Two experts on home-price trends discuss some new tools to help borrowers and lenders hedge against home-price declines.

Mortgage Banking recently interviewed some leading experts on house-price trends and the primary factors shaping them. One of the themes discussed was the illiquidity of the residential real estate market and how that influences the movement of house values. The experts raised hopes for some new tools, including a futures contract to hedge against home-price changes and a new mortgage product with an insurance feature to protect against equity declines. One of the experts interviewed was Robert Shiller, chief economist for Madison, New Jersey-based MacroMarkets LLC, and the Stanley B. Resor professor of economics for the Department of Economics and Cowles Foundation for Research in Economics at Yale University, New Haven, Connecticut. He is also a fellow at the International Center for Finance at the Yale School of Management. Shiller is a noted pioneer for his role in developing tools for more accurate home-price forecasting. He is one of the creators of the S&P/Case-Shiller Indexes (CSI), which are market-specific indicators of home-price changes based on the repeat-sales methodology. The CSI is widely accepted as the most meaningful indicator of market-specific home-price changes. Also interviewed was Dean Williams, chief executive
officer and president of Tulsa, Oklahoma–based Williams & Williams, a firm that conducts worldwide real estate auctions. Williams has spent more than 20 years developing auction-based marketing and sales solutions for real estate, and leads the company’s strategic initiatives—including its auction brokerage platform, investment and underwriting services, and online/interactive services for live auctions. Williams and Williams specializes in auction-based real estate brokerage throughout all 50 states and dozens of other countries through its affiliates. The company projects its annual sales in the United States will top $1 billion in 2007.

With home prices flattening or even falling in some markets, these experts shed some timely insight on where home prices are headed and why.

**Q:** What are your thoughts on the liquidity of the real estate market in the United States, and how does that affect the mortgage banking industry?

**Shiller:** In a very important sense, real estate is one of the least liquid markets of all. It’s very hard to convert your real estate into cash, and as a result the trading shows a lot of inefficiencies. Pricing in real estate markets doesn’t behave like liquid-market prices. There is a lot of momentum with real estate prices; they tend to go the same way for years. Typically, prices don’t move suddenly, but they gradually soften and gradually turn around.

The problem is, of course, that real estate is not standardized, as are stocks. The fact that one share of stock is just as good as any other makes that market instantly more liquid than real estate. There are real problems in the real estate market that have to be solved by very well-thought-out solutions to make the market more liquid.

**Williams:** Real estate is perhaps the most illiquid market there is. In the United States it might be especially so, in that there is no open or competitive place to trade it. There is practically nothing that has been standardized about it—not the real estate [or] the transaction. The way that you buy or sell it is also completely un-standardized and negotiated bit by bit on every single transaction.

The momentum [that Professor Shiller was describing] has fewer ways to stop itself. As a consequence, that momentum builds on itself and becomes a self-fulfilling prophecy. Especially on the upside, since most of us are in fact consumers of real estate, we don’t mind [prices] going up.

The degree to which there is additional risk caused by that illiquidity—it’s probably going to be borne substantially by the real estate finance sector, in addition to the consumer.

**Q:** Stocks, bonds, insurance, mortgages—the market for each of these financial instruments has substantially evolved to offer more liquidity and transparency over the last 50 years. Why do you think the market for real estate sales has remained fundamentally the same?

**Williams:** The real estate [sales process] has been made very complicated. Between the real-estate selling consumer and the real estate–buying consumer, there are a lot of hands in the process—be it an appraiser, loan officer or real estate agent. Those [multiple steps in the process] have been in place in the United States [for a long time], and have become fairly entrenched. That, combined with the regulation at the state as well as federal level, has helped cement the role of the middleman in this industry. That has kept [the real estate market] from transforming, as other industries have, toward more transparency, more openness, more competition and more liquidity.

**Shiller:** I think there have been a lot of innovations in the real estate markets. I don’t know what your time horizon is, but securitization of mortgages has been a hugely important innovation over a period of decades. I think online realty sites are an important innovation. Now, most homeowners go to these sites before they buy a house.

I think the fundamental problem remains the lack of standardization of real estate. There are a lot of high-tech things going on, but fundamentally, a house or a home is so hard to [evaluate]. All of our markets rely on standardization [of] one sort or another. But houses differ in ways that only prospective homebuyers can understand. You have to look at schools, you meet the teachers in the schools, you look at the neighbors, etc. All of these things are hard for someone outside of the actual home-buying decision to judge.

There is almost nobody who buys single-family homes as a business in large numbers and rents them out, and it is because of this fundamental problem. But I think we are making progress even on that problem. Now we are getting better econometric methodology and we have now home-price indexes that are sensible and solid. One consequence of that is now we are getting futures and options markets on home prices. Before long, we are going to see a whole array of financial instruments that help make the housing market more liquid.

**Q:** What is the housing futures and options program, and how did it evolve?

**Shiller:** Well, I like to think it is our idea. My colleagues and I launched the campaign in 1990—that was Karl Case, Allan Weiss and I—to try to get futures exchanges interested in home futures. Then, the next year, in 1991, to our surprise, it happened in London. The London Futures and Options Exchange [London FOX] tried unsuccessfully, however, and they abandoned it in just five months, after a wash-trade scandal.
It has been a long haul, because after the failure of the London FOX, nobody wanted to try it again. The CME—the Chicago Mercantile Exchange—has now developed into a very entrepreneurial institution. When my company, MacroMarkets, approached them about it, we found a meeting of the minds, and they went ahead with it. People say, "How can it work?," because nothing like this has ever happened. But I think we are making it work.

**Q:** For those unfamiliar with them, what are these new futures and options instruments and how do they work?

**Shiller:** The CME is offering both futures and options based on [home prices in certain] cities. At this point, we have 10 cities traded, and the maturities go out one year. So, you can either buy or sell a contract. If you buy a contract, you are effectively putting yourself in a position to gain if the index for that city goes up. If you sell a contract—let’s say the one-year contract—then you put yourself in a position where you will gain if the price in the city goes down.

Most of us are not at the right exposure to the real estate market; some of us are overexposed—we’ve got too much housing, and it’s going to harm us if prices go down. Others are underexposed—let’s say, for example, we are a young family and we are expected to buy a house later; we are harmed if the price of housing goes up. So what we want to do is [find a way for] each of those groups [to] adjust their exposure.

Someone who has too much invested in housing and does not want to sell the house can take a short position in the housing futures market. This will, in effect, insure them against housing-price declines to whatever extent they want—they can protect half of it, three-quarters of it, or even the whole house.

On the other hand, people who are underexposed would take a long position in the futures market, which would benefit them if housing prices go up, which [helps to] offset the problem [of higher prices when] they buy a house later. So, it’s risk management—it’s very much like insurance. We have a road ahead of us to explain this and get the public to understand that this is a very sensible thing to do—to hedge your real estate exposure.

**Q:** Now that it’s been almost a year since it was rolled out, what has the reception been, and what have you learned?

**Shiller:** We’ve seen a big swing in the prices [for these contracts]. It’s really interesting: The home-price futures in all of the 10 cities were showing strong “backwardation”—that means they were showing predictions of price declines in the 4 percent to 8 percent range going out one year. So the market was predicting big drops in home prices. However, it all swung back by early 2007, so that now it’s considered par; they are not expecting any change, or hardly any change, over the next year. I find that surprising, but I guess markets always surprise us. Then, around April 2007, the markets became more pessimistic again, predicting price declines in the 4 percent to 6 percent range.

What we’ve got here is price discovery—we are discovering what the market price is for houses next year—and that is just an incredibly valuable piece of information.

**Q:** Are there clear connections in your mind about how the futures and options programs might benefit the mortgage industry?

**Shiller:** The mortgage industry could benefit in any of a number of ways. First of all, people who hold portfolios of mortgages are effectively exposed to home-price risks because the default rate on mortgages is affected by home prices. If home prices go down, defaults go up. So [this instrument would help them] hedge in the mortgage market.

Secondly, there could be mortgage [products introduced] that incorporate some price-risk protection. When you buy a house and you take out a mortgage, you get protection so that, if the home price goes down, the mortgage balance automatically declines, too. Moreover, if a homeowner is protected against the risk of negative equity in their mortgage, they are less likely to default.

Defaults themselves are very costly; [and] all of these things are costs to the mortgage industry that could be reduced if [these] new mortgage products were offered. But then that would require hedging through the futures market. The company that offers the new mortgage product then wants to lay off the risk somewhere, and the futures market allows that.

**Q:** A real estate auction company obviously approaches the issue of liquidity from another angle. How have real estate auctions evolved from a Depression-era tool used by the government to a way to increase liquidity in real estate?

**Williams:** The government’s use of auctions gave [the practice] a certain stigma coming out of the Great Depression. The
government chose to dictate that the fair, equitable, transparent way to determine value under distress or duress [was to use auctions], but they went further and, in most states, have required that states do it [as well]. So we [didn't see] the evolution of auctioning real estate as a business; we ended up with it as a judicial function pretty much, which gave it a lot of stigma.

The practitioners of [the] real estate auction [business] ended up being primarily small, family, locally owned businesses. They were limited [in what] they could offer in terms of services, technology and robustness. Now, we've got [larger national firms] in the real estate auction space that are approaching it like a business. [They are asking], "Should this be at least a competing platform for real estate sales, if not the platform for all real estate sales, to more efficiently, transparently, conveniently and confidently determine value for both buyers and sellers?"

Q: What has been your company's track record in the real estate auction business over the last year, Mr. Williams, and how does it interact with the mortgage banking business?

Williams: Our company has gone through that transition to a nationwide business focused on the platform issues of getting real estate bought and sold faster and cheaper. The first division that opened up was facing the mortgage banking industry because it seemed to us that the homes that get foreclosed on when mortgages default are the most painful [example] of real estate illiquidity.

To get liquid on a vacant, non-earning, deteriorating asset is costing anywhere from 15 percent to 25 percent of the eventual sales price pre-marketing cost, just in the carry cost, the deterioration of the property, the closing concessions that are incurred and the management of all of that. . . . So, to us, that was the first place to go.

Q: In terms of the futures product and much broader public participation in real estate auctions as a way to buy and sell real estate, is the overall public ready for these solutions? Who is presently your typical user?

Shiller: With our futures markets, the typical user is a very sophisticated person. The market is still rather small; it is growing. It tends to be institutional investors or builders or, in some cases, homeowners.

I wrote about this in my book, New Financial Order, in 2003, that there is a gradual growth of financial sophistication among the general public. This is partly helped by the Internet, and educational institutions are gradually bringing people up [to where they have] a better understanding. Right now, there is very little concept of hedging real estate risk among the general public. This is surprising, since they are very worried about real estate prices and they are talking about them all of the time. They haven't gotten the idea that they can take action. So, we have a marketing problem ahead of us to get the public to understand.

We also want to see other products develop. My company, MacroMarkets, is working with Goldman Sachs and other investment banks to develop different kinds of instruments that would allow homeowners, or others involved in real estate, to manage real estate price risk. So we are talking about index-linked notes, we are talking about futures, forwards and swaps—any of a variety of instruments that would be [sold] over the counter that could be designed to help someone with a particular problem. I believe these things will be coming very soon.

I actually think that these different parts will help support each other. Once the word is out that not only are there futures and options, but there are also forwards, swaps, index-linked notes, new types of mortgages and home-equity insurance, the general concept will get out that real estate is a risk that needs to be hedged.

Recently there has been a lot of optimism about the housing market, and people haven't felt the need to hedge. But our survey evidence shows people are now getting more concerned. [Home]-price declines [haven't happened for] a while, and that is why people are not actively thinking about them. But I think that the enlightenment will grow, and we will see many more of these products coming up.

Williams: I definitely echo that the real estate consumer is becoming quickly educated, so ideas that are good get spread pretty quickly. In our [auction] business, right now the bulk of the sellers are extremely sophisticated. Our seller base, historically, for 20 years, was primarily composed of extremely wealthy and business-minded owners, who were able to concern themselves more with the bottom-line issues than a perception of risk that might not actually be there in terms of real estate pricing. Typically the business-to-business sector is where the growth has been, and probably will continue to be for some time.

The business owner is looking at their real estate risk and portfolio from a much broader perspective. They are concerned with things like recovery rates, transaction costs and carrying costs across the whole platform of real estate ownership. On the individual side, in terms of new products, I anticipate that, and underwriting services—an insurance product for the equity that they hoped was there when they originally bought—obviously would be a great offset . . . to take care of a level of risk.

Q: What is home-equity insurance, and how does it relate to the futures and options program?
Shiller: I believe that the insurance industry has gradually expanded the kinds of risks it can cover as information technology has grown. One of the earliest forms of insurance was fire insurance; that is, protecting the value of a house against a certain kind of risk that can be very easily identified. That was a more important risk in the past than it is now [as building codes and other protections against fire have evolved].

So what we would like to see is homeowners insurance expanded to cover what is, I believe, the biggest risk facing houses. That is a risk of price declines in the market.

The fraction of houses that burn down is some tiny fraction of 1 percent, but the fraction of houses that lose value in a market downturn could be virtually 100 percent of houses, so this is a huge and important risk. The insurance industry is interested in this. But I think that at this point, they are still a little uncertain how they can manage such a huge risk. It is a little bit like insuring against terrorism or other big things.

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because they hit everybody, not just one person—it’s a correlated risk, the kind that traditional insurance has trouble dealing with.

So the concept is that a homeowner’s insurance policy could be expanded to cover the risk of the price declines in the city in which the house is located as measured by some home price index, like the Standard & Poor’s/Case-Shiller Home Price Index that we are producing. Then the insurance company would be covering a much larger component of the risk, and then the insurance company could hedge in one of these other markets—either a traded market or an over-the-counter market. Ultimately, the risk gets spread out over investors all over the world. I think that this risk management would create a very substantial increase in human welfare. So it’s something that we are approaching with a great sense of mission.

Q: What would the impact of this be for the mortgage industry?

Shiller: There are about a dozen U.S. cities that have home-equity insurance policies already. These policies are sponsored by the town or city. There are no policies that are commercial products. They have not been promoted well, and they are not big. Once these policies are big, they are going to change the industry; they are going to change the risks very much. I suppose they would help reduce defaults on mortgages.

I think that these home-equity insurance policies might support the real estate market in the sense that there [would be] no panic selling. Right now, ... if people see prices going down, then they decide to bail out of the market. With home-equity insurance, they have no incentive to do that. It might help prevent a debacle in the real estate market, a debacle that could eventually harm the mortgage industry.

Q: Another tool that could help homeowners avert foreclosures is something, Mr. Williams, you have been talking about—a preforeclosure auction program or the assisted sale auction program [ASAP]. How does that work?

Williams: The servicer introduces ASAP during loss mitigation and collections—we’re now debating how early in the process [the borrower should be offered this option], but it seems the earlier in the process the better. The loss-mitigation counselor or collections department calls on the borrower who is behind in payments, and introduces them to this option as well as the other options. If the buyer is interested, they are transferred to an ASAP counselor inside our firm, who then works with the borrower. If the borrower decides to go forward, they execute a listing agreement. This starts the marketing process, which concludes 35 days later.

It’s a time-definite process: 35 days no matter where the property is located. A combined on-location and online auction occurs, allowing maximum buyer participation. That produces a full-market-value offer that is available at that point in time for that asset in that condition. The borrower has already agreed to accept that offer subject only to the lender’s willingness to accept it as well, should it be short of full loan payoff. If it is short of loan payoff, it is submitted to the lender with a workout package. The investor ultimately has the final say on whether or not the net they’re receiving is worth taking.

Q: Are there other areas where you see room for improvement in real estate liquidity?

Shiller: If we can allow people to manage their risks, that will not only help them manage their lives better, but manage their businesses and their entrepreneurial activities better. Right now, there is no way to occupy a home without taking concentrated risks in that geographical area. That is just an unfortunate linkage that makes no sense from a finance theory. Moreover, builders take big positions in real estate, and those positions ultimately carry with them a great deal of risk. So it hampers their business that they cannot manage those risks. They are not able to manage the risks, comparable risks that other businesses routinely handle. So we need both exchange-traded products and over-the-counter products.

The exchange-traded products have the advantage of standardization and price discovery. The prices have a clear interpretation, and they then become, often, the basis of the models for prices in the over-the-counter market. The over-the-counter market is a market for products that are often tailored to individual situations. They often come sold with some consulting or some help on managing the risk problem.
The products that have been talked about by Goldman Sachs, which I think will be the first one to bring them to market, involve, for example, securities that could be purchased—these are the index-linked notes—that would allow someone to take a position in the housing market. Someone who is underexposed to the housing market could buy one of these futures contract. Someone who is overexposed to the housing securities, and it would perhaps be more user-friendly than a futures contract. Someone who is overexposed to the housing market could short one of these securities.

In the future, what we hope to see also is what we call bear securities, or inverse securities, on real estate. . . . In the housing market context, these would be securities whose price moves opposite [to] the price of a home. Of course, one can effectively do this through a futures market, but a futures market is a rather sophisticated market that most homeowners are not going to get involved with. If we have securities that move opposite the price of homes, that you can buy them and put them in your portfolio and collect a dividend, I think that there will be a lot more effective risk management once people see that it’s no more difficult than buying a stock or a mutual fund.

Q: Do you see areas where your different ventures might overlap to aid in the liquidity of real estate and to introduce tools to better hedge price risk?

Williams: There are two things that occur to me. This year our company will probably have 10,000 homes sell at auctions from the mortgage banking sector. That is a lot of data points. I don’t think it is enough yet, but once we have 50,000 data points annually and those points are regionally dispersed in terms of markets, that data might become interesting and useful in terms of the indexes themselves and how people might use that kind of information to trade with them.

The insurance product, I think, makes a lot of sense. The real estate asset for the typical American family is, and I think will remain, the major asset in their portfolio. To not have any mechanism to hedge that, trade that or buy insurance for that does not make sense. I think that it is likely to be packaged and offered in a bundle of services, whether it’s with property insurance or with the property transaction itself.

Shiller: I think it’s an interesting point being made that he is achieving a standardization of real estate and a database as well. Right now it is difficult to measure home-price movement accurately, because the sales may involve all types of special features. It’s a little bit like when you look at the cash market for a commodity and compare it with the futures price. The cash market has problems with lack of standardization; the futures price becomes the center of attention because of its standardization. So, I think we could get some important benefits. I am very pleased to see that the auction market is growing, because it seems like it’s creating a new sense of liquidity in the market that’s woefully illiquid. . . .

Q: What are the roadblocks for the increased use of the tools you are talking about?

Shiller: I am a social scientist. I would say it’s social norms—conventions. We are brought up to do things certain ways. When I want to sell my house, I call a real estate agent. The real estate agent kind of holds your hand. People just do the same thing year after year, and it becomes like apple pie in America—I wouldn’t try something else. That is the obstacle. It is difficult to get a message across to people that there is a more sensible way of doing things.

Williams: From my perspective, what’s occurred in the capital-market side of mortgage banking in the last 10 years has been nothing short of revolutionary. [The mortgage banking business] has been extremely robust, and has had huge market-setting records in terms of its size, efficiencies and risk-spreading. That marketplace, I think, is very modern and very efficient. It’s also recently—in the last five years—been very creative as well, in terms of loan products. But as a result, when the industry is faced with the actual asset risk itself, the collateral risk, whether it’s pre-foreclosure or post-foreclosure, it hasn’t focused in on that end of the transaction, which you could call the ultimate back end of mortgage investment.

As a consequence, I don’t think there has been much focus from the capital markets about collateral risk, how to lessen collateral risk or how to handle collateral risk—make it more liquid, more efficient. I think that’s unfortunate, but I also think in the near term there may be a lot of motivation to redress that, and hopefully a lot of opportunity as a consequence. I think there is a lot of upside for the underlying mortgage investment, and I think the industry as a whole has a chance to lead in different ways to get real estate bought and sold more effectively and efficiently, to everybody’s benefit.

Q: What do you perceive as the future roadblocks to greater liquidity in U.S. real estate?

Shiller: Well, I am hoping that there are not a whole lot of roadblocks. One thing is that we have regulators who are there to protect the American investors, and I think they perform a very important function. But at times, I view them as obstacles. We have been told that the state insurance commissioners, if we offer a home-equity insurance product, may question it. It’s very unusual. I have spoken to one of them, who told me that they are sympathetic, but it is so different from other products. Sometimes we wonder what it is. Is this insurance? Under whose domain does such a product fall?

In regard to securities, we again have securities regulators. We have the SEC [Securities and Exchange Commission] in Washington, and we have all the state regulators. If we have products that are labeled as securities, then we have to get them by those regulators, and they are checking everything out. But these are not off-the-shelf type products; these are products that are very different. I have already mentioned the education problem, which is a standing problem. I think those are the main obstacles. Once we get the public educated and we get it through regulators, then it will just be a matter of time.

If you look at any of the new developments in finance, they often grew on an exponential curve over a period of years. When they first invented real estate investment trusts [REITs], they weren’t very big—but now they have become huge and important. The first financial futures didn’t start out immediately. So I think that’s the example; once we get past the major obstacles, there will be a growth path over time that will, I think, eventually [allow these] to be hugely important. MB.