The Gulf's Diligence Deficiency

by Ali Al-Salim

The Gulf's oil producing countries command significant wealth, held in both state and private hands. In addition to over $2 trillion of sovereign assets, the Boston Consulting Group estimates Middle East personal wealth alone is currently at least $3.8 trillion and poised to grow 8-10% annually for several years. Less known is whether that wealth is in the hands of prudent principals and fiduciaries.

Judging by last year's Abraaj Group fiasco, the region may be further behind than thought in key areas of governance. The Gulf is home to a spectrum of investor types, including sovereign and pension funds, foundations, family offices and banks. It is clear that not enough Gulf investors conduct adequate due diligence as part of their investment process. As the importance of fiscal responsibility grows, sustainable economic growth will increasingly rely upon effective due diligence. Such measures will also be required to attract and retain local and global capital.

The last crisis

Approximately a decade ago the Global Financial Crisis left the US and came crashing onto the shores of the Gulf. Some of its highest-profile victims included Saudi Arabia's Saad Group, Kuwait's Investment Dar and Global Investment House, Dubai's Shuaa Capital and Bahrain's Gulf Financial House. Massive losses were delivered to both shareholders of these firms and the fiduciary clients whose assets they managed. During this period, dismal investment performance masked losses exacerbated by weak governance. Cases of front-running, insider trading, over-charging fees and related party transactions abounded but few, if any, were discovered by investors let alone investigated and successfully prosecuted by authorities.

Ten years on

A decade later and it is evident the Gulf's investor community continues to suffer a dearth of diligence. It took organisations located over 10,000 kilometres from Abraaj's head office to identify and flag governance issues afflicting the Dubai-based asset manager in early 2018. Throughout much of its 16-year existence, Gulf investors comprised the overwhelming majority of Abraaj's client base. Yet none of Abraaj's Gulf investors identified irregularities or raised meaningful red flags with local regulators, nor did the regulators themselves discover these issues, which included mixing of capital between different funds, and undercapitalization.

Gulf investors simply aren't doing enough to evaluate fiduciaries through the lens of operational quality. Greater Operational Due Diligence (ODD) is needed in assessing the way an asset manager runs its business, both before and after entrusting them with capital.

Complexity

Asset management boils down to investing money—usually for a third party—in public and private markets to generate a financial return. Beneath this simple veneer lives an intricate system of administrators, auditors, banks, brokers, custodians and lawyers that each provide a service to facilitate the buying, holding, selling and valuation of assets. Asset managers are typically responsible for more than one client, not to mention their own balance sheets. They're also responsible for coordinating this orchestra of service providers, in serving the interests of their investors. It's no surprise then that such complexity naturally gives rise to conflicts of interest that need to be disclosed and suitably managed.

'Good' asset management is not solely about investment returns. It entails operating in a manner that is both fair and transparent to investors; after all, it is the investor's capital that is at risk.

Importance of operational due diligence

ODD is required to assess whether an asset manager has the required infrastructure to manage investor capital and sufficient alignment of interest with said investors. Without an adequate level of either infrastructure or alignment, investors expose themselves to a variety of risks that come with no reward.

A 'trust but verify' philosophy is commonly adopted by ODD practitioners. Key questions include: asking which individuals can make wire transfers, and how many signatures are required? How are assets accounted for and valued, and how transparent and independent is that process? What service providers are involved in the management of a fund? Are those parties also independent of the fund manager? What kind of compliance and governance culture does the asset manager have? These scratch the surface of vital questions that help build a holistic picture of the operational qualities of an asset manager.

At one end of the spectrum investors are exposed to the risk of negligence or oversight due to weak operations, at the other, governance failures can lead to outright fraud. Gulf investors must do more to develop policies that codify how they assess operational risk and what their tolerance is for accepting it in their portfolios. These will be important to attract local and global investors and for the success of the businesses and infrastructure they finance.

Local regulators

Recently members of the Gulf financial community have sought to lay blame on regulators for not effectively supervising the investment institutions under their watch. Local regulators have appeared to prioritise improving the operations of their local public equity markets to achieve the coveted status of global index inclusion, especially in Kuwait and in Saudi Arabia. Saudi Arabia has been particularly proactive in enforcing regulations by prosecuting unlicensed activity, insider trading and fraudulent IPOs. While it is notable that regulators throughout the Gulf have shown less explicit interest in the topic of ODD with regard to asset management, one cannot dispel the notion that ODD remains the responsibility of the end investor.

Why haven't investors cared?

There are many reasons for investors' cavalier attitudes towards ODD. The biggest culprit is a lack of awareness. Many investment mandates in the Gulf set by state bureaucrats or principals of family offices focus solely on the merits of an investment fund's return potential, with less attention given to downside risks, specifically those of a 'non-market' variety. Operational risks are disregarded as less impactful on expected performance.

Too often Gulf investors succumb to the fallacy of thinking that large brand-named fund managers are inherently less risky. Such thinking didn't help several Gulf sovereign wealth funds, banks and pensions in 2008 when it was revealed their investments with Bernard Madoff turned out to have financed the world's largest Ponzi scheme. In 2015, another case saw London-based BlueCrest Capital, which managed $35 billion in assets at its peak, disclose that a $2 billion private fund for employees had drastically outperformed the funds managed for their investors, suggesting a different type of principal-agent problem. Also in 2015, Blackstone Group, the world's largest private equity firm, revealed it would pay around $40 million in compensation and fines to settle the regulator's investigation which cited "violations of law or material weaknesses in controls". Earlier that year a rival firm, KKR, paid close to

$30 million in another run-in with its regulator. Each of these asset managers had significant clients in the Gulf at the time.

When the tide goes out

Investors also tend to overlook ODD because outright frauds are frankly uncommon. Many investment professionals see it as unlikely that they will lose their job after investing with a large, illustrious fund manager that is well known and revered, even if they end up failing. The Abraaj situation echoes this sentiment.

ODD can be repetitive, tedious and requires specialist talent. Furthermore, it is concerned with preventing loss, more so than identifying drivers of return. As a result, it is often mistakenly regarded as an unnecessary cost, especially during boom times.

These factors lead to a lopsided allocation of resources. Both financial budgets and human capital are directed towards front-office fund selection roles at the expense of ODD. This can subsequently lead to greater losses when markets turn and governance issues can no longer be hidden.

Diligence needed for the economy

The bigger picture reveals the many benefits brought by greater operational diligence by Gulf investors. It not only lowers the chances of exposing oneself to operational failures but creates a virtuous circle whereby best-practices are shared and adopted, raising the bar for all in the industry. Over time only the most operationally-sound asset managers can attract assets and grow. This improves the quality and robustness of the Gulf's investment industry. It ultimately creates an attractive investment environment not just for local but also foreign capital, something our region is desperately keen to do.

The responsibility for a better Gulf financial industry is shared by all participants. Although regulators have become increasingly active in capital markets' issuance and trading activity, they have done far less to further best practices in asset management.

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I would, however, argue that the onus is on the owners of capital to demand excellence from their fiduciaries—they are the direct beneficiaries.[1] There's little room for excuses either. If investors lack internal resources to conduct effective operational due diligence they can outsource to specialists. Consultants such as Castle Hall, based in Canada, have recently opened offices in Abu Dhabi to support their regional clients evaluate both international and local asset managers and their funds. The costs associated with such evaluations generally come to fractions of a percent of the assets to be invested.

If the Gulf region wishes to be taken seriously as host to globally competitive financial centers and home to sophisticated deep-pocketed investors, then Gulf financial market participants must both perform greater Operational Due Diligence and 'pass-the-test' when subjected to it by foreign investors. It is only as champions of best practice and good governance, that regional actors stand a chance of protecting and growing their financial wealth, while attracting that of others.

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[1] We've seen progress with some large investors such as Abu Dhabi Investment Authority, who consistently report on investing in their Investment Services Department, a unit that manages various internal functions including operational diligence.