THE FINANCIAL PAGE
THROUGH THE ROOF

On September 2, 1666, fire erupted in a bakery on Pudding Lane in London. The fire quickly spread and raged for four days, ultimately destroying four-fifths of the city. To make matters worse, Londoners had been living without a simple but invaluable financial tool: fire insurance. Although the idea of fire insurance had been around since the early sixteenth-hundreds, most people thought of fire as an act of God, and therefore not something that could be reasonably insured against. The Great Fire changed that. Soon after the city was rebuilt, a man named Nicholas Barbon opened up the Fire Office insurance company, and by the end of the century fire insurance was a thriving business.

Today, we insure our homes against fire as a matter of course. And cautious homeowners can also protect themselves against disasters ranging from windstorms and floods to earthquakes. There is one much feared cataclysm, though, against which everyone has so far been defenseless—a housing-price slump. Seemingly every magazine and newspaper in America has now prophesied the imminent bursting of the housing bubble. But even though many Americans have invested all, or almost all, their net worth in their homes, they've had no way of insuring themselves against that asset's value taking a severe tumble.

That's all changing. At a new online site called HedgeStreet, investors can bet on changes in home prices in certain cities. And later this month the Chicago Mercantile Exchange is going to start trading futures contracts pegged to housing-price indexes in ten major metropolitan areas. The Chicago plan, which is the brainchild of two economists, Karl Case, of Wellesley, and Robert Shiller, of Yale, is straightforward: if you just spent, say, $1.5 million on a two-bedroom apartment in Manhattan, and you want to hedge against the risk that it might be worth $1.2 million three years from now, you can sell contracts that will reap you a profit if local prices fall, allowing you to lock in the current value of your home. Alternatively, if you think the housing boom in Los Angeles still has a ways to run—or if you're interested in buying a year from now but are afraid that you'll be priced out of the market—you can place a bet that will pay off if prices keep going up.

If housing futures work the way they're supposed to, they will shift risk from those who are less able to bear it (individual homeowners with hefty mortgages) to those who are more willing to (speculators looking for a big upside on their investments). In the process, they will effectively provide a form of house-price insurance. They could have wider benefits, too. If there is a housing bubble, and it does burst, housing futures would soften the blow to the national economy.

If enough traders participated in the market, it would become, in the long run, a valuable predictor of housing prices in different cities. That would allow buyers to make more rational decisions about how much they were willing to pay for homes, which would make house prices swing less wildly than they currently do.

A housing-futures market makes all kinds of economic sense. But, as the example of fire insurance shows, the fate of a financial innovation doesn't depend on economics alone: culture and habit matter, too. Until the sixteenth century, after all, loans were hard to come by in Europe, because of the Catholic Church's ban on usury. And as the Princeton sociologist Viviana Zelizer has detailed in her book "Morals and Markets," for a long time life insurance failed to thrive in the U.S. because people didn't like the idea of placing a value on human life, and wives often felt as if they were betting on the deaths of their husbands. Life insurance became popular only when insurance companies stopped emphasizing it as a good investment and sold it instead as a symbolic commitment by fathers to the future well-being of their families.

Even today, it's clear that otherwise rational people harbor deep-seated beliefs that make housing futures a tough sell. People generally don't hedge individual investments, because they don't like to limit their potential gains in advance. That's especially true when it comes to housing, because of the ingrained assumption that, over time, real estate is guaranteed to be an excellent investment—even though Shiller, in a recent book, shows that, allowing for inflation, American home prices barely budged during the twentieth century. In that sense, the housing-futures market has what is known as a framing problem: selling a contract seems like betting on housing prices to fall, rather than simply insuring yourself in case they do. Emphasizing that the market is a kind of home-equity insurance might help but even that's no guarantee. In 2002, for instance, the city of Syracuse started a program called HomeHeadQuarters that essentially allows people to pay a premium to insure the equity in their homes. After four years, only a hundred and nineteen homeowners have done so.

For housing futures to become popular anytime soon, then, may require something akin to the Great Fire—perhaps a house-price meltdown in a major city like San Diego. But the last forty years have seen a burgeoning of financial innovation, much of which has given people better tools with which to measure and manage risk, and, as a result, investors have become comfortable with ideas that at first glance seemed improbable. In Mongolia, the World Bank recently gave goatherders the chance to hedge against the possibility of a disastrous number of their goats dying. If Mongolian goat insurance is here, can American home-price insurance really be far behind?

—James Sarewitzki