RESEARCH BRIEF

# Boards of a Feather: Homophily in Foreign Director Appointments Around the World

*Based on BFI Working Paper No. 2020-20, "Boards of a Feather: Homophily in Foreign Director Appointments Around the World," by John M. Barrios, associate professor, UChicago's Booth School of Business; Pietro A. Bianchi, assistant professor, Florida International University; Helena Isidro, associate professor, Insituto Universitario de Lisboa; Dhananjay Nanda, professor, University of Miami*

### KEY TAKEAWAYS

- ✓ Corporations that do business worldwide are increasingly encouraged to diversify their boards by including members from foreign countries
- ✓ Such board diversification is meant to expose corporations to best practices from which they would otherwise not benefit
- ✓ This new research reveals, though, that corporate boards are inclined to choose directors from foreign countries that exhibit similar characteristics to those directors from the home country

Diversity in boardrooms is a watchword among corporations these days, with companies striving to add members that better reflect the gender and racial make-up of their markets. In some cases, this diversity movement is driven by government fiat, as states such as California and countries like Norway, for example, have passed laws requiring certain levels of female representation.

In recent years, focus has also turned to the geographic make-up of boardrooms, with organizations like the OECD and World Bank arguing for increasing geographic diversity in companies that do business around the world. The case for such geographic representation follows from the notion that globalization will induce a convergence of business practices across borders. One respondent to a recent survey on the subject was emphatic about the need for, and benefits of, geographic diversity: "The board has to give itself a composition that enables it to function at a high level of performance outside [the company's] home country."[1]

However, new research reveals that while corporations may have embraced the idea of geographic diversity for corporate boards, and they are acting on that idea, those corporations are actually doing little to achieve that goal. In "Boards of a Feather: Homophily in Foreign Director Appointments Around the World," John M. Barrios of UChicago's Booth School of Business and his colleagues show that a corporate board's effort to diversify geographically often results in a board that looks very similar to the original. Corporate boards, it turns out, search for members from other countries that resemble those from the businesses' home country in a homophilic manner.

[1]Marsh and McLennan Companies, "Governing the Global Company: Oversight of Complexity," 2015.



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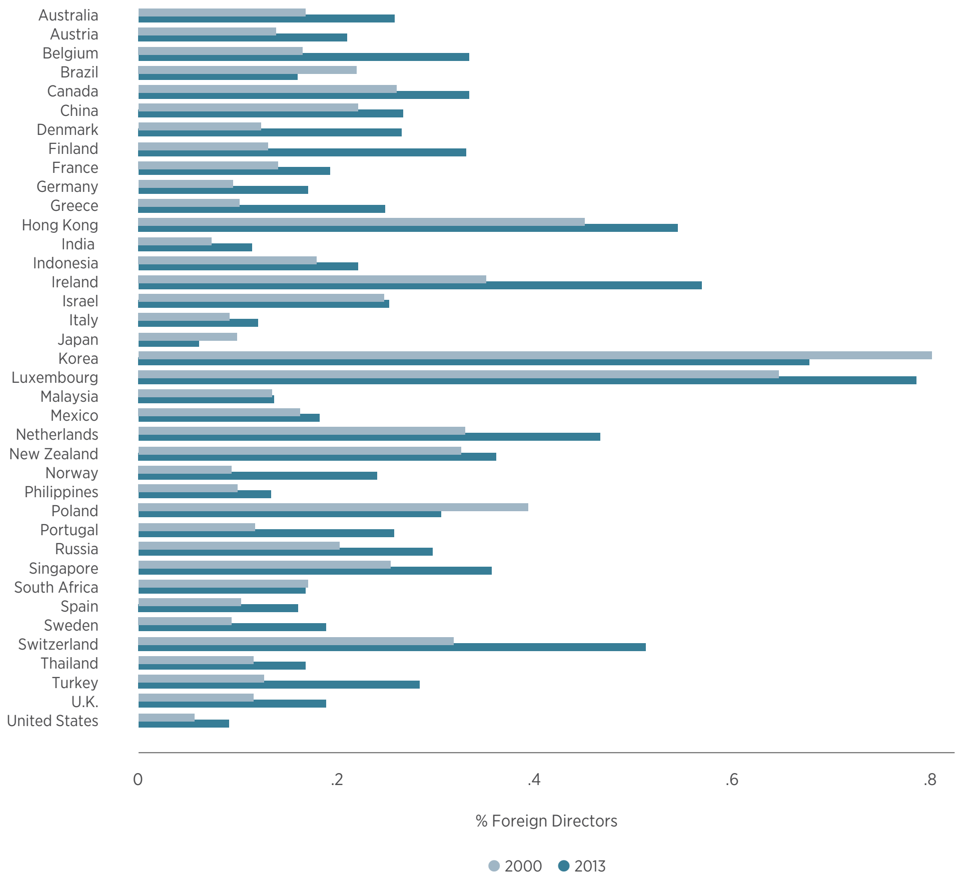
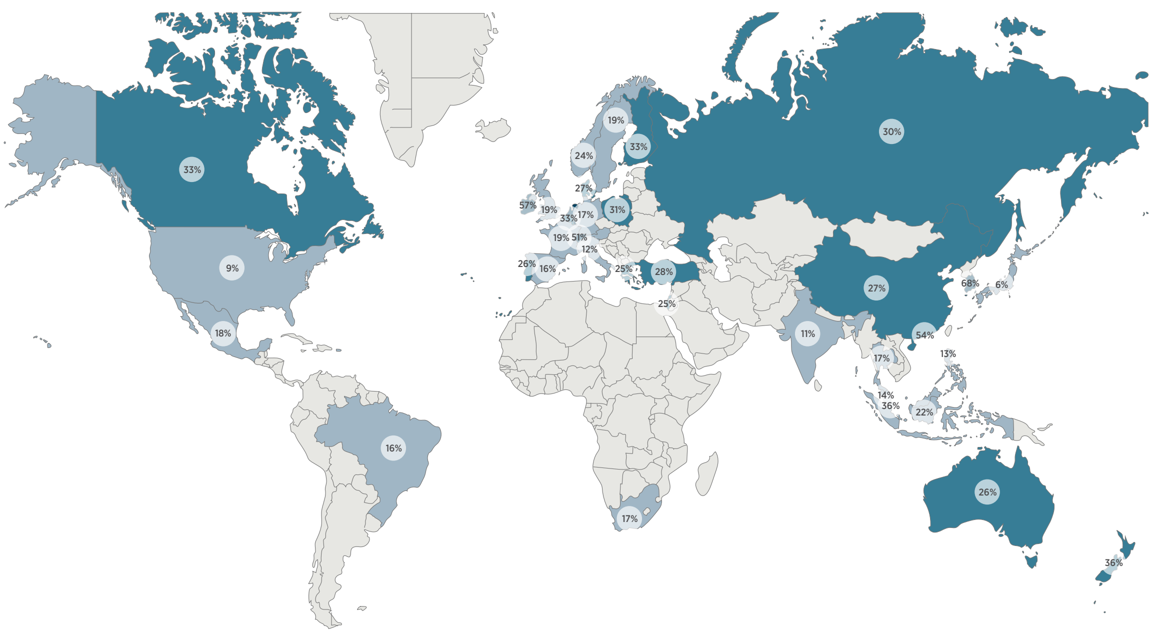
**Figure 1** · Foreign Directors Around the World

*Panel A: Foreign Directors by Country*




*Panel B: World Map of Foreign Directors*




Note: This figure shows the percentage of foreign directors by country. Panel A reports the distribution for 2000 and 2013. Panel B shows a world map of foreign directors in 2013. Values are expressed as percentages of the total number of directors in a country-year.

Put plainly: a US corporation may recruit a new UK board member and call it diversity, just as a company from one Scandinavian country may do the same by recruiting a member from another Scandinavian country, or one South American country may reach across its border to diversify its board. This is often diversity in name only, suggest the authors, as homophilic boards can lead to social conformity and groupthink, and marginalize important considerations that run counter to the norm.

**Diversity in name only?**

A corporation's board of directors not only provides important oversight on issues ranging from strategic direction to compensation and financial performance, directors also determine the make-up and appointment of future board members. In establishing guidelines for the make-up of the board, directors of international corporations have increasingly looked beyond their company's home country to find new members. The idea is that board members from other countries could transfer knowledge, labor, and governance practices that would benefit the searching corporation.

How effective are such cross-border diversifying strategies? What are the distinguishing characteristics of foreign directors on corporate boards, relative to the home country? Put another way, to what degree do all directors on corporate boards, regardless of their country of origin, share common characteristics? Are international corporations truly succeeding in diversifying their boards?

Barrios and his colleagues raise these and other motivating questions in this new work; in so doing, they reveal a gap in existing research that disregards the role of homophily in this process, that is, the tendency to seek directors from other countries that share similar characteristics and backgrounds as those of the home country. Homophily is a powerful force in shaping groups and social connections, including school, work, and marriage, and—according to the authors—in shaping corporate boards. Put plainly: a US corporation may recruit a new UK board member and call it diversity, just as a company from one Scandinavian country may do the same by recruiting a member from another Scandinavian country, or one South American country may reach across its border to diversify its board. This is often diversity in name only, suggest the authors, as homophilic boards can lead to social conformity and groupthink, and marginalize important considerations that run counter to the norm.

To measure country-pair homophily, the authors consider the following attributes: cultural proximity, common religion and language, colonial links, legal origins, and common financial reporting rules. The authors applied these country-pair similarities to a model that incorporates nearly 170,000 directors appointed to about 27,000 corporate boards in 38 countries from 2000 to 2013. Their model explains more than 84 percent of the variation in director appointments across country pairs, including the following findings:

- Firms located in economically significant countries appoint a higher-number of foreign directors originating from other economically significant countries.
- Geographic distance decreases the likelihood of cross-country director appointments;
- Shared borders increase the likelihood of cross-country appointments.
- When homophily is deeply rooted among countries, its effects outweigh other considerations, such as trade, foreign-direct investment, and migration.
- In sum, homophily is a significant determinant of cross-country director appointments.

Importantly, the authors consider both the supply and demand effects of homophily on the market for foreign-based directors. For example, consider Corporation A, which is based in a relatively developed and, thus, a high-governance country. When Corporation A seeks new board members from foreign countries, it will naturally demand directors from high-governance countries, since the appointment of a director from a low-governance country may send a negative signal to the market. Now consider Corporation B from a low-governance country. Corporation B has an incentive to find directors from high-governance countries since such directors would likely raise the board's performance. However, in such a case, potential directors from high-governance countries may be reluctant to serve on the boards from low-governance countries because it will reflect badly those directors' reputation.

These demand and supply considerations also come into play when, for example, governments place quotas on corporation boards regarding race or gender. For example, in the case of Norway noted above, corporate boards are required to meet a gender requirement. Given limited supply of candidates and time constraints due to impending deadlines, some corporations might be forced to extend their searches beyond typical homophilic countries, but in doing so they might also have to compromise their standards and extend their search to candidates they may consider less qualified.

**CLOSING TAKEAWAY**

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## Conclusion

Corporations have been encouraged—and, in some cases, ordered by law—to diversify their boards of directors. Part of this movement toward broader representation has been the effort to increase foreign membership on corporations that do business across borders. The idea is not only to diversify views, generally speaking, but to also benefit from governance practices from around the world.

This new research reveals, though, that much of the foreign diversity on corporate boards is reflective of a corporation's home-country traits. This country-pair homophily, or shared country characteristics, takes precedence in the internationalization of boards, superseding such features as the institutional makeup of foreign firms, other countries' economies, and those countries' social structures. The appearance of potential foreign directors, the language they speak, and their familiarity with the home country's governance practices, play a key role in whether they are selected to serve on a corporate board.

The authors analyzed data from a large sample of director-firm appointments in 38 countries to find that country-pair homophily increases the likelihood of foreign director appointments that resemble board characteristics of the home country. Bottom line: country-pair similarities that are deeply rooted in societies have a significant effect in the international director market.

Homophily is a potent force. Not only, for example, does it mean that boards in high-governance countries will select foreign directors from similar countries, but it also means that boards from low-governance countries will appoint foreign directors from other low-governance countries, and often those that are geographically proximate. This is significant because one of the supposed benefits of foreign diversity on corporate boards is that such boards would benefit from outside input; however, if low-governance countries are only receiving the input of similarly performing countries, then this opportunity is lost. Thus, country-pair homophily limits the potentially positive effects of trade and financial globalization in global convergence of governance quality.

What to do? As the authors show, left to their own devices, corporate boards will not adequately diversify, at least in terms of foreign representation. This suggests that to spur convergence in global governance practices more direct policy response may be in order. One possible solution is to implement geographic quotas akin to the gender quotas established by Norway. However, such quotas may prove challenging for some corporations, especially in the near term as boards scramble to meet quotas. An alternative approach is to subsidize director reputations by utilizing expats in high governance countries to go back to their home countries and sit on akin to what China has done recently to improve their company's governance.

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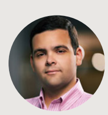

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