

ECB in a pickle. How about a Eurosystem CDO? Or restart unconditional LTR0s

June 15, 2022. The ECB called a special meeting to discuss surging bond yields of peripheral member states. With the inflation problem in Europe, you would have thought the ECB would have welcomed higher rates. Not so. The ECB has a very difficult task. It needs to maintain financial and economic stability, keeping a lid on consumer prices while making sure that member states' interest rates don't diverge too much. This is very difficult to do.

One strategy to encourage convergence is to restart unconditional LTR0s. The problem child is Italy, whose bond yield spread with bunds began the year at 136 but spiked to 243 last week. The LTR0 would allow Italian banks to buy BTPS and finance them via repo with the ECB. The problem with this is that Italian commercial banks are already full up on BTPS.

Another approach is for the European Stability Mechanism to launch CDOs investing in member countries' sovereign bonds. The collateral would be managed by independent third party managers with performance fees and risk retention, while the ESM itself would fund first loss and mezz with a fund funded by Euro members according to their capital key. The senior IG bonds would be fair game for private investors and would likely find an audience.