THE INDEPENDENCE OF THE *SHARI'A* SUPERVISORY BOARD IN THE ISLAMIC FINANCIAL INSTITUTIONS OF THE GCC COUNTRIES

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Abstract

Islamic Financial Institutions (IFIs) are governed by two boards: the Board of Directors (BoD) and the *Shari'a* Supervisory Board (SSB). The SSB is a panel of *Shari'a* scholars who act independently from other governance organs. This paper discriminates between dependent SSBs and independent SSBs by using twenty one variables, which are classified into three groups: the implementation of governance best practices, the recruitment of SSB members, and the relationship between the SSB members and other governance organs. This study is one of the first studies that provide empirical results about the SSB independence. Nevertheless, the research focuses exclusively on the Gulf Cooperation Council (GCC) countries and excludes the other countries where *Shari'a* supervision might have different forms. The study has developed a hypothesis, which was tested by a questionnaire. Data was collected from 76 *Shari'a* Supervisory Boards, 73 Boards of Directors, and 59 shareholders of IFIs in the GCC countries (Bahrain, Kuwait, Qatar, Saudi Arabia, and UAE) during 2009. The discriminant analysis has been used in identifying both dependent and independent SSBs. The paper finds five variables relevant in discriminating the two groups. These variables are the incentives provided to the SSB; the average remuneration to the SSB members; the existence of the policy of penalties for violating the code of conduct; the relation between the SSB members and the BoD; and the role of executive management in recruiting SSB members.

Keywords: *Shari'a* Supervisory Board, Islamic Financial Institutions, Board Independence, Recruitment, Governance Structure

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Introduction

Board independence is an important element in corporate governance literature (Bhagat and Black, 2002). Appointing outside directors in the Board of Directors (BoD) reduces the agency problem and increases earnings quality (Klein, 2002; Peasnell, Pope and Young, 2000). Moreover, the outside directors, due to their presumed independence, monitor and control the management more effectively (Fama & Jensen, 1983; Walsh and Seward, 1990), facilitate firms' borrowing (Mizruchi and Stearns, 1994), and increase information acquisition (Haunschild and Beckman, 1998). Peng (2004) defined the outside director as

> "N*on-management directors who have family and/or professional relationships with the firm or firm management and non-management directors with no such relationships*".

Previous studies have examined the relation between the board composition and firm performance and presented contradicted results. Some studies (Ding and Wermers 2005; Peng, 2004) argued that outsider directors make a difference to firm performance. Other research (Anderson and Reeb, 2003; Baysinger and Butler, 1985; Hermalin and Weisbach, 2003) found that board independence is not associated with better performance. Rosenstein and Wyatt (1996) found a positive relation between the number of outside directors and the stock price. Gupta and Field (2009) argued that a relationship exists between the resignation of outside directors and the negative reaction of investors. However, the research on Board independence has not covered the Gulf Cooperation Council (GCC) region (Barca and Becht, 2001; Claessens and Fan, 2003; La Porta, Lopez-de-Silanes and Shleifer, 1999; Monks and Minow, 2004).

In developed economies, board independence has long been recognized. For example, in U.S.A, the independence of the BoD was emphasized by Sarbanes-Oxley Act (2002) and the listing requirements of the New York Stock Exchange (2002) (Gupta and Field, 2009). In U.K., the Cadbury Committee (1992) recommended that there should be at least three non-executive directors on the board. In Canada, listed firms are required to disclose any association of board members with management as part of the Toronto Stock Exchange listing requirements. In emerging economies, the appointment of outsiders to corporate boards has become an increasingly widespread practice (Puffer and McCarthy, 2003; Young et al., 2002). In 1997, the Korean government instituted a series of corporate reform measures requiring the listed corporation to increase the percentage of outside directors to 25% (Machuga and Teitel, 2009).

In the GCC region, board independence of Middle East and North African banks was measured by International Finance Corporation and Hawkamah (IFC/Hawkamah, 2008). The survey indicated that the majority of banks (57%) have either 0 or 1 independent director, which confirms the lack of independence among the board members (Pierce, 2008: 57).

On the other hand, the GCC region contains 219 Islamic Financial Institutions (IFIs), which is almost half of the total number of IFIs worldwide (appendix 1). The IFIs officially and practically abide by Islamic *Shari'a* in their activities. They are regulated by central banks, capital market authorities, and other regulators, and include banks, insurance companies, mutual funds, hedge funds, and issuers of Islamic bonds. IFIs provide products that may appear similar to the products of the conventional financial institutions but upon closer examination are very different in concept and application. IFIs are usually governed by two boards: BoD and *Shari'a* Supervisory Board (SSB). The BoD has the same roles and characteristics of any traditional board, but the SSB has a unique role of ensuring that all the IFIs are *Shari'a* compliant. Hence, the SSB members should be *Shari'a* scholars with experience in Islamic banking and finance transactions. Moreover, they are completely independent from the BoD and the executive management to practice their role effectively and efficiently.

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) regulates the work of IFIs and addressed the SSB independence in its first standard (AAOIFI governance standard, No. 1, 2008). The standard emphasizes that SSB members have to be non-management directors with no ownership in the IFI. In addition, the AAOIFI governance standard (No. 5, 2008, Para 2) defines the SSB independence as

> *"An attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to influences and pressures of conflicting interests. It is achieved through organizational status and objectivity"*.

This definition emphasizes the internal side of independence (attitude of mind) as well as the external side (organizational status). El-Khelaifi (2005) defines the independence of the SSB as

> "*The authority that enables the SSB to conduct its tasks with objectivity and complete freedom*".

This definition emphasizes SSB independence in achieving its role and conducting its tasks with no pressure from other governance organs.

An SSB becomes independent when an IFI implements the best practices of governance by including the SSB in the articles of association, and establishing a governance committee, a code of conduct, a policy of penalties for violating the code of conduct, and a policy for related party transactions (Issa, 2009). The articles of association of an IFI emphasize SSB independence and frame its role, which reflect the shareholders' commitment in abiding by *Shari'a* principles (Al Baali, 2002; Bakr, 2001). This commitment is manifested by allocating the SSB under the shareholders in the organizational hierarchy (AAOIFI governance standard No. 3, 2008, Para 6; Al Enazi, 2004), and allowing the SSB members to elect one of them as a chairperson (AAOIFI governance standard No. 1, 2008, Para 6; Abdul Bari, 1996; Al Qattan, 2004). Furthermore, the SSB is completely independent in setting its internal policy and approving it by the shareholders (Al Baali, 2002; Al Haiti, 2009; Al Enazi, 2004; El-Khelaifi, 2005). The implementation of these procedures protects the SSB from the pressure of the BoD and the executive management (Al Sabban, 2003).

When the IFI abides by AAOIFI governance standards in recruiting the SSB members, it enables the IFI to recruit the most qualified candidate and eliminate favoritism towards a specific candidate. Thus, the SSB candidates can be nominated by major shareholders, minority shareholders, BoD, executive management, investors, clients, and central banks; nevertheless, the shareholders only are authorized to appoint the *Shari'a* scholar, sign his contract, and approve his remuneration (Ahmed, 2003; Hammad, 2006; Hemaish, 2005) to ensure the SSB legal independence (Bakr, 2002).

The relationship between the SSB and the other governance organs characterizes the SSB independence. When the SSB members become mentally and emotionally independent from other governance organs, they will be able to express their unbiased opinion. This independent status is hard to be measured due to the lack of standardization (Al Qari, 2002; El-Khelaifi, 2005); nevertheless, having advanced knowledge in *Shari'a* and experience in IFIs transactions enable the SSB members to achieve this status (Al Baali, 2002). Furthermore, when the SSB members have no influential relation with other governance organs such as BoD and executive management, they become independent with no effort (Al Enazi, 2004; Al Haiti, 2009; Al Sabban, 2003). Accordingly, the following hypothesis can be inferred.

Hypothesis: The segments of the SSB dependence and independence are reasonably distinct.

Methodology

The hypothesis has been tested by a questionnaire, which was mailed to 219 IFIs in the GCC countries (appendix 1). The data was collected during June 2009. The alpha for the independence model is 0.869, which exceeds the standard measure of 0.70 (Cronbach, 1951; Nunnaly, 1978). The questionnaire was also examined against different types of validity (Sekaran, 2003). The questionnaire tested the impact of twenty one independent variables on discriminating dependent SSBs from independent SSBs.

The elements of the population are divided into three mutually exclusive groups: the shareholders, the BoD, and the SSB members. Stratified random sampling was used (Sekaran, 2003; Thompson, 2002), where the average response rate from each group in the five countries collectively exceeded the standard rate 20% (Ritchie and Lewis, 2003) as per Table 1 except in two groups of Saudi Arabia (BoD and shareholders), and in one group in the UAE (shareholders). Table 1 indicates the details of the response rate for each group.

Table 1. Response Rate as a Percentage of Population

Country	SSB		BoD		Shareholders	
	No.	Rate	No.	Rate	No.	Rate
Bahrain	18	45.00%	19	47.50%	14	35.00%
Kuwait	26	33.33%	29	37.18%	24	30.77%
Qatar	10	50.00%	9	45.00%	9	45.00%
Saudi Arabia	9	23.68%	6	15.79%	4	10.53%
UAE	13	30.23%	10	23.25%	8	18.60%
Average Collection	**76**	**34.70%**	**73**	**33.33%**	**59**	**26.94%**

Descriptive Statistics

The SSB independence was measured by discriminant analysis. The questions used for discriminating the SSBs between dependent and independent boards were classified into three groups: questions with scaling answers, dichotomous questions, and multiple choice questions.

Scaling Questions

The first scaling question asked "*How important is the role of the following parties in recruiting SSB members?*" Table 2 includes the descriptive statistics of this question. The answer includes major shareholders (RECMAJ), minority shareholders (RECMIN), BoD (RECBOD), executive management (RECEXC), investors (RECINV), and central banks (RECCBK). Each party reported the importance of its role in SSB recruitment on a scaling level from 1 to 5 where 1 means not important, and 5 very important. RECMAJ has a mean of 3.0847 and a Standard Deviation (SD) of 1.67423. RECMIN has a mean of 1.9296 and a SD of 1.13797. RECBOD has a mean of 3.6806 and a SD of 1.62573. RECEXC has a mean of 3.8814 and a SD of 1.40301. RECINV has a mean of 2.1096 and a SD of 1.29702. Finally, RECCBK has a mean of 2.4407 and a SD of 1.68432.

Table 2. First Scaling Question Measuring the SSB Independence (N = 76)

Variable	Valid	Missing	Mean	Median	Mode	SD	Min	Max
RECMAJ	59	17	3.0847	3.0000	1.00	1.67423	1.00	5.00
RECMIN	71	5	1.9296	2.0000	1.00	1.13797	1.00	5.00
RECBOD	72	4	3.6806	4.0000	5.00	1.62573	1.00	5.00
RECEXC	59	17	3.8814	4.0000	5.00	1.40301	1.00	5.00
RECINV	73	3	2.1096	1.0000	1.00	1.29702	1.00	5.00
RECCBK	59	17	2.4407	1.0000	1.00	1.68432	1.00	5.00

Note: RECMAJ = Major Shareholders; RECMIN = Minor Shareholders; RECBOD = Board of Directors; RECEXC = Executive Management; RECINV = Investors; RECCBK = Central Banks; SD = Standard Deviation

The second scaling question asked "*How important are the standards of AAOIFI to the institution during the election process?*" which was asked to the BoD. Table 3 contains the descriptive statistics of this question. The answer is designed on a scaling level from 1 to 5 where 1 means not applicable, 2 marginally applicable, 3 recommended, 4 strongly recommended, and 5 mandatory. The STNDRD variable has a mean of 3.3099 and a SD of 1.30484.

Table 3. Second Scaling Question Measuring the SSB Independence (N = 76)

Variable	Valid	Missing	Mean	Median	Mode	SD	Min	Max
STNDRD	71	5	3.3099	3.0000	3.00	1.30484	1.00	5.00

Note: STNDRD = AAOIFI Standards; SD = Standard Deviation

The third scaling question asked "*Which of the following parties sets the terms of the SSB contract?*" which was addressed to the BoD. Table 4 includes the descriptive statistics of this question. The answer is made on a scaling level from 0 to 2 where 0 means no contract, 1 the terms of the contract are set by the shareholders, and 2 the terms of the contract are set by the BoD and/or executive management. The CONTRT variable has a mean of 1.1918 and a SD of 0.93775.

Table 4. Third Scaling Question Measuring the SSB Independence (N = 76)

Variable	Valid	Missing	Mean	Median	Mode	SD	Min	Max
CONTRT	73	3	1.1918	2.0000	2.00	.93775	0.00	2.00

Note: CONTRT = SSB Contract; SD = Standard Deviation

Dichotomous Questions

The first dichotomous question asked "*Do the SSB members own a percentage of the IFI's common stock?*" Table 5 includes the descriptive statistics of this question. The question was asked to the shareholders. Replies indicated that 14.5% of the SSB members had ownership, while 63.2% had no ownership. The missing answers were 22.40%.

Table 5. First Dichotomous Question Measuring the SSB Independence (N = 76)

Variable	Yes		No		Missing	
	Frequency	%	Frequency	%	Frequency	%
INDEPEND	11	14.5	48	63.2	17	22.4

Note: INDEPEND = Independence

The second dichotomous question asked "*Do you have a governance committee to ensure compliance with ethics and values?*" Table 6 includes the descriptive statistics of this question. This question was addressed to the BoD. 46.1% of the respondents declared the existence of the governance committee while 48.7% declined it. The missing answers were 5.3% only.

Table 6. Second Dichotomous Question Measuring the SSB Independence (N = 76)

Variable	Yes		No		Missing	
	Frequency	%	Frequency	%	Frequency	%
GOVCOM	35	46.1	37	48.7	4	5.3

Note: GOVCOM = Governance Committee

The third dichotomous question asked "*Do you have a policy for related party transactions that addresses the conflicts of interest?*" Table 7 includes the descriptive statistics of this question. This question was addressed to the BoD. 67.1% of the respondents confirmed the existence of the policy, while 28.9% revealed its absence. Only 3.9% of the respondents did not answer the question.

Table 7. Third Dichotomous Question Measuring the SSB Independence (N = 76)

Variable	Yes		No		Missing	
	Frequency	%	Frequency	%	Frequency	%
RLTPRT	51	67.1	22	28.9	3	3.9

Note: RLTPRT = Policy for Related Party Transactions

The fourth dichotomous question asked "*Do you have an effective code of conduct reviewed by the SSB?*" Table 8 includes the descriptive statistics of this question. This question was posed to the BoD. 55.3% of the respondents indicated the existence of the code, while 39.5% declared its absence. The missing answers were 5.3% only.

Table 8. Fourth Dichotomous Question Measuring the SSB Independence (N = 76)

Variable	Yes		No		Missing	
	Frequency	%	Frequency	%	Frequency	%
CODCON	42	55.3	30	39.5	4	5.3

Note: CODCON = Code of Conduct

The fifth dichotomous asked "*Do you have a policy of penalties for any violation to the code of conduct?*" Table 9 includes the descriptive statistics of this question. This question was addressed to the BoD. 59.2% of respondents confirmed the existence of the policy of penalties, and 35.5% revealed its absence. The missing answers were 5.3%.

Table 9. Fifth Dichotomous Question Measuring the SSB Independence (N = 76)

Variable	Yes		No		Missing	
	Frequency	%	Frequency	%	Frequency	%
POLPEN	45	59.2	27	35.5	4	5.3

Note: POLPEN = Policy of Penalties

Multiple Choice Questions

The first multiple choice question asked "*What is the relation between the SSB and the other governance organs in the organization chart?*". Table 10 includes the descriptive statistics of this question. The question was addressed to the SSB members. 53.9% of the respondents indicated that the SSB was placed under the shareholders but higher than the BoD, while 36.8% confirmed that the SSB and the BoD are placed at the same level, under the shareholders.

Table 10. First Multiple Choice Question Measuring the SSB Independence (N = 76)

			Valid		Missing	
Variable	Frequency	%	Total	%	Total	%
1. SSB Position in the Organization Chart						
a. SSB > BoD	41	53.9	76	100	0	0
b. SSB = BoD	28	36.8	76	100	0	0
c. BoD > SSB > CEO	3	3.9	76	100	0	0
d. SSB < CEO	2	2.6	76	100	0	0
e. Other	2	2.6	76	100	0	0

Note: (SSB > BoD) = SSB is located higher than the BoD in the organization chart; (SSB = BoD) = both SSB and BoD are located at the same level; (BoD > SSB > CEO) = SSB is located lower than the BoD but higher than the CEO; (SSB < CEO) = SSB is located lower than the CEO.

This position is illustrated in Figure 1. Examples of IFIs that have this type of structure include Al Baraka Islamic Bank in Bahrain and Al Rajhi Bank in Saudi Arabia.

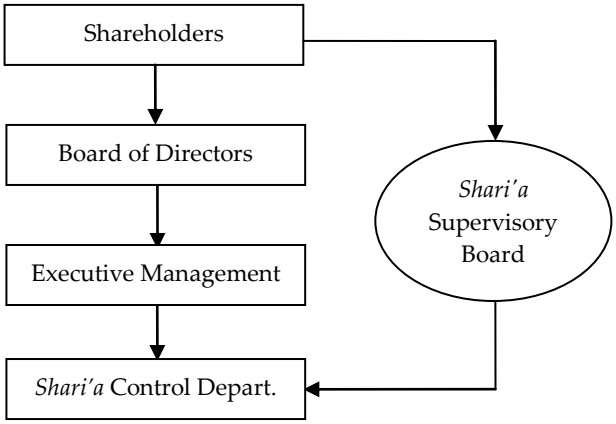

Figure 1. The SSB hierarchical position in the organization chart (first model)

A very small number (3.9%) confirmed that the SSB is located under the BoD but higher than the executive management. This position in the hierarchy can affect SSB independence due to BoD restrictions being imposed. An example of an IFI that has this type of structure is the Arab Banking Corporation – Islamic Bank in Bahrain. This relation is presented in Figure 2.

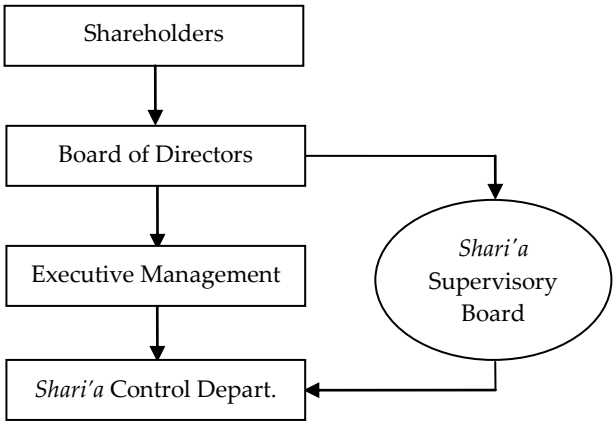

Figure 2. The SSB hierarchical position in the organization chart (second model)

In addition, 2.6% of the respondents confirmed that the SSB and the executive management are located at the same level, under the BoD. This position also might impair the SSB independence due to the management influence on the SSB. Examples of IFI's that have this type of structure are Al Khaleej Development Company "Tameer" and Sakana Holistic Housing in Bahrain. This relation is illustrated in Figure 3. Finally, about 2.6% of the respondents mentioned another location.

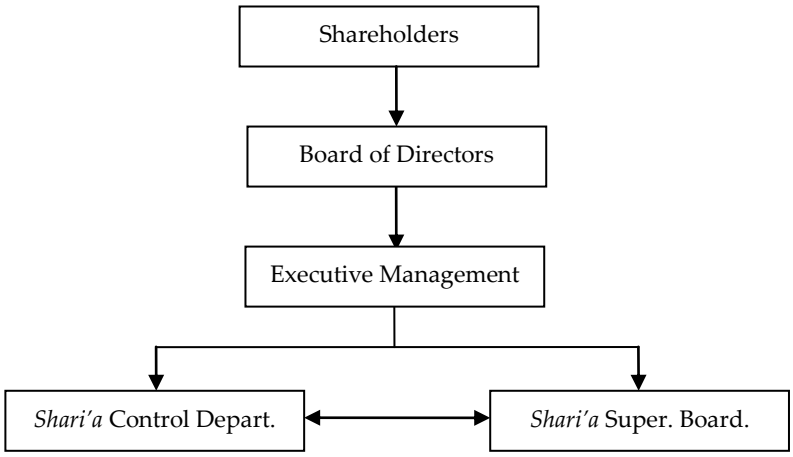

Figure 3. The SSB hierarchical position in the organization chart (third model)

The second multiple choice question asked "*How many votes are required for the election of a new SSB member?*" which was posed to the shareholders. Table 11 includes the descriptive statistics of this question. About 2.6% of the respondents indicated the total agreement of all the shareholders is required for electing new members; while 53.9% required more than 50% of the voting rights to appoint new members. About 21.1% were satisfied by collecting less than 50% of the voting rights. The missing answers were 22.4%.

Table 11. Second Multiple Choice Question Measuring the SSB Independence (N = 76)

			Valid		Missing	
Variable	Frequency	%	Total	%	Total	%
2. Required voting for SSB election						
a. 100% voting required	2	2.6	59	77.6	17	22.4
b. More than 50% required	41	53.9	59	77.6	17	22.4
c. Less than 50% required	16	21.1	59	77.6	17	22.4

The third multiple choice question asked "*What is the minority shareholders' influence on the SSB election process?*" The question was addressed to the shareholders. Table 12 includes the descriptive statistics of this question. A very small number (3.9%) indicated a strong influence of minority shareholders on the election process while 1.3% indicated a significant influence. About 10.5% of the respondents indicated a normal influence of the minority shareholders and 15.8% indicated a slight influence for the minority shareholders. The majority of the respondents 46.1% confirmed that minority shareholders have no influence on the election process. The missing answers were 22.4%.

Table 12. Third Multiple Choice Question Measuring the SSB Independence (N = 76)

			Valid		Missing	
Variable	Frequency	%	Total	%	Total	%
3. Minority shareholders' influence on SSB election						
a. No influence	35	46.1	59	77.6	17	22.4
b. Slight influence	12	15.8	59	77.6	17	22.4
c. Normal influence	8	10.5	59	77.6	17	22.4
d. Significant influence	1	1.3	59	77.6	17	22.4
e. Strong influence	3	3.9	59	77.6	17	22.4

The fourth multiple choice question asked "*Is there any incentive provided to the SSB besides the remuneration?*" Table 13 includes the descriptive statistics of this question. The question was addressed to the shareholders, where 2.6% of the respondents indicated that SSB members receive common stock, while 1.3% receives a percentage of the annual profit. 5.3% indicated that SSB members receive an allowance for attending the meetings, and 3.9% stated that SSB members receive fringe benefits. The majority 64.5% reported that SSB members do not receive any incentive at all. There were 22.4% missing answers.

Table 13. Fourth Multiple Choice Question Measuring the SSB Independence (N = 76)

			Valid		Missing	
Variable	Frequency	%	Total	%	Total	%
4. Incentives to SSB members						
a. Common stock	2	2.6	59	77.6	17	22.4
b. Annual profit	1	1.3	59	77.6	17	22.4
c. Allowance for meetings	4	5.3	59	77.6	17	22.4
d. Fringe benefits	3	3.9	59	77.6	17	22.4
e. Not at all	49	64.5	59	77.6	17	22.4

The fifth multiple choice question asked "*Which of the following positions is held by SSB members?*" which was addressed to the BoD. Table 14 includes the descriptive statistics of this question. About 1.3% of the respondents declared that some of the SSB members are department managers, while 1.3% indicated that some of the SSB members are shareholders with significant ownership. The majority 93.4% confirmed that SSB members do not hold any position in the organization. On the other hand, all the respondents indicated that the SSB has no representative on the BoD or other committees or even counted among the main clients. The missing answers were 3.9%.

Table 14. Fifth Multiple Choice Question Measuring the SSB Independence (N = 76)

			Valid		Missing	
Variable	Frequency	%	Total	%	Total	%
5. Other positions for SSB members						
a. Department manager	1	1.3	73	96.1	3	3.9
b. Member in the BoD	0	0.0	73	96.1	3	3.9
c. One of the main Shareholders	1	1.3	73	96.1	3	3.9
d. One of the main clients	0	0.0	73	96.1	3	3.9
e. Member of the Board Comm.	0	0.0	73	96.1	3	3.9
f. Does not hold any position	71	93.4	73	96.1	3	3.9

The sixth multiple choice question asked "*Is there any relation between the SSB member(s) and the Board member(s)?*" Table 15 includes the descriptive statistics of this question. The question was addressed to the BoD. The answers revealed the absence of influential relations between the two boards. However, 23.7% of the respondents declared the existence of non-influential relation, and 72.4% confirmed that no relation existed between the two boards. The missing answers represented 3.9%.

Table 15. Sixth Multiple Choice Question Measuring the SSB Independence (N = 76)

			Valid		Missing	
Variable	Frequency	%	Total	%	Total	%
6. Relation between SSB and BoD						
a. Influential relation	0	0	73	96.1	3	3.9
b. Non-influential relation	18	23.7	73	96.1	3	3.9
c. No relation	55	72.4	73	96.1	3	3.9

The seventh multiple choice question asked "*Is the average remuneration of SSB members higher / equal / lower than that of the BoD?*" which was addressed to the BoD. Table 16 includes the descriptive statistics of

this question. The answers revealed that SSB remuneration is lower than the BoD remuneration in 59.2% of the IFIs, while it is higher in 14.5% of the IFIs. Only in 15.8% of the IFIs the two boards receive the same amount. The missing answers were 10.5%.

Table 16. Seventh Multiple Choice Question Measuring the SSB Independence (N = 76)

			Valid		Missing	
Variable	Frequency	%	Total	%	Total	%
7. SSB Remuneration vs. BoD Remuneration						
a. SSB Remun. < BoD Remun.	45	59.2	68	89.5	8	10.5
b. SSB Remun. = BoD Remun.	12	15.8	68	89.5	8	10.5
c. SSB Remun. > BoD Remun.	11	14.5	68	89.5	8	10.5

The eighth multiple choice question asked "*Is the performance of the SSB evaluated regularly?*" which was addressed to the BoD. Table 17 includes the descriptive statistics of this question. The results revealed that 60.5% of the SSBs are not evaluated, while 1.3% is evaluated by the shareholders. In 9.2% the SSB is evaluated by the BoD, and in 2.6% the SSB is evaluated by the audit committee. In addition, 22.4% of the SSBs are evaluated by the executive management. The missing answers were 3.9%.

Table 17. Eighth Multiple Choice Question Measuring the SSB Independence (N = 76)

			Valid		Missing	
Variable	Frequency	%	Total	%	Total	%
8. Evaluation to SSB Members						
a. No evaluation	46	60.5	73	96.1	3	3.9
b. Evaluated by shareholders	1	1.3	73	96.1	3	3.9
c. Evaluated by the BoD	7	9.2	73	96.1	3	3.9
d. Evaluated by Audit Comm	2	2.6	73	96.1	3	3.9
e. Evaluated by the CEO	17	22.4	73	96.1	3	3.9

The ninth multiple choice question asked "*At the end of the contract period, what is the percentage of SSB members that are usually replaced?*". Table 18 includes the descriptive statistics of this question. The question was posed to the BoD. 10.5% of the answers indicated the replacement of 1% to 20% at the end of the contract period. 6.6% declared the replacement of 21% to 40%, while 2.6% indicated the replacement of 41% to 60%. A very small percentage 1.3% declared the replacement of 61% to 80%. The majority of the answers 72.4% confirmed the absence of replacement, while 2.6% had other answers. The missing answers were 3.9%. To summarize, the above questions are used for discriminating the SSBs between dependent and independent boards.

Table 18. Ninth Multiple Choice Question Measuring the SSB Independence (N = 76)

			Valid		Missing	
Variable	Frequency	%	Total	%	Total	%
9. Replacement of SSB Members						
a. 01 – 20%	8	10.5	73	96.1	3	3.9
b. 21 – 40%	5	6.6	73	96.1	3	3.9
c. 41 – 60%	2	2.6	73	96.1	3	3.9
d. 61 – 80%	1	1.3	73	96.1	3	3.9
e. No Replacement	55	72.4	73	96.1	3	3.9
f. Other	2	2.6	73	96.1	3	3.9

Empirical Results

Equation 1 is formulated to represent the relation between Independence and 21 variables.

$$\textbf{Independence} = \alpha + W_1\textbf{POST1} + W_2\textbf{ELCVOT} + W_3\textbf{ELCMIN} + W_4\textbf{CENTIV} + W_5\textbf{RECMAJ} + W_6\textbf{RECMIN} + W_7\textbf{RECBOD} + W_8\textbf{RECEXC} + W_9\textbf{RECINV} + W_{10}\textbf{RECCBK} + W_{11}\textbf{STNDRD} + W_{12}\textbf{GVRCOM} + W_{13}\textbf{RLTPRT} + W_{14}\textbf{CODCON} + W_{15}\textbf{POLPEN} + W_{16}\textbf{CONTRT} + W_{17}\textbf{POST2} + W_{18}\textbf{RELAT} + W_{19}\textbf{REMUN} + W_{20}\textbf{EVALU} + W_{21}\textbf{REPLCE} \quad \textbf{(1)}$$

The true values of the model are represented by (α) the intercept and (W_1, W_2, W_3,…..W_{21}) are the weights of the independent variables in discriminating *dependence* from *independence*. Each independent variable emphasizes one element in the SSB independence.

It is expected to find a significant contribution from these variables in discriminating the two groups: dependent SSBs and independent SSBs. The group statistics in Table 5 indicates the difference between the means of the groups for each item. For example, the mean for "POST1" in group 1 is 1.9091, while it is 1.5625 in group 2. Also, the mean for "ELCVOT" in group 1 is 2.1818, while it is 2.2500 in group 2 and so on. The difference in the two means for each variable indicates the ability of the variable to discriminate the two groups. Hence, the variables can be used in discrimination because each one has two different means.

Table 5. Group Statistics

Group	Dependent SSB	Mean	Std. Deviation	Group	Independent SSB	Mean	Std. Deviation
1	POST1	1.9091	1.37510	2	POST1	1.5625	.82272
	ELCVOT	2.1818	.60302		ELCVOT	2.2500	.48378
	ELCMIN	2.0000	1.34164		ELCMIN	1.6667	1.03827
	CENTIV	3.5455	1.63485		CENTIV	4.8750	.44363
	RECMAJ	3.0909	1.57826		RECMAJ	3.0833	1.71145
	RECMIN	1.7273	1.10371		RECMIN	1.9792	1.27979
	RECBOD	4.3636	1.28629		RECBOD	4.1458	1.30449
	RECEXC	3.3636	1.68954		RECEXC	4.0000	1.32086
	RECINV	2.0000	1.26491		RECINV	1.9375	1.42031
	RECCBK	2.5455	1.86353		RECCBK	2.4167	1.66098
	STNDRD	3.5455	1.29334		STNDRD	3.2083	1.36769
	GVRCOM	1.5455	.52223		GVRCOM	1.4792	.54537
	RLTPRT	1.1818	.40452		RLTPRT	1.3542	.48332
	CODCON	1.2727	.46710		CODCON	1.4792	.54537
	POLPEN	1.5455	.52223		POLPEN	1.2917	.50353
	CONTRT	1.6364	.67420		CONTRT	1.4375	.84818
	POST2	6.0000	.00000		POST2	5.8333	.83369
	RELAT	2.5455	.52223		RELAT	2.7708	.47219
	REMUN	1.8182	.75076		REMUN	1.3750	.81541
	EVALU	.5455	1.29334		EVALU	1.2083	1.70054
	REPLCE	4.9091	.70065		REPLCE	4.3125	1.50398

Table 6 indicates the result of Wilks' Lambda (multivariate test) and the model significance, which is an inverse measure of the discriminating data that is not already accountable by the function (Wilks, 1935). Wilks' Lambda has a value of 0.375 which is neither perfect linear relationship nor complete independence, which indicates the robustness of the model. In addition, the overall model is highly significant ($p < 0.01$).

Table 6. Wilks' Lambda

Test of Function(s)	Wilks' Lambda	Chi-Square	DF	Sig.
1	.375	45.605	21	.001

Table 7 represents the eigenvalue which indicates the function appropriateness of the whole model. If eigenvalue equals zero, the model will have no discriminatory power (Le Blanc and Rucks, 1996). However, in our model, the eigenvalue is 1.666 which confirms its discriminatory power. Table 7 also includes the percentage of variance which will be meaningful in case of having several functions where they can be added to get the measure of total discriminating power 100%. Since the model includes one function, it has the whole percentage (100%); nevertheless, the large eigenvalue (1.666) indicates the powerful relation of the model.

Table 7. Eigenvalues

Function	Eigenvalue	% of Variance	Cumulative %	Canonical Correlation
1	1.666[a]	100.0	100.0	.791

[a.] First 1 canonical discriminant functions were used in the analysis.

Most importantly, table 7 includes the canonical correlation coefficient which summarizes the degree of relatedness between the different variables and the discriminant function (Cooley and Lohnes, 1971; Levine, 1977). The value of the canonical correlation usually varies between 0 and 1, where zero denotes no relationship and 1 indicates the maximum relation (Le Blanc and Rucks, 1996). Hence, the model has a high canonical correlation (0.791), it indicates the excellent explanatory capability of the function. In other words, the model explains 89% of the variance ($\sqrt{0.791}$). Thus, the discriminant function can be determined by examining the percentage of variance and the canonical correlation together.

Table 8 includes the structure matrix that lists the ranking order of each independent variable with the discriminant function. The variables are sorted out by their absolute sizes of correlation within the function.

Table 8. Structure Matrix

Independent Variable	Function 1
CENTIV	.514
REMUN	-.169
POLPEN	-.154
RELAT	.144
RECEXC	.140
REPLCE	-.131
EVALU	.124
CODCON	.119
POST1	-.113
RLTPRT	.112
ELCMIN	-.093
STNDRD	-.076
CONTRT	-.074
POST2	-.068
RECMIN	.062
RECBOD	-.051
ELCVOT	.041
GVRCOM	-.038
RECCBK	-.023
RECINV	-.014
RECMAJ	-.001

Accordingly, the first five variables in table 8 are the most important factors in discriminating the two groups. These variables are the incentives provided to the SSB (*CENTIV*); the average remuneration to the SSB members (*REMUN*); the existence of the policy of penalties for violating the code of conduct (*POLPEN*); the relation between the SSB members and the BoD (*RELAT*); and the role of executive management in recruiting SSB members (*RECEXC*). The remaining variables are less important in discriminating the two groups.

Table 9 reports the mean of each group in the discriminant function. Hence, if the score of one variable is closer to –2.651, then this variable probably represents the *dependent* group, but if it is closer to 0.607, then the data probably came from the *independent* group.

Table 9. Functions at Group Centroids

Independence	Function (1)
Dependent	–2.651
Independent	.607

Table 10 presents the information of the actual group membership versus predicted group membership. If the discrimination between the two groups is based on natural guess, we expect a 50% success rate. However, by using the discriminant function the variables were able to classify 93.2% of the SSBs correctly into dependent and independent. The sensitivity rate of the dependent group is 90.9% and the specificity of the second group is 93.8%.

Table 10. Classification Results (Confusion Matrix)

		Independence	Predicted Group Membership		
			1	2	Total
Original	Count	Dependent	10	1	11
		Independent	3	45	48
		Missing cases	17	0	17
	%	Dependent	90.9	9.1	100.0
		Independent	6.2	93.8	100.0
		Missing cases	100.0	0.0	100.0

Note. 93.2% of original grouped cases correctly classified.

According to the results of Table 10, the Positive Probability Value (PPV) and the Negative Probability Value (NPV) can be computed as follows:

PPV = 10 / (10+3+17) = 30%
NPV = 45 / (45 + 1) = 97.8%

The PPV refers to the SSBs that were predicted to be independent but they were dependent, while NPV refers to the SSBs that were predicted to be dependent but they were independent (Pepe, 2003; Riegelman, 2000). Hence, the apparent classification error is about 6.8% which is acceptable within experimental error in social science analysis. Therefore, the results confirm the hypothesis which predicts that:

The segments of the SSB dependence and independence are reasonably distinct.

Conclusion

The research identifies five variables relevant in discriminating the two groups. These variables are the incentives provided to the SSB; the average remuneration to the SSB members; the existence of the policy of penalties for violating the code of conduct; the relation between the SSB members and the BoD; and the role of executive management in recruiting SSB members. The executive management has the highest impact on the recruitment of the SSB members, while the minority shareholders have the least influence on the SSB

recruitment. Between the two extremes, the major shareholders and the BoD play an important role in the recruitment. Both central banks and investors have marginal role on the SSB recruitment. However, the SSB contract is set by the shareholders upon the executive management recommendation. Most of the IFIs comply with the AAOIFI governance standards.

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Appendix 1. The Number of Islamic Financial Institutions Worldwide

No.	Country	Bank	Insurance	Investment Bank	Capital Market	Real Estate	Fund	Total
1	Albania	1						1
2	Algeria	2						2
3	Australia		1		1		1	3
4	Azerbaijan	1						1
5	Bahrain	7	9	18	3	3		40
6	Bangladesh	5	1	1				7
7	Bosnia / Herzegovina	1						1
8	Brunei		2			1		3
9	Egypt	2				1		3
10	Gambia	1						1
11	Germany		3					3
12	Guinea	1						1
13	India			1	1			2
14	Indonesia	3	2					5
15	Iran	12	1	2	1			16
16	Iraq	1				1		2
17	Jordan	2	3	2				7
18	Kenya	1						1
19	Kuwait	3	6	37	13	19		78
20	Lebanon	3	1	2				6
21	Malaysia	16	12	3			3	34
22	Mauritania	1				1		2
23	Niger			1				1
24	Nigeria						1	1
25	Pakistan	8	3	10		6	2	29
26	Palestine	4						4
27	Philippines	1						1
28	Qatar	6	2	5	2	4	1	20
29	Russia	1						1
30	Saudi Arabia	9	15	8	5		1	38
31	Senegal	1	1					1
32	Singapore	1	1					2
33	South Africa	1		1			3	5
34	Sri Lanka		1					1
35	Sudan	10	5	7	1	5	2	30
36	Switzerland			2			1	3
37	Syria	3	3					6
38	Thailand	1						1
39	Tunisia		1	1		1		3
40	Turkey	2	1	3				5
41	UAE	10	7	7	11	3	5	43
42	UK	6	4	4	2	7	5	28
43	USA			4		3	5	12
44	Yemen	3		1				4
	Total	**130**	**83**	**120**	**40**	**55**	**30**	**458**

Sources: GCC Central banks; GCC Stock Exchanges; Zawya database; Securities database; CIBAFI (2009); Arab Banking and Finance Directory (2009-10); McKinsey & Company (2008-09); Kulathakal (2007); Direct calls

Note: the countries highlighted in yellow are the GCC countries