



## BEHAVIOR, PATERNALISM, AND POLICY Evaluating Consumer Financial Protection

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The Consumer Financial Protection Bureau (CFPB) is a powerful government agency founded on the paternalistic notion that a regulator can protect consumers who are incapable, through either ignorance or irrationality, of making the best choices for themselves. [In a paper](#) for the Mercatus Center at George Mason University, scholars [Adam C. Smith](#) and [Todd Zywicki](#) argue that the policy prescriptions emerging from the CFPB are inconsistent with the intent of improving consumer choices. Moreover, policymakers at the CFPB are susceptible to biases and errors in decision-making similar to those of the consumers they seek to protect.

### BACKGROUND

Decision-making at the CFPB is guided by principles of behavioral law and economics (BLE). BLE proponents believe that consumers make systematic errors when choosing financial products and services; they claim that government regulators are better suited to understanding those choices and should seek to correct them through public policy.

For example, some BLE proponents claim that consumers of credit are often ignorant of the indirect costs of their choices, particularly in the mortgage market. One proposed solution would require mortgage companies to offer a synopsis of each loan's conditions, including interest rates by year, worst-case scenarios, and an upfront disclosure of all fees, rates, and provisions.

Despite the lofty goals of BLE, policymakers unfortunately fail to follow through by implementing these fixes properly, for a variety of reasons.

### CONSUMERS' PUBLIC CHOICES ARE BIASED TOO

Consumers acting in their public role as voters tend to be ignorant and irrationally support initiatives that end up hurting them. Special interest groups can manipulate the political process when consumers of public services are naïve about their value. Additionally, consumers can be caught up

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in “availability cascades,” which cause the public to erroneously blame crises on immediate causes rather than the complicated reasons truly responsible. In the case of the CFPB, the lack of institutional oversight may lead to questionable solutions to complex problems—solutions based on public misunderstanding rather than actual information.

## REGULATORS ALSO HAVE INCENTIVES AND BIAS

### **Bureaucrats Lack the Incentives to Properly Execute Policy Goals**

Agencies such as the CFPB are subject to a variety of pressures that undermine policy goals:

- *Capture by the firms they regulate.* Regulators may be dependent on expertise from within the regulated industry, and there may be a revolving door between the agency and the private sector. The CFPB’s former deputy director, Raj Date, left the agency to go into business selling the product he literally wrote the regulations for. Specifically, he is using his knowledge of unqualified mortgage loans to expand an area of mortgage lending that the bureau is attempting to contract, guided—ironically—by Date’s own previous rulemaking.
- *Growth in size and scope beyond their original mandate.* The CFPB has attempted to expand its authority over student loans, which originally only extended to private lenders. In a 2013 proposed rule, the CFPB sought to oversee nonbank student loan servicers such as Sallie Mae. The agency has also tried to regulate auto lenders indirectly through their connection to banks, even though the Dodd-Frank Act specifically forbade regulatory interference in this area.
- *Lack of transparency in the decision-making process.* The CFPB does not publish its hearings in the Federal Register and gives little advance notice of hearings. It also often fails to disclose to targeted firms the reasons for its investigations, or to justify its typically onerous requests for documents.

### **Bureaucrats Are Also Susceptible to Behavioral Biases**

Proponents of using BLE in policymaking significantly underestimate bureaucratic bias, particularly confirmation bias. Policymakers are especially subject to systematic bias in their decision-making because they do not receive ongoing, explicit feedback, as actors in a marketplace do.

For example, the CFPB is employing policy-based evidence-making: using self-reported instances of consumer fraud in a manner inconsistent with the more appropriate method of random sampling. People who report claims are not randomly selected from the population, and they overrepresent the extremes of consumer experiences (e.g., consumers with an ax to grind that may have little to do with the behavior of the financial company). Self-reported claims of fraud are not a credible metric for policymaking.

## REGULATORS ARE IGNORANT ABOUT CONSUMERS

### **Policymakers Don’t Entertain Alternative Explanations for Consumer Behavior**

Policymakers fail to consider that consumers may, in fact, be rational even when they make choices different from those prescribed by BLE. Markets serve a wide variety of consumers who

are exercising different preferences subject to different constraints. BLE offers little in the way of alternative explanations for heterogeneous behavior, and as a consequence tends to create nonfalsifiable hypotheses. Once a regulator has decided that a certain consumer behavior is irrational, even without evidence to support the decision, the persistence of that behavior is seen as further evidence of consumer irrationality.

For example, a recent rule enforced by the Federal Reserve requires that bank customers opt in before receiving overdraft protection. The stated purpose of the rule was to “protect” heavy users of overdraft protection from fees. However, after the rule’s adoption, heavy users were those most likely to opt in, suggesting they actually wanted the protection and were making a rational choice consistent with standard economic behavior.

### **Experts Know Less about Consumer Behavior Than the Market Does**

There can be multiple accurate perspectives on consumer behavior; regulators who ignore some of those perspectives risk failing to appreciate the complexity of consumer behavior. For example, credit card holders who pay off their monthly balances tend to have more credit card services, indicating that credit card services don’t exist simply to trick consumers into a raw deal. Policy aimed at “correcting” consumer behavior may not be needed, and therefore will not work as intended (e.g., regulation of overdraft protection).

### **Without Appropriate Information, Nudges Can Lead to Shoves**

Government agencies operate in complex environments—consumers and businesses anticipate and react to policy in unpredictable ways. The CFPB cannot reorient consumer choice in any direction it wants; it can only eliminate certain choices. Removing options may appeal to the agency but fail to solve the underlying problem, and in fact shift consumers to riskier options. For example, when regulators remove credit options like payday lending, consumers may turn to loan sharks instead. As a result, government agencies may turn to even more coercive measures to control consumers.

## CONCLUSION

Those who seek to implement BLE in agencies that aim to improve consumer choice must not assume that policymakers operate under ideal conditions—that is, without bias and with all the information necessary to make informed decisions. Agencies should prefer autonomous consumer choice, unaffected by regulatory policymaking, and the CFPB would best serve consumers by guiding them to accurate information on financial products, not restricting or altering their choices. Finally, CFPB decisions should be independently reviewed and those decisions should be subjected to rigorous data-collection procedures to ensure their accuracy as well as the agency’s overall accountability.