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Diverse boards: Why do firms get foreign nationals on their boards?

Kristína Sághy Estélyi [a,1], Tahir M. Nisar [b,*]

[a] *Faculty of Business and Management, Brno University of Technology, Brno, Czech Republic*
[b] *Southampton Business School, University of Southampton, Southampton SO17 1BJ, UK*

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A B S T R A C T

Corporate boards are the focal points for strategy and investment related firm decisions, and hence they embody the key features of production and management. In this paper, using a unique dataset of listed firms, we examine the determinants of board diversity based on directors' nationalities and ask whether the presence of foreign directors on boards contributes in some way to firm governance and performance. Our results show that boards containing diverse nationalities are positively and significantly associated with shareholder heterogeneity and the firm's international market operations. Nationality diversity is also positively related to operating performance. Moreover, as we find, institutions relating to investor engagement play an important role in influencing the nature and consequences of board diversity.

1. Introduction

Literature on the costs and benefits of board diversity is fairly divided into two camps. One school of thought argues that diversity of opinion can eliminate many of the pitfalls of relying on a single or a homogenous source of knowledge and expertise. The enthusiasts belonging to this group thus call for greater diversity in the nation's corporate sector. On the other side of the argument, there are people who caution against such a drive for diversity and stress that whereas diversity improves the transmission and processing of information at the apex level of a firm, it also poses challenges to the organization of work. For example, personnel differences may lead to conflicts in the workplace; and there are instances where diversity has overtly betrayed the interests of the group (Farrell and Hersch, 2005; Hilscher and Şişli-Ciamarra, 2013). Yet, corporate boards are commonly inhabited by people with wide differences in characteristics such as age, education, experience, gender, and professional background (Anderson et al., 2011). Diversity is present in boards regardless. It seems to matter little whether there is any political or regulatory push for more diversity on board.

Against this background, we may ask the following questions: (i) can we further refine measures of director diversity so as to encompass all relevant dimensions of diversity?, and (ii) can we investigate the particular characteristics of the firm as

* Corresponding author. Tel.: +44 23 8059 3427, +44 23 8059 3844.
E-mail addresses: estelyiova@fbm.vutbr.cz (K.S. Estélyi), t.m.nisar@soton.ac.uk (T.M. Nisar).
1 Tel.: +420 54114 3725.

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determinants of board director diversity? After all, if firms continue to employ even a small number of directors with a diverse background then they must accrue some tangible benefits that are greater than the cost of employing them. There is hence an economic reason to investigate the practice of "diversity hires". For example, Anderson et al. (2011) find that firm complexity has a strong influence on board heterogeneity. Board diversity is generally investigated under the assumption that analyzing board member characteristics may help understand the effects group composition has on board effectiveness and performance (Adams et al., 2010). The bourgeoning research on board diversity analyzing the salient demographic characteristics such as gender and ethnicity finds that there is a growing preference for female or ethnic minority board directors (Netter et al., 2009). As director characteristics may affect the internal workings of boards, it is likely that directors from different national backgrounds may also behave differently. Director nationality may be a critical factor in how the interests of the various stakeholder groups are played out in the corporate arena. A board's foreign members may also influence the quality of its decisions as nationality is an important yet distinct source of individual competence. One can plausibly assume that knowledge about international markets as well as information about different national regulatory regimes could be a useful asset to have. We thus expect a greater representation of foreign directors on boards as heterogeneity in firm operations increases. However, there are other factors that may hold back firms from widening the diversity of their directors. These include the preference of CEOs and other top executives to choose directors who come from similar backgrounds to themselves. CEO power may thus counter a firm's tendency to expand its resource base through employing different nationality directors. This suggests that factors other than director characteristics may also play a role in board-level appointments.

In this study, we examine the determinants of board diversity by focusing our attention on foreign directors. There have been very few studies conducted on foreign nationality directors (e.g., Masulis et al., 2012; Oxelheim and Randøy, 2013), and with the exception of Miletkov et al. (2014), they do not essentially consider the determinants of having foreign directors. Miletkov et al. (2014) undertake a cross-country comparison of foreign directors' role in how national corporate governance systems are managed. Their study also focuses on particular institutional factors that likely influence the tendency of companies to appoint foreign directors. Using a unique dataset of corporate boards in all UK based listed firms over a ten-year period, we investigate UK specific institutional factors and explain their role in the determinants and impacts of diverse nationality boards. Our interest in this subject is driven by a number of factors. In the UK, shareholders are granted a significant role in board decision-making. Prior research also suggests that UK-based investor institutions actively participate in board decisions and they have a positive influence on firm operating performance (Becht et al., 2010; Buchanan et al., 2012). In our present context, we investigate this issue further in terms of the shared institutional context of the UK firms in the following three forms: i.e., institutional ownership, legal origins and varieties of capitalism. These variables are comprehensive indicators of key institutional differences and are widely shown to have important economic consequences (Hall and Soskice, 2001; La Porta et al., 2008).

We argue that directors of foreign nationality originating from a similar legal and economic background as that of the UK (i.e., the UK law and a liberal market economy) will have a positive impact on firm performance. If this is indeed the case, then examining the institutional foundations of board diversity practices becomes as important as other firm-related variables. We can go so far as to suggest that these practices help open the black box of institution–performance linkages, putting forward nationality diversity as an important channel through which institutions can affect firm performance. Moreover, institutional foundations of board diversity reduce the costs of appointing foreign directors by minimizing the effects of "language and cultural differences" (Miletkov et al., 2014). As Miletkov et al. (2014)have argued, when language and cultural differences are present, there are reduced communication opportunities affecting the ability of foreign directors to make efficient board decisions. UK based directors of foreign nationality potentially do not encounter these reduced communication opportunities as in many cases they have similar backgrounds in terms of legal and economic systems. These arguments also correspond to the findings of Masulis et al. (2012) who show that the attendance record of Canadian directors is significantly better than that of other foreign independent directors, including directors from Mexico. They attribute these differences to the way Canada shares many similarities with the USA against Mexico that differs significantly on grounds of economic development, legal system, language, and culture.

Our results show that both director/firm characteristics and institutions are important in explaining the practice of board diversity. Other than the institutional factors as mentioned above, we find that shareholder heterogeneity and product market heterogeneity are key determinants of nationality diversity on boards. These results suggest that firm decisions on diversity are not merely a reflection of values adhered to by some specific segment of society; they result from cost–benefit considerations of what diversity can bring to the firm. There is also an issue about understanding the role of the demographic characteristics of directors in how they impact on board dynamics. We show that foreign directors actively participate in board activities through their membership of board committees. Board members are more likely to be influential in performing their monitoring and advisory roles if they sit on key committees (Klein, 1998). Similar results are found in relation to the effects of board diversity on CEO pay. We also find a positive relationship between national board diversity and firm performance. However, this relationship is mediated by CEO power: for example, the more powerful the CEO is, the less likely it is that the firm with a diverse board will achieve higher performance. This indicates that our firm performance-related results need to be seen in the light of the special institutional context of the UK's corporate sector.

The remainder of the paper is organized as follows. We first briefly provide a discussion of the costs and benefits of diversity to provide a backdrop to our propositions about the determinants of foreign nationality directors. We draw on the traditional classification of director functions (i.e., monitoring and resource provision) to develop our specific arguments. The next section introduces our dataset and discusses regression variables. We then provide our results. The final section concludes with a discussion of potential areas for future research.