

Housing: Risky Business?

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As the shock waves from a US lending crisis reverberate across the global economy, the phrase 'safe as houses' acquires a somewhat hollow ring. Housing used to be the one area of life that was isolated from the interlocking risks that define the human condition. But it has turned out to be perhaps the most precarious location of all. Ironically, even as government move to bail out their banks, in the pecking order of risk-management, the security and sustainability of housing – the quantity of home assets as distinct from the quality of mortgage debt – occupies a rather lowly position.

In the English-speaking countries of the more developed world, and in a growing number of other societies, housing systems revolve around owner occupation. Between two-thirds and three-quarters of the population in the Anglo-American world own or (more usually) are buying their home. The result is that most people hold the majority of their wealth as property, and personal debts are routinely rolled into mortgages. So much so that home assets are both the centre-piece of households' wealth portfolios, and a financial buffer to lean on, or borrow against, across the life-course.

But any investment and every style of borrowing comes with risks as well as rewards. For housing, credit risks are the most obvious concern: the dangers of mortgage default, eviction or bankruptcy. Equally significant for home occupiers – but less widely aired – are price risks: the possibility that home values may fall, or fail to keep pace with other investments. These credit and investment risks often go together. Those who want to spend from home equity (as people increasingly do) may find that the market is sticky (so that housing wealth can no longer be 'cashed in' by trading down). At the same time, a resurgence of credit rationing may reduce the flexibility mortgagors once had to 'borrow-up' against the value of their homes.

When large institutions are exposed to this kind of risk in relation to any asset, investment or line of credit other than housing, they manage it with financial instruments known as 'derivatives'. These are contracts whose values derive from the performance of an underlying asset or index, but which can be traded independently. The word 'derivative' is generally associated with the esoteric world of high finance: a world far removed from the lives of ordinary people which, thanks to the crisis of 2007, is shrouded in opprobrium. To be sure, the growth of derivatives trading is a major financial event. From a tiny base in the 1980s, the value of outstanding contracts grew to a staggering US\$750 trillion by 2007: nearly ten times the world's combined GDP. But it is important to recognise that the *concept* is over a century old, and that contracts exist to cover everything from pork bellies to silver, from bonds to sulphur dioxide emissions. Only housing is an exception (if we exclude the way home purchase routinely operates as a forward market), and this looks set to change. Notwithstanding its link to the 'd'-word, could this shift be used to mitigate the mix of risks that home buyers currently face?

Some housing economists think so. Consider the position. Today, home buyers have just one option. They must buy both a physical property (the home they love; the housing services they use) *and* the investment vehicle attached to it (the ups and downs of price). But financial engineers can now dismantle this package, so that home buyers can enjoy (and pay for) the housing services element of their home, without carrying all the risks (but also by giving up some of the reward) of the investment component. This is because, in the form of futures, options or swaps, housing derivatives effectively separate the investment returns on housing from the

ownership and use of property. By gathering up these returns into a price index – a possibility first aired fifteen years ago – individuals and institutions who were previously excluded from, or averse to, holding whole properties can invest incrementally into a ‘synthetic’ housing market. That is they can benefit from house price appreciation without owning a single brick, slate or foundation stone. By the same token, those most at risk from declining prices can take steps to mitigate this: for the first time, home buyers can ‘sell short’; they can hedge their housing bets. For example, a first-time buyer who has the whole ‘housing+investment’ package, but who cannot sustain their mortgage repayments could, in theory, sell off some portion of their future investment returns in return for an income or lump sum to tide them over their mortgage arrears.

For the most part, ordinary households do not (and should not) dabble directly in derivatives. But as Yale economist Robert Shiller has often argued, there is no reason, in principle, why they should not be protected by these instruments. Housing derivatives could, in theory, be embedded in retail products, or in housing policy initiatives, in ways that benefit the public. Asian financial markets veteran and derivatives banker Ralph Liu, for example, invented the concept of ‘economic renting’ through SwapRentSM transactions and their embedded mortgage products, with this in mind. Whether derivatives can deliver this ‘free lunch’, whether they are better than more traditional financial instruments, whether they are put into practice at all are all open questions.

Nevertheless, people need somewhere to live. The politics of housing across many world regions for as much as a century mean that this ‘somewhere’ is the market. And, like it or not, ordinary people have often prospered as a result: housing is the most widely spread of all financial assets; it performs well over the medium term; and it is the only substantial resource in most households’ wealth portfolio. But housing markets are uniquely eccentric to the risk-management tools used in practically every other area of asset-management. It is tempting to see the problem for home buyers today as one of being drawn too far into the workings of financial markets. But there is equally the possibility that they are not adequately protected by the instruments invented to handle investment risks. So it could be argued that, in a financial world riddled with crises and uncertainty, hard working home buyers will face a uniquely precarious future if governments, policy makers and the markets they regulate do not work creatively with the concept of housing derivatives.

Further reading

Case, Karl E., Shiller, R. J. and Weiss, A. N. (1993) Index-based futures and options in real estate. *Journal of Portfolio Management* (winter): 83-92

Quigley, J. (2006) Real estate portfolio allocation: the European consumers’ perspective. *Journal of Housing Economics* 15: 169-188

Shiller, R. (2003) *The new financial order. Risk in the 21st century*. Princeton University Press

Further information

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This paper appears in Amin, A., and O’Neill, (eds) (2009) *Thinking about almost everything* (Profile Books).