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Title: **Building a hedge for housing**
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Homeowners' fears that housing markets may be overvalued and on the brink of a crash has spurred several residential real estate hedging market initiatives in the UK and the US.

In the UK, where, according to Halifax Bank, average housing prices have skyrocketed by more than 30% in the past year, financial bookmaker IG Index has sold £20 million in 'spread bets' on average housing prices in 12 regional markets and the entire UK since August. Trading volume is highest on the Greater London regional index. IG Index was started in 1974 to enable UK gold speculators to dodge currency controls. Over the years, it has grown to allow speculation for tax-free capital gains on commodities, stocks and stock indexes, sports and foreign exchange.

The bet mechanism is simple and resembles a future. Participants can take long and/or short exposures on housing index quotes as far as a year forward. Transaction costs are 0.3% or 0.6% of the bet size, depending on whether the purchaser holds the position to expiry or not. Shorts, or homeowners concerned about a sudden fall in housing values, are currently driving the market. Because IG Index has no other markets in which to hedge house price risk, the imbalance of long and short interest has forced one-year prices to trade at a 10% to 15% discount to fair value. John Austin, deputy head of financial trading at IG Index in London, says: "These clients are all homeowners and have all been reading newspaper articles about an approaching 'crash' in house prices."

The bet has accounted for only 1–2% of IG Index's trading profits this year, but Austin calls it the most successful new launch for the company in five years. IG Index plans to market the product more aggressively with the British expatriate community, many of whom might wish to take long positions to preserve their ability to return to their UK housing market of choice.

In the US, a group of Yale University, Oxford University and Massachusetts Institute of Technology (MIT)-trained economists, including MIT's Stephen Ross, have teamed up to develop house price insurance for major metropolitan areas, which they hope to offer by the second half of 2003.

Their Washington, DC-based firm, Real Liquidity, is currently behind a government-sponsored pilot project in Syracuse, New York, where, against national trends, housing prices fell on average by 10% between 1991 and 2001, and by as much as 30% in some neighbourhoods. To rebuild confidence in the market, a local congressman obtained a $5 million grant for a programme to insure the equity of local homebuyers. The result, the Home Equity Protection (HEP) programme, was launched in July.

The cost of protection under the programme is a one-time fee of 1.5% of the value of an owner's principal residence and lasts 30 years. Local real estate values, tracked by zip code, are maintained by a third-party real estate research firm. If the owners wish to sell their home after a minimum contract of three years, and if their local index value has fallen, HEP pays them the protected value of their home multiplied by the percentage decline in the index. To preserve the homeowner's incentive to maintain and improve the home, no attention is paid to the actual sale price of the home – only the index value counts. Should the local index rise, the owner receives nothing and loses the 1.5% fee. The programme currently insures more than 30 homes for a total value of $2.1 million.

Real Liquidity performed the capital reserve calculations with historical and Monte Carlo analysis. Against the worst-case scenario that housing prices in Syracuse decline 30% over the next 30 years, they determined HEP could offer $120 million in protection against its $5 million in capital.

Though in essence an at-the-money put option, HEP was classified as insurance by New York State regulators. HEP's backers also considered offering Syracuse homeowners equity protection through mortgages, where downward movements in the local index value would adjust downward the principal in an outstanding mortgage balance. The concept is already in use in some high-inflation housing markets, where the principal in a mortgage balance is linked to inflation. However, New York State regulatory prohibitions stopped development of this version of protection.

Should regulatory barriers be overcome in New York and other high-valued metropolitan real estate markets, Real Liquidity believes providing mortgage-based equity protection and variations of the Syracuse programme would be attractive to institutional investors, such as pension funds. At more than $11 trillion, the US real estate market is the largest untapped financial market in the world. Also, real estate is usually uncorrelated with stocks and bonds, while positively correlated with wages.

Tom Skinner, an Oxford-trained economist who founded Real Liquidity, says the cost of protection in the new private markets will average around 3% of a home's protected value, though it will vary depending on the risk of the housing market concerned.

Housing futures

Ralph Liu plans to roll out an online futures market for trading real estate risk in California and New York by zip code in 2003. He's got the right background. He ran the Asian derivatives operations of UBS and Chase Manhattan in the early 1990s, until he left to build several Asian equity derivatives exchanges and began his own company in Singapore, Advanced Risk Management Solutions, to sell financial risk and trading systems to private and central banks. After burning his fingers slightly with a financial dotcom play after the technology meltdown in 2000, Liu returned home to southern California and began trading wineries and horse ranches. “That is how I got the idea and saw the great opportunity of creating a hedging market for real estate holdings,” he says.

Margin requirements plus the uncomfortable idea of trading away upside gains on a fully hedged short position could keep retail users away from the exchange. But Liu sees its real value as a secondary market banks would use to hedge their own new line of retail real estate equity options products.

Several online derivatives exchanges – including the IntercontinentalExchange and the International Securities Exchange – have already proven popular with professional traders, which suggests Liu's online futures model could fly. Liu won't disclose the names of investors or the amount of investment attracted so far, but he says he's confident in the venture and has put a “significant” amount of his own money into it. “From my previous banking contacts, it has been very well received,” he says. He's now preparing to file for approval with the Commodity Futures Trading Commission.

Hedging markets for US real estate have been pitched before. In 1993, Yale economist Robert Shiller, author of the best-selling 2000 book Irrational Exuberance, approached several of the Chicago derivatives exchanges to list real estate futures. Despite some initial interest from the Chicago Board of Trade, the venture never got off the ground. Shiller says exchange officials were discouraged by a survey that indicated only short interest. Shiller thinks that wasn't reason enough to block the contract. As with any new product, investors would wait in the wings before committing. “Investors aren't going to give an excited response – they say, ‘I have to see what the price is’,” he says.

But now, the timing may be right. Liu says today's situation is exactly the reverse of the early 1990s – the real estate market is up and the stock market is down. Real Liquidity's Skinner points to better housing price data. In the end, however, the sale will be to the average US individual investor, who is heavily over-concentrated in their housing. “Many people have seen sharp declines in their 401(k) employee investment accounts and worry that their largest asset, their home, could be next,” Skinner says.

Source: