
Taking Homeowner's Insurance to the Next Level

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Issue

Should you address the risk that your house drops in value?

Why?

Air going out of the “Bubble”

Many houses do indeed lose value

Your largest (levered) asset

Insurance Product

- ❖ Insurance against price declines – much like a “put option” on the stock market
 - ❖ Not tied to **your** house (moral hazard)
 - ❖ Tied to a zip code (or region)
 - ❖ Subsidized program in Syracuse, NY

Example

For a one-time premium of 1.5% of the purchase price, can cover the losses over a three-year period

❖ \$200,000 house = \$3,000 premium

❖ Would get the percentage change in index value times purchase price

❖ Index drops 10% = \$20,000 payoff

❖ Index stays flat or rises = \$0 payoff

What Should I Pay?

- ❖ Simple binomial option pricing model
- ❖ Assumptions:
 - ❖ Volatility of price: 5% move up or down per year equally likely; 3 year period; 3% risk free rate of interest; purchase at the money
 - ❖ Eight possible outcomes – four in the money
 - ❖ Fair value is about 3.4% of the value of home
- ❖ Change parameters; change value

Traded Housing Futures/Options

- ❖ Set to start trading on the CME in mid-2006
- ❖ Ten cities (Atlanta is not one)
- ❖ Based on the Case-Shiller Indexes (CSI)

Hedging or Speculating?

- ❖ Like any futures market – it takes both hedgers and speculators to make it work
- ❖ Who are the hedgers?
- ❖ Those whose consumption of or exposure to the real-estate asset class is going to change
 - ❖ Downsizing your house nearing retirement
 - ❖ Real estate held for investment

Planning Considerations

- ❖ What is your horizon in the home (region)?
 - ❖ In our house for the next 20 years
 - ❖ Moving outside the region in the short term
- ❖ How levered are you?
 - ❖ More debt increases need for insurance
 - ❖ What kind of mortgage do you have? Fixed, Variable, I/O
- ❖ How liquid are you?
 - ❖ Lower liquidity increases need for insurance

Pricing Issues

- ❖ Why do real estate values change?
 - ❖ Some factors affect values nationally
 - ❖ Some local supply and demand factors
 - ❖ Some ultra-local factors – “your neighbor is a slob”

Example

- ❖ There could be a large amount of “basis risk” in any of these contracts
- ❖ Differences just within the Atlanta metro area
- ❖ Example: Three-year average median home sales price changes (from AJC web page):
 - ❖ Decatur (zip-code 30030): -2%, 13%, -3%
 - ❖ Annual average: 3%;
 - ❖ Peachtree Corners (zip-code 30092): 19%, 7%, -4%
 - ❖ Annual average: 7%

Planning – Bottom Line

- ❖ Clarity on changes in exposure to real estate asset class is important
- ❖ Hedging markets still very new – valuation and basis risk issues
- ❖ Does the hedge create value for you?
 - ❖ Most corporate hedging done for short-term liquidity reasons
- ❖ Having liquidity and controlled leverage mitigates need for “excess” investment in insurance