

10 Views | 0 CrossRef citations to date | 0 Altmetric

Research Articles

Variable Rate Mortgages: Confusion of Means and Ends

Alan C. Hess


Pages 67-70 | Published online: 31 Dec 2018

🗨️ Cite this article <https://doi.org/10.2469/faj.v40.n1.67>

🌐 CFA Institute members: [sign in to access the Financial Analysts Journal.](#)

Sample our
Mathematics & Statistics
Journals

>> **Sign in here** to start your access
to the latest two volumes for 14 days



🗨️ Citations

📊 Metrics

🖨️ Reprints & Permissions

Read this article

We Care About Your Privacy

We and our 843 partners store and/or access information on a device, such as unique IDs in cookies to process personal data. You may accept or manage your choices by clicking below, including your right to object where legitimate interest is used, or at any time in the privacy policy page. These choices will be signaled to our partners and will not affect browsing data. [Privacy Policy](#)

We and our partners process data to provide:

Use precise geolocation data. Actively scan device characteristics for identification. Store and/or access information on a device. Personalised advertising and content, advertising and content measurement, audience research and services development.

List of Partners (vendors)

I Accept

Essential Only

Show Purpose



by Alan C. Hess

Variable Rate Mortgages: Confusion of Means and Ends

Fixed rate mortgages reduce households' exposure to interest rate risk. With a long-term, low-down-payment fixed rate mortgage, the duration of a house times its value will approximately equal the duration of the mortgage on the house times its value. Changes in the value of the house due to changes in market interest rates will be offset by changes in the value of the mortgage. On the other hand, the financial intermediary issuing the mortgage will be exposed to interest rate risk.

In an effort to reduce exposure to such risk, intermediaries have introduced variable rate mortgages. These instruments allow intermediaries to match the duration of the mortgages they issue against the duration of their deposits. In effect, variable rate mortgages eliminate intermediaries' interest rate risk by transferring the risk to households. Because households are not as efficient in managing risk as intermediaries, this transfer increases the price of risk-bearing in the economy as a whole.

COMMERCIAL BANKS and savings and loan associations have responded to the highly unstable interest rate environment of the past decade by introducing variable rate financial instruments. Variable rate instruments reduce the interest rate risk of intermediaries by transferring this risk to savers and investors. This transfer may not be in the best interests of the economy as a whole.

Intermediaries exist because they are cost-effective suppliers of risk-reduction and risk-bearing services. They reduce risk to the economy by managing well diversified portfolios and absorb risk from customers by bearing nondiversifiable risk. For this latter service, they charge a price, known as the market price of risk, which depends partly on the amount of risk they bear.

Efficiency in risk reduction implies the ability to diversify the greatest amount of risk at a given cost. If intermediaries are efficient risk diversifiers, then, the market price of risk

should be lowest when they are the ones providing the diversification services. By issuing variable rate instruments, however, they transfer risk reduction to savers and investors, who are less efficient risk reducers. As a consequence, the market price of risk rises. Because this price is an element of the cost of capital to businesses and the consumption-saving decisions of households, capital costs may be expected to be higher, causing investment, economic growth and economic welfare to be lower than otherwise.

This effect is especially important for house construction, as the costs of diversification are likely to be higher for households than for businesses. This article analyzes the effects of variable rate mortgages on the cost to households of managing interest rate risk. In particular, it focuses on how variable rate mortgages affect households' ability to reduce this risk by maintaining duration-matched balance sheets. Variable rate mortgages tend to increase the economy's cost of managing interest rate risk by reducing the extent of duration matching by homeowners even as they allow financial institutions to increase their duration matching.

Alan C. Hess is a Professor of Finance and Business Economics at the University of Washington Graduate School of Business Administration.

FINANCIAL ANALYSTS JOURNAL / JANUARY-FEBRUARY 1984 □ 67

The CFA Institute
is collaborating with JSTOR to digitize, preserve, and extend access to
Financial Analysts Journal
www.jstor.org



Log i

> Acc

Lo

> Log

Resto

> Res




Purchase options *

Save for later

PDF download + Online access

- 48 hours access to article PDF & online version
- Article PDF can be downloaded
- Article PDF can be printed


USD 53.00

 Add to cart

Issue Purchase

- 30 days online access to complete issue
- Article PDFs can be downloaded
- Article PDFs can be printed

USD 162.00

 Add to cart

* Local tax will be added as applicable

Related Research

People also read

Recommended articles

Cited by



Information for

- Authors
- R&D professionals
- Editors
- Librarians
- Societies

Opportunities

- Reprints and e-prints
- Advertising solutions
- Accelerated publication
- Corporate access solutions

Open access


- Overview
- Open journals
- Open Select
- Dove Medical Press
- F1000Research

Help and information

- Help and contact
- Newsroom
- All journals
- Books

Keep up to date

Register to receive personalised research and resources by email

 Sign me up



✕