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BEHAVIOR, PATERNALISM, AND POLICY
Evaluating Consumer Financial Protection

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Abstract

This paper examines the relationship between behavioral law and economics (BLE) as a policy prescription platform and its influence on the regulations emerging from the Consumer Financial Protection Bureau (CFPB). We show how these regulations are inconsistent with the intent and purpose of improving consumer choices. We further demonstrate that the selective modeling of behavioral bias in the BLE framework causes an overestimation of the ability of regulators, who in actuality use inefficient, heavy-handed rules based on little if any real empirical findings of "consumer irrationality." Accordingly, the broader lesson on the misapplication of behavioral economics goes beyond the ill-considered policies emerging from the CFPB.

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Behavior, Paternalism, and Policy:

Evaluating Consumer Financial Protection

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I. Introduction

The Consumer Financial Protection Bureau (CFPB) is one of the most powerful and least accountable regulatory agencies in American history. Immune from budgetary oversight by Congress and headed by a single director whom the president cannot remove except under special circumstances, the agency wields unconstrained, vaguely defined powers to regulate virtually every consumer and small business credit product in America (Zywicki 2013a). In part, the CFPB has justified its ongoing intervention into financial credit markets based on a prior belief in the inability of consumers to competently weigh their decisions. This belief is founded on research conducted in the area of behavioral economics, which shows that people are prone to a variety of errors in their decision-making.

Beginning with the seminal work of Nobel Laureate Daniel Kahneman and his coauthor Amos Tversky, behavioral economics has identified numerous purported behavioral "anomalies" through extensive laboratory investigation. Anomalies (or behavioral biases) are defined as observed behavioral deviations from the predictions of neoclassical economic theory, where it is assumed that people rationally optimize according to a given set of information and constraints. Behavioral economists have sought to explain the sources of such anomalous choices by identifying and cataloging a variety of cognitive limitations and psychological biases.

Building on these findings, behavioral theorists have exported their research into the policy realm. This program, led by such luminaries as Richard Thaler and Cass Sunstein—and known as behavioral law and economics (BLE)—applies the insights gleaned from studies of human behavior to improve existing institutions by designing rules to compensate for (or take advantage of) behavioral biases. Starting from the premise that observed choices are inconsistent with neoclassical theory, behavioral economists argue that intervention is necessary to generate desirable outcomes for consumers who would otherwise make poor choices.

It is useful and imperative at the outset to distinguish between behavioral economics and behavioral law and economics research. In this paper, we use these terms to distinguish between distinct concepts. We use the term "behavioral economics" (BE) to refer to the underlying economic and behavioral science research program of hypothesis-testing to identify—and, where possible, to quantify—actual consumer behavior. We use the term "behavioral law and economics" (BLE) to describe the efforts to take the biases identified by BE scholars and to operationalize them into normative prescriptions for judges and regulators.

That we take the findings of BE as given for current purposes should not be read to imply that we endorse the validity or robustness of those conclusions. Despite its early triumphalism, much doubt remains about the validity and importance of BE insights, especially in describing real-world (versus laboratory) behavior. Kahneman, for example, pointed out in a terse communication to scholars within the field of priming that lack of replication is a major source of difficulty in the social sciences in general and psychology in particular, indicating a looming "train wreck" for the field if the problem remains unaddressed.[1] Studies such as Zeiler and Plott (2004) show how even the previously widely accepted findings such as the "endowment effect" are subject to misidentified errors and design problems. We also take as given that these purported biases may have material effects on market efficiency or distributional outcomes and

[1] http://www.nature.com/polopoly_fs/7.6716.1349271308!/suppinfoFile/Kahneman%20Letter.pdf. Visited November 25, 2013.

are not already ameliorated or corrected by lower-cost market and private ordering mechanisms, and thus have policy relevance (see Manne and Zywicki 2014).

Second, we assume in this paper that identified behavioral biases are not only valid in the abstract, but they can be operationalized as a theoretical matter in practice. Thus, for example, we assume that not only do consumers suffer from an "optimism bias," but it is actually possible to determine in which contexts that bias will operate (or not operate). In practice, this will often be impossible. For example, as Zywicki (2013b) observes, a purported optimism bias could lead consumers to either over-save or under-save for retirement and to inefficiently select fixed-rate or adjustable-rate mortgages, depending on which contexts and how powerful the biases are assumed to be. Nor does BLE offer any testable hypothesis to determine in which contexts various biases will operate—it instead offers little more than ad hoc "just-so stories" about purported welfare losses to consumers. However, we assume the regulator can overcome this often-insuperable hurdle.

We also focus on a third context: the institutional environment in which BE assumptions are operationalized into BLE-friendly policies. The findings of BE largely derive from laboratory findings devoid of real-world institutional environments. A variety of obstacles stand between theory and practice. Coordination failures, third-party influence (or intervention), poor institutions, corruption, and simple unknowns all represent realistic considerations that any policymaker must anticipate. Boettke et al. (2012) have pointed out that BLE puts the cart before the horse in prescribing policy based upon laboratory behavioral studies without taking into account the actual context of the policy arena. They show how behavioral approaches resemble previous efforts to curtail market activity based upon deviations from theoretically optimal conditions, such as in welfare economics or antitrust law; they further point out that finding deviations from a theoretical optimum does not in and of itself justify market intervention.

Without understanding the nested context in which their insights will be embedded, theorists risk encouraging activity that little resembles what they really want. Berggren (2011) has found that the vast majority of behavioral policy propositions in leading economics journals do not even apply the studied behavioral bias to the policymaker. Therefore, it is especially prudent that once BLE is operational, policy analysts follow up their prescribed solutions with empirical demonstration that the relevant institutional fixes effectively address the problems originally identified. Without this confirmation, there is little to justify ongoing intervention into market activities. Even if the underlying research supports behavioral fixes, the ultimate gauge of policy effectiveness is its successful application to real-world settings.

While BLE has a questionable track record in dealing with these three obstacles, it is this latter consideration of empirical support of institutional fixes that we address by examining recent behavioral interventions into the area of consumer finance. Policymakers have already begun to use behavioral insights as foundation for interventionist policy. As Wright (2011) maintains, BLE "played a significant role in the creation of the CFPB" (p. 2220), exposing its "meteoric emergence in the legislative and regulatory spheres" (p. 2231). Nevertheless, the dangers inherent in this approach are considerable. With respect to energy regulations, Gayer and Viscusi (2012) show that policies that assume consumer irrationality are cumbersome, immune to contrary evidence, and largely ineffective in correcting the very deficiencies they ostensibly seek to redress.

We contribute to this ongoing discussion by offering insight into the relationship between BLE as a policy prescription platform and the regulations emerging from the CFPB. We show how these regulations are inconsistent with the intent and purpose of improving consumer choices. We further demonstrate that the selective modeling of behavioral bias in the BLE framework causes an overestimation of the ability of regulators, who in actuality use inefficient, heavy-handed rules based upon little if any real empirical findings of "consumer irrationality." Accordingly, the broader lesson on the misapplication of behavioral economics goes beyond the ill-considered policies emerging from the CFPB.

This paper offers guidelines to academics, policymakers, and other interested parties on the application of policies based on behavioral findings. In particular, we attempt to show the following:

1. Political realities belie the attempts of behavioral theorists to construct policy corrections.
2. Actual political decision-making is susceptible to a number of distorting influences, most importantly bureaucratic overreach, behavioral bias on the part of the policymaker, and lack of appropriate information regarding consumer choices.
3. Bureaucrats do not hold the same preferences about political outcomes as behavioral theorists do. They are affected by self-interest like anyone else, which can cause deviations from prescribed policy measures.
4. Regulations based on behavioral findings tend to lean toward heavier forms of intervention that eliminate viable, alternative forms of exchange, thus impeding innovation and creativity in the marketplace. This in turn limits the overall amount of market activity (in this case consumer credit).
5. Policymakers are unlikely to incorporate evidence-based analysis into their decision-making in a manner consistent with the scientific method. Instead, policymakers are susceptible to "confirmation bias" in evaluating evidence.

We first build up to the operationalization of BLE by offering a brief history of the transition of behavioral economics into proactive policy prescription. We segue from this history to focus on the operationalization of certain policies in the area of consumer finance offered by prominent behavioral theorists Thaler and Sunstein in their book, *Nudge: Improving Decisions about Health, Wealth, and Happiness*. We then delve into the origins and current activities of the CFPB. We analyze each of the activities outlined to show how the CFPB departs from the BLE framework. We conclude by offering several policy solutions that might better bridge the gap between BLE and successful policy initiatives.

II. Behavioral Biases and Public Policy

Starting with the seminal pieces by Tversky and Kahneman,[2] behavioral economics arrived like a thunderclap to the domain of neoclassical economics. Considered virtual heresy at the time, the two psychologists claimed to show that people were indeed not as rational as the hyperrational, calculating, utility-maximizing machine that was *homo economicus*. Instead, people displayed deficiencies in judgment that soon came to be known under various labels: representativeness heuristic, availability bias, status quo bias, time inconsistency, loss aversion, confirmation bias, etc.

Already a deeply skeptical profession, the dismal scientists were loath to give up their predispositions toward a fully rational agent as the benchmark of human behavior. Armed with a more thorough set of experimental design tools (and, unlike many experimenters in psychology, actual cash-motivated subjects), Grether and Plott (1979) set out to overturn the pesky results found by a couple of wayward psychologists. In a shocking turn of events, however, the two economists found the very results presented by Tversky and Kahnamen, even when subjects

[2] See Tversky and Kahneman (1975), Kahneman and Tversky (1979).

were properly motivated and design parameters sufficiently controlled. The debate would never again be the same.

Fast-forward to the 1990s. By then, although much controversy remained over the validity of the underlying BE research, the assumed findings of BE began to be translated into BLE policy recommendations. The new field of BLE transformed the body of evidence found in laboratory study into a set of guidelines for real-world policy. While some have questioned the internal consistency of this framework, given that any number of policy suggestions can emerge from its assumptions (see for example Zywicki 2013b), legal scholars have increasingly used its assumptions as a foundation for their own analysis (see Wright 2007).

Sunstein (1997) was formative in this regard by positioning the results of behavioral economics in a way that began to influence policy. He outlines three different tasks for behavioral scholars: positive, prescriptive, and normative. Positive analysis is, of course, the bread and butter of experimental economic research. It involves postulating refutable hypotheses that can then be tested in the laboratory. Prescriptive work involves guiding policymakers toward stated objectives. Just as with the field of law and economics, BLE attempts to show how to achieve better outcomes through the legal and political process. What constitutes "better" is determined by the final task, that of normative work. By discovering the errors people commonly make, behavioral theorists can propose improvements to decision-making that could conceivably cause people to make better choices (pp. 1177–78).

Sunstein also touches upon the problem of public officials exercising authority under the same biases as their private brethren. He explains,

> None of these points makes a firm case for legal paternalism, particularly since bureaucrats may be subject to the same cognitive and motivational distortions as everyone else. But they do suggest that objections to paternalism should be empirical and

> pragmatic, having to do with the possibility of education and likely failures of government response, rather than a priori in nature. (p. 1178)

Hence, positive work must extend to the world of policymaking itself. Otherwise, it is not clear the prescription is valid. If the policymaker is himself biased, then this could distort the outcome away from what was intended by the theorist.

Building off Sunstein's framework, Jolls, Sunstein, and Thaler (1998) further expand on the notion of "anti-anti-paternalism." They claim that while traditional law and economics is reluctant to cede authority to government actors in correcting consumer choices, this reluctance is founded on the assumption of "consumer sovereignty"; that is, consumers are capable of making rationally informed decisions. If this assumption is invalid, then this reluctance is no longer justified. Instead, the merits of paternalism should be considered an empirical and pragmatic matter.

This normative claim is expanded upon in Sunstein and Thaler (2003), who now label this movement with the far catchier name of "libertarian paternalism." As they show, ceding authority to government actors need not be paternalistic in a hard sense. Instead, these authority figures can simply "nudge" consumers in the right direction through soft intervention measures such as changing default choices, using simpler information, framing choices differently, and so forth.

These papers eventually gave birth to the runaway success of *Nudge*, which offered a buffet of behavioral-minded policies from which to choose. Kahneman described *Nudge* in his equally successful book, *Thinking, Fast and Slow*, as "the basic manual for applying behavioral economics to policy" (Kahneman 2011, 372). Given the influence of *Nudge*, it is a reasonable place to begin our examination of the impact BLE has had on the area of consumer financial protection.

III. Protecting Consumers

In chapter 8 of *Nudge*, Thaler and Sunstein detail the troubles and travails of the mortgage market. Using their behavioral framework, they claim that consumers of credit are often ignorant of the costs of their choices. This is particularly true with more complex forms of mortgage loans, such as those with variable interest rates, exotic products such as interest-only loans, and teaser rates where interest remains low for a certain number of years then dramatically increases. If consumers are indeed cognitively limited, then these more complex forms have the potential to prey on those who are most susceptible to manipulation, such as lower-income households.

The solution? Thaler and Sunstein argue that their "RECAP" plan should be employed, where consumers are alerted to easy-to-follow information that allows them to "Record, Evaluate, and Compare Alternate Prices." Transferred into policy prescription, mortgage companies should be required to offer a simple synopsis of the loan conditions, detailing things like expected interest rates by year, worst-case scenarios under the particular loan, and all fees, teaser rates, variable interest provisions, etc., up front. In other words, better choice architecture leads to better choices (p. 140).[3]

Their policy prescription certainly could improve consumer choices, if their underlying assumptions are true.[4] But what might get in the way of effectively implementing such a policy? In chapter 17, Thaler and Sunstein offer a number of responses to challenges often proposed against behavioral interventions. We will outline three that are particularly pertinent to the subject of consumer financial protection and the CFPB.

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[3] A similar approach was offered by Barr, Mullainathan, and Shafir (2008) in their proposal that lenders should be required to offer consumers so-called simplified "plain vanilla" credit products that they would be required to affirmatively reject before being permitted to choose a different product. The "plain vanilla" proposal was included the Obama Administration's White Paper that provided the foundation for the Dodd-Frank financial reform legislation, although it was removed before final passage of the law. For a discussion, see Wright (2011).

[4] Notably, Thaler and Sunstein stop short of urging a complete ban of these various terms and products on the basis that at least some consumers may benefit from access to them even if most consumers do not (in their opinion).

First is the slippery slope argument, which claims that allowing for soft intrusive behavior will inevitably give way to hard intrusive behavior (or put another way, a nudge will become a shove). Thaler and Sunstein respond that nudges should first be judged on their own merits before invoking the slippery slope argument. They also show how several of their chosen nudges provide a steep slope for those who would attempt to transform soft paternalism into hard paternalism. Finally, they argue that a default position is requisite in many choice contexts. Hence, avoiding behavioral intervention on the basis of slippery slope concerns may very well give way to an initial default of hard paternalism anyway (pp. 239–41).[5]

The next objection is the idea that public officials will become corrupt and in turn use nudges for private advantage. Thaler and Sunstein offer two responses. First, public officials and private entrepreneurs both may be tempted to gain from private advantage. So any attribution of villainous motives should be applied equally across both spheres. Second, they argue that their nudges instill greater transparency into choice architecture and hope that such transparency will permeate further into political discourse through publicly reported votes, earmarked legislation items, and contributions from lobbyists (p. 243).

Finally, they discuss the question of neutrality and whether public officials are in a position to know what is best for those doing the choosing. Here they appeal to expertise. They argue that decisions in which much is being required from the chooser, such as in choosing a mortgage plan, experts exist who would be better able to choose on behalf of the choosers than the choosers themselves. They acknowledge that these experts may be self-interested, but conclude that conflicts of interest could be spotted *ex ante* and avoided (pp. 250–51).

[5] See Rizzo and Whitman (2009) for a counterargument to this claim.

Sunstein (2013) expands upon and supplements the list by breaking antipaternalist challenges into five broad areas of concern: *information*, *competition*, *heterogeneity*, *learning*, and *public choice*. Briefly, these refer to the concern that *information* is most readily at hand at the local level and therefore public officials are at a disadvantage in utilizing the best information available. Intervention into markets also intentionally or unintentionally tends to stultify *competition*. This can ultimately reduce welfare even if the intervention improves choices. Further, consumers are *heterogeneous* and any intervention must account for the fact that the market may support multiple preferences at any one time. Political interference tends to reduce this distinction. Market actors also *learn* from their mistakes, so if a behavioral problem presents itself, it is not a given that the consumer will fail to recognize the problem and correct for it in time. Finally, echoing the *public choice* concerns above, Sunstein acknowledges again that public officials are both subject to influence by special interest groups and susceptible to the same biases as the consumers they govern (pp. 33–38).

Thaler and Sunstein lay down the gauntlet to potential skeptics, though, by emphasizing the need for empirical verification that behavioral interventions are found wanting. While acknowledging the considerable challenges BLE faces, they argue that this in itself does not overwhelm the potential benefit that comes with improving choice architecture for the consumer. We agree with Thaler and Sunstein that policy success is an empirical matter. We now proceed to show how BLE fails to improve welfare in the area of consumer finance regulation.

IV. Enter the Consumer Financial Protection Bureau

We turn to the political reality of consumer protection in the form of one of Washington's newest agencies, the CFPB. The CFPB was initiated as part of the broader Dodd-Frank Wall Street

Reform and Consumer Protection Act, itself a reaction to the financial crisis that occurred late in the first decade of the 21st century.

As originally conceived of by then-professor Elizabeth Warren, the framework for the CFPB was grounded largely in old-style consumer protection and in the rising financial crisis. Soon, however, the concurrent streams of heightened calls for increased consumer protection and the academic surge of BLE crossed, leading advocates for the new agency to hitch themselves to the BLE research agenda. (Durkin et al. 2014, chapter 9). Thus, Bar-Gill and Warren (2008) formalized Warren's earlier calls for the new agency, grounding its rationale squarely in behavioral economics. In their article, the authors put the question of consumer rationality first and foremost in criticizing the efficacy of consumer financial markets. They argue that imperfect rationality exacerbates much of the underlying problems in these markets (p. 9), claiming consumers are unaware that they are uninformed (p. 12).

They further buttress Thaler and Sunstein's claim that framing effects have much to do with suboptimal outcomes (Bar-Gill and Warren 2008, 42). They argue that sellers are well aware of the shortcomings of consumer rationality and indeed exploit these weaknesses to gain greater profits (p. 46).[6] For example, they argue that consumers fail to switch to new credit cards once the initial introductory offer ends due to inertia on the part of the consumer. They state, "There is clearly a psychological-inertia component reflected in such high switching costs" (p. 51). In another example, they argue that consumers suffer from optimism bias and are therefore

[6] Bar-Gill and Warren (2008) are unclear on this point about whether they are in fact claiming that exploitation of behavioral biases in fact results in sustainable economic "profits" to lenders (such that there is a sustainable wealth transfer from consumers to lenders) or whether they retain the standard assumption of a zero-profit equilibrium in which any initial supra-competitive profits are dissipated in the competitive process. In the latter event, there would be no sustainable economic profits although there could be wealth transfers among consumers (such as from less-sophisticated or more-biased consumers to more-sophisticated or less-biased consumers). This failure to identify the actual type of economic harm that supposedly results from behavioral biases is a chronic flaw in BLE research (see Wright 2007).

unlikely to properly estimate their future income streams, which leads them to purchase the exotic mortgage products described by Thaler and Sunstein above (i.e., temporarily low introductory rates with small down payments) (p. 53).

Finally, they explain that while numerous agencies regulate consumer financial products, either a lack of motivation (on the part of banking agencies) or a lack of authority (on the part of the Federal Trade Commission) prevents these government organizations from preventing the types of exploitation they outline. Instead, they argue that a new agency is needed with both the authority and motivation to carry out proper consumer financial regulation.

This recommendation came to fruition when the CFPB opened its doors on July 21, 2011. It is situated as an independent bureau within the Federal Reserve. Accordingly, it is effectively independent from direct congressional or executive oversight (see Zywicki 2011).[7] The CFPB states that its "mission is to make markets for consumer financial products and services work for Americans—whether they are applying for a mortgage, choosing among credit cards, or using any number of other consumer financial products." It further insists that

> above all, this means ensuring that consumers get the information they need to make the financial decisions they believe are best for themselves and their families—that prices are clear up front, that risks are visible, and that nothing is buried in fine print. In a market that works, consumers should be able to make direct comparisons among products and no provider should be able to use unfair, deceptive, or abusive practices.[8]

In order to ascertain just what is needed in the regulation of consumer finance, the agency claims to use empirical investigation as its primary means of guidance. As Director Richard Cordray states, "We pride ourselves on being a 21st-century agency whose work is evidence-based. So we also conduct our own in-depth studies on consumer financial products, such as

[7] https://www.federalregister.gov/agencies/consumer-financial-protection-bureau. Visited July 1, 2013.
[8] http://www.consumerfinance.gov/the-bureau/. Visited July 1, 2013.

reverse mortgages and private student loans."[9] The agency also procures information through public requests, submitted complaints, and general public outreach.

So far, so good. The CFPB's rhetoric is very much in the spirit of BLE as propounded by Thaler and Sunstein. The agency's emphasis is on softer forms of intervention such as increasing transparency and general information distillation. Further, its approach is guided by the kinds of empirical testing that BLE promotes as needed to ascertain the validity of paternalistic measures. Finally, it is well armed with a host of behavioral practitioners. Its first in-house research appointment was Sendhil Mullainathan, a well-known behavioral theorist,[10] who was soon supported by a research advisory council consisting of a virtual who's who of the behavioral community (including none other than Richard Thaler himself), although they have done little research on the economics of consumer credit or consumer credit regulation.[11]

So what about the CFPB in practice? The CFPB has only been around for two years. Still, the agency has offered both guidance and formal regulation in a number of areas. Before analyzing the departures from the BLE framework in detail, we survey three of these: (1) qualified mortgages, (2) credit card fees, and (3) student loans. In each case, the agency has shown that it is more interested in deciding the appropriate outcome for the market—an outcome which itself is dominated more by political concerns than by consumer welfare—than it is in helping consumers make the choice for themselves.

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[9] http://www.consumerfinance.gov/newsroom/written-testimony-of-richard-cordray-before-the-u-s-house-of-representatives-committee-on-financial-services/. Visited January 3, 2014.
[10] http://www.consumerfinance.gov/newsroom/treasury-department-announces-senior-leadership-hires-for-the-consumer-financial-protection-bureau/.
[11] http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-announces-consumer-advisory-board-members/.

Qualified Mortgage Loans

In early 2013, the CFPB began posting a number of regulations pertaining to home mortgages. The rules, summarized under the "Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act" (Regulation Z), sought to curb the very kinds of mortgages that alarmed Thaler and Sunstein: those with "exotic" features and chaotically changing rates. The claim again is that consumers are unable to fathom the consequences of these sorts of mortgages and must be protected from harm.

To provide this protection, the CFPB has implemented a new label for "qualified mortgages" as put forth in Dodd-Frank. In a summary of the rule, it states that

> the Dodd-Frank Act sets certain product-feature prerequisites and affordability underwriting requirements for qualified mortgages and vests discretion in the Bureau to decide whether additional underwriting or other requirements should apply. The final rule implements the statutory criteria, which generally prohibit loans with negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years from being qualified mortgages. (p. 4)[12]

In other words, to be labeled a "qualified mortgage," the lending terms must steer clear of the practices outlined by Thaler and Sunstein.

To encourage lenders to comply with the rule, the CFPB will provide "safe harbor" from litigation for any qualified mortgage in the event of default. So once the mortgage is deemed qualified, it is free from legal claims of illegitimacy and thus limits liability for the bank. The flipside of this, of course, is that mortgages without this designation are now more vulnerable to lawsuit (Prevost 2013).

The CFPB claims it is not trying to "stigmatize" nonqualified mortgages (Swanson 2013). Nevertheless, lawmakers from both sides of the political divide have pushed back against the new designation, claiming that it hurts rural lenders (and borrowers) who often use "balloon

[12] http://files.consumerfinance.gov/f/201301_cfpb_ability-to-repay-summary.pdf.

payments" in which the final payments include a larger percentage of the principal balance (Zibel 2013a). In response, the CFPB has made efforts to pacify lawmakers by exempting smaller lenders with $2 billion in assets.[13]

In light of this grand effort to rescue consumers from predatory efforts, it would be prudent to examine the actual evidence on the use of complex mortgages, soon to be deemed "unqualified" by the CFPB. A recent working paper—which includes one author from the Federal Reserve Bank of Chicago—suggests that the targets of such loan terms are not low-income, ignorant buyers but high-income, sophisticated buyers with a pattern of defaults that suggest strategy rather than irrationality. The authors conclude their report by stating,

> Overall, both the characteristics of complex mortgage borrowers and their default behavior cast doubt on the popular perception that complex mortgages are pushed by predatory lenders to naïve households who do not fully understand the mortgage terms. Our results suggest instead that complex mortgages are taken out by relatively sophisticated borrowers who take advantage of the contract specifications and are more strategic in their default decisions than borrowers with more traditional mortgage contracts. (p. 31)

The reasoning behind this claim is that mortgages with deferred rate increases decrease the amount of amortization of the loan and therefore maximize value to buyers who are willing to walk away from the asset (Amromin et al. 2011).

The simple fact is that mortgages are not always purchased by naïve homeowners. They are often used as assets to generate wealth just like any other commodity. Some consumers place emphasis more on investment strategy than consumption of the home. If such buyers feel that the asset no longer warrants investment, then they can simply walk away from the investment, and where a house is worth substantially less than the remaining principal on the mortgage it is highly rational to do so. In this sense, mortgages can be seen as a "put option" where the buyer

[13] https://www.federalregister.gov/articles/2013/05/02/2013-09750/amendments-to-the-2013-mortgage-rules-under-the-real-estate-settlement-procedure-act-regulation-x.

makes the constant choice of claiming the asset at the end of the loan period (usually 30 years) or giving the asset back to the lender. This is not to say that all buyers are sophisticated, only that the intentions when utilizing complex mortgages are pluralistic; though the evidence cited above indicates that more are viewing the asset as a "put option" than not. Regardless, recognizing that there is more than just one type of consumer should be a starting point for understanding mortgage markets.

So what does the CFPB make of this counterintuitive finding? On page 564 of its 800-page (anything but simplistic or straightforward) initial report on qualified mortgages, the agency references the study but states a conclusion counter to its findings. The CFPB report states, "The lower payment possibility for these loans allows borrowers to qualify for loans that they otherwise may not have been able to afford; but this comes with the same risks just described. The performance of many of these loans was also very poor, and worse than expected, with the onset of the downturn."[14] Far from acknowledging the most common use of complex mortgages, the CFPB portrays the loan terms as preying on buyers unable to afford them and consequently a damaging result during the 2008 financial crisis. While there is nothing untruthful in the statement, this portrayal suggests an enormous amount of confirmation bias on the part of the CFPB.

Indeed, one of the chief difficulties with the BLE framework, as we will explain below, is that it does not address how to incorporate evidence that is contrary to its initial hypothesis (see Zywicki 2013b). If we assume a priori that consumers are ill-equipped to handle their decisions, then what evidence could possibly convince us otherwise? As a case in point, studies such as Ghent and Kudlyak (2011) have found that incentives very much matter when analyzing the

[14] http://files.consumerfinance.gov/f/201301_cfpb_final-rule_ability-to-repay.pdf, January 10, 2013.

probability of default on home mortgages. In their study, Gent and Kudlyak show that states with recourse laws, in which lenders have greater opportunity to recover the principal of the loan by seizing additional assets, tend to have lower default rates, particularly when the value of the home is greater than $500,000. In other words, incentives matter. But this runs counter to the belief that consumers are not responding rationally to their choice context (see Wright 2007 for additional evidence in this vein), so the CFPB ignores it or even represents it inaccurately.

Bank and Credit Fees

Another source of ire for advocates of consumer protection is the various fees charged by banks and other creditors. These range from fees for transmittance to overdraft protection to various add-on features employed by credit card companies, among others. BLE research proffers a number of rationales in support of heightened regulation. For example, following Gabaix and Laibson (2006), Bar-Gill and Bubb (2012) argue that many of the fees that credit card issuers assess (such as late fees or over-the-limit fees) are "shrouded" or "non-salient" costs and so are largely ignored by consumers when selecting or using a credit card. Similarly, BLE scholars have argued that those who use overdraft protection "excessively" (more than 10 times per year) must be subject to certain behavioral biases that cause them to irrationally overuse the product, such as optimism bias or any of the other innumerable biases reported in the literature.

One example is the marketing by credit card issuers of certain "add-on products" such as credit insurance, which pays a consumer's credit card bill in whole or in part in the event that he or she becomes unemployed or suffers certain other calamities. In July 2012, the CFPB warned credit card companies about these services, stating that "credit card issuers have employed deceptive promotional practices when marketing the products, including failing to adequately disclose important product terms and conditions."[15] Following this announcement, the CFPB fined both Capital One Financial Corp. and Discover Financial Services, claiming that the companies were using deceptive techniques to lure consumers into purchasing services that they otherwise would not purchase. Unsurprisingly, the immediate result of this action was a dramatic shift away from these services with major institutions such as JPMorgan Chase, Bank of America, and American Express pulling out altogether of the "credit protection" market. American Express spokeswoman Marina Norville explained, "We are very sensitive to concerns that the regulators have, so we're pulling back." Kevin McKechnie, head of the American Bankers Insurance Association, went a step further, hinting at the CFPB's underlying tactic of choosing best market practices: "I don't want to ascribe to them the belief that they want to pick winners and losers in the market." But he added, "We may have to revisit that question in the future" (Dougherty 2012).

In a similar vein, the newest target of the CFPB is overdraft fees. These are fees banks commonly charge customers who overdraft their accounts. These fees constitute a significant source of revenue for banks; further, the services to which they are tied are valued by consumers who need quick access to credit that might otherwise be unavailable. The CFPB's interest in the area has sparked the same kind of recoil generated by its condemnation of credit card add-ons. Richard Hunt, president and chief executive of the Consumer Bankers Association, a trade group of big and regional banks, has said consumers "have the right to choose the products and features which best provide for their family's daily needs" (quoted in Douglas 2013).

[15] http://files.consumerfinance.gov/f/201207_cfpb_bulletin_marketing_of_credit_card_addon_products.pdf, July 18, 2012.

The CFPB approaches the issue with a focus on the burden these fees place on presumably unaware consumers. In a white paper released in June 2013,[16] the bureau argues that these fees constitute costly services that are less beneficial than other services banks offer, such as linked accounts (i.e., accounts where a savings account or credit line is used to backstop overdrafts). Despite previous regulations that stipulate banks must allow consumers to opt in to these programs, Willis (2013) claims these types of services remain in the marketplace largely due to the machinations of banks themselves, which subtly coerce their customers into opting in to overdraft protection services. Following Willis, Bubb and Pildes (2014) recommend that stronger intervention be pursued through direct product regulation (pp. 61–64).

We echo Flores and Zywicki (2013) by first pointing out that any service is costly in a literal sense, assuming services are not free. The larger question is whether the service is the least costly opportunity available to the consumer and if the consumer is aware of this. Flores and Zywicki show that those who most often overdraft are more likely to opt in to overdraft protection (p. 17). This would be a somewhat banal observation except for the fact that the CFPB claims this as evidence that a small percentage of consumers are taking on an unnecessary burden by engaging this service. (Of course, one could say the same about people who purchase flood insurance.) Constant use of the service alone is not indicative of irrational behavior, particularly if it is the best option available. A question the CFPB has not addressed is whether these consumers actually have access to the more attractive opportunities they claim are less costly. If banks do not typically extend credit lines to frequent users of overdraft protection, or if these persons do not have much in the way of savings, then overdraft fees may be the least burdensome way of accessing short-term credit. There would then be no reason to rely on

[16] See CFPB, “Impact of Overdraft Programs on Consumers,” 77 Fed. Reg. 24687 (April 25, 2012), http://www.gpo.gov/fdsys/pkg/FR-2012-04-25/html/2012-9851.htm.

consumer irrationality as the culprit behind utilizing overdraft services (see Zywicki 2012b for a rational choice–based take on overdraft behavior).

Unfortunately, by targeting these types of services, the bureau is likely limiting credit to those with even less attractive options. Consumers sometimes face desperate choices. This is not a matter of choosing between a cheap option and a costly option, but instead between a costly option and a very costly option. Bank analyst Dick Bove goes so far as to say that these limitations on credit practices can send consumers to such shadow banking institutions as the mafia (Benoit and Zibel 2013). As Zywicki (2011) argues, "Regulators cannot wish away the need of low-income consumers for credit: If your car's transmission blows, you need $2,000 for repairs to get to work, whether or not you have it saved in the bank (and most low-income Americans don't). If you can't get a credit card, you're going to have to get that money from a payday lender, pawn shop or loan shark."

In response to these concerns, the CFPB has made great efforts to explain that it is not banning these practices. The reality, though, suggests otherwise. While an outright ban would certainly constitute a more explicit form of burdensome intervention, putting the screws on banks for practices that previously were considered legal increases the implicit costs of using targeted services. At some point, it no longer is worth it to risk the ire of the agency. Instead, the market is left abandoned with little regard for the consumer's true interests.

Federal Reserve economists Durkin and Elliehausen (2012) report in a Federal Reserve Bulletin that consumers are actually quite satisfied with credit protection services. This finding comes from a properly controlled survey of households (i.e., not self-reported) on a variety of credit services. In contrast to the CFPB's interpretation, the Fed authors conclude, "It seems that the marketplace offers consumers a choice concerning the purchase of debt protection products and consumers exercise that choice as part of their financial decisions about borrowing. While there may be abusive practices among some lenders who operate outside the realm of ethical behavior with respect to the sale of debt protection products, survey evidence suggests that, in the views of consumers, such behavior is not the norm."[17]

Student Loans

Another target of the CFPB is student loan markets. The CFPB is limited in how it can address student loans since it has no jurisdiction over public-sector lending in education. That authority instead belongs to the Department of Education. In fact, only about 15 percent of student loans originate from private organizations (Dougherty 2013b). Nevertheless, the CFPB has targeted this sector repeatedly, once with a report in July 2012[18] and more recently in May 2013.[19]

Using the oft-repeated observation of the immense burden of student debt, the CFPB reports that students are given few options to defray this burden by private lenders, suggesting private lenders employ a combination of easier repayment strategies—such as those offered by government-supported loans—and debt consolidation utilizing the historically low interest rates currently seen in markets. The agency does not, however, address how lenders can restructure their market to offer these attractive rates in practice (Dougherty 2013c).

To understand the structure of private lending markets, one must consider the incentives of these loan markets. It is public loans—not private loans—that are subsidized by taxpayers, letting lending institutions like Sallie Mae, the market's leading private purveyor of student

[17] http://www.federalreserve.gov/pubs/bulletin/2012/pdf/consumer_debt_products_20121227.pdf, December 2012.
[18] http://www.consumerfinance.gov/pressreleases/consumer-financial-protection-bureau-and-u-s-department-of-education-joint-report-finds-a-cycle-of-boom-and-bust-in-private-student-loan-market/, July 19, 2012.
[19] http://files.consumerfinance.gov/f/201305_cfpb_rfi-report_student-loans.pdf, May 8, 2013.

loans, off the hook when a loan goes bad. In these cases, offering attractive repayment options at reduced rates makes sense since Sallie Mae wins either way. If the buyer pays back the loan at reduced rates, then Sallie Mae recoups part of the loan agreement. If the buyer still defaults, then the government picks up the tab. Hence, public lenders face a far different opportunity cost of servicing loans than their private brethren. Any serious comparison must take these divergent incentives into account.

Because private lenders have no such arrangement with the government, they incur the entire loss of a loan gone bad. To compensate for this risk of default, lenders rely on good loan recipients to subsidize the bad. In other words, debtors are paying for not only the risk of their own loan, but that of others' loans as well. Without this arrangement, it is unclear how private lenders would be able to deal with the number of defaults found in these sorts of markets. This point exposes a flaw in the CFPB's argument that "after students graduate, find jobs and begin to establish a repayment record, their risk of default declines—and so they should become eligible for lower rates" (Carrns 2013b). In fact, many borrowers probably do effectively refinance into lower-interest-rate options (such as home equity loans) and prepay their student loans. But leaving that aside, while it is true that the risk of a particular borrower has decreased, the overall risk in the market has not—the very nature of the product is that there is some cross-subsidization from borrowers who make their payments to offset the default losses for those who do not. Thus, requiring reduced interest rates for the result of such a practice would almost certainly force private lenders to increase rates even more for initial borrowers, to increase up-front costs (such as charging origination fees), to alter other terms (such as imposing more severe default rules), or to restrict access to higher-risk borrowers, such as low-income borrowers who are probably most in need of access to higher education credit.

The broader purpose of the CFPB's efforts is apparently to pressure lenders to write down part of the debt incurred by students. The result of such pressure, as we saw with credit card debt insurance and overdraft protection, will be to limit the market for student loans from private lenders, driving more students to public lenders (or driving them out of higher education completely). Again, the agency is attempting to select the outcome of choice, as if there is simply a menu of options with which a more focused, public-spirited entity can manage the affairs of the market. The reality is that the agency can only tell consumers and companies what they cannot do. It simply has no control over what comes next, as consumers and companies try to adapt by making do with what is left on the table. In the case of student loans, clearly that entails greater public loans and taxpayer subsidies.

V. Departures from the BLE Framework

We now move to the final challenge: even if BLE is sound in theory, it must be implemented through a real-world bureaucracy and political system that is subject to its own distortions and biases. Moreover, the CFPB is unconstrained by the usual checks and balances that have evolved over time to temper the pathologies typical of bureaucracies. In this section we will outline how the actions of the CFPB depart significantly from the policy prescriptions of the BLE framework. Thaler and Sunstein's core argument is that consumers benefit from better choice architecture. Their assumption, though, is that a public entity like the CFPB can create a better architecture through political channels. While their treatment of the challenges this potential effort faces is notable, the reality is that political conditions undermine the feasibility of such an effort in practice.

Departure 1:

Consumers are just as bad at making public choices as they are at making private ones. Thaler and Sunstein claim that introducing transparency into political decision-making will obviate the potential for political bias. Unfortunately, this is simply not the case. What Thaler and Sunstein do not account for, rather ironically, is that even if consumers are irrational and biased in their private decisions, they are even more so in a public choice context. As Caplan (2007) has argued, consumers acting in their public roles as voters are not only ignorant but tend to irrationally support initiatives that end up hurting them in the long run. There is plenty of debate about why consumers are ignorant in their public roles, or even how pronounced this ignorance is. Nevertheless, claiming that watchful consumers will keep politicians in check is somewhat utopian.

If instead we assume that consumers of public services are largely naïve about the value of these services, then it follows that the political process is subject to manipulation by special interest groups (the so-called *public choice* problem noted above). The reason, going back to the seminal work of Mancur Olson (1965), is that special interest groups have a particular involvement in political decision-making while the everyman is mostly unaffected. Thinking about this relationship in terms of benefit-cost analysis, consumers (usually) pay very little for one particular government service. So while consumers as a whole represent a Goliath-like being, the rational choice is to depend on others to make decisions on their behalf, as becoming informed is simply not worth it. Therefore, it stands to reason that small groups will have a disproportionate influence over public outcomes.

For example, the authors of the Fed study on complex mortgages cited above find that unemployment rates and low-income growth levels, both associated with rural areas, positively contribute to delinquency (Amromin et al. 2013, 24). Put another way, the very areas that are excluded from CFPB regulation (rural banks) are more likely to be in need of it. Thus, leaving aside the wisdom of the underlying policy itself, a clear case of politics trumping efficacy has led the CFPB away from both its purported goals and the policies prescribed by the BLE paradigm.

Coincidentally, Kuran and Sunstein (1999) provide another reason to be skeptical of consumer oversight. In their law review article, they explain how consumers can be caught up in “availability cascades” which cause the public to erroneously blame the most immediate causes as opposed to the more complicated reasons behind crisis events. In the case of the financial crisis, there was clearly a rush to put the blame on banks for offering improper loans to naïve consumers (see Foote, Gerardi, and Willen 2012 for an overview and debunking of this narrative). Despite studies that discount this explanation, the public can hardly be trusted to weigh the evidence objectively. This is especially so when politicians have an incentive to exploit and even stoke public ignorance for electoral advantage. For example, Congress established an official blue ribbon Financial Crisis Inquiry Commission to investigate the causes of the financial crisis—but then enacted the Dodd-Frank financial reform legislation months before the commission submitted its report.[20] Kuran and Sunstein even go so far as to argue that bureaus should have institutional barriers such as mandatory cost-benefit analysis, peer review by other agencies, and congressional oversight to reduce this rush to judgment (pp. 751–54).

Zywicki (2012a) pointed out early in the CFPB’s life cycle that the bureau’s insulation from institutional oversight would cause bureaucratic mischief. Kuran and Sunstein’s insight contributes to this point by showing how consumers can be a source of bureaucratic missteps as well. Put another way, reducing a bureau’s insulation from institutional oversight not only

[20] http://www.gpo.gov/fdsys/pkg/GPO-FCIC/content-detail.html.

exacerbates internal mischief but may allow for external mischief as well in the form of overwhelming popular encouragement of what in the end are questionable solutions to complex problems.

The irony is that the CFPB is not only especially prone to populist alarmism, but is itself arguably a product of such availability cascades. Smith and Yandle (2014, chapter 6) explain how the CFPB emerged from the financial crisis as a means of dampening public resentment over the government bailout programs, which largely targeted supply-side considerations. In this sense, the CFPB placates consumers angry over a highly complex chain of events that was the 2008 financial crisis and further allows for future policies that assuage public sentiment. Ensuring safe mortgages, targeting annoying credit card fees, and protecting student debtors from aggressive lenders are all issues that resonate with the public. They may even be beneficial to consumers. Nevertheless, popular sentiment is hardly an effective gauge of effective reorientation of such a complex set of transactions. Moral outrage must be coupled with—or, better yet, overcome by—rational consideration, lest such measures end up harming the very consumers they are supposed to protect.

Departure 2:

Bureaucratic incentives contradict the assumptions contained in the BLE framework.

But it is not enough to recognize the difficulty bureaus have in dealing with consumers and special interests. We must also take into account the interests of the politicians and bureaucrats responsible for actual political outcomes. This constitutes a powerful point often made in political economy, and one that the BLE paradigm totally ignores: public officials have their own unique set of interests that are somewhat independent of the policy goals prescribed for them.

Consider the parameters of the CFPB's operation. Niskanen (1971) articulates the now well-known principle that bureaus tend to grow larger, not smaller, over time. This is already evident in how the CFPB has approached the area of student loans. While the CFPB's efforts have focused on private lenders, it is clear they want authority over public lenders, too. In a rule proposed in March 2013, the agency sought to oversee nonbank student loan servicers. While it did not name any servicer in particular, it did include any company servicing more than a million accounts, which would, of course, include the largest servicer, Sallie Mae. It is unclear at this time whether the agency will be successful in this endeavor. What is clear is that the agency is seeking to grow at a greater pace than its original mandate allowed for or anticipated (Carrns 2013a).[21]

Also, bureaucrats often become entangled with the firms they attempt to control. Labeled the capture theory of regulation (Stigler 1971), this entanglement can occur for a variety of reasons. It may be that regulators are too dependent on the expertise of regulated firms when determining appropriate policy solutions. Or it may be due to a revolving door between private firms and public bureaus, with individuals cycling between the two as their careers progress.

While it is far too early in the CFPB's development to see ample evidence of this, one fascinating anecdote is worth noting. Raj Date, who served as deputy director of the CFPB until early 2013, exited the agency in order to go into business for himself. What is intriguing about this move is that Date is going into an area the CFPB is attempting to curtail, that of unqualified mortgage loans. While the industry is downsizing its involvement in this area, Date claims that the area is under-served and that the risk is manageable. He is also taking several former CFPB officials with him, including Garry Reeder, the bureau's former chief of staff,

[21] http://files.consumerfinance.gov/f/201303_cfpb_fact-sheet_larger-participants-student-loan-servicing.pdf. Visited November 25, 2013.

mortgage servicing expert Chris Haspel, and Mitchell Hochberg, a former regulatory lawyer with the agency (Zibel 2013b).

With his unique inside knowledge of the decision-making process within the CFPB, surely Date has an advantage in determining how to skirt the boundaries set forth by the very bureau for which he used to work. He will be able to expand an area of mortgage lending that the bureau is attempting to contract. Putting aside the questionable ethics of such a move, this demonstrates that actors within public bureaus cannot be counted on to always uphold the values put forth by their advocates.

Finally, transparency is a curious assumption to make of a bureau. Self-interested public officials often will only act transparently when appropriate constraints are placed on them. Given the CFPB's independence from congressional oversight noted above, we can assume that transparency is not obviously forthcoming. Indeed, in an otherwise fairly supportive report on the CFPB, the Bipartisan Policy Center (2013) maintains that the CFPB lacks transparency in much of its decision-making. For example, the CFPB does not publish its hearings in the *Federal Register*, the official journal of the federal government. It also gives little in the way of advance notice of its hearings, which nevertheless can affect large portions of the financial sector. And it fails to consult primary stakeholders in a large number of cases. The report states that "the CFPB should not, whether in appearance of practice, grant preferential access to one group at the exclusion of another but should instead emulate the transparency practices of other federal agencies by allowing robust participation in its regulatory efforts by both consumer groups and regulated entities" (pp. 38–39). Lack of transparency not only dampens bureaucratic accountability, but can also bias decision-making—as we will now show.

Departure 3:

Bureaucrats are themselves susceptible to behavioral biases.

To put it mildly, proponents of BLE significantly underestimate bureaucratic bias. Thaler and Sunstein appreciate that choices do not take place in a vacuum. Context matters. Sunstein (2013) even says that a Behavioral Public Choice would prove useful in supplying the field with a means of understanding potential biases on the part of policymakers (p. 37).

But to date, this vein of analysis is left almost totally unpursued. Berggren (2011) exposes this lacuna in analyzing behavioral studies performed in the last 10 years in the top 10 journals in economics to see just how behavioral theorists treat political institutions when offering policy prescriptions. He specifically asks (a) whether the authors offer explicit policy prescriptions and (b) whether they incorporate political institutions into their model/ experimental design. The criteria for this latter element is fairly wide, as he only looks to see whether they apply their findings to the political actors themselves; that is, whether the politician is cognitively limited in the same manner as everyone else. Berggren finds that 20.7 percent of behavioral theorists offer policy prescriptions in the leading journals. He further finds that 95.5 percent of the articles offering policy prescriptions do not apply their analysis to the politicians themselves.

Nevertheless, a public choice architecture remains to be uncovered through which any correction to private choice architecture must emerge. Surely one of the more dangerous biases of public officials is the presence of confirmation bias. As pointed out above in the context of complex mortgages, the CFPB is already susceptible to this bias, its claim to use evidence-based decision-making notwithstanding. Instead, the bureau seems to more appropriately employ the method of policy-based evidence-making. Relying on self-reported claims of consumer fraud should not be construed as following the scientific method. Those who report claims are not randomly selected from the population of consumers of financial services. Those who go through the trouble of actually reporting issues probabilistically speaking represent the tails of the distribution. Only at the CFPB are self-reported survey instruments considered credible sources of opinion.

Glaeser (2006) provides additional evidence for this consideration. He models choice architecture across two corresponding contexts, one public and one private, starting from a position of behavioral symmetry across the two contexts and then introducing certain institutional parameters to estimate the capacity for bias in decision-making. He outlines three cases where the capacity for error is endogenous to the private or public context, and finds in each case that the public context is likely to generate more errors, not fewer, than the private context. These results were primarily due to private actors having a greater incentive to discover and correct errors than public actors. He maintains, "The flaws in human cognition should make us more, not less, wary about trusting government decision-making. The debate over paternalism must weight private and public errors."

Cooper and Kovacic (2012) expand on Glaeser's work by showing how policymakers are particularly subject to myopic behavior, inertial tendencies, and confirmation bias. They point out that while market actors are subject to offsetting signals, policymakers have less in the way of ongoing, explicit feedback that would reveal these shortcomings. We know that politicians make errors in systematic ways (see for example Sobel and Leeson 2006 for a discussion of various biases displayed by the FEMA response to Hurricane Katrina). What makes this notable in BLE-informed policy areas is that policymakers are no longer subject to the same evidentiary constraints when determining the efficacy of their efforts. Wright (2011) goes so far as to claim that this shift in government activities is in paradox with the traditional standards of the older Welfare Economics approach; that is, if consumers are not presumed rational, then their revealed preferences are largely irrelevant in ascertaining the value of their choices. Yet the Welfare tradition, which guides benefit-cost analysis, is founded on just this claim. Once we remove the plank, the preferences of the consumer are scattered to the wind, to be replaced by those of the government bureaucrat.

Departure 4:

BLE fails to provide policymakers with alternative explanations of consumer behavior to overcome confirmation bias.

Thaler and Sunstein recognize that bureaucrats are not perfect, as we outlined above, but argue that they are privy to a greater level of expertise and information than the average consumer. Putting the opportunity for political mischief aside, can we rely on this expertise as a sufficient constraint on biased decision-making by the bureaucrat? The evidence the CFPB offers leaves us skeptical. For example, the CFPB's insistence on "plain vanilla" products and simple mortgages implies an inability to recognize heterogeneity among consumer tastes. But this in itself is a byproduct of the BLE framework. Once we remove the assumption that consumers are rational, the substituted schema for adjudicating rational decisions relies on a narrow vision of what some idealized consumer would want. Furthermore, this reductionism severely limits the role of empirical evidence in judging the underlying soundness of the framework. Once the idealized consumer is constructed, real-world choices that diverge from this framework are dismissed as biased, while confirming evidence (if any) is automatically weighed more heavily as supportive of the underlying BLE model.

The interventionist recommendation by Bubb and Pildes (2014) noted above is a particularly striking example of this tendency within BLE thinking (Zywicki 2013c). Recall that one of the examples they stress (following Willis) was the Federal Reserve's adoption of rules requiring bank customers to opt in in order to receive overdraft protection for point-of-sale and ATM debit card transactions. One stated purpose of the rule was to "protect" heavy users of overdraft protection (those with more than 10 overdrafts per year). Nevertheless, after the rule was adopted, heavy users of overdraft protection were those who were most likely to opt in—a result, as noted, which is entirely consistent with standard economic analysis. For Bubb and Pildes, however, the failure of the policy to change the behavior of heavy overdraft users was instead interpreted as evidence of how deeply irrational those consumers are, necessitating still more forceful government measures in order to bring about the desired result. In short, Bubb and Pildes have created a nonfalsifiable hypothesis: once the central planner has decided that a certain consumer behavior is irrational, the continued persistence of consumers in that behavior is seen as further evidence of the depth of the irrationality. The example of overdraft protection is especially telling, therefore, because the consumer behavior in question so strongly supports the hypothesis of standard economic behavior, namely that consumers use overdraft protection rationally in light of the constrained options that they face (Zywicki 2012b). As we noted above, the possibility that the observed behavior is inconsistent with the model's assumptions of irrationality should at the very least be addressed, if not accepted as evidence that consumers are acting rationally.

To serve as a viable policymaking framework, BLE has to be able to account for alternative explanations for consumer behavior. This is particularly important, given the knowledge that policymakers are already subject to confirmation bias. Glaeser's work, along with Cooper and Kovacic, is just a start in this regard. This is not to say that all behavioral prescriptions are null, for surely there is great potential for improving choices. But it does call into question the effectiveness in practice of policy prescriptions generated without offering alternative explanations for consumer behavior.

Departure 5:

Experts can never know as much as the market can in guiding consumer behavior.

Another problematic assumption made by the BLE framework is that of information and expertise. Thaler and Sunstein argue that while no one is perfect, experts are better positioned to make sense of the difficult choices consumers make. We don't dispute that experts have something to say (to be sure, this would be a somewhat self-deprecating claim). We do dispute, though, the idea that experts can ever know enough to fully understand the choices confronting consumers.

Information retrieval on financial decision-making is no trivial task. Consumers approach financial decisions from an indefinite number of perspectives. As we saw with complex mortgages, consumers may be tricked but can also do the tricking. In a similar vein, Brown and Plache (2006) survey consumer financial behavior in the use of credit cards; they find that credit card holders who pay off their monthly balances tend to have more credit card services, not fewer. In other words, there is no indication that these services are there simply to trick consumers into a raw deal. Which perspective is "right" ignores the fact that multiple perspectives can be held at any one time when looking at consumer behavior as a whole. The best the expert can do is try to get the best information possible into each consumer's hands.

Even proponents of more aggressive BLE-style approaches recognize the limitations of generating intended responses. Willis (2013) points out that "when firms oppose nudges, they respond to the change dynamically" (pp. 1227–28) in a way that is difficult, if not impossible, to predict ex ante. If behavior does not move in the intended direction, then it is hard to argue that consumer welfare has been improved, at least according to the precepts of BLE.

Departure 6:

Lack of appropriate information leads to heavy-handed policy ("shoves").

It is in fact because of this deficiency in information that policymakers are likely to be more heavy-handed than (at least some) BLE advocates prefer. Both Willis (2013) and Bubb and Pildes (2014) point out numerous cases of BLE policies gone astray. But in light of this failure to generate intended outcomes, they advocate even stronger intervention. Much of this reaction seems to emerge from frustration with results not syncing up with the underlying BLE paradigm. In a telling comment, Bubb and Pildes claim it is hard enough to regulate firms when they are congenial with behavioral advisors, and that nudges such as "disclosure mandates imposed on lenders in the wild are likely to be even less effective" (p. 55).

The authors may yearn for a utopian world under the control of behavioral policy advisors, but the environment in which policymakers actually operate involves a far more complex network of marketplace exchanges than even the most aggressive type of behavioral interventions would render controllable. Wagner (2007) makes the case that market and public organizations resemble more an entangled network of interests than a streamlined causal mechanism with public organizations moving market organizations in the "right" direction. Put another way, it is not as if public organizations act first and then private organizations respond in predictable fashion. Instead, you have a network of competing private organizations tied to various public organizations—such as the CFPB—which anticipate and respond in unpredictable ways to policy, while at the same time attempting to offset these changes by appealing to other public organizations like Congress.

Recognizing that policymakers operate in this more complex environment offers a more pragmatic perspective on the nature of political change. Public organizations like the CFPB cannot simply reorient consumer choice in the direction they want. At best, they can only remove options from the consumer's choice set. Even then, it is difficult to anticipate how both consumers and firms will react to these new constraints. As we noted above, consumers in dire straits may not have the luxury of securing credit on favorable terms. Desperation may force consumers to pursue risky options. Removing these options then does not solve the underlying dilemma. It only pushes these consumers to even riskier options (e.g., loan sharks).

Unfortunately, these unintended consequences have done little to assuage the bureau's tendency to handpick market solutions rather than serve as a source of guidance. This tendency for the CFPB to attempt to control market outcomes makes sense when paired with the point made above regarding information retrieval. Creating a rule that enables all consumers to make better choices is quite possibly not feasible. The amount of nuance required, along with the omniscient understanding of choice contexts for all consumers, is a burden no bureaucrat will ever surmount. So instead, policies are used as bully instruments. While this may pacify public servants, it makes life difficult for those who have to make life choices in a newly restricted domain of credit services.

This is perhaps why, contrary to their more aggressive brethren, Thaler and Sunstein are quite clear in their assertion that choice should be improved, not controlled (Thaler and Sunstein 2008, 251–54). They optimistically believe that bureaus will feel the same. But instead the CFPB essentially bullies firms into choosing market services that the bureau itself endorses. Whether this is best for the consumer is left up to debate. That it departs from the BLE paradigm set up by its progenitors is not.

VI. Conclusion

We have shown that policy departs from the prescriptions of BLE largely due to the context of public choice. Like Thaler and Sunstein, we encourage the development of better choice architecture. But to passively assume that this can be generated by the political process is to limit the very science that informs us of the need for better choices. Instead, we must consider choice architecture, in both the private and the public context.

We therefore echo Berggren's sentiment that BLE is much in need of a complementary behavioral political economy framework. Theorists should not assume that policymakers will automatically follow through with their suggestions, especially when these suggestions can be used to do more harm than good. Instead, the set of assumptions applied to private choices should be applied to public choices as well. Behavioral theorists have a comparative advantage in understanding the potential for bias in choice. It is high time this was applied to the realm of politics.

Also, autonomous consumer choice should receive greater priority. Regulatory bodies inevitably will have an effect on the services firms choose to offer. Still, a less antagonistic approach would allow consumers to choose from a wider variety of options. And as Klick and Mitchell (2006) argue, paternalist intervention is likely to be most error-prone in environments with heterogeneous goods like consumer credit (p. 1657). The CFPB is best placed as a resource for guiding consumers to accurate information on financial products. As it deviates from this function, it ironically loses control over the choice context consumers face, forcing consumers to pursue even riskier options.

Echoing arguments made by Cooper and Kovacic (2012, 53–54), we believe "adversarial review" by an independent body of experts, possibly housed elsewhere within the Federal Reserve, should inform the analysis made by the bureau. Policy suggestions by the CFPB could be vetted by this body, which could then offer an opinion that may or may not coincide with the conclusions of the CFPB. We noted several instances of this above, where members of the Federal Reserve have come to conclusions contrary to those of the CFPB. Clearly, the capacity for balanced debate exists; it is only a matter of utilizing these services.

Furthermore, the CFPB should apply more rigorous data-collection procedures, such as those used in the survey conducted by Durkin and Elliehausen. Self-reporting bias is a well-known flaw in survey design, where those with extreme opinions tend to dominate the observations. A randomly selected sample from the population of those who use credit instruments would better inform the agency about what the true opinion is of existing credit services. Any foul play discovered should be balanced against the benefits the average consumer reports.

Finally, the CFPB's structure should resemble more closely that of comparable agencies, such as the Federal Trade Commission or the Securities and Exchange Commission, both of which are bipartisan commissions and subject to congressional oversight. By making the agency so autonomous, all the difficulties and problems outlined above are only exacerbated. Consumer choice is an area that government should tread lightly. Better institutions—and accompanying institutional analysis—can go a long way toward achieving the goals of the BLE framework.

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