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2009

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Recommended Citation

Waheed, H. (2009). Enabling Good Housing Decisions: Choice Architecture. *Federal Reserve Bank of Boston Communities and Banking, 20* (4), 9-11. Retrieved from https://repository.upenn.edu/lgst_papers/35

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Enabling Good Housing Decisions: Choice Architecture

Abstract
To counteract clients' bad mortgage choices, community groups must first understand the emotional component of housing decisions. The author explains how choice architecture can help prospective homebuyers avoid mistakes.

Disciplines
Business Law, Public Responsibility, and Ethics

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Enabling Good Housing Decisions

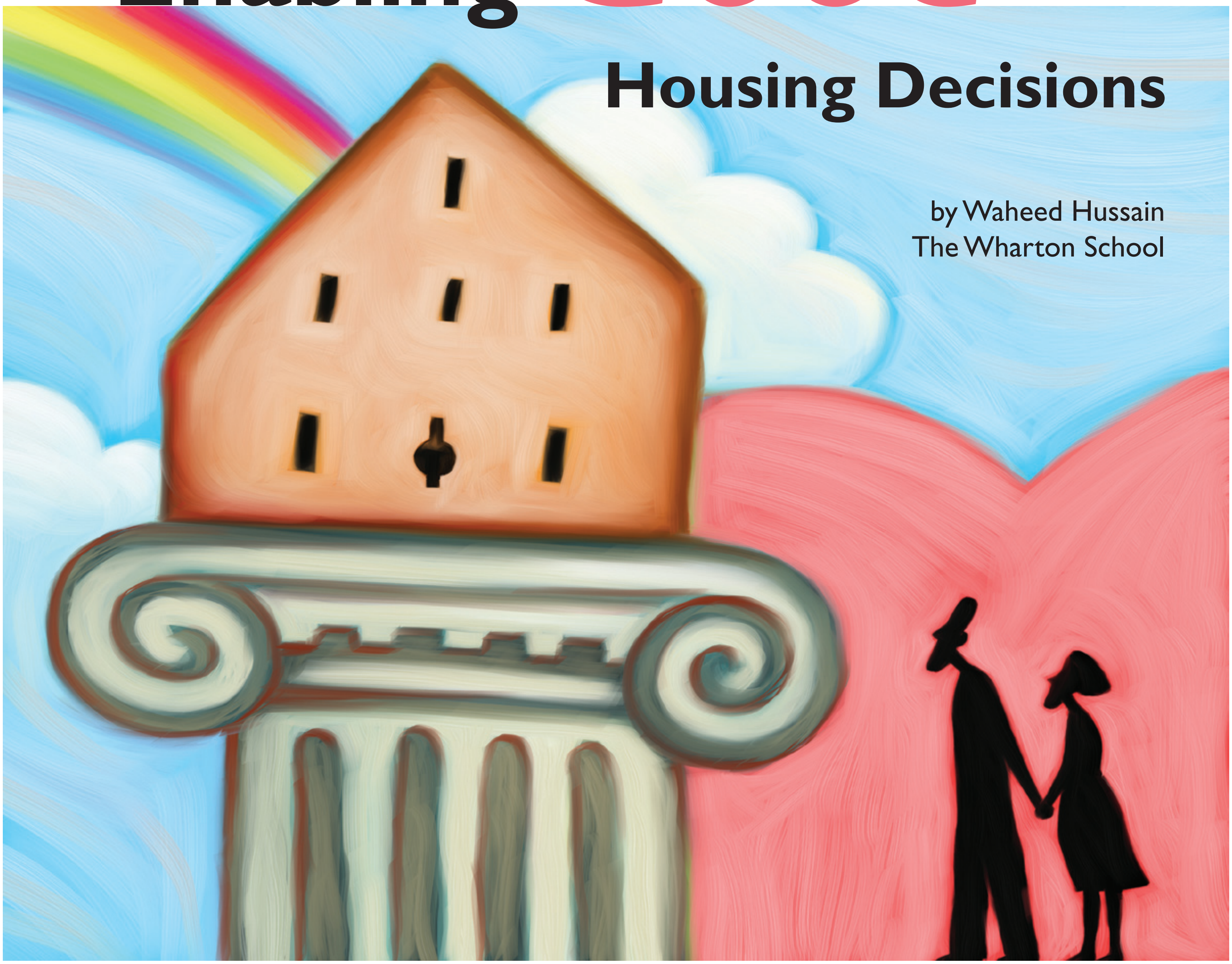

Illustration: Kirk Lyttle

by Waheed Hussain
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In 2005, at the height of the housing bubble, a McDonald's worker in Maryland making $35,000 a year took out a $500,000 loan to buy a house.[1] This is just one example of the kind of financial decision making that contributed to the current crisis.

It is not possible to address problems with the way people buy homes without first understanding the personal aspects of their decision.

Borrowers sometimes make bad decisions, but it is important not to forget how hard mortgage decisions are. Borrowers are typically not like bankers and financiers, who are experienced in assessing risks and making profitable contracts. For the average borrower, the mortgage contract is about making a home for himself and his family. It belongs to the world of emotional bonds and social aspirations. We seriously underestimate the challenges that borrowers face when we think of their decisions as narrowly financial ones. To promote better decision making, it is necessary to understand the borrower better.

The Personal Dimension

Buying a home often requires people to reconcile themselves to certain aspects of their lives. A person may like her job, but she may also like the fact that she could leave it if she wanted to do something else. Once she takes on a large financial commitment, her options will be constrained. So for many people, buying a house requires that they admit to themselves that they are not going to join the Peace Corps any time soon.

Marriage is also a commitment but not necessarily one with financial consequences. Buying a house together, however, means that you can no longer leave the relationship without serious repercussions.[2]

Another personal challenge stems from the fact that buying a house involves longer-term plans. One of the most important considerations is children. The choice between a one-bedroom condo or a six-bedroom country house is not just about living modestly or lavishly; it is also implicitly about whether children will figure into one's future, and if so, how many. In the United States, home-buying decisions involve not only the number of children a person will have, but also her aspirations for them.

Unlike most other members of the OECD (Organisation for Economic Co-operation and Development), an international partnership of nations, the United States ties school funding to local property taxes. So the decision about where to live is also an important decision about the schools that children will attend. Heading to the right neighborhood might mean better schools and a brighter future. The wrong neighborhood may mean an uphill battle.

A house is, intentionally or unintentionally, a public declaration of class position and social status. People often want to live in certain neighborhoods or certain parts of the country because they want others to recognize them as successful professionals or members of the "creative class" or some other important status group. Some people just want to move to escape the stigma attached to their current address.[3]

Perhaps the most difficult personal challenge in buying a home is managing the psychological need for security and wholeness. Interviews in marketing research often reveal how deeply "home" resonates:

> My first memory of home was my mother's picking me up from the bus stop after my first day at school. I was very nervous about going to kindergarten and even though that first day turned out better than I expected, I was still so glad to see her waiting for me when I got back. We went home, had a snack together, and talked about the day. From then on, we did that every day until I went to high school. *—a 24-year-old woman.*[4]

We need a place to call home because we need a place to perform the rituals that eventually give us a sense of psychological integration and wholeness. And we keep returning home—for the holidays, after a death in the family, after a hard day at work—because it is a place where we recover ourselves, a platform from which to launch and relaunch ourselves into the world.

It is not possible to adequately address problems with the way people buy homes without first understanding the personal aspects of their decision.

The Financial Dimension

Layered on top of the personal dimension of homebuying is the financial dimension, which introduces additional challenges.

How does one translate personal aspirations into dollar figures? Living in a better school district costs money. But how exactly can one put a price tag on that? How to compare the marginal improvement in a child's future with the marginal increase in a monthly mortgage payment? How much should a person making $35,000 a year and living in an area with a high crime rate be willing to spend to give a child safer surroundings? There are actually no good answers to such questions because the values involved are so different that they cannot be sensibly weighed against each other.

Another major challenge is determining budget constraints. What exactly is affordable? That is not easy question to answer. One reason is that what one can afford depends on what one will earn, and what one will earn depends on a range of factors difficult to predict, including health, the supply of workers with the same skills, and the overall prospects for the economy. What one can afford also depends on the housing market itself. Are prices likely to rise? Is the market inflated or undervalued? The average person would find that difficult to assess.

In recent years, the question of what one can afford has become even more difficult because of the proliferation of financing options: different term lengths, interest rates, and fees; fixed-rates versus adjustable-rate mortgages; interest-only loans; teaser rates; and so on. Assessing the options requires a more sophisticated grasp of finance than most consumers possess.

Using Choice Architecture

Mortgage decisions are difficult for both personal and financial reasons. Even under normal conditions—without a housing bubble and sales pressures—it is unsurprising that people struggle with these decisions and some make big mistakes. Given how serious the consequences can be, society has a moral responsibility to take reasonable measures to make the decision-making process more manageable.

One approach would be to engage in what economist Richard Thaler and legal scholar Cass Sunstein call *choice architecture.*[5] The idea is to structure the menu of alternatives presented to borrowers so as to point them toward a good decision. For example, legislation might be designed to present homebuyers with a 30-year fixed mortgage as the default borrowing arrangement. Banks could still compete for customers by offering lower fees and interest rates. And more-sophisticated borrowers or those juggling fewer pressures could opt out of the default arrangement and seek more-complex financial arrangements with somewhat more risk. The benefit would be to ease the burden on homebuyers, already struggling with the personal aspects of their decision, by steering them in the direction of a reasonably good financial alternative.

Community groups also can improve the situation through choice architecture. An organization that serves an ethnic or religious community has a certain insight into the shared needs of its members. Using that insight, the organization can simplify the market's multiplicity of choices into "smart lists" of alternatives that would serve the needs of most of their clients reasonably well.

Consider the financial aspect of homebuying. Even if the government did not adopt a policy presenting the 30-year fixed mortgage as the default option, a community group could present its clients with a smart list comparing the rates and fees offered by local banks on this type of loan. The message would be that although these are not the only options, they are the sorts of alternatives that have served clients well in the past.

Similarly, an organization could formulate smart lists that simplify the personal aspect of homebuying. If the community group knows that its members tend to have certain transportation needs or religious commitments, it can gather lists of housing options near public transportation or religious institutions when homes come on the market. Essentially, the community group can act as a consumer cooperative, using its resources and expertise to find and present alternatives to its members.

A mortgage is an important financial transaction, but most people enter the mortgage market without the financial sophistication of a banker. Choice architecture and smart lists, because they take into account both the personal and financial challenges underlying the mortgage decision, can help make mortgage lending a little safer for everyone.

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Endnotes

[1] A. Klein and Z. Goldfarb, "The Bubble," *The Washington Post*, June 15, 2008, A01.

[2] "Breaking Up Is Harder To Do After Housing Fall," *The New York Times*, December 30, 2008, A01.

[3] See Richard Sennet, "Memories of Cabrini," *Respect in a World of Inequality* (New York: Norton, 2003).

[4] See Clotaire Rapaille, *The Culture Code* (New York: Broadway Books, 2006), 97.

[5] See Richard Thaler and Cass Sunstein, *Nudge* (New York: Penguin, 2008).

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