing stability, investor confidence, and competitiveness. For investors, this study provides critical insights by aiding in the evaluation of investment prospects in the banking sector. For policymakers and regulatory bodies in Kenya's financial sector. Regulators can leverage these insights to strengthen policies on risk management, reporting standards, and financial transparency. For scholars and researchers, the study serves as a valuable foundation in exploring financial stability and performance in emerging economies. It provides empirical evidence that supports or challenges existing financial theories, enriching scholarly discourse on risk management, capital markets, and firm performance. Ultimately, the study promotes evidence-based learning and equips academic institutions to contribute meaningfully to policy formulation, financial education, and national economic development strategies.

Theoretical Review

This section provides a comprehensive review of the relevant literaturethat guided the study.

Portfolio Theory

Markowitz introduced modern portfolio theory (MPT) in 1952, emphasizing diversification and risk-return tradeoffs in asset selection. Markowitz argues that investors and, by extension, institutions like banks should diversify their asset portfolios to minimize risk while maximizing returns. In the context of banking, asset quality influences the portfolio's risk-return profile. A higher-quality loan or investment portfolio, consisting of low-risk and performing assets, stabilizes bank earnings and supports market capitalization. The theory underlines that poor asset quality, especially non-performing loans, reduces expected returns and increases volatility. Therefore, banks with better asset quality management are more likely to achieve superior financial outcomes by optimizing the composition of their asset portfolios through proper diversification and risk analysis.

Portfolio theory is grounded on several assumptions: investors are rational and risk-averse; they seek to maximize utility based on risk-return trade-offs; asset returns are normally distributed; and the correlation among assets can be quantified. The theory assumes that markets are efficient and that all necessary information is freely available to investors to inform decisions. It also presumes a single-period investment horizon, which is often unrealistic for financial institutions like banks that manage long-term assets and liabilities. Furthermore, the theory assumes that diversification can eliminate all unsystematic risks, leaving only systematic risk. While these assumptions may not fully apply to real-world conditions in the

banking sector, especially in developing markets, they provide a structured way to evaluate how the quality and composition of assets impact overall bank risk exposure and market capitalization.

In commercial banks listed at the NSE, Portfolio Theory offers a valuable lens through which asset quality and market capitalization can be assessed. Banks maintain asset portfolios primarily composed of loans, government securities, and other financial instruments. By applying Markowitz's framework, banks can evaluate how the mix of performing versus non-performing loans affects expected returns and the volatility of their earnings. Diversification across sectors, customer segments, and loan types can reduce portfolio risk and enhance stability. Regulators like the Central Bank of Kenya emphasize portfolio quality through prudential guidelines on NPLs, provisioning, and risk classification. Thus, managing asset quality through diversification, rigorous appraisal, and recovery procedures becomes central to optimizing financial outcomes under the logic of portfolio theory.

While portfolio theory is foundational in finance, it has limitations when applied to real-world banking, especially in emerging economies. One critique is its assumption of normally distributed returns, which does not always hold in the case of banking assets prone to extreme losses, such as defaults or market crashes. Also, banks face regulatory constraints, such as capital adequacy ratios and sectoral lending limits, that limit full diversification. In addition, behavioral factors such as managerial overconfidence or political influence on lending can distort asset allocation decisions, undermining the ideal rational decision-making assumed by the theory. Moreover, the theory does not explicitly account for liquidity risk or macroeconomic shocks, which can severely affect asset quality.

While Modern Portfolio Theory posits that investors diversify assets to maximize expected utility through mean variance optimization, its direct application to commercial banks is conceptually constrained. Banks do not allocate assets solely to achieve optimal risk–return trade-offs; rather, portfolio decisions are heavily shaped by regulatory capital and liquidity requirements under Basel III and prudential guidelines issued by the Central Bank of Kenya. Under risk-weighted capital frameworks, assets such as government securities attract lower risk weights and therefore improve capital adequacy ratios, incentivizing banks to rebalance portfolios for regulatory capital efficiency rather than purely for diversification benefits (BCBS, 2011; CBK, 2013).

Conceptual Framework

A conceptual framework outlines the hypothesized link between asset quality and the market capitalization of listed commercial banks. By establishing these connections, the framework serves as a guide for the research process, helping to clarify the direction and scope of the study.

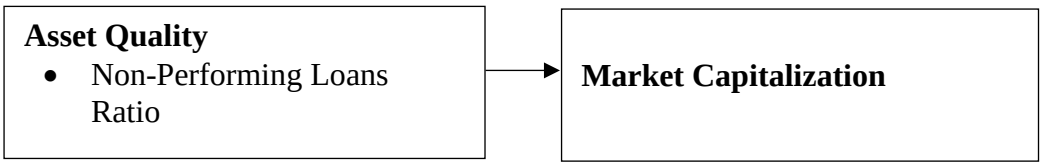

Figure 1: Conceptual Framework

Empirical Review

Batrancea and Munteanu (2022) examine the relationship between asset quality and profitability in Romania's banking sector. Using regression analysis on data from 30 banks over five years, the study finds a significant negative impact of non-performing loans (NPLs) on profitability, measured by ROA and ROE. The study concludes that deteriorating asset quality, reflected by rising NPLs, negatively affects profitability. However, the study is limited by its focus on a single country's banking system, restricting its broader applicability. Additionally, the research focuses solely on NPLs, neglecting other indicators of asset quality such as loan loss provisions and credit risk management practices. Furthermore, the study could have incorporated macroeconomic variables that might influence asset quality.

Ngugi and Mwaura (2019) focus on the impact of asset quality on the profitability of banks listed on the Nairobi Securities Exchange in Kenya. The study uses quantitative regression analysis with data from 10 banks over four years. The findings show that poor asset quality, reflected by higher NPLs, is negatively correlated with profitability, suggesting that non-performing loans impair the market capitalization of Kenyan banks. A key limitation of the study is its relatively short time frame, which might not capture long-term trends or cyclical economic impacts on asset quality. Additionally, the study does not account for the wider macroeconomic environment, such as inflation or political instability, which could affect both asset quality and profitability.

Sufian and Habibullah (2020) analyze the determinants of profitability in Philippine banks, particularly focusing on asset quality. They use a time-series approach with secondary data from 12 banks spanning from 2010 to 2019. The study shows that NPLs negatively affect profitability, with higher asset quality (lower NPLs) contributing to better market capitalization. However, the study does not consider other important macroeconomic factors, such as economic growth or interest rate fluctuations, which could influence both NPLs and profitability. Additionally, while the study's sample size is adequate, it might have benefited from a broader range of banks, including rural or smaller banks, to make the results more generalizable to the entire Philippine banking system.

Chirwa and Odhiambo (2021) investigate the relationship between asset quality and market capitalization across Sub-Saharan African banks. The study utilizes panel data from 50 banks in 10 countries from 2010 to 2019. It finds a significant negative relationship between asset quality (NPL ratio) and market capitalization, confirming that poor asset quality hampers profitability. However, the study fails to consider the heterogeneity across countries in the region, as varying economic environments and banking regulations might influence results. Additionally, the study focuses solely on NPLs, ignoring other critical indicators like asset diversification, capital adequacy, or macroeconomic factors that could significantly impact asset quality and profitability in Sub-Saharan African banks.

The reviewed studies Batrancea and Munteanu (2022), Ngugi and Mwaura (2019), Sufian and Habibullah (2020), and Chirwa and Odhiambo (2021) reveal consistent gaps in the literature. Most rely solely on the NPL ratio to measure asset quality, neglecting broader indicators such as loan loss provisions and risk-weighted asset composition under Basel III. Ngugi and Mwaura (2019) use a short four-year period that may not capture regulatory shocks like the interest rate cap introduced through the Banking (Amendment) Act, while Sufian and Habibullah (2020) and Batrancea and Munteanu (2022) inadequately incorporate macroeconomic factors influencing credit risk. Although Chirwa and Odhiambo (2021) adopt a multi-country approach, they do not sufficiently address regulatory heterogeneity across jurisdictions supervised by authorities such as the Central Bank of Kenya. Additionally, the dominant focus on accounting-based profitability measures (ROA and ROE) limits understanding of market-based performance outcomes, highlighting the need for broader, multidimensional, and context-specific analyses of asset quality and bank performance

METHODOLOGY

This study adopted a causal research design. This approach is preferred because it enables the exploration of the cause-and-effect relationship between financial soundness and market capitalization. The target population for this study consisted of all 11 commercial banks listed on the Nairobi Securities Exchange from 2018 to 2024. A census method was employed to avoid sampling bias when the study population is small (Kothari, 2007). The study used secondary data collected using a secondary data collection schedule. The acquisition of secondary data was facilitated by the use of financial statements, independent audit reports, prospectuses, and the Nairobi Securities Exchange Handbook, all of which are accessible from the NSE, Central Bank of Kenya website, as well as individual bank websites. Data was gathered over a span of seven years, namely from 2018 to 2024. The study collected panel data that combines both cross-sectional and time-series data. This approach allowed for the examination of variations across individual banks (cross-sectional) as well as over time (time-series). The data was analyzed using both descriptive and inferential analysis. STATA version 18 was used to analyze the data. The following analytical panel data model was adopted;

$$\mathbf{Y_{it} = \beta_0 + \beta X_{it} + \varepsilon} \quad \textbf{.....Equation 1}$$

Where;

Y represents the market capitalization of commercial banks listed at NSE

$\boldsymbol{\beta_0}$ represents the constant term

$\boldsymbol{\beta}$ represents the regression coefficients of the independent variable

X represents asset quality

i represents an individual listed commercial bank

t represents a time period (year)

$\boldsymbol{\varepsilon}$ represents the error of the term.

FINDINGS AND DISCUSSION

The chapter presents the results and discussion. The results are based on descriptive, diagnostic, and inferential analysis.

Descriptive Statistics

Table 1 summarizes the descriptive statistics results.

Table 1: Descriptive Statistics

Stats	Market Capitalization	Asset Quality
N	70.00	70
min	1,210.18	0.0466683
max	187,180.50	0.5305587
mean	70,505.19	0.1342075
sd	49,937.99	0.0745702
variance	2,490,000,000	0.0055607

In this study, market capitalization serves as the dependent variable and represents the total value of a commercial bank's outstanding shares listed at the Nairobi Securities Exchange (NSE). It is a proxy for investor confidence, perceived firm value, and performance. The data shows that market capitalization among the sampled banks ranges widely from KES 1,210.18 million to KES 187,180.5 million, with a mean of KES 70,505.19 million and a standard deviation of KES 49,937.99 million. This high variability indicates significant disparities in market valuation among listed banks, reflecting differences in scale, profitability, and public perception.

Asset quality evaluates the level of risk associated with a bank's asset portfolio, particularly in terms of non-performing loans (NPLs). A higher quality of assets translates into reduced credit risk and improved earnings reliability. In this study, asset quality ranges from 0.0467 to 0.5306, with a mean of 0.1342 and a standard deviation of 0.0746, suggesting relatively consistent but modest asset quality across the banks. Lower asset quality increases the likelihood of loan defaults, which can undermine profitability and market performance.

Trend Analysis

Trend analysis is a financial analysis technique used to evaluate an organization's performance over a period of time by examining patterns and changes in financial data. It involves comparing financial statements of different years to identify upward or downward movements in key variables such as sales, profits, assets, liabilities, and cash flows.

Trend Analysis for Market Capitalization

Trend analysis for market capitalization examines the changes in a company's total market value over a period of time to assess its growth, stability, and investor perception.

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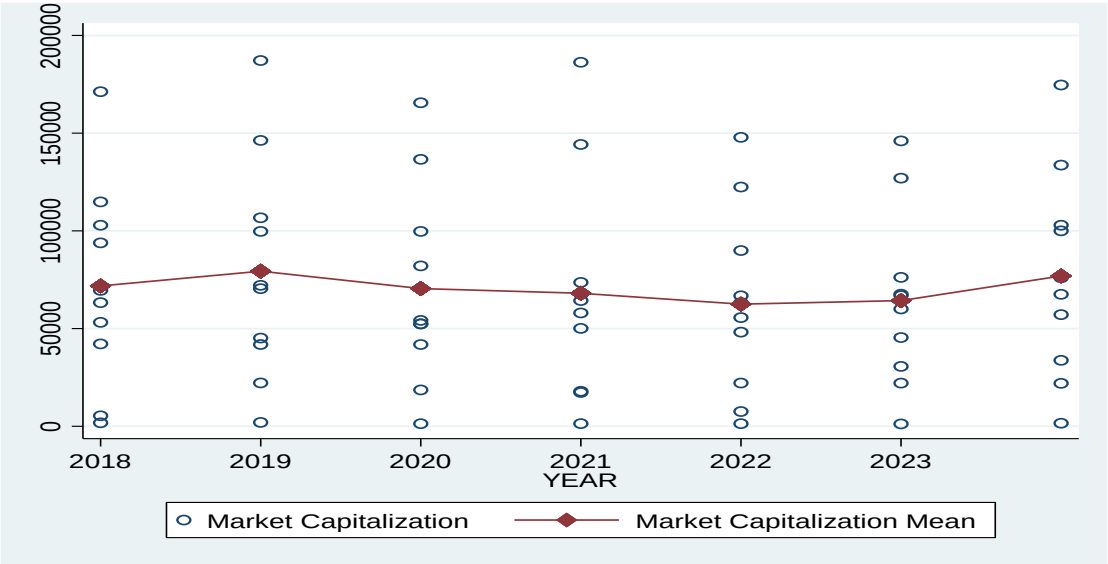

Figure 2: Market Capitalization Trend

The market capitalization of listed firms at the Nairobi Securities Exchange (NSE) between 2018 and 2023 exhibits a notable trend, with 2021 standing out as a pivotal year. From 2018 to 2020, the mean market capitalization likely remained stable or experienced gradual growth. The year 2021, however, marked a significant inflection point, as highlighted in the data. In the subsequent years, 2022 and 2023, the trend is likely adjusted in response to the 2021 shift. If the earlier year saw growth, the following period might reflect consolidation or a mild correction as the market stabilized.

Trend Analysis for Asset Quality

Trend analysis for asset quality assesses the condition and performance of a firm's assets over time to determine their ability to generate income and retain value. Asset quality reflects how effectively an organization manages its resources and the extent to which its assets are productive, recoverable, and free from impairment.

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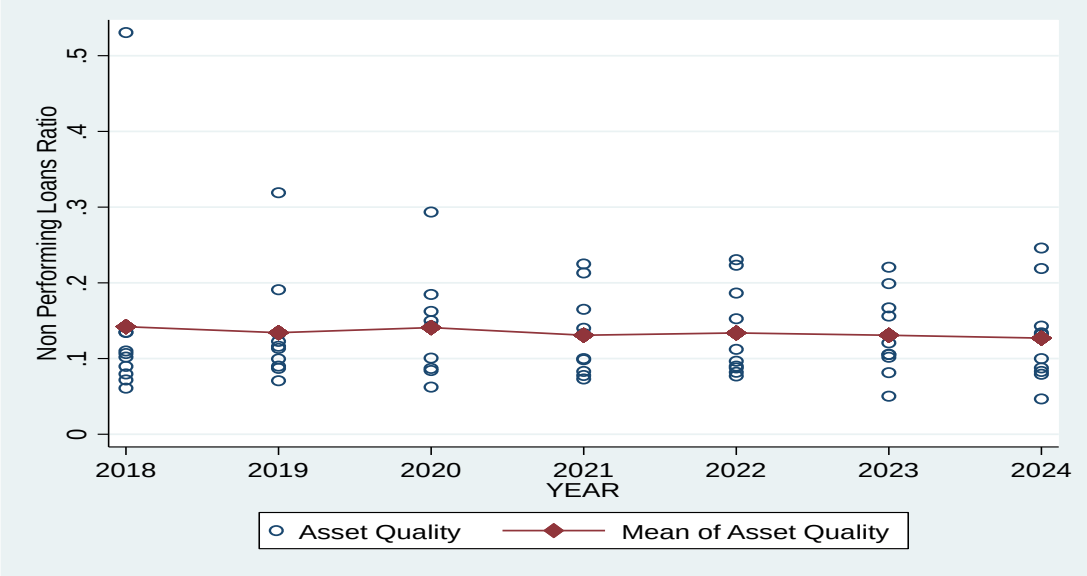

Figure 3: Asset Quality Trend

The analysis of asset quality, represented by the mean NPL ratio in the red line, shows a slight but consistent improvement over the seven years. On average, the ratio decreased gradually from about 1.4 in 2018 to approximately 1.2 in 2024, suggesting that overall asset quality has been improving over time. However, the wide scatter of the individual data points, represented by the blue circles, indicates substantial variability across entities. Notably, significant outliers were observed in the early years, with NPL ratios reaching as high as 5.3 in 2018, 3.2 in 2019, and 3.0 in 2020. These extreme cases pulled the average upward, masking the relatively better performance of most institutions. In reality, the majority of entities maintained much lower NPL ratios, generally below 2.0, highlighting stronger asset quality.

Inferential Analysis

The inferential analysis comprised correlation analysis, simple linear regression, and multiple linear regression. Correlation analysis was used to examine the strength and direction of associations between variables. Simple linear regression was applied to test the effect of each independent variable on the dependent variable individually, while multiple linear regression was employed to assess the combined influence of all independent variables on the dependent variable.

Correlation Analysis

To explore the effect of financial soundness on market capitalization, a correlation analysis was conducted. The results of the correlation between financial soundness and market capitalization are summarized in Table 2.

Table 2: Pearson Correlation Analysis

		Market capitalization	Asset quality
Asset quality	Pearson Correlation	0.4731	1
	Sig. (2-tailed)	0.0000	
	N	70	

Asset quality recorded a stronger correlation of 0.4731 ($p < 0.001$), showing that improved loan performance and lower non-performing assets significantly enhance market capitalization. This indicates that investors pay close attention to the health of a bank's loan portfolio when valuing its stock. This is consistent with Batrancea and Munteanu (2022), who established that higher non-performing loans reduce profitability, and Ngugi and Mwaura (2019), who found that poor asset quality negatively affected listed Kenyan banks' performance. Both studies support the view that reducing NPLs directly improves bank stability, profitability, and ultimately, market capitalization.

Panel Regression Analysis

Panel regression analysis was conducted to establish the direct effect of financial soundness indicators on the market capitalization of commercial banks listed at the Nairobi Securities Exchange. The results are as follows:

Table 3: Regression Fixed Effect of Asset Quality on Market Capitalization

Fixed-effects (within) regression		Number of obs	=	70		
Group variable: BankID		Number of groups	=	10		
R-sq:		Obs per group:				
within = 0.5112		Min	=	7		
between = 0.0285		Avg	=	7		
overall = 0.2238		Max	=	7		
		F(1,59)	=	61.71		
corr(u_i, Xb) = -0.2411		Prob > F	=	0.000		
Mkt Cap	**Coef.**	**Std. Err.**	**t**	**P>t**	**[95% Conf.**	**Interval]**
Asset quality	0.633809	0.080681	7.86	0.000	0.472366	0.795252
_cons	2.240896	0.026031	86.09	0.000	2.188809	2.292984

The regression results in Table 3 reveal that asset quality exerts a strong and statistically significant effect on the market capitalization of commercial banks listed at the Nairobi Securities Exchange. The coefficient of 0.6338 ($p = 0.000 < 0.01$) indicates that a unit improvement in asset quality leads to a substantial 0.6338 increase in market capitalization, holding other variables constant. The regression model is shown below.

$$Y = 2.240896+0.633809X \text{……..Equation 2}$$

With a within R-squared of 0.5112, asset quality explains 51.1% of the variations in market capitalization across the sampled banks. The study is supported by Sufian and Habibullah (2020), who demonstrated a similar negative relationship between NPLs and profitability in Philippine banks, supporting the current findings. Chirwa and Odhiambo (2021) also confirmed that poor asset quality suppresses market capitalization in Sub-Saharan Africa, underscoring its regional relevance. Likewise, Ghosh (2020) reported that higher NPLs reduce profitability in Indian banks. However, Boudriga, Taktak, and Jarboui (2020) introduced a nuanced view, showing that effective credit risk management can offset the negative impacts of NPLs. This suggests that while asset quality is critical, its effects may vary depending on risk mitigation strategies.

SUMMARY, CONCLUSION AND RECOMMENDATIONS

The chapter is structured into four sections. The first section provides a summary of the major findings, highlighting the influence of asset quality on market capitalization. The second section outlines the conclusions drawn from these findings in relation to the study objective. The third section presents recommendations for policy, practice, and management, while the final section offers suggestions for further research.

Summary

The descriptive results showed that asset quality varied significantly across banks, largely due to differences in non-performing loan portfolios. Higher levels of impaired assets suggested reduced financial strength, while lower levels reflected stronger stability. The Pearson correlation revealed a strong and positive association between asset quality and market capitalization, demonstrating that banks with better-quality assets enjoy higher investor trust and stronger valuations. Simple linear regression results confirmed this relationship, indicating that asset quality accounted for significant variation in market capitalization, making it the most influential single factor among the indicators tested. In the multiple regression model, asset quality retained its dominance with a strong coefficient, emphasizing that controlling non-performing loans and maintaining high asset standards directly enhances market capitalization.

Conclusion

The study established that asset quality significantly affects the market capitalization of commercial banks listed at the Nairobi Securities Exchange. Asset quality, measured by the proportion of non-performing loans in the total loan portfolio, signals the effectiveness of credit risk management. A lower level of non-performing loans indicates stronger asset quality, which boosts investor confidence and enhances market value. Conversely, poor asset quality erodes profitability and undermines investor perception, thereby lowering market capitalization. The findings reject the null hypothesis and affirm that asset quality is a crucial factor influencing valuation, as it reflects both financial stability and growth potential.

Recommendations

To safeguard asset quality, banks should actively manage non-performing loans by tightening credit evaluation frameworks, strengthening collateral requirements, and enhancing borrower monitoring. Proactive loan restructuring and recovery strategies are also critical in minimizing loan losses. Regulators should enforce stringent provisioning and reporting standards to ensure transparency. Improved asset quality not only enhances profitability but also reduces credit risk, thereby positively influencing investor confidence and market capitalization sustainability.

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