

# **A MICROECONOMETRIC MODEL OF THE CHOICE BETWEEN FIXED AND VARIABLE RATE MORTGAGES IN THE UK**

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12 April 2007

## **ABSTRACT**

Assuming expected utility maximisation and rational expectations the future path of interest rates, conditions are derived for the choice of fixed rate over variable rate mortgage. Interest rate forecasts are obtained from data on bond yields. Borrowers are assumed to have Constant Relative Risk Aversion (CRRA) preferences, with risk attitude assumed to depend on borrower characteristics. Monte Carlo integration is used to evaluate the probabilities appearing in the likelihood function. The model is estimated using microdata from the UK Survey of Mortgage Lenders (administered by the Council of Mortgage Lenders). The assumption of rational expectations among borrowers is decisively rejected by the data. The results obtained here could in principle be exploited by lenders in their design of fixed rate products.

**Key words and phrases:** Fixed and variable rate mortgages; expected utility theory; rational expectations; binary data.