

Stock Market Reaction to Political Events (Evidence from Pakistan)

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Abstract

This study examines the impact of events of different nature like: political, natural calamities and terrorism on the share prices of the financial sector of Pakistan. A sample of 14 companies are selected randomly from the financial sector (Insurance and Banking) listed on the KSE-100 index. The time span is of four years i-e 2007-10. The data is analyzed through paired samples t-test statistics. The results indicate that events have significant impact on the stock prices and prices behave negatively when a major event emerges on national or international front. A joint effort is required from different individuals, stake holders, regulators, economists, investors, government and foreign officials to secure the effectiveness of the financial market in Pakistan from the curse of political pressure, terrorists and suicidal bombing which in return help in the prosperity of the country. To encourage and motivate the investors both domestically or internationally the governance system in country should be fair and transparent and secure environment would increase the morale of the investors.

Keywords: Paired sample t-test statistics; Events study Method Approach, Stock Prices

1.1 Introduction

Stock market is a place where trading of publicly owned securities took place. It plays pivotal role in transferring of surplus funds from one individual to another and performs the function of financial inter mediation between two parties one has in surplus and the other one has deficit in income. Stock market has a strong link with the global and domestic stability of a country. The regional, national and global uncertainty and unsound financial standings affects the stock exchange in a country. Crops production, manufacturing industries or infra structure damages due to natural disasters, calamities and political uncertainties adversely affect the stock markets stability and integrity. The economic situations inflation, recession and price fluctuations have direct impact on

the direction of stock market. Corruptions and other factors involving world events also had direct effects on the trust worthiness of the system as a whole. The regions which are at war or facing some terrorist activities as we are facing in our country have slashed our Annual Developmental Programs, has also adversely affected our business, commerce and stock markets within the affected region. Karachi stock exchange is the biggest stock exchange in Pakistan among the Lahore and Islamabad stock exchanges due to its high market capitalization, high turnover. The ethnic crisis, target killings, irrelevant agitations have badly suffered this area and low productive activities have marred the investors interest and their hesitation from further investment in the country. Year 2007-10 are counted as the dark period for Pakistan, in which miserable events arose in high number and globally it had affected the reputation of the country. These crises had restricted the foreign and domestic investments because the investor did not have any hope to achieve. The prevailing condition of suicidal and terrorism attacks by Taliban, Al-Qaeda, miscreants and the political climate badly affected our economic stability and the stock markets. Some events had crippled our stock market such as 9/11 terrorists attack, London bombings, killings of foreign journalists and some top influential leaders (Benazir Bhutto, Nawab Akbar Bugti etc), political instability in the time of General Pervaiz Musharraf, judiciary war against government, fights in tribal areas and Malakand Division, US Drone attacks in FATA. These events had badly hit the stock return in the KSE. These events had caused speedy fluctuations and unrest in the Karachi Stock Exchange. KSE 100-index was launched in November 1991 with a base of 1,000 points. By 2001, it had grown to 1,770 points. By 2005, it had skyrocketed to 9,989 points. It then reached to 12,285 in February 2007. KSE-100 index touched the highest ever benchmark of 14,814 points on December 26, 2007 and market capitalization of 4.57 trillion, a day before the assassination of former Prime Minister Benazir Bhutto, when the index nosedived. The index recovered quickly in 2008, reaching new highs near 15,500 in April. However, by November 22, 2008 during the global financial crisis of 2008 it had fallen to 9,187.

1.2 Impact of Terrorism on the Economy and the Financial Sector

The terrorist activities were on the peak till the end of 2010 in Pakistan. Terrorists had targeted armed forces, police men, rangers, places of business activities and even the innocent civilians. The continuous attacks by such people had badly affected the economy of the country and the poor masses were in the state of trauma and terror all the time. Business activities slowed down and the already running were either fully or partially destroyed. The consequences of the terrorism on the economy and the financial market can be divided into short term and long term effects. In the short run the consequences may be the destruction of life and property, damages to infrastructure and communication system and the timely movement of people from their houses to some safe places. While the long run effect can be the lack of confidence in the people. It had diminished the two aspects of the human nature. Employees and the entrepreneur were in the state of that the employees feel insecurity about their job and the entrepreneur are not sure either their future returns will be achieved? The macroeconomic variables in the Pakistan economy are continuously decreasing, the damages to the government property and the killing of the civilians due to suicidal and bombings placed extra burden on the economy. The reluctance of the foreign investors to invest in the country lessens the Foreign Direct Investment in the country. Terrorism has also a significant impact on the financial market of the country. It has direct and indirect influence on the market when the twin World Trade Centre was blown, every market in World was affected due to such attacks and the terrorism creates the atmosphere of uncertainty due to which stock prices exhibit volatile behavior. Any attack that cripples the financial infrastructure, either by shutting down internet and telecommunications or by physically closing an exchange, would make shares in these companies at risk. There is no absolute strategy for hedging against terrorism in financial markets; there are stocks that are less likely to be hurt if the market is

rocked by an attack. Make sure you know where your portfolio sits in this ever-changing world so that if any worst happens, your finances will be prepared – and your risk would be diversified which will help in getting rid of financial loss.

1.3 Financial Sector at a Glance

The Financial Sector of Pakistan is comparatively performing well in still at the time when the country is suffering from the menace of terrorism, poor law and order situation, political un-rest, foreign indulgence in different illegal activities and the degrading of bond ranking by S&P. The financial sector of the country comprises of the commercial banks, investment banks/investment companies/ securities companies, leasing companies, insurance, Non-Bank Financial Institutions (NBFIs), Microfinance banks, Central Depository of National Savings (CDNS), Banking and insurance sector have a dominant position among others due to its high growth rate and profitability.

1.3.1 Banking Sector

The banking sector fulfill the fundamental purpose of the financial intermediation, taking deposits from those having excess funds and lending them to those having shortage of funds in the form of loans with a fixed interest.

(Insert Table 1 Here)

In fiscal year 2008 deposits slows down to 9.4% as compare to 18.1% in the last 5 years. The reason for the decline in the deposits is due to uncertain environment in the country. During the 2nd quarter of 2010 deposits (both time and demand) has boost by Rs. 44.3 billion as compared to the decrease of Rs. 73.1 billion in year 2009.

1.3.2 Insurance Sector

Insurance is a form of risk management, used to minimize the risk against any loss. The main role of insurance is to share the risk of possible loss between two units for some fee known as risk premium. This sector encourage financial steadiness by enabling economic agents to carry out various transactions with the facility of transfer and distribution of risks. As a crucial component of the financial system, life insurance plans are an important source of savings and long-term institutional investments essential for the development and growth of bond markets. The role of life insurance as a financial intermediary is particularly important in countries like Pakistan with low levels of financial penetration. In Pakistan Insurance sector consists of two major categories: Non Life and Life insurance companies. And further they are differentiated as public and private sector insurance companies. The non life private limited companies in the sector were fully control ten major companies and acquire the market premium up to 84% and the remaining 16% is captured by the public sector companies and this sector also faced the challenging condition of our country and did not show good results in this unsure environment. There are four companies in the public sector which are owned by the government of Pakistan. These are State Life Insurance Corporation of Pakistan, National insurance company limited, Pakistan Reinsurance Company Limited, and Alpha Insurance Company Limited.

(Insert Table 2 Here)

This sector has showed healthy performance in the last years due to high uncertainty in the country. Some initiative steps by the government also improve the efficiency of this sector by privatizing the poor performing state owned companies. Certain challenges and the poor security atmosphere and unrest in the capital and money market in year 2008 and 2009 hinders in the performance of the sector. Both of the two sectors have huge potential which the government has not realized till now. The sector can contribute a lot to the GDP, and create

many opportunities of savings, investments and employment which are the main problem in Pakistan. The government should take proactive strategies to flourish these sectors and provide assistance to it and in the long run government will benefited a lot from these sectors.

2. Literature Review

Different research studies were conducted by different scholars to identify those factors which affect the share prices. In this research we will focus on events study and analyzing stock prices behavior due to such events arising from time to time in the country. That may be comprises of Political, International Issues, Terrorism, and natural Calamities occurring from time to time in Pakistan and affect KSE stock prices. (Chesney., 2010), studied the empirical impact of the terrorism along with some extreme events on the financial market and a data of 25 different countries for 11 years were collected where different terrorist activities took place. Two approaches were used for the analysis: non-parametric methodology and the events study. The results concluded at the end showed that financial market behave significant negative relation to terrorist attacks and catastrophic events supporting the significant relation of the political risk on the market due to which the market slowed down. (Akysha M. Shakil, 2009), studied the affect of different events on the trading volume and fluctuations in the prices of the KSE-100 index. For their study they use Pearson Correlation to test either these events have some affect on KSE trading volume or not and finally they conclude that stock return fluctuate from their actual due to occurrence of different events. Examining the effects of the terrorism on the financial markets of Pakistan in 2006-08, (Gul, Tayyeba et al., 2010), carried out a research that whether there are some relationship between these two or not. For analysis secondary data of some key indicator of the three markets and daily data of terrorism incidents were collected. And the data was analyzed through Multiple Regression Model; they concluded that the economy and the financial market have adversely affected by such activities.

(Malik Hussain & Shakil Ahmed, 2009), use Phillips Perron unit root test to inspect the connection with trading volume and returns. The major event on the base of which research is conducted is the effect of the pre-resignation and the post-resignation Ex President Pervaiz Musharraf. The results showed that the impact of the political events on the trading volume and return of the stock prices is significant and prices behave bearish and bullish trend due to the intensity of the event. (Khan et al., 2009), based six different events of political and terrorism nature and studies its effect on the stock returns in association with Pak-American relationship they randomly select six major events and analyzed its effect on the KSE-100 index. Events for the analysis are: 9\11 World Trade Centre, murder of Denial Pearl, war against terror, fights between militants in Waana, Drone attacks and the resignation of the military, the findings showed that these events have some positive influence on the returns of the KSE. The effect of terrorist attacks on Japanese Stock Exchange is examined by (Vikash Ramiah et al., 2008), that how the recent attacks around the world influence different sector of Japanese Stock exchange. Five major events of terrorism were selected: 9/11, Bali bombing (12th Oct 2002), Madrid bombing March (2004), and London (2005) and Mumbai (2008). Parametric and non-parametric method of testing was applied for analysis. The outcome show that the market show negative returns in the short run and due to 9/11 attacks and have weak response towards Bali, Mumbai and London bombings, while reacts negatively to Madrid terrorist attacks.

(Fowdar & Koonjal, 2008), "Political risks cost the world economy \$800b in 2003 especially due to terrorism." The speed of price reaction to news and certain political events is of great interest for both investors, researchers which directly or in-directly influence the stock exchanges around the globe. Study was conducted whether political news or events affect the returns of the Stock Exchange of Mauritius or not. Spearman's rho and regression analysis was used and finally they conclude that political risk and economic news both are highly

valuable and affects the stock exchange. Most of the non local investors used political risk to evaluate the performance and efficiency of the market, because political events can influence its performance in a striking manner. (E. Clark et al., 2006), studied the effect of the political risk on the Pakistani Stock market. Hierarchical Bayesian models and Markov Chain Monte Carlo (MCMC) sampling was used for the analysis. They collected political events in Pakistan from 1947 to 2001 and compared it with the returns and conclude that the events have some influence on the returns of the country stock market. (Aktas & Oncu, 2006), examine the impact of political event on the stock exchange of Turkey. When the Turkey Parliament reject the bill against Iraq, if the bill was accepted then American Army can be easily deployed in Iraq and started war against the Saddam government. This decision by the government drops the IMKB Turkey national stock index very sharply. The authors used daily data, OLS for the analysis and studied the pre and post effect of the event. Finally they concluded that stock prices behave inversely when any un-pleasant political event arises in a country.

Same study of the impact of the political events on the stock market is conducted by, (Dar, Feng, and Chun, 2005). They analyzed the Taiwan Stock Exchange (TSE) prices for the possible influence due to events of political nature. For analysis they used two statistical tools: Event Study Methodology and MVRM. The final conclusion they drawn indicates that reaction of the prices to the event is insignificant because of the uninformative nature of events. daily data to analyze how stock and foreign exchange markets react to terror. The data distinguishes location, (Eldor and Melnick, 2004), uses type of attack and target, number of casualties, and the number of attacks per day for 639 terror attacks between 1990 and 2003 in Israel. Suicide attacks had a permanent effect on both the stock and foreign exchange market, as did the numbers of victims, while location of a terror attack had no effect on either market. Finally they concluded that stock market up to some extent reacts to such activity. Political risk and events arise in such scenario can bring different changes in the stock market returns. (Bilson et al., 2002), adopt such scenario and carried out a study in the Pacific Basin. They presented evidence that political risk may be able to explain some of the variation in emerging stock market returns at both country and aggregate portfolio levels. Their findings reveal that political risk is important in explaining return variation in individual emerging markets, particularly in the Pacific Basin, but not in developed markets. Political events arise in a country can bring some major changes in the stock market. (Robbani and Anantharaman, 2002), carried out a study to notice the influence of such events on the indices of some stock market. A sample of selected indices was randomly selected from counties i-e Pakistan, Sri Lanka, Indonesia and India. Such sample were selected because of the political uncertainties are more common in these countries. Daily data of share prices of the selected indices and events of political nature for four years were collected. Events was considered as independent variable and represented by a dummy variable regression coefficient. The results of the T-test showed that political events have long term effect on the share prices. Stock market is very sensitive and their prices can be affected by any negative political situation with in a country. Natural calamities can influence the stocks of any company based on such assumption (Shelor et al., 1990), conducted a study on the real estate industry and examine the after effect of earth quake on the stock returns of the sector using t-test and beta for risk. The interpreted results from analysis suggest that the earth quake has a significant negate impact on the California real estate sector stocks returns. (Cutler et al., 1989) studied the US market for the same assumption and concluded that the influence of the market to political events exists. From the views and research studies by different economists, scholars and financial analyst's state that events have pessimistic impact on the prices and the markets showed bullish trend to these events depend on the nature and intensity of the event.

2.1 Hypothesis

The hypotheses on which the study is based are:

H_1 : Events have impact on the share prices.

H_0 : Events doesn't have impact on the share prices.

3. Methodology

The sample of the study consists of fourteen firms from financial sector. Out of fourteen there were ten banks and four insurance companies. The time period of the study is from 2007-2010. The sample consists of following Insurance companies and Commercial Banks: KASB, Muslim Commercial, Meezan, NIB (Formerly PICIC), My Bank Ltd, National Bank of Pakistan, Saudi Pak commercial, Soneri, Standard Chartered and United Bank Ltd. From the Insurance sector Admajee, American Life, Asia, and Askari General are selected. Information about two variables was required i.e., event and stock prices. Daily stock prices figures are collected from the KSE web portal. Events of different natures like: terrorism, political and of natural calamities data are collected based on its daily occurrence. Most of the data are collected from Business Recorder, State Bank of Pakistan and the Karachi Stock Exchange websites.

The effect of events on share prices can be noticed as pre-occurrence and post occurrence of event. This is an Event study to examine the impact of the events on the prices of the firms in the financial markets. Daily data of event and prices are collected because of the immediate effect. Event can affect market on the day or after a couple of days when it occurred and its effects can be observed easily. Analyzing long horizon causes problem and the outcome is not desirable. (Jun and Uppal, 1994), argued that monthly or annually data sometime shows fake results due to continuous change of information occur in the market from time to time. (Khilji, 1993) and (Uppal, 1993) used the monthly and annual data of the analysis but the results were not effective as desired.

4. Analysis and Discussion

This study focused exclusively on the effect of the events on the financial sector of Karachi Stock Exchange. The data analyzed through SPSS using Paired samples t-test statistics showed that, the events have significant impact on the share prices. The analysis is carried out in two ways. First, the data is analyzed to find the effects of events on the firm individually. Secondly, to find the influence of events on the whole sector means the combined effect.

(Insert Table 3 Here)

The table 3 findings showed that each firm reacts negatively to the event and the firm share prices show bullish trend after the happening of event. All firms P-values are less than 0.05.

(Insert Table 4 Here)

Table 4 showed the combined effect of the events on the share prices of the whole insurance sector. Here the results are also significant.

(Insert Table 5 Here)

In table 5 averages of the standard deviation and the mean values are taken before and after the events, which clearly demonstrate that the averages are declining when the event occurs. After the event the Standard deviation and the mean figures decrease which shows that event occurrences has some effect. The p-value is 0.001 which is less than 0.05 and showed the significant effect by events on all the firms in insurance sector. Most of the companies in the banking sector when treated individually behave negatively on the happening of the event. The combined effect of all firms within the banking sector showed significant behavior to the events. The mean and standard deviation changes after the event which clearly demonstrate the rejection of the null hypothesis (events have no impact on share prices). The p-values for all the companies in the sector are less than 0.05, and the outcome is statistically significant.

(Insert Table 6 Here)

Table 7 showed the combined effect of the overall banking sector due to occurrence of events, the mean and the standard deviation before the event were 58.595 and 86.630 respectively but when the event occurred the averages decreased and exhibit that the event has affected the returns of the sector after its occurrences.

(Insert Table 7 & 8 Here)

In table 8 the p-value is less than 0.05, which suggest that the share prices of all the banks in the sector behave downward trend.

5. Conclusion

The research study conducted is to find out how the stock prices react when an event occurs. The findings from the analysis clearly showed that event have significant impact on the share prices of the Karachi Stock Exchange. Some major events that took place in 2007-2010, drop the KSE-100 index from top to bottom. The results of the individual firms and then the comparison of the whole insurance and banking sectors are in supporting of accepting alternate hypothesis (H_1) i-e event have impact on the prices of the stocks in the said sectors. The significant relation of the events on the stock prices is consistent with the study of (Khan et al., 2009), who concluded the negative impact of events on the share prices of the Karachi Stock Exchange. (Chesney et al., 2010), concluded that the insurance and the banking sector showed high sensitivity and negative impact to events of natural calamities and the terrorists activities. Hence it is concluded that events have significant impact on the stock prices and the research hypothesis that was derive before the study that an event does have an impact on the stock prices is approved. And the financial sector in Pakistan showed significant relation to event when it occurs.

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Table: 1 Highlights of the Banking System (Rs, Billions)

| | 2005 | 2006 | 2007 | 2008 | Sep-09 | Dec-09 |
|--------------------------------|-------|-------|-------|-------|--------|--------|
| Total Assets | 3,660 | 4,353 | 5,172 | 5,627 | 6,105 | 6,529 |
| Investments (net) | 800 | 833 | 1,276 | 1,080 | 1,593 | 1,753 |
| Advances (net) | 1,991 | 2,428 | 2,688 | 3,183 | 3,119 | 3,248 |
| Deposits | 2,832 | 3,255 | 3,854 | 4,217 | 4,483 | 4,787 |
| Equity | 292 | 402 | 544 | 563 | 641 | 662 |
| Profit Before Tax (PBT) | 94 | 124 | 107 | 63 | 70 | 91 |
| Profit After Tax (PAT) | 63 | 84 | 73 | 43 | 42 | 54 |
| Non-Performing Loans | 177 | 177 | 218 | 359 | 422 | 432 |
| Non-Performing Loans | 41 | 39 | 30 | 109 | 128 | 125 |
| Capital Adequacy Ratio | 11.3 | 12.7 | 12.3 | 12.3 | 14.3 | 14.1 |

Source: State Bank of Pakistan

| Share In Percent, Amount In Billion Rupees | | | | | | | | | |
|-------------------------------------------------------------------------------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| Life | 73.7 | 73.7 | 71.4 | 71 | 70.6 | 67.1 | 58.8 | 62.2 | 64.3 |
| State owned | 71.6 | 71.2 | 67.7 | 66.8 | 65.5 | 61.5 | 52.1 | 56.2 | 56.3 |
| Domestic | 1.2 | 1.5 | 2.4 | 2.6 | 3.1 | 3.3 | 4.2 | 3.6 | 5 |
| Foreign | 0.9 | 1 | 1.3 | 1.6 | 2 | 2.3 | 2.5 | 2.4 | 3 |
| Non-Life | 23.4 | 23.1 | 24.5 | 25.2 | 26.6 | 30.2 | 37.2 | 33.4 | 31.7 |
| State owned | 9.9 | 9.4 | 9.3 | 8.6 | 8.4 | 7.4 | 6.6 | 6.5 | 6.9 |
| Domestic | 12.7 | 12.8 | 14.2 | 15.9 | 17.4 | 22 | 29.8 | 26.2 | 24 |
| Foreign | 0.8 | 0.9 | 1 | 0.7 | 0.8 | 0.8 | 0.8 | 0.7 | 0.7 |
| Reinsurance | | | | | | | | | |
| State owned | 2.9 | 3.2 | 4.1 | 3.8 | 2.8 | 2.6 | 3.2 | 3.6 | 3.2 |
| Takaful | - | - | - | - | - | 0.3 | 0.5 | 0.7 | 0.8 |
| GDP share | 2.6 | 2.8 | 2.9 | 2.8 | 2.9 | 3 | 3.4 | 2.9 | 2.8 |
| Total Assets | 113.4 | 129.7 | 151.3 | 174.6 | 201.7 | 246.1 | 325.1 | 341.4 | 386.8 |
| <i>Source: Annual Audited Accounts of Insurance Companies and Economic Survey of Pakistan 2009-10</i> | | | | | | | | | |

Table: 2 Asset structure of the insurance industry

Table: 3 Insurance Sectors

| Company | t-statistics | P-Value | Remarks |
|----------------|--------------|---------|-------------|
| Adamjee | -4.793 | 0.000 | Significant |
| American Life | -4.749 | 0.000 | Significant |
| Asian | -2.263 | 0.024 | Significant |
| Askari General | -4.309 | 0.000 | Significant |

| <i>Table:4</i> | t-statistics | P-Value | Remarks |
|--------------------|--------------|---------|-------------|
| Combined Insurance | -3.427 | 0.001 | Significant |

| <i>Table: 5</i> | Dummy | N | Mean | Std. Deviation | Std. Error |
|--------------------|--------------|------|--------|----------------|------------|
| Combined insurance | Before event | 1395 | 58.128 | 89.760 | 2.403 |
| | After event | 1155 | 47.009 | 70.367 | 2.071 |

Table: 6 banking sector

| Company | t-statistics | P-Value | Remarks |
|--------------------|--------------|---------|-------------|
| KASB | -3.367 | 0.001 | Significant |
| MCB | -3.651 | 0.000 | Significant |
| MEEZAN | -4.6 | 0.000 | Significant |
| MYBANK | -5.102 | 0.000 | Significant |
| NBP | -4.33 | 0.000 | Significant |
| NIB | -3.918 | 0.000 | Significant |
| SAUDIPAK | -4.336 | 0.000 | Significant |
| SONERI | -4.609 | 0.000 | Significant |
| Standard Chartered | -4.165 | 0.000 | Significant |
| UBL | -3.913 | 0.000 | Significant |

| <i>Table: 7</i> | Dummy | N | Mean | Std. Deviation | Std. Error Mean |
|-----------------|--------------|------|--------|----------------|-----------------|
| Combined banks | Before event | 2790 | 58.595 | 86.630 | 1.640 |
| | After event | 2310 | 49.167 | 74.257 | 1.545 |

| <i>Table: 8</i> | t-statistics | P-Value | Remarks |
|-----------------|--------------|---------|-------------|
| Combined Banks | -4.124 | 0.000 | Significant |

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