



Journal of Business and Social Science Review  
Issue: Vol. 1; No.11; November 2020 pp.27-35  
ISSN 2690-0866(Print) 2690-0874 (Online)  
Website: www.jbssrnet.com  
E-mail: editor@jbssrnet.com  
Doi: 10.48150/jbssr.v1no11.2020.a4

## **The Impact of Foreign Direct Investment on Profitability of Sudanese Banking sector**

### **Nasreldin Mohamed Tomsah**

Assistant professor Economics and Business Administration College  
Mashreq University, Sudan.  
E-mail: mohamed.hamad@mashreq.edu.sd

### **Abdel Mahmoud, Ibrahim, Tahmad**

Assistant Professor  
Nile Valley University, Economics  
Sudan  
Email.tahmad313@gmail.com

### **Algoot Ahmed Mohamed**

Assistant professor Economics and Business Administration College  
Mashreq University, Sudan.

### **Abdelhady Elsamany Hamza**

Assistant professor Economics and Business Administration College  
Baha University, KSA

#### **ABSTRACT**

The study investigates the impacts of Foreign Direct Investment (FDI) on profitability on Sudanese banking sector in general and its effects on local banks in particular. In doing so, the profitability of banks has been measured in terms of return on assets (ROA) and return on equities (ROE) respectively.

The study used stratified stage cluster sampling covering (18) local commercial banks and (6) foreign banks operated in Sudan. The finding reveals that, no differences in profitability in the banking sector including (both local and foreign banks) in terms of (ROA) in general and hence, foreign banks have impacted local banks profitability in terms of (ROE) positively.

The study recommends that in order to enhance the overall profitability of the Sudanese banking sector it is necessary to attract FDI flow through triggering competition and achieving spillovers. Further, the government should continue providing incentives to encourage inward FDI, in order to bring additional capital. Technology and making the local market accessible to foreign investments, especially for the banking services sector.

**Keywords:** Foreign Direct Investment (FDI), Profitability, Return on Assets (ROA), Return on Equities (ROE), Sudan.

#### **1. INTRODUCTION**

FDI related studies have important policy implications for governments worldwide. However, it spends considerable resources on incentive programs that aimed at attracting FDI in hopes of reaping the benefits of globalization as well as maximization of spillover effects (UNCTAD, 2004). Moreover, the studies reveal differences in the performance of foreign-owned affiliates and domestically-owned firms across; countries; industries, over time and also on the plant level (Griffith, 1999; Gorg and Greenaway, 2004; Blomstrom and Kokko, 1998). However, empirical evidence is not always conclusive. In some studies, foreign owned affiliates perform better than domestic firms. But other studies have shown the reverse to be "true". Such "inconsistency" is largely due to the fact that many explaining factors impact on a firm's performance and the wide variety of measurements is being used to measure performance such as, productivity; profitability; sales growth; R&D and wages etc.

This “inconsistency” throws up the question as to: Are foreign owned firms performing differently with domestic firms? Does foreign ownership matter for firm profitability?

Many literature had explored the odd phenomenon of foreign affiliates have a lower ROE than local firms, suggesting different causal factors. Affiliates are more likely to repatriate profits through dividends, interest, and royalty payments to parent firms (Dunning and Lundan, 2008).

These payments are treated as a cost by the affiliate (Mataloni, 2000). Therefore instead of showing on the balance sheet as a profit, such earning will be calculated into costs. On the other hand, a favorite explanation centered on the possibility of transfer pricing and suggestion that foreign firms were actually doing better than it seemed, but this has proven hard to verify empirically (Bellak, 2004). Mataloni (2000) also took market share and age effect into account for explanation, controlling the factor that some foreign affiliates are newly acquired or established. Such explanatory factors are consistent with the theory of Liability of Foreignness' (Hymer, 1976; Kindlberger, 1969; Zaheer, 1995), which argued that foreign firms may not perform as well as some of their domestic counterparts due to unfamiliar business/cultural environment.

The main objective of this study is twofold: firstly, investigate whether the foreign banks perform significantly better than local banks in terms of profitability. Secondly; provides a useful recommendation to senior managers as well as investors and policy maker's decisions. And hence, this study focuses on whether there is impact of foreign direct investment on profitability of the banking sector. In other words, it addresses the impact of FDI on the Profitability of Sudanese banking industry by foreign ownership banks participating in the business.

Therefore, study contributes to the field of international business and finance and Examining how foreign ownership affects firm profitability has important policy implications for governments worldwide, which spend considerable resources on incentive programs aimed at attracting FDI in hopes of reaping the benefits of globalization (UNCTAD, 2004) and upgrading domestic competition and technology in order to promote economic growth eventually. Because, FDI plays a critical role for economic growth and development, particularly in a large sized with rich resources country like Sudan, who looks forward to the injection of foreign capitals. MNCs carrying funds, resources and technologies become a major and important influence shaping the host country's economy. Thereafter, it plays an important role for economic growth and development, particularly in a large sized country with potential natural resources like Sudan, who relies on the injection of foreign capitals. MNCs carrying funds, resources and technologies become a major and important influence shaping the host country's economy. Thus, it impacted on managerial and financial performance of foreign and local commercial banks in Sudan. Managerial practices consist of technology adoption and human resources management practices, financial performance consists of profitability and productivity ratios. And how it contributes towards management practice in all levels than can gain benefits or advantages in order to developmental information and communication technology for strategic decision making. To these, owners and managers, information and communication technology (ICT) provides external environment and performance -related information along with the analytical tools needed for strategic decision support (top level).

In this context FDI and its impact on bank profitability has a considerable debate among economists; management; theorists and practitioners. Therefore, rationale of the present study emerges from the fact that such an issue is rarely explored outside western context, Sudan is no exception in order to enhance the state and local governments to direct their foreign investment policies for successful outcome. In doing so, it explores to what extent FDI on the basis of benefits that local commercial banks get from existing of foreign banks operating in Sudan and affects local banks profitability using profitability indicators in banking industry data in order to reply the followings; do foreign banks perform better than domestic counterparts in terms of profitability? Is there a positive correlation between profitability and foreign direct investment?

## **2.THE LITERATURE REVIEW AND EMPIRICAL APPLICATION**

In this respect the existing literatures, FDI importance and MNC activities receive a wide coverage, particularly in, large, developed economies such as the United States, Europe and Japan due to their sophisticated business activities and large proportion of total capital flows. And more recently, in the past two decades, many less developed countries/regions and emerging economies like China, Russia, South America, and Africa have drawn popular attention due to their economic potential and growing participation on the world stage.

## 2.1 Conceptual Framework:

### 2.1.1 Definition of FDI

The definition of FDI is complex. According to the OECD Benchmark definition and the IMF Balance of payment, FDI “reflects the objective of obtaining a lasting interest by a resident entity in one economy (‘direct investor’) in an entity resident in an economy other than that of the investor (‘direct investment enterprise’). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise” (OECD, 2009 and IMF, 2005).

The World Investment Report 2009 defines it as “An investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)”. (UNCTAD, 2009). A common feature shared by the above definitions lies in the use of terms such as ‘lasting interest’ and ‘long-term relationship’. According to Moosa (2002) these terms are used to distinguish FDI from portfolio investment since the latter represents a short-term investment with high turnover of securities. Additionally, a non-clear distinction can complicate the assessment of the effects of FDI inflow as well as its policy formulation in the host country (Francis, 2010).

### 2.1.2 Attracting FDI

In-order to reap the benefits of inward FDI, governments are now changing policies to attract. Some academics propose that in-order for a country to attract foreign direct investment; by using financial incentives such as tax allowances; duty drawbacks; investment allowances and reducing structural constraints in-order to attract potential investors into their economy (Hayford, 2008). Wang and Wong (2009) state that if an economy wants to gain positive economic growth from FDI, two economic conditions must exist in-order to attract these foreign firms to the domestic market: a sufficient level of human capital and a well-developed financial market. The host country must be an attractive destination for foreign investors as the investment choice will be dependent on the capabilities and opportunities that exist in the host country.

**Jensen (2006)** confirms that governments should focus on policies that attract inward FDI since these investments rarely produce a negative result for economic growth. She also states that FDI is expected to bring numerous benefits to the host country’s economy such as capital inflow and knowledge gain from the foreign partner, while creating efficiencies in the affiliated local firm’s processes with the use of technology which may not be available to the local firm if the FDI firms decided not to invest. The effects of FDI on structural change are highly dependent on the policies and institutions of the host country. Jensen (2006) indicates that economic policies that promote institutional building, establishment of the rule of law and the promotion of a transparent and fair business environment are good starting points for attracting investors. In addition to this she says that political factors like economic reform and ‘state capture’ have large and significant effects on the inflow of FDI.

Other factors that play a part in the decision to invest in a country by foreign investors are the tax laws of the country, as well as the infrastructure available in the host country. Ndikumana and Verick (2008) suggest that investment in different types of countries namely resource-intensive, relative to non-resource-intensive countries are driven by different factors. These include among others the telecommunication infrastructure which is critical in non-resource-intensive countries.

**Abor et al, (2008)** completed studies in Ghana and their research has confirmed that inward FDI has positively contributed to the improvement of local-affiliated firms, which encourage governments to concentrate in attracting FDI. These spillovers benefits assisted in making the host economy more competitive and accordingly improvements in the performance of the affiliated local firm are evident. Meyer and Sinani (2009) suggests that spillover effects experienced by non-affiliated local firms from the foreign investors vary according to the awareness, capability and motivation that the local firm demonstrates in-order to react to entry of foreign firms into the market. These spillovers all lead to a more competitive environment as the benefits of FDI is not only restricted to the local partner.

The benefits that arise from inward FDI as reported by (Cheung, of no less importance in attracting FDI is a conducive investment climate/environment, which embodies various political, economic, and social

factors. Political stability, economic stability, the host government's attitude towards foreign investment, and the availability of infrastructure compose the most important elements in this investment environment.

Policies related to acquisitions, profit remittances, tax structure and tax exemptions, guarantees against nationalization and confiscation, labor policies, export and import policies, and foreign exchange regulations are some of the policies weighed carefully by foreign investors (Gadkarim2012).

### **2.2.3 FDI and profitability**

Although the emergence and investment behavior of FDI firms are well studied (BarbaNavaretti and Venables, 2006; Brakman and Garretsen, 2008), the literature has so far largely neglected to investigate the profit distribution within multinational groups. Exceptions are recent public finance papers which suggest that FDI profits tend to be distorted towards affiliates with a low corporate tax rate as FDI firms shift paper profits from high-tax to low-tax entities and tend to bias the location of profitable investment projects in favor of low-tax affiliates ( Fuest, and Riedel, 2009).

There are two strings of the literature which suggest a positive profitability gap between FDI firms and their local counterparts: the first proposes agency costs to give rise to a higher profitability of foreign investment, while the second suggests that the same pattern is induced by home market advantages .The agency cost theory is related to the notion of "vertical" FDI, i.e. the presumption that value chains comprising various functions like manufacturing, logistics, marketing and R&D are geographically separated across borders.

Recent contributions brought forward empirical evidence for this kind of vertical fragmentation (R. J. Mataloni, and Slaughter, 2005). Assuming that the profitability of functions within the value chain differs, the FDI may strategically choose the location of profit-driving operations. Several papers in the business economics literature suggest that FDI firms have a tendency to keep valuable functions with the head office as physical distance hampers communication and the headquarters management thus faces agency and information costs if these operations are run abroad ( O'Donnell, 2000).

Nevertheless, the last decade was also characterized by the development of new technologies like the internet and the mobile phone which have lowered communication costs and might henceforth have dampened agency problems caused by geographic separation ( Blinder, 2006).This suggests that the profitability gap is not constant over time but has declined in recent years.

A second literature strand proposes that the profitability gap between foreign and their domestic counterparts may be induced by a different mechanism which is related to the notion of "horizontal" FDI. Precisely, the papers suggest that exporting the FDI business model and products to foreign countries by setting up production and sales units there may result in lower profitability rates since these units may for example have less knowledge about language, customs and consumer behavior than their domestic competitors or since the FDI's products might have been developed to fit domestic not foreign consumer preferences (Brakman and Garretsen, 2008).

Todaro and Smith (2011) proceed to say that the main objectives of FDI firms are to maximize the return on capital and as such they are not particularly interested in development. FDI firms seek out the best profit opportunities and are largely unconcerned with issues such as poverty; inequality; employment conditions and environmental problems. The host government's budget deficits usually result in the importation of capital equipment and intermediate products and the outflow of foreign exchange in the form of repatriated profits; management fees; royalty payments and interest on private loans.

### **2.2 Foreign Banks VS Local Banks Profitability:**

Claessens et al. (2001) define foreign bank penetration as the percentage of foreign banks to total banks in a country, where a foreign bank is defined as a bank with shareholdings by foreigners exceeding 50 percent. They find that foreign bank penetration reduces local bank operating costs, non-interest income and profits, implying that competition from foreign bank penetration benefits the operating efficiency and function of the local banking sector.

Since the study of Claessens et al. (2001), there has been much discussion on the advantages and weaknesses of foreign bank penetration. Some studies argue that competition and cherry picking from foreign bank penetration worsen local bank performance. Barajas et al, (1999) found that during 1985–1998,

Rising foreign bank penetration in Colombia increased management costs and reduced loan quality in the local banking industry. Weller (2000) drew similar conclusions regarding banking system transitions in Poland and Australia.

There are many empirical studies suggesting that the overall economic development of a country is a positive function of the development of its financial sector, in particular the banking system. Recent studies have shown that countries with well-developed financial institutions tend to experience more rapid rates of real GDP per capita growth (Levine and Zervos, 1998; Rajan and Zingales, 1998). Moreover, empirical studies have shown that there is a positive correlation between foreign ownership of banks and the profitability of the banking sector (Goldberg 2000).

There is also the experience of the impact of the participation of foreign banks in different countries. Like Dages. (2000) who examined the lending patterns of domestic and foreign banks and found that foreign banks typically have stronger and less volatile lending growth than their domestic counterparts. They also found that diversity of ownership contributes to greater credit stability during periods of turmoil and weakness for the financial system. Weller (2000) showed that the greater proportion of multinational banks entering the market resulted in lower credit supply among Polish banks during the early phases of transition (1999).

The benefits of increased foreign participation in the banking sector are discussed by (Lardy, (2001). Noticed that over the period 1988–1995 and for a large sample of countries, foreign bank entry was generally associated with a lower incidence of local banking crises.

The most comprehensive empirical study of foreign bank entry was carried out by Claessens, (2001), who investigated the relationship between foreign bank entry and the performance of the domestic banking sector in 80 countries. They used panel estimations with 7,900 bank observations over the period 1988–1995. The main results of the study show that foreign banks tend to have higher profits than domestic banks in developing countries, while in developed countries foreign banks are less profitable than domestic banks. Their results also indicated that greater foreign bank presence is related to lower profitability, costs and margins among domestic banks.

Hermes and Lensink (2003) further developed the model used by Claessens .(2001) Who used bank level accounting data from 990 banks in 48 countries for the period 1990–1996. Threshold estimations were used to study how foreign bank entry effects are related to a country's economic development in the short-term. The results indicate that at lower levels of economic development, foreign bank entry is associated with higher costs and margins for domestic banks. At higher levels of economic development, foreign bank entry has a less significant effect on domestic bank profitability. This result adds some support to the technology gap hypothesis.

Ramlall (2009); Pilloff and Rhoades (2002) all found that there is a positive relation between bank size and profitability. Even in recent times, Sufian (2009) confirms such relationship. On the contrary, studies such as Koasmidou, (2008); Spathes, (2002) also established empirically, a negative relation between bank size and profitability. In an argument by Athanasoglou , (2006), profitability is believed to be influenced by both endogenous and exogenous factors. The endogenous factors are firm specific factors that result from the decisions and policies of management.

Examples of such factors are efficiency, profitability, liquidity, and capital structure and asset quality ratios. The exogenous factors are industrial structural factors such as ownership, market concentration and stock market development and other macroeconomic factors. For the purpose of this study, the endogenous factors are used since they are the areas that the banks are expected to differ in. The exogenous factors are not expected to be significantly different since they are not firm specific but affects all firms in the industry.

In a study by Chen (2011) of 70 countries, almost all the coefficients are significant, indicating strong impacts of bank specific factors on profitability. Chen (2011) found that the higher the opportunity cost incurred, the higher the return that banks can

### **3. METHODOLOGY :**

#### **2.1 Data sources and Collection**

On the basis of stratified stage cluster sampling unit covering (18) of local commercial banks and (6) foreign banks operated in Sudan using questionnaires as a tool to collect the primary data about the profitability in

banks in terms of ROA and ROE. The sample was covered headquarters; senior managers; sections heads; and employees at the headquarters of the selective banks according to following criteria:

- ✓ Banks have five or more years operating in Sudan
- ✓ Banks' headquarters in Khartoum state.

In light of the above criteria, the bank divided into following types:

- Domestic Banks that the majority of their shareholders being Sudanese
- Foreign Banks that are at least 50 percent foreign owned (i.e. more than 50 percent of its share capital is owned by foreign residents as noted in (Aessens and et al, ,2001). Or as defined by Yanzhang et al 2009) as 100% foreign-owned firms and domestic firms as 100% domestic-owned firms. Accordingly, the Central Bank of Sudan (CBOS) defines the Foreign bank as the bank with majority of ownership is foreign. For the purpose of this study a bank with more than 50 percent foreign ownership is a foreign bank. Besides this, Secondary data was collected from banks audited annual reports ; statements ; magazines ; banks union reports and bulletins for the period from 2010 –2018 collecting data about the performance in banks in terms of profitability using financial ratios of Return Of Assets (ROA); Return On Equities (ROE). Accordingly, two samples can be selected in the following steps:
  - Step (1) has covered the top managers and heads of sections as a stratified sample stage cluster where the stratification is the type of bank (domestic and foreign), the primary sampling units are the banks.
  - Step (2) covered the stratified two-stage cluster sample where primary sampling units are the banks (domestic and foreign) and employees are second stage sampling units. The sample included only the commercial banks operated in Sudan located in Khartoum state before 2010, so all the respondents of the questionnaire were only from one culture which would be a great accomplishment if a future a study tested respondents who belonged to different cultures and foreign banks enter the country after 2005. And the secondary data is collected for the period 2010- to 2018 and it was exclusive to the FDI impacts on one type of banks (commercial) in general and only financial sector particularly .

### 3.2.1 Profitability measurement:

No doubt, performance indicators have been widely utilized and mentioned in management and finance literature. Some of the most popular ones were accounting measures such as: Return Of Assets (ROA); Return On Equity (ROE); Return On Investment (ROI); Sales or Sales growth among others (Miller and Eden,2006). Following Miller and Eden (2006) The study measured the profitability of the firm by using the return on assets (ROA) and return on equities as proxy for the firm performance.

Profitability ratios are the financial ratios which talk about the profitability of a business with respect to its sales or investment. Since the ratios measure efficiency of operations of a business with the help of profit, they are called profitability ratios. They are quite useful tools to understand the efficiencies of a business and thereby assist management and owners to take corrective actions.

Profitability ratios are the tools for financial analysis which communicate about the final goal of a business. For all the profit oriented businesses, the final goal is none other than the profit. Profits are the lifeblood of any business without which profits.

The purpose behind calculating the profitability ratios is to measure the operating efficiency of a business and returns which the business generates..The different stakeholders of a business are interested in the profitability ratios for different purposes. The stakeholders of a business include owners, management, creditors, leaders etc.

The profitability ratio was used because it is useful to get insight of a business and helps to get indication on the sufficiency or adequacy of profits. Besides, it finds out the rate of return and makes the business comparable to the industry which here is domestic banks and its foreign counterparts. These ratios are used by banks and financial institutions while lending to the business as the ratios insure them about the regular payments of interest and installments.

According to Israel (1992), there are several techniques for determining the actual sample size. However, this study follows Stephen Thompson formula for our desired sample as follows:

$$n = \frac{Z_{\alpha/2}^2 P (1 - P)}{\epsilon^2} * deff_{st} \dots\dots\dots(1)$$

Where

$Z_{\alpha/2}$  = The confidence coefficient (for 95% confidence  $Z_{\alpha/2} = 1.96$ )

P = Proportion of banks with an attribute of interest. (taken as P = 0.5 for planning purpose)

$\epsilon$  = The error margin.

$deff_{st}$  = The stratified cluster sampling design ( $deff_{st} = 1.5$ ).

Substituting these design parameters into n above gives

$$N = \frac{1.96 * 0.5 + 0.5}{0.1^2} = 144$$

Accordingly the sample size for the specified local commercial and foreign banks in stratified two-stage cluster sample where primary sampling units are the banks (domestic and foreign) and employees are second stage sampling units are 80 respondents in order to test the following hypotheses:

- Foreign banks do not perform better than domestic counterparts in term of ROA and ROE.
- Foreign banks perform better than domestic counterparts in terms of ROA.
- Foreign banks perform better than domestic counterparts in terms of ROE.
- Foreign banks perform better than domestic counterparts in terms of ROE.

**4. TESTING HYPOTHESES AND FINDINGS:**

Testing the hypotheses in accordance with the contribution of independent variables towards dependent variable, simple linear regression, and Test and P-value analysis is used.

H01: Foreign banks does not profitable than the local banks in term of return on assets

H11: Foreign banks are more profitable than the local banks in terms of return on assets.

H02: Foreign banks are not more profitable than the local banks in terms of return on equities.

H12: Foreign banks are more profitable than the local banks in terms of return on equities.

| Variable | group   | Mean  | Std. Deviatio | T-value | P-value |
|----------|---------|-------|---------------|---------|---------|
| ROA      | Local   | 6.880 | 2.312         | 1.119   | 0.273   |
|          | Foreign | 5.987 | 2.052         |         |         |
| ROE      | Local   | 8.060 | 3.701         | 2.640   | 0.013   |
|          | Foreign | 5.213 | 1.932         |         |         |

Source: Authors Calculation based study survey

Table(1) shows the following:

- ✓ The P-value of T-test (0.273) is greater than significant level (0.05) that means there is no statistical difference between local bank and foreign bank in ROA. Which implies that there is no differences in profitability in terms of ROA between local banks and foreign banks.

The null hypotheses should be accepted and and the alternate hypothesis should be rejected

- ✓ The P-value of T-test (0.013) is less than significant level (0.05) that means there is statistical difference between local bank and foreign bank in ROE for local banks.

Which indicates that the local banks are doing better than the foreign banks in terms of ROE .

The null hypotheses should be accepted and the alternate hypothesis should be rejected.

**4.1: The Major Findings:**

As noted earlier the objective is to investigate whether the foreign banks perform significantly better than local banks in terms of profitability and to provide useful recommendations to senior managers, investors and policy makers. The findings reveals;

There is no statistical difference between local banks and foreign banks in ROA.

- The results showed that there is a statistical difference between local banks and foreign banks in ROE for local bank. Therefore, data analysis and interpretation revealed the following .:

#### **ROA:**

One interesting finding in this study indicates that there is no statistical difference between foreign banks ROA and local banks ROA. This result aligned with outcomes of Chhibber and Majumdar (1999) in a cross-section study from India, studying the correlation between foreign ownership and firm performance, where performance is defined in financial terms as return on assets (ROA) or return on sales.

The authors use foreign ownership data for each firm, the years foreign ownership is observed differs among firms. Chhibber and Majumdar find no significant correlation between foreign ownership and ROA at ownership levels below 51%.

#### **ROE:**

One interesting finding in this research indicates that there is a positive correlation between ROE of foreign banks and ROE of local banks .This result coincides with findings of Yi Zu , (2010). Matthew and Esther, (2012) studies the profitability of both foreign and local commercial banks in Ghana, Their study employed the use of profitability ratio (return on equity ROE). Findings revealed that local banks on profitability ratio (ROE) outperformed the foreign banks. Local banks are shown to have performed better than foreign banks in terms of (ROE) as a profitability ratio employed in their study.

It could possibly be explained by foreign owned firms having higher expenditures in such an industry comparing to their local counterparts for innovation and technology development Yi Zu, (2010). But without more detailed tests controlling other possible causes and with more data available rather than forbidden by confidential reasons, it cannot be explained conclusively. In case at hand, one can be summarized that profitability is challenging practices in the banking sector in Sudan. It is suggested that banks operating in Sudan should give due consideration to profitability in order to achieve better financial performance.

In Summary, the empirical results of the study are mixed and inconclusive . Therefore for further research should imply analysis considering different sectors such as the agricultural ,mining , petroleum or education sector also it is recommended to turn this research into a basic research.

### **5. CONCLUSIONS**

This study attempts to enhance the understanding of FDI entry in Sudan and its impacts on performance of domestic firms. It has investigated performance of foreign and domestic commercial banks in Sudan and concluded that the government should continue providing incentives, to encourage inward FDI, in order to bring additional capital and market access into the local market, especially for Sudan, a large promising country located into a hub of the world.

Finding in this study supported foreign owned firms have a higher profitability than local firms. Attracting more FDI is in hope of increasing overall productivity for the country through competition and spillovers. However, government policy would be wise to enact such policy to maximize benefits and minimize potential harms to local industry.

Finally, it is hoped that the issues raised in this study reinforces the need to target the research discourse in finance and international business at how practitioners might find the concept more useful. This is crucial if practitioners are to consider any future theoretical discourse FDI.

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