

# Do Foreign Firms Bring Value to Emerging Financial Market?

(An Empirical Evidence Indonesia Banking)

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**Abstract**—The research aims to study the value created by the foreign shareholders in the Indonesia banking industry from 2016-2018. The research analyzed the performance of foreign-owned banks versus domestic owned banks. The banking industry is one of main drivers of the main drivers of economic growth. The study focused on the 19 banks that are categorized as bank books 3 and 4 as per the central bank regulation. The shareholders' status will be the independent variable, and the key financial ratios will be dependent variables. The financial ratios are capital structure, credit risk firm size, and profitability ratio. We use non-parametric (Mann Whitney) and parametric (Dummy Variable Regression). The empirical results show that there are differences in profitability and firm size. The profitability was shown in return on assets, return on equity, economic value-added. The firm size was shown in total assets and equity. The local banks performed better than foreign banks in return on assets, return on equity, economic value-added, and net interest margin. However, foreign banks only performed better than local banks in equity size. There was no significant difference in capital structure and credit risk. The results are significant at  $\alpha = 1\%$  for return on asset, economic value-added, and equity size.

**Keywords**—banking, financial ratio, foreign ownership, profitability

## I. INTRODUCTION

The banking system performs the function of new capital creation in the economy of a country. All economic crises resulted in a banking crisis. If banks experience a crisis, the economy will experience a recession. This can be seen from the global and Asian economic crises of 1928, 1988, 2008, and other economic crises.

In 1998, when Asia experienced an economic crisis, several countries experienced a banking crisis as well. Indonesia is one of the countries that experienced the 1998 banking crisis. The number of banks liquidated totaled 16 banks and banks under the supervision of the Indonesia Banking Restructuring Agency (IBRA) amounted to 54 banks.

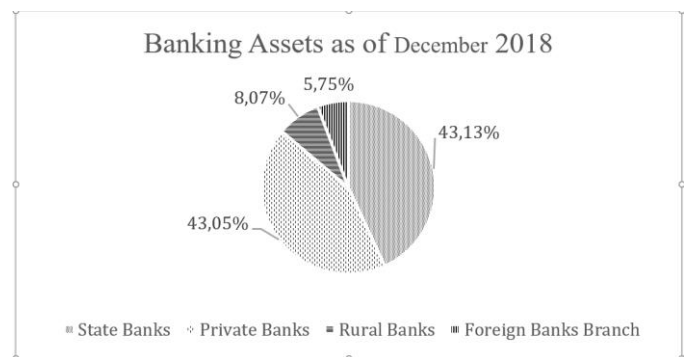
After the banking restructuring from 1999-2002, many investors entered Indonesia and acquired banks in Indonesia, almost all banks in Southeast Asia such as UOB, OCBC, DBS, CIMB, Maybank, which have investments in Indonesia. Besides, other foreign banks such as ICBC, CCB, Woori Bank, Shinhan Bank, J Trust, Standard Chartered Bank, and SBI have also invested in Indonesia. Previously, there were Citibank,

BoA, JP Morgan Chase, HSBC, Mitsubishi Bank of Tokyo, Sumitomo Bank, Mizuho Bank, Bank of China, and others are invested in Indonesia banking. Foreign investors, directly and indirectly, have a significant amount of investments in Indonesia.

Reference Luo et al. [1] found that exposure to the branch networks of foreign banks is associated with improved profitability at domestic banks, higher efficiency, and increased non-interest income, consistent with knowledge transfer from foreign banks. These relationships are most pronounced for joint-stock domestic banks (JCBs) presumably because their ownership structure fosters knowledge transfer.

Cross border banking could increase insolvency risk. Banks that finance their operations with deposit funds are more profitable than those who employees wholesale and internal funds [2].

However, the largest banks in Indonesia are still dominated by 4 Indonesian banks, namely Bank Mandiri, Bank Rakyat Indonesia, Bank Central Asia, and Bank Negara Indonesia. Three of the four banks are state-owned banks. The performance of domestic banks has been consistent over the past five years. The state-owned banks contribute 43,13% of total banking assets, as stated in figure 1.



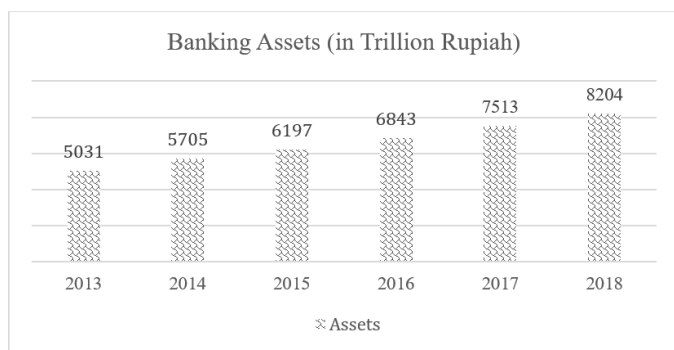
Source: [3].

Fig. 1. Banking assets.

Competition between local banks and foreign banks has overgrown. The presence of foreign banks has increased competition that is healthy for consumers. Banking performance has also been far better than before the 1998 crisis. The total asset in banking has grown 63% for the last five years, as stated in figure 2.

Since 1998, banking has been closely monitored by the Central Bank of Indonesia (Bank Indonesia) and is now under the supervision of the Financial Service Authority. Limitation of ownership, number of loans to related parties, and exposure to specific industries are also limited. Rigorous reporting is also carried out. Ownership of individuals is limited to a maximum of 40%.

The current study became unique by examining the value created by the shareholders. The shareholders' status will be used as a dummy variable. The research will be focused on the banks under Books 3 and 4 categories based on Indonesia regulations. Based on the regulation of Bank Indonesia No. 14/26/PBI/2012, the banks were categorized into 4 groups as follow: (1) Bank Book 1 with capital of less than Rp1 trillion; (2) Bank Book 2 with capital between IDR 1 trillion to less than IDR 5 trillion; (3) Bank Book 3 with capital between IDR 5 trillion to less than IDR 30 trillion; and (4) Bank Book 4 with capital more than IDR 30 trillion.



Source: [3].

Fig. 2. Banking Asset (2013-2018).

Research on foreign shareholder's value creation is still uncommon, especially in banking of developing countries like Indonesia. Among some examples are Johan et al. [4], Batten et al. [5], Dong et al. [6], Ghosh [7], Bongini et al. [8], Mori et al. [9], Saif-Alyousfi et al. [10], Agustin et al. [11], Azoury et al. [12], Shawtari [13], Basri et al. [14], Kowaleski [15], and Rathnayake et al. [16].

Reference Johan et al. [4] study the value created by foreign firms in the Indonesia finance company industry over the period 2001-2011. The research analyzed seven micro key financial variables (profitability, efficiency, growth, firm size, liquidity, solvency, and asset quality). We use parametric panel data dummy regression. The empirical results show that finance companies owned by foreign firms are more efficient, lower in profitability, more prominent in size, higher in growth capability, lower in liquidity, and higher insolvency.

Batten et al. [5] utilize several key firm characteristics to establish the extent that information asymmetry impacts the level of foreign ownership in Vietnam. The findings indicate that foreign investors adopt a long-term investment horizon and employ a buy and hold strategy to exploit potential growth prospects. These investors avoid firms with riskier financial management practices and where information asymmetries provide advantages to domestic investors. Overall, these findings support the importance of linking deregulation with financial market openness and transparency to enhance and encourage international portfolio investment.

Dong et al. [6] examines the cost and profit efficiency of four types of Chinese commercial banks over the period from 2002 to 2013. We find that the cost and profit efficiencies improved across all types of Chinese domestic banks in general, and the banks are more profit-efficient than cost-efficient. Foreign banks are the most cost-efficient but the least profit efficient. The profit efficiency gap between foreign banks and domestic banks has widened after the World Trade Organization transition period (2007-2013). Ownership structure, market competition, bank size, and listing status are the main determinants of the efficiency of Chinese banks.

Ghosh [7] examine how the behavior of foreign banks impact domestic bank performance. The research employed the dynamic panel data methodology as compared to alternate techniques owing to the ability of this technique to effectively address the endogeneity problem of some of the independent variables. The results suggest that foreign bank presence exerts significant spillover effects. At the same time, increased foreign banks appear to impel domestic banks to cut back lending.

Bongini et al. [8] focuses on the role of financial development in the economic growth of Central, Eastern and South-Eastern European (CESEE) countries in the post-communist era (1995–2014), which coincides with the opening up of financial markets to foreign investors and the global financial crisis. They investigate whether economic growth in CESEE countries has benefited from the presence of foreign-owned banks. To this end, we introduce some refined measures of financial development and control for banks' financial strength. The results challenge the idea that bank credit fosters economic growth and that foreign-owned banks are indisputably a positive addition to local markets able to foster economic growth.

Mori et al. [9] examine the effects of board composition on the profitability of banks in Tanzania. The paper utilizes a secondary panel data set of information on the boards, their operations, and financial statements of 35 banks. The data were collected between 2009 and 2013. The results show a significant difference in board composition and profitability between local and foreign-owned banks. Local banks have higher income and profits.

Saif-Alyousfi et al. [10] assesses the profitability of Saudi banks using the parameters of the Capital Adequacy, Asset Quality, Management Quality, Earning Ability, and Liquidity framework over the period 2000-2014 using pooled ordinary least square and fixed-effect model. Our results indicate that domestic banks are more profitable than foreign banks. We also find that both foreign and domestic banks with higher capital are more profitable. Banks with a higher non-performing loan are less profitable: Foreign banks carry more credit risk in their portfolio. In contrast to domestic banks, operating expenses to total income for foreign banks is significant but negatively related to profitability, indicating that cost management inefficiency adversely affect the profitability of this group.

Agustin et al. [11] evaluate the performance of banks in Indonesia. The study has examined the static effect of ownership structure on bank performance in Indonesia over the period 1995–2006. The sample consists of 74 banks, namely 56 private banks, 15 community development banks (BPD), and three federal banks from 1995 to 2006. The data was analyzed

using the dummy variable regression method, the general least squares method, and the method of random effects. The findings of this study show that the BPD performed better compared to private banks. This indicates that BPDs have better performance rather than private banks which is since customers can be able to pay loans, they have special knowledge on that area, and the performance of BPD is supervised by the local government. Also, the amount of equity, economic growth, financial crisis, and financial ratios affect the performance of the bank. However, bank status does not affect bank performance.

Azoury et al. [12] examines whether ownership concentration and a certain type of ownership can affect the financial performance of Lebanese banks. It uses longitudinal data from the most significant 35 Lebanese banks over the period 2009–2014 and employs the panel regression model. The empirical results show that ownership concentration and a certain type of shareholders play an essential role in the area of corporate governance in Lebanese banks. In particular, bank financial performance is positively associated with ownership concentration, managerial ownership, and foreign and institutional ownerships; however, family ownership is not related to bank performance. Also, this paper shows that both ownership concentration and managerial ownership have a U-shaped relationship with bank performance.

Shawtari [13] examines bank performance using different performance measures, namely, return on assets, return on equity, and bank margins (MAR). The findings of the paper substantiate that the banking models are significant performance indicators. However, the results are contingent on the GDP growth of the country. The results indicate that the impact of ownership types is inconclusive in all measures of performance. However, the GDP is significant when it interacts with the types of ownership, particularly for foreign and government banks, although the evidence is mixed and unfavorable for government banks.

Basri et al. [14] assess the performance of the Malaysian Islamic banking industry since the introduction of the first Islamic bank two decades ago by using financial ratios. The ratios are divided into four categories; profitability, liquidity, risk and solvency, and commitment to the economy and Muslim community. The chosen financial ratios indicated that domestic Islamic banks performed better during the 2005 to 2012 period in terms of profitability, but the foreign Islamic banks excelled in terms of liquidity, risk, and solvency ratios.

Kowaleski [15] examines the effects of foreign branch activity on commercial banks in the Central, Eastern, and Southeastern European countries for the period 1995-2015. The research found that the negative effect is stronger for foreign banks owned by multinational banks than by non-bank entities.

Rathnayake et al. [16] examines the impact of corporate ownership structure and ownership concentration (OC) on the corporate performance of listed firms in China. Ordinary least square and two-stages least squares models are used to capture the relationship between the independent variables and firm performance by considering the possible endogeneity of both performance and ownership variables. The ownership structure variables are negatively related with firm performance measured by Tobin's Q ratio. The proportion of state-owned shares and negotiable A-shares are significantly correlated with

firm profitability. Second, the results show that Chinese firm ownership had a strong positive relationship with firm performance. The previous research show in table 1.

TABLE I. PREVIOUS RESEARCH

Variable	Foreign's Financial Institutions Perform Better Than Domestic Financial Institutions	Domestic's Financial Institutions Perform Than Foreign Financial Institutions
Capital Structure	Reference [4] and [14]	Reference [15] and [16]
Credit Risk	Reference[14]	Reference [10][15] and [16]
Profitability		Reference [4], [6], [9], [10], [14], and [16]
Firm Size	Reference[4]	Reference [15] and [16]

Although there is already numerous research concerning the value creation of shareholders, especially in the banking industry, there is no conclusive results yet on the banking industry. Therefore, it is essential to research this topic, especially in a specific industry such as the banking industry.

This study will analyze the value created by the shareholders in banking in Indonesia during the 2016-2018. The performance measurement will be based on financial performances and ownership status.

The rest of the study is organized as follows. After the introduction in Section 1, the data and methodology are described in Section 2, followed by the results and discussion in Section 3. Finally, Section 4 provides conclusions and recommendations.

In this study, the main research questions were as follows:

- Is there any difference in Indonesia banking's capital structure compare between foreign investors to local investors?
- Is there any difference in Indonesia banking's credit risk compare between foreign investors to local investors?
- Is there any difference in Indonesia banking's profitability compare between foreign investors to local investors?
- Is there any difference in Indonesia banking's size compare between foreign investors to local investors?

## II. RESEARCH METHODS

### A. Methodology

The variables in this research refer to 4 significant ratios on capital structure, credit risk, profit ratio, and firm size. This study added a specific measurement for the impact of ownership on bank performance. The impact of ownership status is to measure the impact of ownership (foreign vs. domestic) in determining profitability, credit risk, capital structure, and firm size.

### B. Dummy Variable Regression

The parametric test model in this study is developed from the dummy regression model [17]. The variables in this study refer to 11 measurements on capital structure, credit risk, profit ratio, and firm size. These variables are adapted and developed into four measurement ratio groups with 11 research variables.

To test the financial performance between domestic shareholders of banks and foreign shareholders of banks are coded differently (DO = dummy). DO code for domestic shareholders = 1, code for foreign shareholders = 0. Financial performances are studied based on the ratio of capital structure, credit risk, profit ratio, and firm size. Each of the financial indicators is tested parametrically and non-parametrically. Parametric tests are conducted by dummy regression towards each variable by the equation as follow:

$$Y_{it} = a + b_1 DV_{it} + \epsilon \tag{1}$$

Note :  
 $Y_{it}$  = ROA, ROE, EVA, CAR, NPL, NIM, RR, LFR, DER, ESI, FSI.  
 DV = dummy ownership, 1 for domestic shareholders and 0 for foreign shareholders

**C. Non-Parametric Mann Whitney Test**

Non-parametric test model in this study follows the model developed by Chang and Ariff [18], Wang [19], Hagendorfl and Keasey [20], and Johan et al. [4]. This research model will focus on the performance difference between the two groups of independent and paired samples. This test aims to test the characteristics of the two groups of independent samples. Mann Whitney test is an alternative testing to the t-test without any restriction. This test can also apply for a different number of samples tested in the two groups.

Mann Whitney U formula test:

$$U = n_1n_2 + \frac{n_1(n_1+1)}{2} - R_1 \tag{2}$$

Or

$$U = n_1n_2 + \frac{n_2(n_2+1)}{2} - R_2 \tag{3}$$

where:  
 n1 = number of sample 1  
 n2 = number of sample 2  
 R1 = number of ranks of the sample 1  
 R2 = number of ranks of the sample 2

Non-parametric test performed with Mann Whitney Test Using  $\alpha = 10\%$ . Based on the t-statistics value and p-value, the variables that are significantly different between the integrated and independent companies will be noticeable.

**D. Hypothesis**

There were no differences in financial performance between banks with domestic shareholders and banks with foreign shareholders. Financial indicators to be tested in this study are capital structure, credit risk, profit ratio, and firm size.

Based on previous research, the hypothesis is as follows in table 2:

TABLE II. RESEARCH HYPOTHESIS

Hypothesis	Variables	Foreign Banks and Domestic Banks
H1	Capital Structure	No Differences
H2	Credit Risk	No Differences
H3	Profit	No Differences
H4	Firm Size	No Differences

Based on previous research, the hypothesis is that the foreign shareholder will have a positive impact on capital structure, credit risk, profit, and firm of banking.

**E. Variables and Measurement**

The variables and measurements are described as follows:

TABLE III. RESEARCH VARIABLES

Variables	Measurements
Capital Structure	Capital Adequacy Ratio, Loan Fund Ratio, Debt to Equity Ratio
Credit Risk	Non-Performing Loans – Gross (NPL), Reserve Requirement
Profit	Return on Assets, Return on Equity, Net Interest Margin, Economic Value Added
Firm Size	FSi = ln (Total Assets), ESi = ln (Equity)
Ownership Status	Foreign and Local Ownership

**F. Data**

This research used secondary data that was collected from various official publications by the institutions. The data are panel data that consisted of cross-section and time-series data from 2016-2018. The sample is the banks that issued their official financial statements during the research period. The banks are under categories Book 3 and 4. The sample consisted of 19 banks. All banks are registered under the Financial Service Authority (FSA) (Otoritas Jasa Keuangan). The research framework show in Figure 3. and the formulation of the variables is described in Table 3.

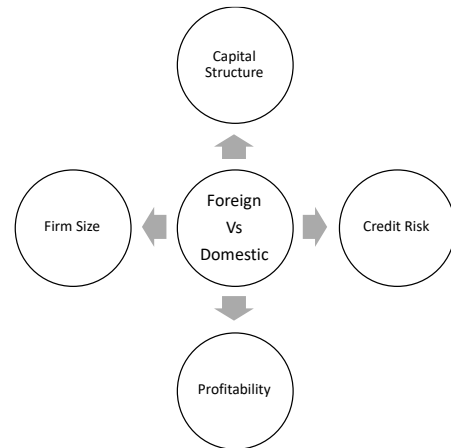


Fig. 3. Research framework.

**III. RESULTS AND DISCUSSION**

**A. Capital Structure**

The Capital Adequacy Ratio (CAR), the banks reached the lowest at 13,34% and the highest at 30%. It showed that there is a bank that almost reached the minimum level as allowed by the regulator. On average, the debt to equity ratio reached 6,81x, and the lowest at 2,79x, and the highest data 11,33x. The debt to equity showed the leverage that a bank could have.

**B. Credit Risk**

On the non-performing loan, a bank has a lowest rate at 0,73, and another bank reached the highest at 8,83%. However, on average the banks under category book 3 and 4, have an average at 2,834%. On average, the NPL still lower than the

regulation by the central banks. On the reserve requirement, the bank have a minimum reserve at 5,04% and the highest at 99,05%. On average the bank categories 3 and 4 provided 8,30% on the reserve requirements. The descriptive statistic in table 4

TABLE IV. DESCRIPTIVE STATISTIC

Variables	N	Min.	Max.	Mean	St. Deviation
Return On Assets	57	-4.89	4.34	1.9442	1.39789
Return On Equity	57	-38.33	28.04	11.9533	9.18024
Economic Value Added	57	-0.4483	0.2154	0.0545	0.09180
Capital Adequacy Ratio	57	13.34	30	19.7475	3.44624
Non-Performing Loan (Gross)	57	0.73	8.83	2.8335	1.38046
Net Interest Margin	57	3.76	10.10	5.7558	1.4355
Reserve Requirement	57	5.04	99.05	8.3035	12.2428
Loan Funding Rate	57	71.35	95.54	85.6082	6.13991
Debt To Equity Ratio	57	279.2	1133.20	681.7646	209.69483
Equity Size	57	17.7521	20.8414	18.9993	0.9034
Firm Size	57	15.5368	18.9595	16.9789	1.03614

**C. Firm Size**

The largest bank is BRI with the assets of IDR 1,125 Trillion and the smallest bank at the asset of IDR 51 Trillion. On average, the banks have an asset of IDR 282 Trillion. On equity, the most significant equity is IDR 171 Trillion, and the smallest equity is IDR 5,5 Trillion. On average, the equity reached IDR 42 Trillion.

**D. Profitability**

The Return on Assets has reached an average of 1,94%. The highest ROA is 4,34% and the lowest at -4,89%. Negative ROA is due to the loss of a bank. On Return on Equity, Bank Permata achieved -38,33%. On average banks booked Return on Equity at 11,95% and the highest at 28,04%. BTPN produced a higher net interest margin at 10,10% and UOB Bank booked the lowest net interest margin at 3,76%. On average, the banks achieved a net interest margin of 5,755%. The Research Results show in table 5.

TABLE V. RESEARCH RESULTS

Variables	Non - Parametric Test (Mann Whitney)		Parametric Test (Dummy Variable Regression)	
Return On Assets	-2.469	**	2.418	**
Return On Equity	-4.763	***	4.661	***
Economic Value Added	-4.763	***	4.661	***
Capital Adequacy Ratio	-0.432		-1.076	
Non Performing Loan (Gross)	-1.023		-0.961	
Net Interest Margin	-1.918	*	1.101	
Reserve Requirement	-1.120		-1.079	
Loan Funding Rate	-0.200		0.258	
Debt To Equity Ratio	-1.087		1.862	*
Equity Size	-2.078	**	3.092	***
Firm Size	-1.055		2.117	**

**E. The Results of Testing H1(Capital Structure)**

With the Parametric and Non-Parametric test, there are no significant differences for banks owned by domestic and foreign shareholders. However, there were significant differences in Debt to Equity Ratio based on Dummy Variable Regression and significant at a = 10%.

**F. The Results of Testing H2 (Credit Risk)**

There were no significant differences found in the credit risk. All banks have the same credit performance on both Non-Performing Loan and Reserve Requirement.

**G. The Results of Testing H3 (Firm Size)**

There was no significant difference found in the equity and firm size based Non-Parametric approach. However, based on Dummy Variables Regression, there were significant differences in equity and firm size between banks owned by domestic and foreign shareholders. The equity size obtains statistically significant at a = 1%. The firm size obtains statistical value at a = 5%. Foreign banks performed better in equity size than local banks.

**H. The Results of Testing H4 (Profitability)**

As showed in table 5, both parametric and non-parametric tests showed that there were significant differences in profitability ratio. It showed at Return on Assets, return on Equity and Economic Value Added. Mann Whitney test also showed that the Net Interest Margin was the difference between domestic and foreign-owned banks. The local banks performed better than the foreign banks in return on equity, return on assets, and economic value-added.

The Return on Assets obtains statistically significant at a = 5%. The Return on Equity and Economic Value Added reached significant at a = 1%. The Net Interest Margin also significant at a = 10% by using the Mann Whitney test. The research summary show in table 6.

TABLE VI. RESEARCH SUMMARY

Variables	Results	Supported by Previous Research
Capital Structure	Not Significant	
Credit Risk	Not Significant	
Firm Size	Significant on Firm Size and Equity Size)	Reference [11], [8], [14], [17], [4], and [16]
Profitability	Significant on Return on Equity, Return on Assets and Economic Value Added)	Reference [11], [12], [16]

**I. Managerial Implications**

The research results will be an essential input for the regulators in monitoring and regulating the bank competition. It is also crucial for banks to improve their performance.

**IV. CONCLUSIONS**

This paper investigates whether there was a significant difference in performance between locally owned and foreign-owned banks. It proved that there were significant differences

in profitability by both statistic parametric and non-parametric tests. It showed that it is different in Return on Equity, Return on Assets, Economic Value Added, and Net Interest Margin. It also found that there was a significant difference in firm size, especially total assets and equity. The foreign banks only performed better in equity size. Moreover, there was no significant difference in credit risk and capital structure. The local banks performed better in profitability.

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