

Methods of Price Risk Management in the Housing Markets

Index derivatives, insurance contracts and joint ownership

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Owning your own home is, for most households, life's biggest investment.¹ But buying a house is normally not the result of a traditional investment appraisal where return is weighed against gain. It is primarily a consumer decision, often with great financial risk as a by-product. Many homeowners have a very unbalanced and heavily mortgaged asset portfolio, where the value of the house represents several hundred per cent of the owner's net capital. Heavily mortgaged households – in the U.S. today or Sweden at the beginning of the 1990s – have seen how quickly their property assets can be wiped out by falling prices. Despite the rapid development of the financial markets in recent years – not least in connection with housing financing – there is still a shortage of financial instruments or insurance contracts that make it possible for individual households to safeguard themselves against fluctuations in property prices and housing costs. While individuals are increasingly expected to take financial responsibility for their retirement savings and safeguard themselves from risks associated with ill health and old age, there is still a lack of corresponding alternatives for managing the risks linked to choice of housing.

Modern financial technology should also be able to be used for managing the risks associated with housing. It should be possible to sign a contract which allows households to maintain the distinction between a decision to invest in housing capital and a decision to consume accommodation. The aim of this report is partly to discuss in more detail the need for new methods to hedge housing price risks and partly to discuss how such markets can come about in practice. Section 1 gives a brief background to why most households choose to own their home and how this affects the way their wealth is structured. Section 2 takes up the price risks associated with housing. Price risks are gauged by various types of indexes, and in order to understand the different ways of assessing risk as well as the options for hedging, it is important to understand how indexes are constructed and how reliable they are. This is discussed briefly in Section 3. In the following sections we ask the question of how significantly different categories of household could benefit if there were the possibility of trading in derivatives linked to property price indexes. This question is answered first within the framework of an ordinary static portfolio model in Section 4. The discussion then broadens in scope in Section 5 by considering that not only house prices but also rent prices are risky and by discussing the significance of the tendency of correlation between wages and house prices. Section 6 presents an overview of the various derivatives and insurance markets which have been tested in practice and identifies a number of problems which need to be resolved in order for such markets to succeed. This discussion continues in Section 7, which concludes the report. One conclusion is

¹ Smith and Searle (2009) contains a number of essays which, with different starting points, discuss the home as an investment.

that the state could facilitate the emergence of such a market by commissioning Statistics Sweden (SCB) to coordinate information with regard to house prices and regularly produce updated price indexes for private homes and cooperative apartments.