

Negative equity house price risk could be ended, new research confirms

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The risk of house prices crashing and leaving millions of homeowners in negative equity could be removed if the financial sector adopts new models of investment for housing that are widely used in other areas of finance, according to major new research.

The findings, by Professor Radu Tunaru, Kent Business School at the University of Kent, Nobel Prize winner Professor Robert Shiller, Yale University, and Professor Frank Fabozzi, EDHEC Business School in France, have been published in the *Journal of Derivatives*.

The researchers set out to discover if it would be possible to create financial products that would allow banks to 'hedge' against [house prices](#) declining and for homeowners to benefit from these gains if this happened.

Specifically, homeowners would link their property to a financial product when selecting a mortgage with the knowledge that if houses prices fell and left them in negative equity, they would recoup the difference from the fund that had hedged against [house](#) prices. Homeowners would receive this amount at the maturity of the financial contract, likely earlier than their mortgage was paid off.

Conversely, if house [prices](#) went up homeowners would not benefit from the gains on the property's value as it would be balanced by the losses of the fund that their property was linked to. However, with around 80% of homes in the UK bought for use, rather than as speculative investments, the researchers say many people may well prefer this risk-averse strategy when buying a home.

Furthermore, with almost half of all economic wealth in nations such as the USA and UK tied into [real estate](#), it would avoid the risk of a huge shock to economic markets, as occurred during the subprime crises and [global recession](#) in 2007.

For many years it has been argued that one major reason for the lack of development in real estate derivatives was the lack of flexible models able to capture the characteristics of the house price data but still flexible enough in terms of implementation.

With advances in financial econometrics and financial engineering education over the past three decades models such as those developed in the paper satisfy both requirements. As such they argue that the lack of financial models cannot be used as a rationale for hampering the creation of house price derivatives products.

Professor Radu Tunaru from the Kent Business School said: 'The research makes it clear that real estate derivatives could be a key product to provide more stability to real estate markets, potentially helping avoid huge economic shocks caused by any future house price crash, similar to that which occurred during the Great Recession. This could help remove a lot of the uncertainty when purchasing a house and avoid the risk of [negative equity](#), which is often a major concern for homeowners.'

The paper, *Evolution of Real Estate Derivatives and Their Pricing* by Frank J. Fabozzi, Robert J. Shiller, and Radu S. Tunaru, has been published by IPR Journals in *The Journal of Derivatives*.

More information: *Journal of Derivatives*, [DOI: 10.3905/jod.2019.26.3.007](#)

Provided by University of Kent

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