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U.K. Pension Fund Debacle Illustrates How Government-Created Moral Hazard Can Lead to Systemic Risk

Pat Parkinson | Oct. 12, 2022

The debacle in the U.K.'s pension sector is a vivid example of how government policies can create moral hazard and how moral hazard can create systemic risk.

With the encouragement of their regulator, many U.K. private pension funds invested in liability-driven investments (LDIs). What is an LDI? It is a fund that amplifies returns on low-risk, low-return U.K. government securities by employing leverage, largely through derivatives. The counterparties that entered into the derivatives contracts with the LDIs required them to enter into margin agreements. According to the WSJ, at least one pension fund was worried by the risks posed by investments in LDIs, presumably including potential liquidity pressures on LDIs in the event that yields on gilts rose sharply, triggering margin calls on the LDI and forced sales of assets to meet those calls.

So, why was the pension regulator encouraging such investments? It appears that past interventions in the gilt market by the Bank of England convinced the pensions regulator that this risk was contained — that in effect there was a put to the Bank of England. The pension regulator stated in a 2020 email to the pension fund: "Our guidance to pension schemes is written on the basis that our regulatory colleagues at the Bank of England will be successful in their remit of maintaining monetary and financial stability."

We are certain that the Bank of England does not see its remit as creating an obligation to place a floor on the price of gilts. But this is the tricky thing about moral hazard: what matters is not the intent of public policies but how those policies are perceived. While we usually think about moral hazard as affecting private decision-makers, this episode seems to show that decisions by regulators can also be affected. And that is especially dangerous because, as in this episode, decisions by regulators can affect investment decisions an entire financial sector. When considering market interventions, central banks need to take moral hazard very seriously and recognize how difficult it is to avoid or mitigate. This is especially true of central bank asset purchase programs because, unlike traditional collateralized lending at conservative haircuts, purchases transfer price risk to the central bank.

Moral hazard is already in the air in the United States. Any action by the Federal Reserve akin to the Bank of England's, which would be the Fed's third intervention to support the Treasury market in three years and the second that entailed asset purchases, would risk converting moral hazard to moral certainty in markets that there is a Fed put.

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