Risk

Tech, Brexit and the UK's identity crisis

Michael Spencer, founder of Nex and Icap, fears a return of exchange controls under a Labour government. *By Duncan Wood*

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Nobody knows how Brexit will play out, but few people in finance are more attuned to its hidden undercurrents – and its stakes – than Michael Spencer.

The former Conservative party treasurer and serial entrepreneur has worked through 40 years of change in London, founded one of the City's great modern success stories – global broking giant Icap – and still has his eyes fixed firmly on the future with new firm, Nex. Its tech focus has won fans among investors, but is also a double-edged sword – cost overruns on an ambitious distributed ledger project led to a profit warning in October.

Brexit worries him. "I am concerned about what it means for the City of London particularly. I think it is highly probable the UK will reach a free-trade agreement of sorts – not least because we are a material net importer – but reaching a deal for our services sector will be more complicated. I am genuinely concerned London will come out of Brexit with a less-than-satisfactory outcome. I hope I'm wrong," he says.

In the near term, he expects a two-year transition period in which UK-based firms continue to have access to EU markets on more-or-less their current terms.

What happens after 2021 is what really worries him: a bad final deal for the City; a failure to relaunch the UK as a competitive, high-growth economy; and a victory for the left-wing Labour party at the next general election under its leader Jeremy Corbyn, which he fears would ultimately result in the introduction of exchange controls.

"The country is now in a higher-risk zone, economically, than we have been for quite a long time, and the verdict on whether it was a good or bad decision to leave the EU may well not be known for a decade hence," he says.

Spencer voted to remain in the EU in last year's referendum – "not with great evangelical zeal", he notes – after agonising about the decision. Now, Nex and other UK firms face precisely the consequences that prompted his vote.

"Every businessman in the UK who trades with Europe is keen to know what the new template is going to look like. We simply aren't going to get great clarity very quickly. The idea that we were ever going to complete a deal by April 2019 was always a fantasy. So there will have to be a transitional period, and I think two years is a perfectly reasonable thing to expect and look forward to. On that basis, we will likely be operating under current rules until 2021 – and we will hopefully know next year or early in 2019 what the rules look like," he says.

He plays down the threat of a no-deal Brexit, in which the two sides are unable to agree on the terms of the UK's departure or their future trading relationship – a prospect that would leave the country operating under tariffs set by the World Trade Organisation.

"I think the prospect of us leaving the EU on WTO terms is a card we need to have in our hand, but in practice is not a card we would want to play – the game theory of negotiations does mean you have to look like you're prepared to walk away from the table. I have no doubt a lot of thought has been given to this," Spencer says.

So far, so good – a two-year extension of current terms, followed by some kind of trade deal, is a lot cheerier than some scenarios. But Spencer identifies three broad ways in which it could go wrong.

First, the transition may not materialise, or may not offer sufficient protection for UK financial services firms. In this case, contin-

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gency plans would be activated – London-based banks that want to continue serving EU customers would need to take up the options they have on office space in Frankfurt and elsewhere, resulting in potentially tens of thousands of jobs leaving the city.

Spencer’s Nex – which breaks into four divisions focusing on post-trade plumbing, electronic trading, tech investments and an exchange – has European offices in Stockholm and Milan, but absent any new regulations would be able to keep serving its customers from London or elsewhere.

“If we need to, we will move our business; but I don’t think that’s likely – we don’t feel particularly threatened,” he says. If euro-denominated derivatives clearing is forced out of the UK, Spencer says the compression business at Nex – which helps clearing house participants manage their swaps books – would “no doubt connect up from London to an EU clearing structure, just as we do for clearing in Frankfurt today”.

Second, there is the shape of the final deal itself as it relates to financial services – a topic that has not been discussed in any detail, outside the clearing tug-of-war. Spencer argues it is in the EU’s interest to allow London-based firms to provide financial services to European customers, because of the City’s “material global expertise” – and he warns a restrictive arrangement might result in many of those services moving to Asia, the Middle East or the US, rather than to the continent.

But continued access is far from a sure thing, he concludes: “I’m hopeful, but can’t represent that I’m not concerned. The City does have a vulnerability to Brexit and it’s difficult to quantify that now.”

Post-Brexit identity

Finally, he worries about the brewing political war over the UK’s post-Brexit identity. Spencer may not have voted to leave, but he says the country can still make a success of it by “cutting red tape, cutting regulation, simplifying labour laws, making the tax and compensation environment attractive.”

There is just one problem: “This is certainly not the vision of Britain that is being espoused by the Labour party under Corbyn, which is positioned for a post-Brexit move to the extreme left, with significant tax increases for the corporate sector, for higher earners, and – no doubt – increased capital gains tax,” he says.

He also predicts a Labour government would introduce a super-tax on bank bonuses and profits, and that it would reintroduce some form of exchange controls – the UK abolished its currency restrictions in 1979. This is not Labour policy, but Spencer has been reading – or perhaps misreading – the tea leaves. At the party’s annual conference in September, the shadow chancellor, John McDonnell, said it had consulted experts about how to cope with a possible collapse in the value of the pound in the event of Labour winning power.

“If Labour is elected, the reality is it will inevitably lead to a massive flood of capital out of the country and a significant decline in the sterling exchange rate – it would likely reach parity with the US dollar and would fall well below parity with the euro,” says Spencer. “In this environment, I can imagine Corbyn and McDonnell arguing it is in the national interest to prevent the flow of capital out of the country and imposing what they will say – no doubt, at the time – are temporary controls. They will then become permanent and will result in catastrophic damage to the economy if they do so.”

Serving as the Conservative party’s treasurer from 2006 to 2010, Spencer was close to former UK prime minister David Cameron and chancellor George Osborne. He offers a narrow endorsement of Cameron’s successor, Theresa May, saying she “has the strength of character and stubbornness to see the Brexit negotiations through to 2019”, while adding it is “improbable” she will end up leading the Conservative party into the next election.

Despite the clouds now gathering over the country where Nex employs roughly a third of its 1,900 people, Spencer is aiming to build a new force in tomorrow’s global financial markets. The company was created in January 2017 via a deal that split Icap in two – its voice broking assets went to bitter rival Tullett Prebon, with a portfolio of other businesses forming Nex. As of November 2, the Nex stock price was 37% higher than at launch.

Spencer says he engineered the deal – “the split of the firm was my design and intent” – because he wanted to spend the rest of his career looking forwards.

“While I don’t think voice broking will become extinct, I think it is yesterday’s business,” he says. “In contrast, I am an absolute believer in the transformative power of technology. So I wanted to focus on where the future is going to be, as opposed to where the past was.”

Spencer’s beliefs about what the future holds are reflected in the structure of Nex and its tech-heavy businesses. For example, the bet that underpins the post-trade division – Nex Optimisation, which accounts for almost half of the company’s revenues – is that banks will continue outsourcing back-office and operational tasks to third parties, and will look for the

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smallest number of providers possible.

"The big institutions are much more cost-conscious than they used to be, so why duplicate huge amounts of technology spending where Goldman Sachs and JP Morgan and Deutsche Bank are all trying to solve the same issue? It makes manifest sense to democratise this process wherever possible," he says.

Cost overruns

Margins at the division fell for the second quarter in succession, the company announced on October 2, in part because of cost overruns at distributed ledger project, Nex Infinity. The new database is designed to make reconciliation and reporting easier for customers.

"It's intellectually a very original piece of thinking, but like anything of that nature, pinning down the costs is difficult, and we have had cost overrun on it," says Spencer.

Two weeks after the profit warning, Nex announced the departure of Jenny Knott, the division's chief executive.

Does the company now have a grip on the final bill for the project? Spencer says it's too soon to be sure: "Jenny Knott left here less than 10 days ago, so we have a new person in command – Ken Pigaga – and he is going to report back."

The division also faces new competition for one of its best-known products – the compression service run by legacy company TriOptima. Until October, TriOptima had been the only approved provider of compression at LCH's SwapClear, the world's largest interest rate swaps clearing house. It has since been joined by startup Quantile Technologies, launched by two Morgan Stanley veterans last year.

Spencer welcomes the competition, and says there is no plan to bid for the rival firm: "I respect the Quantile team very much, but they're not anywhere on our buy list."

Competition may come from less-traditional quarters, too. Spencer acknowledges banks could try to commercialise the post-trade tools, analytics and data they have built or gathered in-house, but says the firm spends more time speaking to banks about co-operation than worrying about competition.

"We have conversations with banks all the time, and are involved in some conversations around what we can do co-operatively."

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Elsewhere, Nex is betting on the continued spread of electronic trading via its markets division, which contains US Treasury trading platform, BrokerTec, and foreign exchange venue EBS. In October, the average daily volume across the two platforms totalled $770 billion, with all products posting year-on-year growth. Spencer expects a growing share of the world's liquid instruments to be executed on screen, and predicts that less-liquid products will also be drawn in as platforms apply new technology to the problem of spotty transaction flows.

The company also contains what is in essence a venture capital fund – Nex Opportunities. Here, the bet is that important new firms will emerge from the current galaxy of fintech startups. So far, Nex has restricted itself to investments that overlap with its other businesses – such as Acadiasoft, the messaging firm that now plays a vital role in the margining of non-cleared derivatives.

Spencer says he could branch out, with crypto-currencies a current focus: "I've been talking with my colleagues about expanding our horizons. For example, should we be doing anything in crypto-currencies? A huge number of new currencies have launched – it has the feel of a huge bubble – but nevertheless I believe this world is here to stay, it does solve some problems in terms of the very efficient transfer of title [and] efficient transactions. Those are the sort of things that interest me at the moment," he says.

This is where Spencer seems happiest. Like any trader or broker, when things are in motion he has a chance to make a difference – and make some money.

He gets lyrical about London's 'Big Bang' in 1986 – a liberalising package that torched old rules on ownership and competition for the city's brokers and dealers. Some years later, he "loved it" when open-outcry trading pits switched to screens.

But he is withering when asked about another potentially transformative change – Europe's incoming trading and transparency regime, the second Markets in Financial Instruments Directive.

"To me, it's the opposite of Big Bang. That was a liberalisation, it was about taking away rules that existed in the past. It attempts to apply new rules to prevent market abuse, client abuse, information abuse, and so I don't think it's a liberalisation at all. I'm sceptical as to the overall value it will bring," he says. ■