Applied Financial Economics ›
Volume 2, 1992 - Issue 3

Original Articles

Interest rate risk management with futures for financial intermediaries

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Pages 179-185 | Published online: 02 Nov 2006

Cite this article https://doi.org/10.1080/758516632

Abstract

Optimal futures hedging positions are derived without any a priori restrictions imposed on the financial intermediaries' management utility function. Optimal hedging positions are estimated using actual time-series futures hedging data over the 1982– 88 period and compared to actual hedging figures. It is shown that a priori restrictions are not necessary. It is also shown that such a priorirestrictions yield suboptimal futures contracts which may explain why previous studies have shown that banks are underhedged. The results strongly suggest that financial intermediaries' futures hedging positions do offset the overall interest rate and quantity risk of operations.

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