

Interest Rate Uncertainty and the Financial Intermediary's Choice of Exposure

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ABSTRACT

The financial intermediary's choice of operating as a broker with minimal risk exposure or as an asset-transformer with interest rate risk is modeled as a funds inventory decision made prior to the resolution of uncertainty regarding the borrowing or lending interest rates. It is shown that an increase in the interest rate uncertainty leads the intermediary to reduce its exposure, thereby offering decreased asset-transformation and more brokerage services. However, a stochastic increase in the interest rates leads to greater asset-transformation and less brokerage services.

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