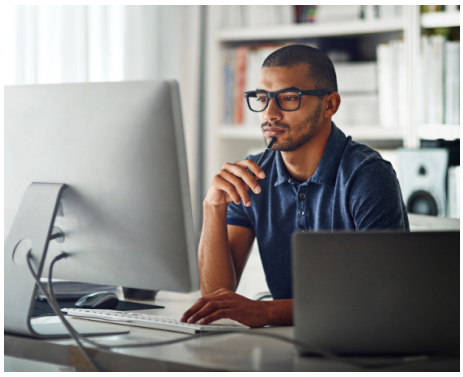
Covid and Connectivity:
Charting a Strategic Course During a Time of Great Uncertainty

White Paper

Connecting opportunities

In this paper, IPC looks at why market participants should consider reviewing their connectivity strategies as the financial community adjusts to the Covid-19 pandemic. Taking a fresh look at connectivity is one way that trading firms can move their business forward despite the uncertainty that the pandemic creates. What is critical is that firms view connectivity in a holistic way, and not just in terms of hardware, software and infrastructure.

Introduction



In the face of a sudden and overwhelming crisis, financial trading firms on both the sell side and the buy side have managed to make a series of remarkably swift and effective adjustments to Covid-19. Helped by the vendor community, they quickly switched to remote trading, often by deploying soft turrets. In so doing, firms ensured that they – and their clients – were able to meet the moment.

The months ahead now offer an opportunity to take a deep breath and consider what kind of longer-term strategic adjustments firms might want to make. High up on the list should be connectivity.

Connectivity is a broad issue that involves much more than hardware, software and infrastructure. Many firms tend to focus on technology, physical networks and basic measures such as latency. But it also concerns the market ecosystems in which firms currently trade or might want to trade, the business models they operate, the service models they use and the nature of their market participation in terms of asset classes or trading styles. In this paper, we will look at some of the issues which firms should think about as they begin to review their connectivity strategies.

While there is still tremendous uncertainty concerning Covid-19 and the world economy, there are certain things we do understand which can help firms develop an effective strategy in a post-pandemic world. Many of these are based on trends that were well underway before the virus, including cost pressures, asset class-based connectivity solutions, the proliferation of electronic trading, network and routing developments and the broader take-up of the cloud. By making sense of these trends, firms can begin to chart their future despite all the current uncertainties.

Defining connectivity

A recent report by Celent notes that connectivity can mean many different things to different firms. It can involve access to market data, communication methods, routing technology, network infrastructure and a host of other issues.

We suggest that one way to think about connectivity is holistically, and to do so by employing three concepts: "who", "what" and "how". The first of these, "who", refers to a firm's access to other market participants, to trading venues and to market ecosystems. It is all about the trading communities that a firm wants to participate in. "What" refers to the types of connectivity that a company needs. That could mean accessing market data, or the ability to conduct electronic trading or any number of other functional factors, including pre-trade to post-trade requirements. And "how" refers to the ways that firms address those "who" and "what" questions, via hardware, software, protocols and infrastructure.

Thinking about connectivity in a holistic way

Who?

The market participants and ecosystems that your firm wants to connect with

What?

The types of functions you want to perform, from accessing market data to conducting electronic trades

How?

The hardware, software, protocols and infrastructure that will enable you to address your connectivity needs

When thinking about connectivity, many firms jump straight to "how". But by viewing connectivity within this broader framework, we can see that the "how" question becomes much more difficult to answer properly if a firm has not yet adequately defined "who" and "what". Issues as varied as the fragmentation of liquidity, the advent of electronic trading or the types of trading strategies employed can all have profound implications for the decisions that firms make in determining their connectivity approaches and partners.

Celent identified six key trends impacting connectivity. These are: the rise of e-trading across asset classes, the cost and commercial models trading firms employ as liquidity fragmentation continues, networking innovation, take-up of the cloud, technologies that impact client engagement, and security/compliance issues.

What is clear is that each of these trends can have an impact on the who, what and how questions that firms need to grapple with. We will touch on some of them here, looking at how firms can move ahead with strategic reviews of their connectivity requirements in light of what we know about Covid-19.

Reconsidering the trading footprint

The question of "who" starts with the geographies, asset classes and financial ecosystems where a market participant already trades or where it may want to trade. Recent events are likely to have forced some firms to begin reviewing their trading footprints in light of a changing liquidity landscape. Companies have discovered how much they need to be ready for sudden shocks that require trading flexibility as liquidity shifts. There have been already been some academic studies that have shown how Covid factors can impact liquidity in specific ways in the short term.

When it comes to cross-border flows, the pandemic has also introduced new political risks, as highlighted in an article for World Finance. The article for instance noted how U.S. President Donald Trump in May had ordered the federal pension fund, the world's fifth largest pension fund, to no longer invest in Chinese equities. Still, the most critical finding of this article was that cross-border flows needed to be viewed in terms of their long-term trends. They actually reached a peak just before the global crisis of 2008 and since then there has been a sustained period of global de-integration. In this sense, the disruption caused by Covid has only been intensifying a trend that had begun more than a decade before.

A similarly long-term viewpoint is called for when considering the economic impact on liquidity, only here the picture is more benign. Indeed, worries that the global economy was about to undergo a fundamental change have subsided. A report from Standard & Poor's noted that it had affirmed most European bank ratings in recent months, in line with a conclusion by the European Central Bank that the region's banks could cope with the Covid-inspired recession provided lost economic output had recovered by the end of 2022.

But while political and economic risk have caused asset prices to gyrate significantly and have had an immediate impact on liquidity, the dominant long-term factors are more likely to involve issues such as market structure and regulatory risk. In this sense, Covid has also served to highlight, rather than introduce, important trends that may impact firms' connectivity strategies.

For instance, credit market participants will be well aware that secondary markets have undergone major changes during the past decade as broker-dealers have withdrawn from this space. As Standard & Poor's noted in a separate article, the loss of liquidity provision has been mitigated by the increasing role played by exchange traded funds (ETFs). This, the agency said, was on display during the pandemic-induced volatility.

Or, consider the question of e-trading that Celent highlighted. A recent report by Greenwich showed how e-trading over much of the past decade had showed a clear rise for both FX and fixed income market participants. The pandemic has only encouraged more of the same.

What the examples above suggest is that trading firms need not feel paralyzed by Covid. The pandemic may intensify a trend or it may interrupt it. But what matters most is that firms take the long view by identifying the underlying business factors that are expected to impact liquidity in the markets they wish to trade in.

Reconsidering connectivity requirements

Celent's report highlighted the rapid evolution of connectivity for buy side and sell side firms. "As liquidity sources continue to fragment, cost-conscious dealers will seek innovative commercial ways to reduce spend on connectivity. This will need to be balanced with the trend toward increasing purpose-built connectivity as electronic and algorithmic trading proliferates across asset classes," the firm wrote.

They suggest a framework for thinking about connectivity in terms of networks, protocols and tools. In terms of networking, there is the physical level and the logical level to consider, and both throw up a number of cost-benefit issues for firms based on latency requirements, service models and business models. For instance, a high-frequency trading model demands best-in-class latency, which is likely to involve microwave connectivity at points on the network. Or, a buy-side participant operating in a distant geography is likely to require hosted solutions.

Provided firms have a clear understanding of what kind of business they want to do in future – the "who" and the "what" – they can begin to focus on the connectivity requirements that will help them achieve their objectives.

At the same time, it pays to think about some of the ways that the pandemic may have a lasting impact on market structure and regulation. As a result of the shock that the virus created, the financial community can now fully appreciate the value of remote trading options.

Similarly, we can expect the regulatory community to begin to factor in pandemic risk into its approaches. Already this has begun. For instance, the European Systemic Risk Board (ESRB) is looking at **what kind of tools the buy side is using to manage** liquidity in light of the pandemic. We can only expect more of such scrutiny going forward, and this can be factored into a firm's connectivity strategy.

Celent also highlighted some of the initiatives underway as firms begin to review their connectivity. A clear message is that market participants are increasing collaboration. For instance, the firm noted how smaller dealers are leveraging the infrastructure of larger banks.

Looking ahead

In such a fluid and dynamic situation, firms can also expect even more innovation. The pandemic in this regard can be seen not so much as a game-changer but as a development that has shined a bright light on some of the more pressing issues in the connectivity space. "The coronavirus showed some of the challenges of point-to-point voice networks. We saw tremendous demand for better integration of the voice and electronic channels," Celent wrote.

We at IPC have been at the forefront of connectivity innovation, with our online provision of soft turrets and our focus on emergent technologies that integrate voice and data. We also expect cloud technology to play an increasingly large role, along with a heightened focus on networking and trading tools that provide maximum flexibility, transparency and cost efficiency. IPC's network, Connexus Cloud is an unparalleled multi-cloud platform for the global financial markets. A financial ecosystem that interconnects nearly **7,000 diverse capital market participants** across **750 cities** in over **60 countries**.

However, our approach to connectivity goes beyond technology and innovation. IPC brings together a large and global financial community, connecting trading firms across geographies and asset classes. As financial markets adjust to a post-pandemic world, we will be focused on service, collaboration and expertise to ensure that the trading community can address the connectivity challenges that lie ahead.

To learn more about how IPC insights and how we are adapting to the Covid-19 pandemic, go to: www.ipc.com/ipc-insights

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