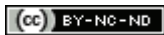


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RETHINKING CONSUMER PROTECTION POLICY IN FINANCIAL MARKETS

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Liran Haim^{*}

ABSTRACT

Financial products for consumers usually are characterized by complexity and incomprehensibility. Consumers typically find themselves defeated when attempting to control their financial destiny by understanding these products. This Article explores the economic and social factors that lead to this reality, analyzes its highly negative private and social ramifications and proposes an appropriate policy response. I argue that the current market structure creates a reality in which financial institutions are motivated to produce complex financial products for consumers in order to maximize their profits. This market structure, combined with inadequate policy, induces inefficiency by allocating the comprehension costs of financial products to the consumer.

My thesis is that a fundamental change in risk allocation policy will steer the market toward consumer comprehension of financial products and, therefore, will reduce private and social costs, increase consumer trust in financial institutions and promote social cohesion. I propose a new default liability rule under which financial institutions would be required to introduce internal procedures and mechanisms to ensure product comprehension among all of their consumers. To encourage maximum compliance with my proposal, I suggest implementing a reputation-based incentives method that would require every financial institution branch to

^{*} Visiting Scholar, Columbia Law School; Fellow Lecturer, Faculty of Law, University of Haifa. This Article greatly benefited from excellent comments received by Ricardo Ben-Oliel, Benjamin Geva, Mahmut Kobal and Ronald Mann. I thank Marco Bellia, Stephan Meier, Francesco Palazzo and my colleagues in the center of international programs at Columbia Law School for valuable suggestions and stimulating conversations during the preparation of this Article. I am also grateful to Noa Alsheich for insight, inspiration and help of any kind.

publicly post a service quality ranking assigned by the regulator. I also support a trust-oriented licensing policy that would encourage the inclusion of new trustworthy financial institutions in the market and offer the implementation of a new regime for supervising financial product contract terms.

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INTRODUCTION

Financial products for consumers are too incomprehensible. What are the factors that create this reality? Should it bother also those who understand what an APR is, how best to repay their student loans, or whether it is worthwhile to take out a mortgage? What role do financial institutions play in this reality, and should they be obligated to do more?

Although these questions served as the backdrop to several topics of research during my academic career, I finally became motivated to examine them as a wider phenomenon last January. I had been invited to a dinner with a colleague of mine who just recently moved to New York. He had spent the previous several days searching for the least expensive way to transfer funds from his home country to the United States and finally decided to do so by opening a local “free checking account” in a large federal bank. When he examined his balance sheet a few days after the fund transfer, he was surprised to discover a charge of \$30 more than he had been informed of when opening the account. A short conversation with his new banker revealed that the extra \$30 represented a “correspondent fee,” which is a payment for a mediating bank (the correspondent) involved in executing the money transfer.

As no one had directed his attention to the existence of a correspondent bank and to the possibility of this extra charge in advance, my colleague complained that all those hours spent searching for the cheapest products had been for naught, and that if he had been able to understand that the fee would include an extra \$30 he would have used a money order. He also expressed his general frustration with the industry, claiming that there is no reason to research the prices of basic financial services, since in the end they are completely incomprehensible; therefore, he claimed “it’s just a total waste of time.”

Although I had encountered similar incidents in the past, and had even contemplated the idea that there was a larger problem behind them, this story crystalized the issue for me: here was a well-educated and informed consumer who had conducted a market survey for the most efficient product, and still he could not make the most profitable decision.

Unfortunately, this is a recurring story. Among those affected are: homeowners who lost their homes since they could not understand the fee structures on their mortgages when they were issued; consumers who suffered great financial distress since they did not understand the concepts

of “double cycle billing” or “universal default” on their credit card plans; or still other consumers who simply had observed the distress of others, lost their trust in the mainstream financial system, and opted out from becoming its consumers before even trying. However, what caught my attention this time was the repeating universal pattern of “too complex” and “too incomprehensible,” along with the fact that these are not just products designed for well-advised corporate clients, but, rather, a daily problem experienced by nearly every consumer who uses financial products. All of the above led me to believe that these individuals’ stories point to a larger phenomenon—that something is fundamentally wrong with our financial market’s consumer protection policy.

Therefore, in this Article I will address the issue of “too complex” and “too incomprehensible” financial products for consumers and their effect on the market. As the topic of financial products for consumers is as broad, varied and complex as the products themselves my discussion will focus on the more prominent market failures and policy decisions that influence the issue of consumer financial product incomprehensibility.

The discussion will go as follows: In the first part, I will analyze several unique characteristics of the consumer financial products market and present empirical data with respect to its complexity. In the second part, I will focus on the main causes of financial product complexity, arguing that under the current market structure financial institutions are motivated to maximize their profits by offering products that are too complex for comprehension by consumers. The third part will analyze the major failures caused by product complexity in the market of financial products for consumers, emphasizing the high costs incurred by consumers and the decrease in social welfare. The fourth part will analyze the approach taken by policy makers in order to deal with the market failures that result from consumer financial product complexity. I will argue that since complex financial products are considered to be a market constraint, regulators mainly focus their efforts on dealing with their incomprehensibility on the demand side of the market. This policy, together with market conditions, allocates the comprehension costs of financial products toward consumers by default. Finally, in part five, I will propose a change in risk allocation rules that shifts the costs of complexity to financial institutions, making it mandatory for them to adopt internal procedures and mechanisms that—by default—will ensure the result of financial product comprehension by each of their consumers. I will also propose several supportive measures for

steering the market toward the direction of comprehensibility. These measures will include a reputation-based incentive system that will require every financial institution branch to publicly post its assigned service quality ranking. It will also include a new trust oriented licensing policy that supports the inclusion of new trustworthy financial institutions in the market, as well as a new regime for supervising financial contract terms. As I will describe, my proposals stand not only to increase market efficiency, but also to engender important social values. My suggestions will be followed in part six by practical recommendations for policy makers and courts.

I. UNDERSTANDING THE MARKET

The issue of product complexity exists in many different fields of consumer contracts.¹ Nevertheless, when discussing financial products for consumers several unique realms should be considered.

First, financial services are an essential gateway for any consumer who wishes to take part in the social mainstream. Basic options, such as receiving a salary, renting a car, purchasing on the internet and remote payment of bills, are hardly available to consumers without access to deposit-based products, electronic means of payments and other mainstream financial products. Therefore, while complex hotel packages or unclear mobile-phone bills might exclude consumers from using a specific retail product, the exclusion from the financial mainstream has much broader implications on a consumer's life and social standing.

Second, using financial products without understanding them exposes consumers to far more severe consequences than other ill-advised uses of retail products—a result that can be devastating to a consumer's entire life,

¹ See, e.g., RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS AROUND THE WORLD 128–38 (2007) (analyzing complexity aspects of credit card contracts); OREN BAR-GILL, SEDUCTION BY CONTRACT: LAW, ECONOMICS, AND PSYCHOLOGY IN CONSUMER MARKETS 66–68, 141–45, 208–11 (Oxford Univ. Press 2012) (analyzing complexity aspects of credit card, mortgages, and cellular contracts); Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q. J. ECON. 505, 506–08 (2006) (mentions a few complexity aspects in the printer market and in hotel chains).

and sometimes even to her family.² For instance, a consumer can lose her house due to a misunderstanding of the terms of her mortgage. Establishing a pension or life insurance plan can influence the rest of a consumer's life. A consumer may find that her checking account has been depleted after losing her debit card. Her life savings may be lost due to investments that she did not fully understand. Additionally, she can be thrown out of the financial mainstream due to a bad credit rating.

Third, financial products use terminology that—whether we like it or not—creates cognitive barriers of comprehension among large segments of the consumer population.³ Terms such as compound interest, revolving credit, nominal APR, etc., have a built-in cognitive mechanism which makes them more difficult to be understood and explained than free calling time on a cell phone or the amount of rides on one's MetroCard.

Fourth, the cumulative risk that consumers may lose their trust in financial institutions due to their incomprehension products has broad social consequences that do not exist with respect to any other product. Simply put, when many consumers who have lost their faith in financial institutions decide to run and withdraw their funds from their banks, society pays the price of the collapse of our financial system.⁴

Understanding the special characteristics of consumer financial products is the first step to understanding the products on the market and their social importance. However, the second, no less important realm is that the current mainstream financial products are too incomprehensible for consumers.⁵ It is enough to examine basic data to grasp the scale of the phenomenon. According to a recent Consumer Financial Literacy Survey, 33% of consumers could not anticipate the fees they would be charged by their bank or credit union.⁶ A previous survey conducted in 2011 found that

² Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 7, 16 (2008) (defines credit products as the most complex products in the marketplace).

³ Melvin Aron Eisenberg, Comment, *Text Anxiety*, 59 S. CAL. L. REV. 329, 334–35 (1986).

⁴ Luigi Guiso, *A Trust Driven Financial Crisis. Implications for the Future of Financial Markets* 11 (European Univ. Inst. Dep't of Econ., Working Paper 2009).

⁵ See Bar-Gill & Warren, *supra* note 2, at 5 (“... innovation in financial products has produced incomprehensible terms and sharp practices that hurt consumers and reduce social welfare”).

⁶ HARRIS INTERACTIVE INC., THE 2013 CONSUMER FINANCIAL LITERACY SURVEY 20, <https://www.nfcc.org/newsroom/FinancialLiteracy/index.cfm> (last visited July 20, 2013) (stating that the surveyed consumers were surprised in the past by a bank or credit union, for example, with regard to unexpected charges, holds on their money, or overdraft fees).

29% of adult consumers experienced the same difficulty with mortgage payments.⁷ It also found that 28% of adult consumers did not order a copy of their credit reports since they did not believe it would be of any use.⁸ This data regarding consumers' incomprehension of their daily financial products is amplified by initial data from the Consumer Financial Protection Bureau (CFPB), which state that 65% of all complaints filed to the Bureau in 2012 were resolved after an explanation was provided by the financial institution to the consumer's complaint.⁹ This data suggests that such an explanation was not available or clear to the consumers when they purchased the product. More broadly speaking the data also indicates a phenomenon that I will discuss further later on: consumers do not truly understand most of their financial products most of the time.¹⁰

Incomprehensible financial products for consumers influence market behavior in a very specific manner. Among other market rules, financial efficiency depends on price-based competition. In order to accomplish price-based competition, consumers must first understand the product that they intend to purchase. They should then be able to search the market for less expensive alternatives, and finally be allowed to switch from a more expensive option to a cheaper one. As ensuring a functional market of financial products is crucial for modern society, it is to be expected to be one of society's first priorities. Nevertheless, when consumers cannot understand basic attributes of their products due to their incomprehensibility, they cannot undertake any efficient searching or switching actions. Should they attempt to do so, many of them will find that the product price has increased tremendously due to transaction costs. In the context of this Article, the most important costs are information (and its comprehension), search and switching costs. As we will see, when these

⁷ HARRIS INTERACTIVE INC., THE 2011 CONSUMER FINANCIAL LITERACY SURVEY 11, http://www.nfcc.org/newsroom/FinancialLiteracy/files2011/NFCC_2011Financial%20LiteracySurvey_FINALEPORT_033011.pdf (last visited July 20, 2013) (stating that 29% of surveyed consumers suggested that the terms of their mortgages turned out to be different than what they had initially expected).

⁸ *Id.* at 13–14 (stating that 65% of adult consumers have not ordered a copy of their credit report during the past 12 months, and that 43% out of them did not do so as they believed it will not be useful).

⁹ CONSUMER FIN. PROT. BUREAU, CONSUMER RESPONSE ANNUAL REPORT 24–25 (2012) (As mentioned in the report, the program became fully operational only at the end of 2012.).

¹⁰ *Id.* at 23–26; *see also* Bar-Gill & Warren, *supra* note 2, at 27 (citing a survey by the Center of American Progress and the Center for Responsible Lending which found that 38% of consumers believe that most financial products are too complicated for them to understand).

costs become too high in comparison to the product price and predicted benefits, they have the potential to create a disincentive for consumers to choose their products on price-related bases.

To the naked eye, all consumers enjoy the privileges of a competitive financial market. They can search for financial services on the web, and especially in the various financial institutions' pages, and they can also choose their financial services providers freely. The large array of financial institutions in the country should also contribute to vigorous competition among those institutions. Nevertheless, despite this apparent reality, the overwhelming data suggest that around 22% of United States households have never changed their bank accounts and that switching banks based on price-related considerations has been done only by 15% of consumers.¹¹ Moreover, 28% of United States households do not use mainstream financial services, while one in every twelve households do not even have a bank account—those consumers evidently use more expensive and limited-function financial services.¹²

The aforementioned analysis and data create a paradox. On the one hand, financial products for consumers are the most basic and crucial of products, not only for consumers but for the entire society. On the other hand, however, at least some consumers seem to avoid making price-based decisions with regard to their products or simply leave the financial system, with all of the consequences that such a decision carries with it. As I will elaborate later, those failures are only the tip on the iceberg of product complexity. Many of them, as well as others, are caused by a combination of a market structure that encourages the design of complex financial products and policy decisions that are unable to resolve these complexity failures. All of those factors contribute to sky-high financial product transaction costs and damage important social values.

In order to fully evaluate these phenomena, my argument will continue in three main directions: First, I will isolate the current market characteristics which result in financial product complexity. Second, I will discuss the high additional costs that derive from that complexity. Third, I

¹¹ Elizabeth K. Kiser, *Household Switching Behavior at Depository Institutions: Evidence from Survey Data* 8 (Fed. Reserve Bd. Fin. & Econ. Discussion Series, Working Paper No. 44, 2002).

¹² SUSAN BURHOUSE & YAZMIN OSAKI, 2011 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED POPULATION 3 (2012).

will introduce the inefficiencies of the current policy that is being designed to address those products' incomprehensibility by consumers.

II. THE REASONS FOR FINANCIAL PRODUCT COMPLEXITY

As we can see, consumer financial products have the tendency to influence consumers' lives and society at large in vast ways. Why is it, then, that such important products, in particular, are considered to be the most complex of them all? When considering the reasons for financial product complexity, five main explanations can be offered.

First, financial institutions typically hide the "extra" costs of the product inside the contract, exposing only the initial costs and the product benefits to the consumer's naked eye. In this way, the unsophisticated consumer will encounter substantial difficulty in discovering the product's hidden attributes prior to being charged for them. While it might be expected that those kinds of mechanisms would not survive in a competitive market, the work of Gabaix and Laibson on the concept of "shrouding" products contributes greatly to refuting this belief. Based upon the previous work of DellaVigna, Malmendier and Ellison,¹³ the Gabaix and Laibson model emphasizes "shrouding" as a mechanism that firms use in order to increase their profits by influencing up-front consumer decisions to purchase products, while sheltering their "unappealing" attributes, such as surcharges, back-ended fees, penalties, accessories and options.¹⁴ For example, banks will introduce consumers to the benefit of a checking account, while "hiding" in their contract certain fees, such as debit fees, ATM charges, bounced check fees, and the like. Therefore, in a competitive market, financial institutions that use unshrouded products will not be motivated to educate ("debias") consumers, since this will only lead those consumers to use the shrouded products more sophisticatedly (instead of

¹³ Stefano DellaVigna & Ulrike Malmendier, *Contract Design and Self-Control: Theory and Evidence*, 119 Q.J. ECON. 353 (2004); Glenn Ellison, *A Model of Add-On Pricing*, 120(2) Q.J. ECON. 585 (2004).

¹⁴ Gabaix & Laibson, *supra* note 1, at 511–12; K. Jeremy Ko & Jared Williams, *The Effects of Regulating Penalty Fees for Consumer Financial Products* 2–3 (Sec. & Exch. Comm'n Div. of Risk, Strategy & Fin. Innovation, Working Paper No. 3, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2122793.

causing them to switch from the shrouded product to an unshrouded one).¹⁵ Consequently, shrouded products are an almost inevitable outcome of free market forces.

Second, as financial institutions do not create new tangible products, but rather base their business on managing the population's money, they must resort to much more complex ways of maximizing the efficiency of their product design. One of those ways is to design products that will have lower and simpler costs for consumers at the beginning of the product's life (referred to as teaser rates), while matching their revenues by requiring much higher and varied costs as consumers increase their use of the product. As studies show, many consumers will focus on the short-term costs of a product, while dismissing its long-term costs (especially when those costs are more difficult to understand).¹⁶ Moreover, as the switching rates in the market for consumer financial products are relatively low, most consumers are likely to encounter the complex, long-term costs of the product. In this reality, as time goes by, many consumers are likely to find themselves with products that have become much more complex to comprehend. For example, while some issuers in the credit card market have adopted for many years a pricing technique that is based on repayment of their interchange fees by their consumers, many other issuers have worked for a long time to adopt new pricing techniques that reduce the initial costs of issuing and using the card. As such, those issuers have been able to offer credit cards with low initial and permanent costs, while matching their expenses of producing the cards and paying interchange fees with their revenues from charging high interest rates.¹⁷ The result is that while many consumers purchased those cards in order to enjoy the low initial fees, they have ended up paying much more for their credit uses—an outcome that they usually did not understand when purchasing the card. The point emphasized by the above example is that this new pricing

¹⁵ Gabaix & Laibson, *supra* note 1, at 507; Ko & Williams, *supra* note 14, at 11.

¹⁶ MANN, *supra* note 1, at 137–39. Ted O'Donoghue & Mathew Rabin, *Doing It Now or Later*, 89 AM. ECON. REV. 103, 103–04 (1999) (discussing the connection between consumer impatience, sophistication and time preferences); Stephan Meier & Charles Sprenger, *Present-Biased Preferences and Credit Card Borrowing*, 2 AM. ECON. J. 193, 203–04 (2010) (concluding that present-biased consumers are more likely to use credit cards extensively).

¹⁷ Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 384–92 (2007).

technique was very complex for consumers to comprehend, and, therefore, it was the cause of great confusion for consumers at different stages of the product's life.¹⁸

Third, many mainstream consumer financial products use compulsory bundling as a pricing technique. This means that the products are designed in such a way that consumers are required to purchase a package of services that financial institutions can profit from as a whole.¹⁹ The most salient example is the checking account, in which the fee structure is usually in the form of a monthly charge which includes the use of several financial services. Those charges are oftentimes reduced or waived if a consumer is obligated to maintain a certain balance in the account. Bundling is a highly profitable mechanism for financial institutions: first, as consumers probably will not use all the different bundled services each month; second, since the bundled product assists in "locking in" the consumers it places financial institutions in a better position to supply other financial services to them; and third, as financial institutions profit from the balance that consumers maintain in the account. Nevertheless, for consumers, the bundling of several services together makes it difficult to appreciate those services' financial worth, as it inhibits their ability to evaluate or purchase each product on its own. Moreover, the more financial products are bundled together, many consumers will end up paying for services that they do not in fact need, but which are included in their "package." This is another element that renders financial products (or the packages of products) more complex and incomprehensible for consumers.²⁰

Fourth, one of the main ways for financial institutions to compete with one another is segmentation—namely, designing products that will best serve the needs of specific segments of consumers. In this way, costs and revenues can be planned better by implementing more accurate predictions

¹⁸ MICHAEL S. BARR, NO SLACK: THE FINANCIAL LIVES OF LOW-INCOME AMERICANS 89–90 (2012).

¹⁹ BAR-GILL, *supra* note 1, at 19–20; Oren Bar-Gill, *Bundling and Consumers Misperception*, 73 U. CHI. L. REV. 33, 38–46, 48–51 (2006). Barry Nalebuff, *The Strategy of Bundling*, in THE MANY FACETS OF LEADERSHIP 293, 295–301 (Marshall Goldsmith, Vijay Govindarajan, Beverly Kaye, Albert A. Vicere eds., 2002).

²⁰ BARRY NALEBUFF, BUNDLING, TYING, AND PORTFOLIO EFFECTS—CONCEPTUAL ISSUES 61–62 (2003), available at <http://www.dti.gov.uk/CCP/topics2/pdf2/bundle1.pdf> (describing the influence of bundling in obscuring true product prices).

of a specific segment's needs and typical uses of a product. The result of segmentation on the one hand is much more efficient and profitable financial products; but on the other hand, it creates an increase in the amount of similar financial products with different fee structures.²¹ Therefore, segmentation has the potential to cause consumer confusion over seemingly similar products (for instance several similar mortgage deals or a variety of checking account plans), despite the fact that one provides superior benefits over the other. Furthermore, as each financial product is characterized by a multiplicity of attributes, the segmentation process creates dozens and maybe hundreds of attributes worth consideration by consumers. As studies show, a consumer's ability to understand those attributes declines rapidly as their number increases beyond three.²² Therefore the segmentation process leads to products whose comprising attributes and different variations are too complex for the average consumer to comprehend.

Fifth, since financial products involve financial and economic aspects, they are easier to define with complex financial wording, which is unintuitive to consumers. While the employees of financial institutions and their lawyers might understand this language and its terms, most consumers cannot make much sense out of it. For instance, a 2010 study indicates that consumers are unable to understand basic terms in their recently obtained mortgage agreements, such as "amount financed" (the loan amount minus finance charges), or "discount fee" (which is a fee they need to pay). Worse yet, some consumers misinterpret "amount financed" as the total amount of the loan, and "discount fee" as a discount, and therefore they end up taking out much more expensive loans than they had anticipated.²³ Thus, we can

²¹ MANN, *supra* note 1, at 138. *See also* LIZABETH COHEN, A CONSUMER'S REPUBLIC 292–331 (2003).

²² Alan Schwartz, David M. Grether & Louis L. Wilde, *Irrelevance of Information Overload: An Analysis of Search and Disclosure*, 59 S. CAL. L. REV. 277, 296–97 (1986); MANN, *supra* note 1, at 134 (reviewing the literature).

²³ James M. Lacko & Janis K. Pappalardo, *The Failure and Promise of Mandated Consumer Mortgage Disclosures: Evidence from Qualitative Interviews and a Controlled Experiment with Mortgage Borrowers*, 100 AM. ECON. REV. 516, 518–19 (2010); *see also* Jeffrey Davis, *Protecting Consumers from Overdisclosure and Gobbledygook: An Empirical Look at the Simplification of Consumer-Credit Contracts*, 63 VA. L. REV. 841, 854–56 (1977) (finds that most consumers will face great difficulties understanding basic financial contracts such as credit card agreement).

see that a simple misunderstanding of financial wording can raise the level of complexity of financial products.

This Article's discussions thus far have led to the conclusion that under the current market structure financial institutions will produce complex and incomprehensible financial products in order to increase their profits. Not only do financial institutions lack incentive to change this reality, but it also appears that it is highly profitable arrangement for them. This situation begs the following question: is it so problematic that these products are complex? As I will elaborate, since product complexity leads to enormous private costs for consumers, reduces market competition, damages the social trust in the financial system and decreases social cohesion tremendously, it should be conceived as one of the more crucial problems of the market.

III. THE COSTS OF COMPLEX FINANCIAL PRODUCTS

A. Transaction Costs for Consumers

A consumer's thorough assessment of all of the available information regarding a product is essential to making an informed decision in a competitive market. When the product is a \$0.99 candy bar, an assessment of the information regarding the transaction is fairly simple. But, as a product becomes more and more complex, consumers might find that far more skills and resources are required in order to fully understand them, driving the additional costs of purchasing the product much higher. In a perfect market, those costs could cause inefficiency to the point at which consumers would consider giving up the use of the product. However, due to the nature of financial products, and especially their necessity in consumers' day-to-day lives this option is inconceivable for many consumers, extremely expensive for others, and might even result in high cost for society.

I will now proceed to examine the costs to consumers of understanding financial products, focusing on the market barriers that prevent them from comprehending those products while maintaining reasonable transaction costs. Since the costs of making sense out of financial products are extremely high, most consumers will not assume them and therefore will suffer the market inefficiency that comes with using incomprehensible products.

1. Information Costs

As I mentioned, in light of the various product designs, techniques and market structures, financial products are very complex. One of the ways in which the market attempts to deal with this complexity is to provide consumers with large amounts of information, which is usually delivered to them by financial institutions—either as a result of practice or, as I will elaborate later, based on mandatory requirements of disclosure. The declared purpose of this information is to impart consumers with knowledge that will allow them to fully comprehend the different aspects of the products they are using.

Under this premise, consumers who engage in the most basic transaction of opening a bank account will receive a 50-page booklet informing them of the different basic services and their fees; a consumer who issues a credit card will receive a lengthy credit card agreement detailing various interest rates, fees, legal provisions, etc.; and, most consumers of financial services will receive monthly statements and several other information packets on a regular basis.

While some consumers might review this kind of information to some extent, many others will find it impossible to do so. As recent data shows, 14.5% of adults in the United States lack basic literacy skills.²⁴ This figure indicates that those consumers are simply unable to make sense of written information in English in any form. Moreover, many more consumers lack the basic numerical skills required to understand basic financial information. For example, only 18% of consumers surveyed could correctly calculate how much they would save on a \$200 investment for two years at a 10% annual interest rate.²⁵ In another group, 30% of participants responded incorrectly to all three basic questions involving simple probability, percentage and portion calculations, while only 16% responded

²⁴ NATIONAL CENTER FOR EDUCATION STATISTICS, NATIONAL ASSESSMENT OF ADULT LITERACY (2003), *available at* http://nces.ed.gov/naal/kf_demographics.asp (stating that the interviewed adults demonstrated “below basic” English literacy skills, such as searching, comprehending, and using continuous texts, including editorials, news stories, brochures, and instructional materials).

²⁵ ANNAMARIA LUSARDI & OLIVIA S. MITCHELL, FINANCIAL LITERACY AND RETIREMENT PREPAREDNESS: EVIDENCE AND IMPLICATIONS FOR FINANCIAL EDUCATION PROGRAMS 8–9 (2007), *available at* <http://www.econstor.eu/bitstream/10419/25516/1/527633305.PDF>.

correctly to all three questions.²⁶ While illiterate consumers will have difficulty understanding many forms of products, innumerable consumers will find it especially difficult to understand financial products in particular, as numerical skills are essential to understanding basic financial concepts such as: compound interest, double cycle billing, APR, etc. Without understanding them, financial products will not make much sense. For those consumers the mere dissemination of such information by financial institutions reflects an unrealistic assumption—that they actually will be able to review the information without an immeasurable investment of resources.

However, illiteracy and innumeracy are not the only reasons that prevent consumers from reviewing the handout information distributed by financial institutions. Current studies show that due to several cognitive barriers and biases, the more complex and less appealing the information is to the eye, the more consumers tends to ignore it, even if they are able technically to understand its wording to some extent.²⁷ This tendency may even increase with regard to financial products, since those products involve in many cases greater risks for consumers.²⁸ Moreover, in many cases consumers may not even appreciate that they are in need of the handout information or that this information will be relevant to their use of

²⁶ Lisa M. Schwartz, *The Role of Numeracy in Understanding the Benefit of Screening Mammography*, 127 ANNALS INTERNAL MED. 966, 969 (1997) (the subjects were asked how many times a coin would come up heads in 1000 flips, to convert 1 out of 1000 to percentages, and to repeat this conversion backwards).

²⁷ Sheena S. Iyengar & Mark R. Lepper, *When Choice is Demotivating: Can One Desire Too Much of a Good Thing?*, 79 J. PERSONALITY & SOC. PSYCHOL. 995 (2000) (concludes that overloading consumers with information can reduce their cognitive skills and their desire to choose); Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203 (2003) (“Because individuals’ selection of choice strategies can be viewed as balancing the desire to achieve accuracy with the desire to minimize effort, it follows logically that as decisions become more complex, decision-makers will tend to adopt simpler choice strategies to cope with that complexity.”).

²⁸ Daniel Kahneman & Amos Tversky, *Choices, Values and Frames*, in BEHAVIORAL AND SOCIAL SCIENCE: FIFTY YEARS OF DISCOVERY 153, 154–55 (Neil J. Smelser & Dean R. Gerstein eds., 1986) (analyzing psychological biases in risky decisions); Julie R. Agnew & Lisa R. Szykman, *Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice, and Investor Experience*, 6 J. BEHAV. FIN. 57 (2005) (reporting an experiment concerning with investment choices where more information and risk have caused the subjects to opt for the default option).

the product.²⁹ Given this reality, the average consumer of a financial product who receives a 50-page booklet upon opening a bank account perceives it as such a distinct and stressful document that the only thing left to do, in most cases, is to put it in the drawer.

However, assuming that all consumers will opt not to review financial product-related information is an oversimplified assumption. It is indeed probable that some consumers who possess enough education, time and resources will decide to review carefully at least some of the product information. Nevertheless, even for those consumers, the transaction costs necessary in order to understand the complex language of the variety of shrouded financial information regarding bundled products is extremely high. Therefore it is only reasonable that they will not assume them.

The most difficult and time-consuming task involved in making sense out of the information is teasing out the relevant data, among the mixture of that which is supplied, and evaluating its impact on the specific consumer. Undertaking this task can prove to be extremely difficult even for highly educated and professional people, as the most relevant information (such as bounced check fees, overdraft rates, late fees, etc.) is shrouded inside a financial contract exposing only its immediate benefits to the naked eye.³⁰ Moreover, due to product bundling and segmentation it is quite likely that a consumer will be required to understand not only the sophisticated-shrouded mechanism behind one product, but several products all bundled together into one shrouded contract.³¹ For most (if not all) consumers, undertaking this task will result in an exorbitant transaction costs.

Perhaps one of the best ways to demonstrate the difficulty and complexity involved in understanding financial products to their full extent is to examine the resources needed for expert judges to understand these products. For instance, in the New Jersey Supreme Court case of *Gerhardt v. Continental Insurance Co.*,³² three judges expressed their frustration with the deliberated financial product, suggesting that its meaning was

²⁹ Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513 (2005).

³⁰ Gabaix & Laibson, *supra* note 1, at 506–07; Ellison, *supra* note 13, at 619–20.

³¹ See *supra* Part II (discussing the market effects of bundling and segmentation).

³² *Gerhardt v. Cont'l Ins. Co.*, 225 A.2d 328 (N.J. Super. Ct. 1966).

ambiguous, obscure and evidently incomprehensible to some of them.³³ United Kingdom judges reacted similarly in the *J. Spurling (Ltd v. Bradshaw)* case, stating that banking contracts are obscure, and therefore, their contractual terms would have to be simplified before consumers could be held liable according to several of their clauses.³⁴ In an Israeli case involving one of the largest Israeli banks (Leumi), three judges in the Standard Contracts Tribunal reviewed the bank's current account contract. At their 194-page judgment which took seven years to be rendered, the judges indicated (apparently with some frustration) the high complexity of the contract, while eventually voiding 28 of its clauses.³⁵ While those kinds of transaction costs can be absorbed by courts, they most certainly cannot be assumed by consumers.

To conclude this point, it can be argued that despite all the aforementioned barriers, there may still be some highly educated and sophisticated consumers who can review the relevant financial information and even understand it with reasonable costs. If this is the case then those consumers can drive the market into efficient equilibrium by serving as proxies for ill-informed consumers.³⁶ Although this reality can occur in some markets I believe that in the market of financial products for consumers, it is a highly improbable outcome mainly due to segmentation (aside from the low probability that any consumer will fully understand the financial products).³⁷ As was previously described, financial institutions invest great efforts in creating products that will accommodate for different sectors' needs. One effect of this practice is the segregation of the market to

³³ Eisenberg, *supra* note 3, at 309–10 (reporting that the judges inspected an insurance policy and stated as follows: “I don’t know what it means. I am stumped. They say one thing in big type and in small type they take it away.” “I can’t understand half of my insurance policies.” “I get the impression that insurance companies keep the language of their policies deliberately obscure.”)

³⁴ *J. Spurling Ltd. v. Bradshaw*, [1956] 1 WLR 461, 466 (Eng.).

³⁵ Plea 195/97 The Attorney Gen. v. Bank Leumi, PM 5736(1) 481 (2004) (Isr.). Also see, Ricardo Ben-Oliel, *The Attorney General v. Bank Leumi—A Lengthy Appraisal by an Israeli Court of a Banking Account*, 21 BANKING & FIN. L. REV. 61 (2005).

³⁶ Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983) (concluding that in a market with homogenous consumers, the small and sophisticated part of consumers is enough to foster competition and bring the supplier to offer efficient product to the entire market); see also Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, WIS. L. REV. 679, 691–92 (2004).

³⁷ MANN, *supra* note 1, at 139 (suggesting that in the credit card market the choice of the more sophisticated consumers will not drive the market toward efficiency).

different sectors by financial institutions and, subsequently, their ability to anticipate the specific products that will be used by those selected consumers who are actually able to comprehend them. Therefore, the more educated and sophisticated consumers will only drive a severely limited part of the market (that which uses products designed for the educated and sophisticated segment) toward efficiency, leaving the majority of consumers to deal with the high and inefficient costs of complexity.³⁸

2. Search Costs

As it well known, a price-based substitution between products is essential for creating a competitive market. The main concept behind such substitution is that when consumers search and finds a financial institution that offers a similar yet cheaper product than the one they are currently using, rational consumers will switch to the cheaper product found. Price-based competition also increases social welfare, as it brings upon competition between different financial institutions, which results in price reduction to the point of market equilibrium.³⁹ However, given that in reality consumers do not maintain knowledge of all the various products, they will have to spend resources in order to search for it. Consumers will invest in this search for a cheaper product as long as the marginal search costs will exceed the profit they believe will be achieved from switching to the new product. Nevertheless, as was explained previously, most consumers inevitably will find it extremely difficult to comprehend their own financial products, let alone all of the others that they have found during their search.⁴⁰ Therefore, product complexity will drive up the search costs for alternative financial products, thereby eliminating

³⁸ Gillette, *supra* note 36, at 692–93 (suggesting that some sellers would be able to segregate buyers into classes and predict in advance which product will be used by each class. In this way seller will be able to continue and exploit unsophisticated buyers.).

³⁹ Paul Klemperer, *The Competitiveness of Markets with Switching Costs*, 18 RAND J. ECON. (1987); Steven A. Sharpe, *The Effect of Consumer Switching Costs on Prices: A Theory and Its Application to the Bank Deposit Market*, 12 REV. INDUS. ORG. 79 (1997); see also BAR-GILL, *supra* note 1, at 24–25.

⁴⁰ See *supra* Part II (explaining that as the number of product attributes exceed three, consumers will suffer a sharp decrease in their ability to comprehend those attributes).

consumers' incentives to search among financial institutions even when they are not satisfied with their own.

In order to better understand the high search costs of alternative financial products it is helpful to analyze the data from a survey conducted on Household Switching Behavior at Depository Institutions. According to the survey about 32% of United States households never have changed depository institutions.⁴¹ The main reason that brought 51% of consumers to change institutions was not price related, but rather due to some kind of relocation.⁴² In other words, most consumers have never changed banks or did so only when they had no choice. When asked why they had decided not to change banks, 34% of consumers who had stayed with their banks for more than one year stated that they did so "because it would be too much trouble" for them to close their account and open a new one elsewhere.⁴³ Given that under the current market structure search costs are extremely high due to incomprehensibility of alternative financial products, this "trouble" is completely understandable. Moreover, the data reveals that out of the 34% of consumers who stated that it would be "too much trouble" to switch banks, 63% demonstrated a moderate to high dissatisfaction with the financial services they were receiving in their current financial institutions.⁴⁴ Thus, we can assume that in a perfect market, in which different alternatives were available to those consumers they would search for better financial products. However, as the complexity of products drive search costs to be extremely high, consumers are left with inefficient products.

3. *Switching Costs*

As product complexity leads to high information and search costs for consumers, relying on financial institutions' customer service should become the efficient market solution for consumers to better understand complex products and switch to more profitable options.

⁴¹ ELIZABETH K. KISER, HOUSEHOLD SWITCHING BEHAVIOR AT DEPOSITORY INSTITUTIONS: EVIDENCE FROM SURVEY DATA 5 (2002), available at <http://www.federalreserve.gov/pubs/feds/2002/200244/200244pap.pdf> (stating that the typical household tenure at a depository institution is 10 years).

⁴² *Id.* at 6–7, 19.

⁴³ *Id.* at 10–11.

⁴⁴ *Id.* at 13, 25.

And indeed, as the data indicate, 75% of the entire households that stayed with their banks for more than one year did so due to customer service.⁴⁵ Setting aside the fact that those numbers are considered extremely high, they also indicate that consumers do not utilize customer service in order to switch banks, but merely find it the best reason to stay with their own. From an economic perspective this means that consumers perceive the marginal cost of customer service to exceed the predicted benefits of switching. In other words, consumers have developed a strong reliance on financial institutions' representatives to simplify their products for them, and they perceive this service to be even more important than financial product prices. Given that in the current market structure there is no duty to provide consumers the best available services, consumers have understood that finding the "right banker" can make the entire difference.

The aforementioned conclusion is strengthened even further if we examine the loss of trust among consumers who found customer service to be inadequate or even abusive. As the data shows, some of those consumers simply left the mainstream financial system.⁴⁶ As Caskey unequivocally explained, for those consumers it is worth paying more for their financial services—using pawnshops, money orders, non-bank cashing services—as long as they can understand the product and its fee structure by themselves.⁴⁷

The above analysis indicates that in the current structure of the financial products market, consumers design their choices while relying deeply on customer service, since they do not see a more effective and cheaper way to reduce the additional costs of understanding the nature of

⁴⁵ KISER, *supra* note 41, at 10 (discussing how only 58% mentioned the price level as a factor); CLAIRE MATTHEWS, CHRIS MOORE & MALCOLM WRIGHT, WHY NOT SWITCH? SWITCHING COSTS AND SWITCHING LIKELIHOOD (2008), http://centre-bankingstudies.massey.ac.nz/fileadmin/research_outputs/FinsiaPaper_Revised_Sept2008.pdf (last visited July 20, 2013) (indicating that around 50% of consumers in New Zealand conceive the difficulty of learning new bank products and the interruption in the routine services as an obstacle while considering whether to switch to another financial institution).

⁴⁶ BURHOUSE & OSAKI, *supra* note 12, at 26–28 (stating that 8.2% of previously banked households in the United States specifically mentioned that they do not keep a bank account since they distrust banks and their practices).

⁴⁷ JOHN P. CASKEY, FRINGE BANKING: CHECK-CASHING OUTLETS, PAWNHOPS AND THE POOR 68–83, 116–18 (1996).

the financial service. As such, consumers do not switch financial institutions on a price-related basis.

That said, although the analysis so far explained how product complexity drives customer service to be a substantial factor for consumers of financial products, it still does not account fully for the negative influence of the situation on switching costs (other than considering customer service much more than prices). In fact due to the high price-tag that consumer of financial products place on customer service, it would be expected that they would actively initiate switching between financial institutions in accordance with their level of service. It would appear that the reason that this is not the reality is related to the difficulty in objectively evaluating customer service in advance in the financial product market. The immeasurable amount of factors to consider influences the way in which customer service is evaluated by consumers. Among those factors are the level of product understanding demonstrated by representatives, their training in effectively explaining it, the complexity of the products and their fee structures, and the nature of the consumer herself. Therefore, under current market structure, in order to evaluate the customer service of another financial institution one must first change providers.⁴⁸ When faced with this choice it appears that at least some consumers opt to remain with their current institutions because they already possess the proper means to understand the main products and their fee structures.⁴⁹ They prefer this option over taking the risks entailed in switching to a new institution where they cannot predict the outcomes in advance.⁵⁰

⁴⁸ Zsófia Tóth, *Approaches to Consumer Trust in Banking Sector, with Special Regard to Young Customers*, PROCEEDINGS OF FIKUSZ 205 (László Áron Kóczy ed., 2009) (stating that consumers trust in their current banks more than in other banks).

⁴⁹ To clarify, I am not suggesting that product complexity is the only cause of high switching costs at the market of financial products for consumers. Nevertheless, as I indicated, it is a substantial factor which drives switching costs to be extremely high. For discussion regarding other factors which influence switching costs, see James Surowiecki, *Why Banks Stay Big*, THE FINANCIAL PAGE, available at http://www.newyorker.com/talk/financial/2009/11/02/091102ta_talk_surowiecki?printable=true¤tPage=all (last visited July 20, 2013).

⁵⁰ KISER, *supra* note 41, at 15.

B. Transaction Costs for Financial Institutions

When considering financial institutions' transaction costs, the first question that must be asked is whether in practice such costs actually exist given the current market structure, or whether those costs justify a separate discussion. This question arises as in the current market structure any cost incurred by financial institutions will eventually be factored into the price of the product. Therefore, such a cost is no longer borne by the financial institution, rather by the consumer. Despite this confluence of costs, an independent discussion of each of them is warranted for two reasons. First, since those costs are incurred by financial institutions—at least in the first stages—it is important to introduce them as such in order to emphasize the institutions' direct ability to reduce them. Second, the issue will be relevant to a later discussion in this Article in emphasizing the market dynamics in which financial institutions can produce complex products while making consumers bear the costs of complexity.

So, what are the costs of financial institutions due to product complexity? They are mainly those costs incurred by employee training and information handling. As it turns out, consumers are not the only ones who find it difficult to understand the financial products being designed for them. In fact, those products are so complex that even some of the financial institutions' employees have trouble understanding them. Those employees must be trained to understand the products. The data on this issue, naturally, is difficult to come by since financial institution employees will not admit that they could not fully comprehend the basic products that they sell to consumers. However, we can attempt to appreciate the scale of the phenomenon by examining related data. As indicated by the CFPB, 65% of all complaints filed in 2012 were resolved after further explanation was given by the financial institution.⁵¹ This data indicates that financial institutions incurred extra costs as a result of the additional explanations they were obliged to provide their consumers. Whereas at least a portion of those products and services are supplied directly by the financial institution's employees (excluding automated products or services), it is only probable to assume that at least some of them did not possess a full

⁵¹ CONSUMER FIN. PROT. BUREAU, *supra* note 9, at 25.

understanding of the product when explaining it to their consumers (and thus further explanation was required in order to resolve the complaint).

Furthermore, another 15% of complaints were reported resolved due to monetary relief.⁵² This means that the financial institution incurred the costs of handling those complaints and reimbursing consumers in light of misunderstandings involving their products. In order to fully evaluate the phenomenon, we should also keep in mind that the aforementioned figures are likely higher in reality, as the above do not include the costs of internal complaints and lawsuits submitted to the courts on which we have no accurate data. In attempting to reduce the costs of handling complaints, monetary relief, and legal proceedings, it is only logical that financial institutions will invest in training their employees to better understand their own complex products, at least to the point of limiting their exposure to a regulator's scrutiny.

Additionally, as was previously mentioned, financial institutions will incur the costs of handling the information related to their products. Those costs will include preparing, printing and distributing all of the products' relevant information—whether this information is needed in practice or, as will be discussed later, mandated by the rules of disclosure.⁵³ In addition to the fact that this information is difficult to construct, and in many cases will require the advice of economic, social and legal experts, it is also expensive to circulate—oftentimes on a monthly basis.

As financial institutions will take those costs into account when designing their products, complexity will drive the costs of financial products even higher.

C. Social Costs

The preceding discussion leads to the conclusion that consumers pay high costs for financial product complexity. Nevertheless, the point I want to raise now is that this inefficiency cost is much higher than its absolute value, as it is not distributed equally among the various sectors of society.

⁵² *Id.*

⁵³ AS studies show, one of the main disadvantages of disclosure is its high societal costs. See, e.g., Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 735–42 (2011); Ko & Williams, *supra* note 14, at 15–16, 22–25.

In fact, the cost of this inefficiency is borne mainly by low- and middle-income (LMI) consumers, who essentially subsidize the use of complex products by other echelons of society. Thus, the additional social costs that we pay for product complexity—which I would claim are the highest of them all—are the decrease in social cohesion and equality among the population. Society also incurs high costs when large segments of the population use more expensive financial products designed by the fringe banking industry.

As was elaborated above, consumers suffer from miscomprehension of their financial products and from a stagnant financial market—both are the result of the high transaction costs that derive from product complexity. As I also mentioned, comprehension of information is not defined in absolute terms; its definition is a matter of the relative level of understanding. This means that subject to incursion of transaction costs, some consumers will be able to understand financial products better than others. Following my previous analysis, factors such as education, time availability, and financial resources can help determine which level of comprehension each consumer may reach. As we know, these factors are highly correlated to one's socio-economic class.⁵⁴ Therefore, the probability that high income consumers will find it easier to understand financial products than moderate and especially low income consumers is more than likely. Thus, as the “more informed” consumers will have better means of understanding financial products, LMI consumers will be left with the choice of using them without understanding them (at least to some extent) or finding alternatives to

⁵⁴ See, e.g., Jean Kinsey & Ray McAlister, *Consumer Knowledge of the Costs of Open-end Credit*, 15 J. CONSUMER AFF. 249, 260 (1981) (finds that low levels of income and education are correlated with less knowledge and understanding of the basic information related to credit cards); Angela C. Lyons, Mitchell Rachlis & Eric Scherpf, *What's in a Score? Differences in Consumers' Credit Knowledge Using OLS and Quantile Regressions*, 41 J. CONSUMER AFF. 223, 236–37 (2007) (finds that LMI, older and Hispanic consumers tend to be significantly less informed with regard to their credit reports than the rest of the population); Simon Firestone, Robert Van Order & Peter Zorn, *The Performance of Low-Income and Minority Mortgages*, 35 REAL ESTATE ECON., 479 (2007) (finds that low-income consumers are less likely to repay their mortgages at the optimal time); Nadia Massoud, Anthony Saunders & Barry Scholnick, *Who Makes Credit Card Mistakes* (2007), available at www.philadelphiafed.org/research-and-data/events/2007/consumer-credit-and-payments/papers/Scholnick_Who_Makes_Credit_Card_Mistakes.pdf (finds that poor people are more likely to pay fees by mistake).

mainstream financial products. As I will elaborate, both of those choices carry intolerable social costs.

The LMI consumers who choose to use incomprehensible financial products will pay the market costs of price structuring, shrouded attributes, bundling and segmentation. When doing so, LMI consumers will subsidize the use of complex financial products by other consumers.⁵⁵ Thus, an unimaginable reality is created in which consumers that have less subsidize the use of financial products for consumers who have more. On the other hand, LMI consumers who choose not to use financial institution products will find themselves outside the financial mainstream. In this case they will find it very difficult to function in modern society and probably will look for alternative financial services. As Caskey's work indicates, those consumers will find their refuge in "fringe banking," which includes pawnshops, check cashing outlets, money orders, etc. While those institutions are probably better at serving LMI consumers, they exclude their consumers from the financial mainstream and are very costly not only to LMI consumers, but to the entire society.⁵⁶ Moreover, the overwhelming result of this reality is a deterioration of consumer trust in their financial institutions, which may incur, as I will explore later, an even more expensive social price.⁵⁷

As we examine the two options available for LMI consumers due to financial product complexity, we acknowledge the sad reality that even today—half a century after the publication of David Caplovitz's important work—the poor still pay more, at least for their financial products.⁵⁸ As a

⁵⁵ KO & Williams, *supra* note 14, at 28 (stating that consumers who understand more aspects of shrouded products pay less than the ones that do not understand them).

⁵⁶ In a joint research which I am currently conducting with Ronald Mann, we analyze the social costs of fringe banking and compare them with the costs of electronic payments. We find that the costs of fringe banking are relatively much higher in comparison with electronic payments since fringe banking use mainly paper-based payment instruments which are much more expensive to society due to their high production costs, checkout time, handling costs and safety costs. Also, fringe banking does not enjoy the advantages of economies of scale, which prevents them from reducing those costs as the time passes. See Liran Haim & Ronald J. Mann, *Putting Stored-Value Cards in Their Place* (forthcoming 2014) (on file with the author). See also Ronald J. Mann, *After the Great Recession: Regulating Financial Services for Low- and Middle-Income Communities*, 69 WASH. & LEE L. REV. 729, 738–46 (2012); CASKEY, *supra* note 47, at 68–84.

⁵⁷ See *infra* Part V.B.

⁵⁸ DAVID CAPLOVITZ, *THE POOR PAY MORE : CONSUMER PRACTICES OF LOW-INCOME FAMILIES* (2007).

modern society that aspires toward equality among its population, we cannot accept such a blow to social cohesion. Under these circumstances the cost of complex financial product design is simply not worth the social price.

IV. UNDERSTANDING PROTECTIVE POLICY FOR CONSUMERS OF COMPLEX FINANCIAL PRODUCTS

The above discussion leads us to the conclusion that although the market forces drive financial institutions to issue complex products for consumers, the result is not beneficial to consumers and society. My analysis, so far, demonstrates that financial product complexity results in unreasonable transaction costs for consumers, such that they cannot appreciate the true nature, attributes and costs of their financial products. Those products also incur high social costs. Therefore, while complexity is the result of excessive financial product planning and market conditions, it creates a reality of unreasonable costs for consumers and a decrease in social welfare. In fact, the data indicates a failure that drives market forces toward complex financial products, while resulting in an unbeneficial outcome.

In light of these conclusions, in the next stage of the discussion I will examine the ways in which policy has dealt with these failures so far. While various scholars have criticized several of the tools employed by policy makers, I will attempt to take a step back and explain the common ground behind the use of each of those tools in the policy context. As I will elaborate, it appears that this common ground focuses on the demand side of the market—in other words, the failures that occur when consumers try to understand financial products—rather than on regulating more intensively the supply side that apparently plays a role in driving the market to this inefficient place.

A. Disclosure Rules

The first and perhaps most salient policy tool that is used to impart consumers with information regarding their financial products is mandatory disclosure. Over recent years disclosure rules have become the panacea that policy makers employ in an attempt to cure the variety of consumer pain and suffering in the financial market. The main premise behind using

disclosure is that it provides consumers the information that they need to understand their financial products and make informed decisions. However, as I suggested before, mandatory disclosure has not solved the problems of transaction costs in the financial market—if anything it has exacerbated them.

The Truth in Lending Act (TILA) and its subsequent amendments and regulations are perhaps the best example of the limited effect of disclosure. The TILA assumes that the extension of credit to consumers may be simplified by imposing various disclosure rules on financial institutions.⁵⁹ As a result of the TILA, many lenders in the financial market are required by law to reveal and even highlight (sometimes in special formats) credit information for their consumers.⁶⁰ Despite this strong regulatory intervention, it appears that after almost 50 years of extensive and growing disclosure, there are still many consumers who do not understand the basic features of their loans⁶¹ or cannot appreciate the costs of credit.⁶² For this high amount of consumers, disclosure did not solve the fundamental problem of comprehension.

The Real Estate Settlement Procedures Act (RESPA) was, and still is, premised on the same notion.⁶³ It required mortgage lenders to supply mandatory disclosure regarding the nature and costs of the real estate settlement process. It even created the forms through which disclosure must be conducted. Again, the notion behind this regulation was that consumers are able to make a more conscious choice when applying for a mortgage if

⁵⁹ The Truth in Lending Act of 1968, 15 U.S.C. §§ 1601–1667 (2013) (Section 1601 states: “It is the purpose of this title to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices.”).

⁶⁰ The most salient term that must be disclosed is the Annual Percentage Rate (APR). Other terms include fees, grace period, finance calculation method, etc.

⁶¹ Lauren E. Willis, *Decision Making and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 789–98 (2006).

⁶² Jinkook Lee & Jeanne M. Hogarth, *The Price of Money: Consumers' Understanding of APRs and Contract Interest Rates*, 18 J. PUB. POL'Y & MARKETING 66, 70 (1999); Nadia Massoud, Anthony Saunders & Barry Scholnick, *Who Makes Credit Card Mistakes* (Aug. 2007), www.philadelphiafed.org/research-and-data/events/2007/consumer-credit-and-payments/papers/Scholnick_Who_Makes_Credit_Card_Mistakes.pdf (stating that consumers pay late fees and penalties while using their credit cards due to misunderstanding of the product).

⁶³ 12 U.S.C. §§ 2601–2617 (2012).

they have all of the information at their disposal. Nevertheless, it seemed that these disclosure rules also failed to give consumers a better understanding of the cost of mortgages. In fact the best evidence of this failure is that recently the rules have been redesigned by the CFPB.⁶⁴

Why did disclosure fail? Ben-Shahar and Schneider's study tries to answer this question by analyzing a verity of consumer products and empirical studies on mandatory disclosure relating to those products.⁶⁵ In the context of the financial product market, the following are the four most compelling arguments as to the failure of disclosure.

First, as consumers are only able to digest certain amounts of information, disclosure rules work best when they come in small doses—in other words, when there are only a few important details that consumers need to know about a product.⁶⁶ However, disclosed information becomes very ineffective when a consumer who applies for a mortgage receives dozens of pages containing figures and miscellaneous information on a wide variety of topics that they are unlikely to be able to examine and decipher.

Second, as innovation is considered to be the power behind financial products, it will be difficult for mandatory disclosure to keep up with it.⁶⁷ Even if disclosure will allow some consumers to understand financial products to some extent,⁶⁸ the financial institutions' reaction will be to restructure the product in a new and more complex way in order to protect their pricing techniques—making disclosure irrelevant, at least in part. The TILA's disclosure rules, for example, became less effective when credit card issuers adopted the new over-limit fees back in the nineties, since those were not a part of the TILA's original disclosure requirement.⁶⁹

⁶⁴ See *infra* Part IV.A.

⁶⁵ Ben-Shahar & Schneider, *supra* note 53, at 679–729.

⁶⁶ *Id.* at 705–09 (stating the large quantity of information that consumers are being required to deal with during one day at modern society).

⁶⁷ Bar-Gill & Warren, *supra* note 2, at 85 (stating that in the race between the regulator and financial institutions, regulation will most probably be left behind).

⁶⁸ Consumer understanding can also occur to some extent by financial institutions that will introduce new pricing techniques that will undercut current fee structure.

⁶⁹ *Household Credit Servs., Inc. v. Pfennig*, 541 U.S. 232, 243 (2004) (ruling that over-limit fees are not part of finance charges as defined by TILA). From this reason I also have doubts regarding an argument raised by Bar-Gill, claiming that regulators can design more efficient disclosure rules by identifying the most important information for consumers and presenting it in the simplest way. See

Third, some consumers simply do not possess the basic skills or resources to understand the disclosed information. As Ben-Shahar and Schneider point out, consumers will find it extremely hard to locate the information, make sense of it, understand its relevance and true meaning, or even remember its content for further use.⁷⁰ As was discussed above, those difficulties have become extremely high due to studies indicating consumer reluctance to utilize financial institutions.⁷¹

Finally, as a recent study also shows, disclosure entails high private and social costs. Again, financial institutions bear the burden of preparing and disseminating the disclosed information. As the risk of negligent disclosure is extremely high, they are likely to seek legal assistance in order to do so. Consumers in turn dedicate many resources to understanding the disclosed information, often rendering their transaction costs sky high. Simultaneously, legislators constantly work to keep up with financial innovations of complex products, and thus great legislative resources are expended only to find that the financial institutions have already switched to different techniques that are not yet covered by current disclosure rules. And lastly, society pays the price of decreased competition and reduction in social cohesion, as the ill-informed consumers subsidize those who are able to make some sense out of the disclosed information.⁷²

The above picture regarding the failure of disclosure as a consumer protection measure is quite powerful. The inability to influence the consumer side of the market for financial products by providing more and more information is rather obvious. Nevertheless, disclosure continues to be one of the main instruments adopted by financial product consumer protection regulations. The Dodd-Frank Act adopted disclosure as one of its main tools to achieve a more effective consumer protection regime. It even introduced the concept of disclosure trials, which are intended to improve the ways in which disclosure imparts consumers with information.⁷³ The

BAR-GILL, *supra* note 1, at 37. As I mentioned, at least with regard to consumers financial products, a disclosure of this kind—even if effective—will just bring financial institutions to change their pricing method and reshrouded their product in a way that will eliminate the advantages of the new disclosure rules.

⁷⁰ Ben-Shahar & Schneider, *supra* note 53, at 710–23.

⁷¹ *See supra* Part III.C.

⁷² Ko & Williams, *supra* note 14, at 28.

⁷³ 12 U.S.C. § 5532 (2012).

CFPB has stated that it will adopt electronic disclosure in order to ensure better consumer comprehension of financial products.⁷⁴ The Bureau has also introduced us recently to the new and improved mortgage disclosure forms, which yet again entail immense amounts of information in small fonts, high density and complex wording.⁷⁵ As the effectiveness of disclosure is highly dubious, the insistence on the part of policy makers to continue its extensive use is peculiar, particularly in the consumer financial product market.⁷⁶

B. Educating Consumers

Another highly popular policy tool for imparting knowledge of financial products to consumers is offering educational programs for financial literacy, mainly in more “needed” areas.⁷⁷ The basic concept behind those programs are that consumers are able to make far more conscious decisions when they are better informed about concepts such as money, compound interest, credit, bank accounts etc.⁷⁸ Resources are therefore constantly invested by policy makers in various financial literacy educational programs. For quite some time these programs have been available for those who need them, such as high-school students, LMI consumers, the elderly, etc.⁷⁹

⁷⁴ CONSUMER FIN. PROT. BUREAU, CONSUMER FINANCIAL PROTECTION BUREAU STRATEGIC PLAN FY 2013—FY 2017 (Feb. 2013), <http://www.consumerfinance.gov/strategic-plan/> (stating the Bureau’s main goal as: “consumers can understand the costs, benefits, and risks associated with consumer financial products and services initially and over the term of the product or service” and that one way to fulfill this goal is to “develop ways to provide financial product disclosure information to consumers electronically”).

⁷⁵ Real Estate Settlement Procedure Act (Regulation X), 12 C.F.R. § 1024 (2012); Truth in Lending Act (Regulation Z), 12 C.F.R. § 1026 (2012).

⁷⁶ To clarify, whereas my analysis addresses only financial products it most certainly does not my intention to totally dismiss disclosure as a consumer protection tool. As I mentioned, disclosure might be useful with small and concise doses of information. However, as I discuss one of the most complex products available for consumers which probably has the most influence on their lives, I believe that as a policy tool its faults exceeds its benefits.

⁷⁷ Lauren E. Willis, *Against Financial Literacy Education*, 94 IOWA L. REV. 197, 202–04 (2009). See also *supra* note 25.

⁷⁸ Willis, *supra* note 77, at 202–04.

⁷⁹ See Financial Literacy and Education Commission, *Promoting Financial Success in the United States: National Strategy for Financial Literacy* (2011), http://www.treasury.gov/resource-center/financial-education/Documents/NationalStrategyBook_12310%20%282%29.pdf.

However, as studies show, like disclosure, the impact of financial literacy educational programs on consumer understanding of financial products is controversial.⁸⁰ One study which examined the impact of personal financial management courses on high-school students found that the students who took the course were no more financially literate than those who did not.⁸¹ Another study indicates that short-term credit education does not assist LMI consumers in making more informed credit decisions.⁸² In light of those and other similar studies, some actually perceive financial literacy education to be part of the problem and not the solution.⁸³

When considering the reasons for the limited success of financial literacy education, not surprisingly, we encounter very similar obstacles to those which stand in the way of the success of mandatory disclosure policy. As it would appear, the skills needed to understand today's complex financial products are varied, and there is only a limited amount of skills that seminars on credit rates or house mortgages can teach. Even if we assume that education can impart consumers with the knowledge that will allow them to understand each product's attributes, there still will remain too many relevant attributes that due to cognitive barriers consumers will not be able to consider at the same time.⁸⁴ Moreover, the constant innovation, pricing, bundling and reshrouding techniques in the financial product market render the knowledge acquired irrelevant after a short period of time.⁸⁵ Finally, studies now show that the costs of financial literacy education programs are harmful to social welfare in light of their

⁸⁰ Willis, *supra* note 77, at 202–04, 260–75. *See also* Mann, *supra* note 56, at 740.

⁸¹ Lewis Mandell & Linda Schmid Klein, *The Impact of Financial Literacy Education on Subsequent Financial Behavior*, 20 J. FIN. COUNSELING & PLANNING 15 (2009).

⁸² Jinhee Kim, E. Thomas Garman & Benoit Sorhaindo, *Relationships Among Credit Counseling Clients' Financial Well-being, Financial Behaviors, Financial Stressor Events, and Health*, 14 J. FIN. COUNSELING & PLANNING 75, 77, 85 (2003) (“This study showed that there were no significant and direct effect of credit counseling on financial behavior, financial well-being or health.”).

⁸³ *See, e.g.*, Willis, *supra* note 77, at 283–85; Mandell & Klein, *supra* note 81. Michael Kosfeld & Ulrich Schüwer, *Add-on Pricing, Naive Consumers, and the Hidden Welfare Costs of Education* (2011), <http://ideas.repec.org/p/iza/izadps/dp6061.html> (last visited July 20, 2013).

⁸⁴ *See supra* Part II, *supra* note 22.

⁸⁵ For the credit card consumers of the nineties, understanding the concept of over the limit fees was very helpful while in the new millennium this concept has been replaced by “double cycle billing.”

controversial benefits.⁸⁶ It would seem that the results of those studies would only be amplified if we were to consider the additional transaction costs that consumers incur by participating in such programs.

Despite this overwhelming data on the highly controversial effectiveness of consumer education, the Dodd-Frank Act designated financial literacy education as a means of addressing financial product complexity and supporting the inclusion of LMI consumers into the financial mainstream.⁸⁷ Moreover the Act empowers the director of the CFPB to establish an office of financial education, which is to be charged with developing initiatives and strategies to educate and empower consumers to make better financial decisions.⁸⁸ As was recently published by the CFPB this office, together with other five offices of the Bureau, will work under a national strategy to reach consumers in key moments of their financial lives, when they are assumed to be most receptive to receiving financial education.⁸⁹ The Bureau will supply those consumers with relevant information, tools and support that will enhance their financial knowledge.⁹⁰ Even if we ignore the aforementioned data and assume that the new national strategy will have some impact on consumers' financial skills, it will still face what I consider to be the biggest flaw of financial literacy education—it cannot successfully reach all who need it. Given this reality, even if the new policy should have some success, it will still serve to increase the inequality in society, since the burden of subsidization will fall on much smaller groups that will not be able to achieve its benefits.⁹¹

⁸⁶ Willis, *supra* note 77, at 260–75; Kosfeld & Schüwer, *supra* note 83 (stating that educating consumer in competitive markets may decrease social welfare if education is insufficient to alter the equilibrium information and pricing strategy of firms).

⁸⁷ See Dodd-Frank Wall Street Reform and Consumer Protection Act, 111 Pub. L. No. 203 § 1205(b)(2).

⁸⁸ *Id.* § 1013(d).

⁸⁹ CONSUMER FIN. PROT. BUREAU, FINANCIAL LITERACY ANNUAL REPORT 14–26 (2013), <http://www.consumerfinance.gov/reports/financial-literacy-annual-report/>.

⁹⁰ *Id.*

⁹¹ See *supra* Part III.C.

C. Supporting Equal Financial Options

While competition is considered the primary motivation for financial institutions to improve their products to suit consumer demands (including the demand for more comprehensible products), some discussion is required on the efforts of policy makers to increase competition in the financial product markets. As studies indicate that the distribution of bank branches is comparatively low in LMI communities, policy makers focus their efforts on increasing competition in those areas.

The Community Reinvestment Act (CRA) is arguably the most salient tool that has been employed in an attempt to address this issue.⁹² Its original goal was to improve credit service in LMI areas by encouraging the opening of more bank branches and increased competition in the financial market for LMI consumers, but it soon began to consider the effectiveness of retail banking services in matching the communities' demands.⁹³ As LMI consumers also desire understanding their financial products,⁹⁴ the consideration of such parameters in a bank's CRA rating, presumably, should have led to the creation of more comprehensible financial products.

While some scholars criticized the efficiency of this tool and others lauded its commendable goal,⁹⁵ one thing is certain—the increase in competition did not cause consumers to receive products that they could understand better or desire more.

As studies indicate quite strikingly, LMI consumers still do not understand many of the mainstream financial products. For instance, as was revealed in a recent survey by the Federal Reserve, 26% of unbanked consumers explained that they do not need a bank account but used much more expensive non-bank services. Another 7.1% stated that they do not trust bankers and their products.⁹⁶

There are several reasons, however, why even a strong competition-encouraging force, such as the CRA, does not render the LMI consumer financial product market functional—and, in fact, much improvement

⁹² Community Reinvestment Act of 1977, 12 U.S.C. §§ 2901–2908 (2013).

⁹³ CASKEY, *supra* note 47, at 133–35; Barr, *supra* note 29, at 106–13.

⁹⁴ See e.g., Mann, *supra* note 56, at 741 (emphasizing the importance of financial product comprehension for LMI consumers).

⁹⁵ Barr, *supra* note 29, at 113–120.

⁹⁶ BURHOUSE & OSAKI, *supra* note 12, at 3.

remains necessary. First, despite the CRA, it seems that the mainstream financial options available to LMI consumers remain insufficient to achieve a competitive outcome.⁹⁷ The economy of shrouded products provides a second explanation: competition does not actually motivate financial institutions to debias consumers, but rather to create more shrouded products. Therefore, competition will not resolve financial product complexity problems.⁹⁸ A third explanation, offered by Mann, is that complex products are simply the only way that mainstream financial institutions know to make profit.⁹⁹ Fourth, as was discussed above, there is a certain “chicken and egg” syndrome at play, in which consumers of complex financial products rely heavily on customer service and therefore never switch banks. As a result, those banks never feel competitive pressure.¹⁰⁰ And finally, it is highly likely that the current market structure relies on a certain percentage of consumers not fully understanding financial products. After all when LMI consumers pays more in fringe banking for products which are cheaper in mainstream banking, policy needs to be changed.

Acknowledging this problem, the Dodd-Frank Act initiated sponsorship programs to encourage financial institutions to create suitable accounts and payday loans for LMI consumers.¹⁰¹ The only problem with this idea is that it appeals mainly to the current types of mainstream financial institutions, and there is no reason to believe that they will change their primary methods of doing business. As was explained before, it seems that strong market forces will drive those institutions to continue to create complex products. Should this prove to be true, this policy will suffer from the main flaws of its predecessors.

⁹⁷ Many consumers still find it easier and more available to use fringe banking institutions rather than mainstream financial institutions. In this context the number of 28% of underbanked households speaks for itself. For these statistics *see id.* at 5.

⁹⁸ Gabaix & Laibson, *supra* note 1, at 507–10; Ko & Williams, *supra* note 14, at 11; *see supra* Part II.

⁹⁹ Mann, *supra* note 56, at 748.

¹⁰⁰ *See supra* Part III.A.3.

¹⁰¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 1201–1210, 124 Stat. 1376 (2010).

D. Analyzing Current Policy

The commonality among all the different tools adopted by policy makers for dealing with complex financial products is that they focus their attention on the demand side of the market—the default assumption being that consumers can be changed or imparted with means and knowledge that will allow them to understand the products. This is not to suggest that policy makers have not made any attempts to regulate the supply side of the market or to distribute the cost of complexity more reasonably in order to resolve market failures, but merely to establish the fact that such attempts were not adequately successful. Current policy, coupled with market structure, leads consumers to bear the high burden of understanding complex financial products by comprehending all of the disclosed information, attending seminars or switching their financial products after finding better ones in an allegedly more competitive environment. What is more, in addition to the above, financial institutions constantly create more complex products, supply more information to be analyzed in seminars, and close branches in underserved areas. As the cumulative burden on consumers adds up to extremely high transaction costs, the responsibilities placed by policy makers on consumers are simply unreasonable.

In order to fully understand the unreasonable burden policy makers in this country have imposed on us—the consumers—let us picture for a second the consumer who follows the policy makers' model. This consumer will seek to participate in the financial mainstream therefore she will probably try to open a bank account. To this end, she will likely go to the closest branch to her home and obtain a copy of the account manual. As this booklet is around 50 pages in length, she will sit at home and read it. In order to understand it, she will constantly look at the notes she made during her financial literacy seminars (which she will have passed successfully). After spending the days (and even weeks) required to understand the booklet (assuming she was successful), she will go to another two banks and undergo the same process. She will then compare all the different services—costs, benefits and disadvantages—only to find out that due to shrouding and bundling techniques each bank offers only a handful of products at cheaper costs than the others. Our consumer will not give up but rather will decide (as she learned in her seminars) which of the products are most important to her financial needs and will choose her bank accordingly (only to discover that competition did not actually create significant price

differences). She will then continue to monitor the documents she receives weekly or monthly from her bank in order to ensure that the prices and services have not changed, that her balance has been calculated correctly and that no unauthorized uses have been made of her account. If any product's terms or fees should change, our consumer will undergo the same process described again. This scenario is based on the premise that our imaginary consumer lives in an area that actually has a variety of banks and that she knows how to read the disclosed information and make the proper calculations with regard to it. We also assume here that our imaginary consumer's financial needs will remain constant; otherwise she will need to repeat this process for a new product (i.e. a credit card, a mortgage, etc.). By the way, we still have not factored in our consumer's day-to-day life, which includes more than understanding financial products. She likely engages in basic, time-consuming activities, such as working 10 hours a day, having a family life, co-managing a household, paying bills, eating and sleeping (at least a few hours).

Still, this average life that policy makers have planned for us is not the most problematic element in the policy's design. The biggest problem arises if our imaginary consumer has not listened closely enough in her seminar, failed to understand certain legal language, miscalculated the rate of some hidden fee, or incorrectly compared the total gross amount of the service. In this case, she probably will have invested great time and effort to no avail, as eventually she will select a product that was not the most suited for her. Because she has failed to meet the policy makers' default burden of ensuring understanding, she will pay more than necessary only because the product is too complex.

Now let us examine the role of our imaginary consumer's financial institution—that is the institution that designed and profited from the complex product. According to current policy, the financial institution's role is much more modest. All in all, it supplies mandatory information after opening a branch and putting the complex product on the market. When imagining this picture, those of us who do not really know how much we pay for our financial products should feel quite normal.¹⁰²

¹⁰² Bar-Gill & Warren, *supra* note 2, at 33–34 (stating several studies which found numerous consumers' mistakes with regard to credit-based financial products).

However, the enormous private costs borne by consumers are dwarfed when compared to the social costs that all of us pay for this market structure. These costs begin with the damage to market competition, because of which consumers end up with inefficient products. It continues with some 60% of consumers losing their faith in banks and financial institutions.¹⁰³ And it currently appears to end with the alienation of 28% of consumers from mainstream financial services, driven to use fringe banking products as an alternative.¹⁰⁴ This results in a substantial decrease in social cohesion and a long-lasting loss of faith in financial institutions.

Why has policy failed again and again to achieve a more reasonable and efficient risk allocation? First, consumers are not homogenous. As such, it is much more difficult to influence the market via uniform rules such as current disclosure and education. In addition to financial products, they also have a great deal of other retail products to navigate, alongside their own daily personal and professional lives. The nature and pace of life simply do not allow most consumers to and conduct financial calculations everyday. Such is life. Most attempts to widely steer the demand side of the consumer financial product market are likely to have little if any success. On the other hand, financial institutions are the “experts” on the financial market especially the complex products they so eagerly produce. They also know their consumers best, based on the segmentation processes they underwent while designing the product and their daily relationship with each and every one of them. In light of this, from a policy perspective, it seems much more reasonable to allocate many of the complexity risks to the financial institution or supply side of the market.

The problem with current policy is that it does not seem to consider this approach to its full extent. On the one hand, policy makers seem determined to help achieve consumer comprehension of financial products. On the other hand, they function based on the same premise that they have adopted since the dawn of time—meaning that the problems do not stem

¹⁰³ EDELMAN, EDELMAN TRUST BAROMETER: U.S. FINANCIAL SERVICES AND BANKING INDUSTRIES (2012), available at <http://www.slideshare.net/EdelmanInsights/2012-edelman-trust-barometer-us-financial-services-and-banking-industries> (stating the results from an international survey which indicates that only 41%–46% of United States consumers trust financial institutions. This number is the lowest out of the 10 industries that were reviewed.).

¹⁰⁴ BURHOUSE & OSAKI, *supra* note 12, at 3. See *supra* note 56.

from the current policy framework but rather from the ways in which it is being implemented.¹⁰⁵ This approach explains why we continue to see more ineffective disclosure, highly controversial seminars and several other instruments that do not assist in increasing consumer comprehension. The belief that if there are enough bank branches consumers will be able to make more conscious choices does not adequately appreciate the fact that each bank offers relatively the same (incomprehensible) product in a slightly different package. But worse still is the fact that all those policy means result in increasing costs to financial institutions, which in turn factor into the prices of their products, and again force the consumer to pay more for policy inefficiency. As product innovation and new pricing techniques probably will continue to be ahead of policy—in its current form—perhaps a better policy approach would be to stop giving consumers more of the same ineffective medicine, and more importantly, to cease holding them accountable for its inefficiency.

The above analysis therefore leads to the conclusion that under the current premise, there will always be a new complex product, there will always be geographical areas that lack sufficient competition.¹⁰⁶ and there will always be something new for consumers to learn. So if this side of the equation is so difficult to influence, perhaps we should consider changing the baseline premise. Instead of focusing on the demand side of the equation, it would behoove policy maker to try influencing the supply side of it. The common presumption is that “the market” supports the production of complex products and the exploitation of consumers’ misperceptions with regard to them. However when designing our policy, such an approach

¹⁰⁵ I discussed the notion of “same policy in a slightly different package” above. *See supra* Part IV.A–C. The most salient example is probably the Dodd-Frank Act, which designated mandatory disclosure and financial literacy education as substantial tools in the new consumer protection policy in the financial market. *See also* Bar-Gill & Warren, *supra* note 2, at 28–29 (stating that in the past, as a result of consumers’ miscomprehension of many disclosure terms in TILA’s the regulator simply changed the disclosure rules in regulation Z).

¹⁰⁶ In fact, over the last few years, the concentration in the United States’ banking industry is experiencing an upward trend. David C. Wheelock, *Have Acquisitions of Failed Banks Increased the Concentration of U.S. Banking Markets*, 93 FED. RES. BANK ST. LOUIS REV. 155 (2011); Ryan Swift, *Banks, The Fed, and Moral Hazard*, SWIFT ECONOMICS (Sept. 29, 2010), <http://www.swifteconomics.com/2010/09/29/banks-fed-and-moral-hazard/> (stating that as of 2009, the big four banks in the United States—Bank of America, Citigroup, JPMorgan-Chase and Wells Fargo—held 39% of United States customer deposits).

should not ignore the fact that “the forces” responsible for driving the market to that point are in large part the financial institutions themselves.

V. A NEW APPROACH

A. *The Approach*

The above discussion underscores the need for a new approach to addressing the failures created by financial product complexity. The main premise is that we cannot accept a reality in which consumers cannot understand their financial products and live peacefully with the market failures that derive from that reality. While investing regulation resources in the consumer side of the market only results in higher costs with highly controversial outcomes, it appears that a new approach should try to focus on extensively influencing the financial institution side. As I have mentioned, the drawback to regulating the supply side of the market is that financial institutions—by default—will focus on creating new and more complex products, as that is the most efficient way to draw profit from consumers’ miscomprehension of the products’ attributes.¹⁰⁷ My argument is that a profit-oriented approach can also help to dissolve this failure. Therefore, I support a legal arrangement that will change the risk allocation rules, which currently, as I elaborated before, allocate most comprehension costs to the consumer side of the market. In order to achieve a change in risk allocation, policy should make it mandatory for financial institutions to undertake internal procedures and mechanisms that will *ensure the result of financial product comprehension* by each and every one of their consumers. In this way policy creates a strong incentive for financial institutions to make consumers comprehend their products better while using their unique knowledge and expertise to achieve this goal. It also refrains from intervening (at least not directly) with product design and financial innovation. As I will explain further,¹⁰⁸ this is also a most efficient way to deal with the aforementioned market failures while supporting other social virtues.

¹⁰⁷ See *supra* Part II.

¹⁰⁸ See *infra* Part V.B.

According to my proposed approach, financial institutions assume legal responsibility for resolving the consequent market failures derived from the complex products that they produce. The emphasis shifts from investing countless regulatory means that may or may not be appropriate for consumer comprehension, to persuading financial institutions (which interact with the consumer on a regular basis) to choose carefully the appropriate means of achieving consumer understanding of their products as a result. It also shifts from designing regulatory tools that are used in a uniform way for all consumers into a much more individually-oriented approach, which obligates the financial institution to evaluate the way of achieving across-the-board consumer comprehension according to its special characteristics. For instance, a bank that overloads consumers with documents will not meet its obligation if it does not adequately ensure that every one of them has understood the products before using them. The documents can say anything (therefore the incentive to overload a consumer with information will probably reduce subsequently). Similarly, a banker who provides a service to “less informed consumers” will be required, for instance, to explain that if they fail to pay the charges on their credit card by a certain date, collectors will come to their houses and repossess their families’ cars at the start of the following month. Or to return to the example with which I opened this Article, my colleague would have a legal claim against his bank if it did not explain the role of and fee collected by, a correspondent bank in an international money transfer.

Under this new approach, the question then becomes: were the means taken by a financial institution those necessary to ensure the result of comprehension by a specific consumer. If the answer is negative then the financial institution is liable for any damages that were caused to the consumer as a result of her incomprehension. As I will further elaborate, this rule would lead to a much more beneficial outcome. It would alter the allocation of costs in the consumer financial product market. It also would strengthen the two highly important social values to which we continue to return—consumer trust in financial institutions and social cohesion. What is more, together with other market incentives and change in regulation it would create a fundamental change in financial institutions’ practices.

B. Justifications

Three main points support the premise that my theory is more beneficial, fair and socially valuable than the one that is currently in place.

The first point deals directly with the issue of economic efficiency. As was analyzed above, complex financial products impose high transaction costs that reduce private benefits and social welfare. Since financial institution product complexity both creates those additional costs and is the source of great financial profit to the financial institutions, it seems it would also be most efficient to allocate the costs of attaining consumer understanding of those products to the financial institutions. Those institutions are in the best position to factor those costs into the design of their products as well as to distribute them equally and equitably among their consumers. Moreover, given that financial institutions design their complex financial products, there can be no question that they understand them best. There can also be no question that financial institutions possess, by far, the most accurate knowledge on each of their consumers due to segmentation techniques and their constant connection with them. Therefore, financial institutions are also the most fitting and efficient body to explain those products accurately to their consumers and to adapt this explanation to each and every one of them. This solution also would reduce regulation costs substantially—eliminating the cat and mouse syndrome, whereby regulators invest significant resources and time to determine the optimal rules for consumers to best comprehend a financial product, only to discover that financial institutions have changed the product to be exempt from regulatory scrutiny. Under my suggested approach, there is no safe harbor from regulatory scrutiny. The final responsibility for determining the measures that will achieve consumer comprehension rests with financial institutions, leaving regulators with the job of supervising their execution. The creation of a new default rule would also resolve the failure of “debiasing” which is inherent to the economy of shrouded products. To recall, according to the economy of shrouded products, in a competitive market financial institutions lack incentives to “debias” consumers, since “debiasing” will only lead those consumers to use their current shrouded

products more sophisticatedly (instead of switching suppliers).¹⁰⁹ Therefore, no supplier will act first to “debias” consumers as it will not be able to make any profit from such an act. Under my approach, financial institutions will have to “debias” consumers with regard to their own products, therefore eliminating the first mover paradox. In this reality the incentive of all financial institutions to use more sophisticated shrouding techniques will reduce tremendously,¹¹⁰ and a practice of honest pricing can become an economic reality.¹¹¹ Finally, my approach would also reduce the costs of disclosure and education. As the burden of consumer comprehension shifts to the financial institutions, there is no need to subject consumers to the large and frustrating amounts of mandatory disclosures or to financial literacy programs (which they of course might still attend for other reasons). Financial institutions would have the discretion to determine the most effective way to achieve consumer comprehension, given that the emphasis would have shifted from uniform means to achieving results. Naturally, this discretion would be subject to supervision and the risk of liability for breaching their duties.

The second justification for my approach is that it aims to increase consumer trust at financial institutions.¹¹² The concept of trust has a special implication and importance in the context of financial products for consumers. Trust in a country’s financial system is a founding concept of the entire banking business and of the financial product industry. The work of Ben-Oliel deals with this issue in depth.¹¹³ According to Ben-Oliel, several features establish trust as a primary principle of commercial banking. First, consumers who do not trust their banks will not deposit their funds with them or withdraw their already-deposited funds from them. If such consumers are numerous, the result is the utter lack of any financial system that relies on deposits to conduct its business. Furthermore, financial

¹⁰⁹ Gabaix & Laibson, *supra* note 1, at 506–10; *see supra* Part II.

¹¹⁰ BAR-GILL, *supra* note 1, at 30–40 (explaining the first mover paradox but focusing on a demand side-based solution).

¹¹¹ Ian Ayres & Barry Nalebuff, *In Praise of Honest Pricing*, 45 MIT SLOAN MGMT. REV. 23 (2003) (discussing the economic justifications of honest pricing practices).

¹¹² Avinandan Mukherjee & Prithwiraj Nath, *A Model of Trust in Online Relationship Banking*, 21 INT’L J. BANK MARKETING 5, 13 (2003); *Study Shows Consumers Distrust Banks More Than Any Other Industry*, THE FINANCIAL BRAND, available at <http://thefinancialbrand.com/22896/edelman-banking-financial-services-consumer-trust-study/> (last visited July 20, 2013).

¹¹³ RICARDO BEN-OLIEL, BANKING LAW (GENERAL PART) 102–03 (1996).

institutions are not ordinary retail service providers; they provide a service that has a substantial social impact and importance. It affects commerce efficiency, retail service distribution, economical liquidity, the nation's financial strength and stability, and more. As policy makers are aware of the social importance of financial products and consumers' trust in them, they too invest substantial amounts of funds every year in licensing, regulating, supervising, and deposit insurance—all of which are intended to increase consumer trust in financial institutions and their soundness.¹¹⁴ Additionally, financial institutions themselves appreciate the crucial importance of consumer trust and continuously endeavor to improve it via advertisements, logos, loyalty programs, and the like. Finally, I would also maintain that the importance of trust in financial institutions is highly important in the United States, as a recent survey shows that only 46% of consumers trust financial institutions (and even less trust banks), which places those institutions at the bottom of the list of trustworthy businesses in the country.¹¹⁵ As I stated previously, we all pay a huge social price for this financial mistrust.¹¹⁶ Analyzing the market of financial products for consumers within the prism of trust underscores another major failure in the current market structure. On the one hand financial institutions need consumers trust to sustain their businesses; on the other hand the market they have created obligates them to uphold strategies involving tricks and traps, directly leading to a constant deterioration of the same trust they so eagerly seek to build. This reality is paradoxical and, as was previously mentioned, highly unbeneficial and even risky to society. However, under my aforementioned suggestion, financial institutions would be obligated to

¹¹⁴ See, e.g., JONATHAN R. MACEY, GEOFFREY P. MILLER & RICHARD SCOTT CARNELL, *BANKING LAW AND REGULATION* 267–69 (2001) (stating the federal deposit insurance system was established in order to increase consumers trust in the financial system); financial institutions supervision is also established to ensure consumers that the Government is committed to financial institutions' soundness; see also Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, Dodd-Frank Act 124 Stat. 1376, 1540 (2010) and § 1021, 124 Stat. at 1979 (increases the amounts insured by federal deposit insurance from \$100,000 to \$250,000. This act was supposed to increase consumers trust in the soundness of their deposits. It also established the CFPB in order to achieve a more fair market of financial product for consumers.).

¹¹⁵ EDELMAN, *supra* note 103, at 8–9; *Temkin Trust Ratings*, TEMKIN GRP. (Apr. 30, 2012), <http://experiencematters.wordpress.com/2012/04/30/2012-temkin-trust-ratings/> (ranks consumer trust in 206 different types of businesses and places the largest United States banks at the bottom of list).

¹¹⁶ See Haim & Mann, *supra* note 56 (the social costs of fringe banking are extremely high).

maintain trust in their products by ensuring their comprehension by consumers.¹¹⁷ There is no better way to secure consumer trust than to legally mandate that financial institutions resolve one of the biggest difficulties faced by consumers in today's financial world—the complexity of financial products. In parallel, my model imposes a duty on policy makers, regulators and the courts to act as supervisors of the execution of this obligation, and as such to contribute their share toward regaining consumer trust in financial institutions. To conclude this point I should emphasize that in addition to the various policy makers' efforts to increase trust in financial institutions discussed in the previous section, the concept of consumer trust and its importance have not disappeared from the eyes of the courts. In several cases, United States courts have imposed fiduciary duties on financial institutions requiring them to consider consumers' interests even before their own and to explain their services to them.¹¹⁸ As is well known, fiduciary duties are used to uphold the relationship of trust.¹¹⁹ Nevertheless, like policy makers, the court has adopted those duties in accordance with a default rule by which the consumers bear the burden of demystifying the complexity of financial products.¹²⁰ Therefore, only in specific cases in which consumers could prove the existence of a special trust relationship did the courts imposed the standards of fiduciary

¹¹⁷ Jens Baumgarten, Ben Snowman & Wei Ke, *Rebuild Consumer Trust by Offering a Fair Deal*, AM. BANKER (June 21, 2012), http://www.americanbanker.com/search/index.html?zkDo=search&frommonth=01&fromday=14&fromyear=2012&tomonth=07&today=14&toyear=2013&publication=all_articles&query=Rebuild+Consumer+Trust+by+Offering+a+Fair+Deal&x=18&y=9 (stating that a comprehensible communication of product costs to consumers is a key element on winning back consumers trust in banks).

¹¹⁸ *See, e.g.*, *Stone v. Davis*, 419 N.E.2d 1094, 1097–99 (Ohio 1981) (The court declared that a fiduciary relationship is one in which special confidence and trust is reposed in the integrity and fidelity of another and there is a resulting position of superiority or influence, acquired by virtue of this special trust. Therefore it was determined that when a bank gives advice to consumer regarding a loan or mortgage insurance, it acts as a fiduciary.); *Bank of Red Bay v. King*, 482 So. 2d 274, 285 (Ala. 1985) (the court stated that a fiduciary duty may arise when a customer reposes trust in a bank and relies on the bank for financial advice or in other special circumstances); *ADT Operations, Inc. v. Chase Manhattan Bank*, 173 Misc. 2d 959, 963 (N.Y. Sup. 1997) (stating that fiduciary duty may be created by express provisions of contract or by factors such as length of relationship of parties, their financial interdependence, and their sharing of confidential and proprietary information).

¹¹⁹ J.C. SHEPHERD, *THE LAW OF FIDUCIARIES* 3–35 (1981).

¹²⁰ *See, e.g.*, *Rush v. S.C. Nat'l Bank*, 343 S.E.2d 667 (S.C. Ct. App. 1986) (stating that the normal bank-depositor arrangement is not a fiduciary relationship although it can become one under limited circumstances such as when the bank advises a consumer on services that it offers).

relationship. In light of my previous analysis, the reasoning behind the courts' conception that consumers should trust their financial institutions only on "special occasions" remains a mystery. My above-expressed opinion on the importance of trust in any financial system is quite different from that which guides policy makers and the courts today on the issue of too complex financial products. In light of Ben-Oliel's work, I believe that the principle of trust in a financial market does not need any proof. It is one of the founding axioms to which economies and societies should aspire. Ideally, consumers should be able to trust each and every product that financial institutions create, and legal arrangements must ensure and protect this trust as a highly important social value. My suggested approach could assist in achieving this goal by introducing a default rule acknowledging that financial institutions bear primary responsibility for gaining their consumers' trust.

The third argument in support of my approach is perhaps the hardest to pin down as it considers social values such as fellowship and cohesion, to which I refer to in the context of this Article as the social obligation to ensure the availability of mainstream financial products to all segments of society. As was mentioned previously (but is worth mentioning again), 28% of United States households does not have access to mainstream financial products.¹²¹ Again, one of the primary causes to this situation is the complexity of mainstream financial products, which has the greatest effect on those who experience more difficulty understanding these products.¹²² Setting aside the social costs resulting from this situation (as fringe financial products are much more costly for their users and for society), the more significant problem is the social message that sustaining this reality sends to almost a third of the country population—that they simply do not belong to its mainstream. For these consumers being stuck in the reality of using pawnshops or money orders instead of payment cards sends a message that they are excluded from the dream of success. Under this reality, society suffers not only from the financial costs of fringe banking but mainly from the decrease in social cohesion. In the 21st century, society cannot afford to have the accessibility of financial products for its LMI

¹²¹ BURHOUSE & OSAKI, *supra* note 12, at 3–6.

¹²² See *supra* Part III.C.

consumers dependent on them paying more for less (paying more for fringe banking and getting less beneficial services). It also cannot afford to have consumers living under the impression that they cannot understand the mainstream. The way to resolve this situation passes through providing those consumers with products that match their needs.¹²³ One highly important attribute of those needs is comprehensibility.¹²⁴ It is highly possible that imposing a duty on financial institutions to guarantee product comprehensibility to all consumers will cause them to focus more on upholding this duty even with regard to the LMI segment. As serving LMI consumers with current complex products might become more costly to financial institutions (due to comprehension costs), and as those institutions cannot raise the price of a product only among a specific sector of the population, the logical outcome is that those institutions will seek a way to create new products which will better fit LMI consumers and thereby reduce comprehension costs. Such a reform might lead financial institutions to focus on and compete within the LMI segment and provide those consumers with the products that they want and need. After all, for a nation that is proud of making complex products such as computers and cars simple and available for the entire world, one just cannot simply accept that this innovative capability stops at the door step of mainstream financial institutions. My personal belief is that the competitive pressures described above might cause financial institutions to finally provide LMI consumers the products they really desire and can understand better.

C. The Means

The successful execution of my proposal depends on two main factors: precise implementation and support by a suitable market environment that will encourage it. While the first factor deals directly with the application of the liability rule I suggested above, the other means that I will mention serves to support it by steering the market towards the direction of transparency, comprehensibility and trust, as I have suggested in this

¹²³ Mann, *supra* note 56, at 747–51 (stating that LMI consumers have different financial constraints and therefore they prefer institutions that can meet those constraints).

¹²⁴ *Id.* at 741 (“One reason households are choosing payday loans instead of credit cards and fixed-term bank loans is that they make more sense for them.”).

Article. My discussion will continue by addressing the implementation of the liability rule moving to the methods which will support it (beginning with market-oriented incentives and moving to more extensive regulation).

1. Assessing Liability

Although the liability rule I suggested above is quite broad, its success lies in precise implementation. The most important factor in the implementation process is the adaptation of the means that financial institutions choose to use with regard to each and every product that they offer. For example, the means that should be employed by financial institutions in order to ensure each consumer's comprehension with regard to credit cards might be different from those that should apply with regard to checking accounts. Those means might also change from one consumer to another, as different consumers possess different kinds of knowledge and comprehension skills. Therefore, it will eventually be up to financial institutions to determine the means of ensuring that each consumer comprehends each and every product. In order to accomplish this task, financial institutions will likely need to undertake more extensive internal procedures and mechanisms on macro and micro levels. On the macro level financial institutions will have to use their knowledge and expertise in order to identify the important attributes that are relevant for consumers in each product and to determine the best ways of communicating the information to them clearly. On the micro level they will probably have to hire more capable personnel, conduct more precise and product-oriented trainings, and encourage their employees to understand better the capabilities and needs of each consumer. In extreme cases, if all the necessary means to achieve consumer comprehension fail, financial institutions will have to offer their consumers advice that suits their financial needs. As will be explained below, I also believe that some regulatory guidelines can be helpful in accomplishing this precise implementation and in relieving some of the vagueness that might surround it. The implementation of these means will have to be assessed, eventually, by regulators and courts. They will impose liability on financial institutions that have not taken the necessary means to ensure consumer comprehension.

2. *Measuring Complexity*

An important market-oriented means of steering financial institutions towards the new direction I have suggested in this Article is to encourage more competition in the field of service quality and especially precise and clear explanation of financial products. As was elaborated above, financial product comprehension depends mainly on product design, consumer characteristics, and financial institutions' investments in allowing consumers to comprehend their products fully. While the research entailed herein indicates that in practice the two first factors remain constant, policy can lead to encourage the improvement of financial institution representatives' professionalism, services, and the manner in which they communicate the explanation of their products to their consumers. The most salient difficulty in this context is causing financial institutions to compete on this plane, especially given that within the current market structure there is no efficient way for consumers to evaluate professionalism and product quality in advance.¹²⁵ Therefore, under the current market structure consumer preferences are distorted and create high search costs and market stagnation.

To resolve these difficulties I suggest a reputation-based incentive system which will require every financial institution branch to publicly post a service quality ranking assigned by the regulator. According to my suggestion a uniform index of service quality evaluation should be implemented by the regulator. This index would calculate several factors that influence consumer comprehensibility of financial products, such as: professionalism, trainings, consumer satisfaction, consumer feedbacks, the number of justified complaints with regard to incomprehensibility of products, and others. The index would be determined by an official regulator and it would be mandatory to display it in every financial institution's entrance and on every service counter. As such, consumers would be able to easily appreciate in advance their chances of receiving a more professional, precise and comprehensible financial service at each and

¹²⁵ See *supra* Part III.A.3.

every provider, an act that consequently would strengthen consumer trust in professional and trustworthy financial institutions.¹²⁶

A similar standard is already being applied, for example, in the restaurant industry in order to measure their sanitation and hygiene levels. As studies show, such standards have led to a substantial improvement in restaurant sanitation, as consumers were given a means of evaluating this important parameter before deciding whether to eat at a restaurant.¹²⁷ Consequently, the number of consumers who eat in restaurants has increased as well. Similar consequences can be achieved in the financial institution industry should they be subject to a trustworthy, mandatory, public and constant evaluation of their service quality. This kind of standard will lead financial institutions to improve their services, products, and consumer trust in the long run. Accordingly, consumers will feel more content as they will be able to evaluate financial institutions according to a parameter that is highly important to them as individuals and to society as a whole.

3. Supporting Trustworthy Practices

The next policy step I wish to suggest is to reduce entry thresholds in the market of financial products for consumers for non-financial-in-nature institutions which can be determined to be supporting trustworthy practices and transparent pricing. I believe that those institutions that already uphold desired business practices should be considered more positively if and when they wish to take part in the market of financial products for consumers. I strongly support the idea raised by Mann a few years ago that Wal-Mart, for instance, should have a bank.¹²⁸ Although Mann suggested this idea as a means of cutting the costs of payments and increasing competition in the

¹²⁶ Mukherjee & Nath, *supra* note 112, at 12 (stating that reputation is a key element to gain consumers trust in financial institutions).

¹²⁷ Ginger Zhe Jin & Phillip Leslie, *Reputational Incentives for Restaurant Hygiene*, 1 AM. ECON. J. MICROECONOMICS 237 (2009).

¹²⁸ Ronald J. Mann, *A Requiem for Sam's Bank*, 83 CHI.-KENT L. REV. 953 (2008) (suggesting a uniform model for the licensing of payment suppliers that will allow for more institutions—like Wal-Mart—to enter the payment market subject to specific and necessary regulatory requirements).

financial market, I believe that it can also contribute substantially to reducing financial product complexity for several reasons.¹²⁹

First, it is highly probable that retail institutions will introduce new financial product pricing techniques which will cut the costs of financial products while increasing profits from other retail products. For example, retailers can offer financial products at lower prices in order to attract more consumers to their place of business, and by doing so, increase their retail products sales and, subsequently, their profits.¹³⁰ In this case, institutions will not be driven so easily to use pricing techniques that profit from consumer miscomprehension of their financial products. To put it more simply, while financial institutions are caught by the practices of shrouding, bundling, price planning and complex language to increase their profits, some retail suppliers are more willing to find other ways of achieving those profits. Therefore it appears that those institutions will be able to introduce much more comprehensible financial products to consumers.

Second, many retail suppliers base their marketing strategies on consumer trust in their business practices, by offering transparent, clear and comprehensible products.¹³¹ They do so in order to ensure that their consumers will continue to make purchases from their stores. The ones I wish to target in this proposal are those with the most outstanding results in these fields. It is only reasonable that suppliers that already uphold those strategies will not change their behavior when they move to the business of financial products for consumers. Therefore, they will probably apply the “what you see is what you get” policy to financial products.

Finally, in addition to the benefits that new institutions will bestow upon their financial product consumers, they can also bring about competitive pressures on the plane of product complexity, especially as they increase in number. This pressure might be exactly what financial institutions need in order to change their current business practices and introduce new, more transparent and comprehensible, ones. In this case the

¹²⁹ Mann, *supra* note 56, at 744 (stating that Wal-Mart would be able to better serve the financial needs of LMI consumers, partly since it already enjoy their trust and familiar with their tastes for products).

¹³⁰ See Mann, *supra* note 128, at 957–63.

¹³¹ EDELMAN, *supra* note 103, at 7 (stating that consumers trust retail suppliers—such as food and beverage suppliers, telecommunication suppliers, technology suppliers, etc.—much more than financial institutions).

chances that product complexity will reduce in the overall financial market also increase.

4. *Supervising Contract Terms*

The last point I wish to raise is to impose restrictions on certain terms in consumer financial product contracts. This suggestion is, of course, not completely new. Several countries, for many years, have enacted laws and regulations which limit unfair contractual terms.¹³² Banning certain contractual terms is also a required outcome of this article's analysis, as market efficiency rules support imposing a duty on financial institutions to explain their products to consumers—a duty that could become highly impossible when contract terms are abusive or overly incomprehensible. However, the risk of this practice lies with its intrusion on contract design, which might eventually be reflected in the price of the products.¹³³ There is also the risk that financial institutions will adapt their contractual terms to bypass restrictions that target specific clauses.

The issue of regulating standard contract terms is quite broad. Naturally, a full discussion of the topic is beyond the scope of this Article. Nevertheless, in light of my discussion so far, I wish to suggest some guidelines for a *moderate and balanced* supervision of consumer financial product contract terms that would reduce consumer miscomprehension of their financial products, while limiting their negative influence on the market to the greatest possible extent.

¹³² The European Union has enacted the Unfair Terms in Consumer Contracts Directive at 1993 in order to ban unfair terms in consumer contracts. See Council Directive 93/13/EEC of 5 April 1993 on Unfair Terms in Consumer Contracts, 1993 O.J. (L 95). The United Kingdom has enacted the Unfair Contract Term Act and the Unfair Terms in Consumer Contract Regulation; both of them allow banning contract terms that unfairly create a significant imbalance between consumers and their financial institutions. See Unfair Contract Term Act, 1977, c. 50; Unfair Terms in Consumer Contracts Regulations, 1999, S.I. 1999/2083. In Israel, Standard Contracts Law, 5743-1982, 37 LSI 6 (1982) allows courts to ban and even redesign standard contract terms if they are abusive to consumer rights. In the United States the court adopted the doctrine of unconscionability in order to uphold judicial scrutiny with regard to abusive contract terms. See, e.g., Korobkin, *supra* note 27, at 1258–78 (suggesting a model of regulating non-salient contractual terms and discussing the unconscionability doctrine). Mann has also suggested banning some terms in credit cards contracts if their effects are highly unfair to consumers. MANN, *supra* note 1, at 143–48.

¹³³ MANN, *supra* note 1, at 143–48; Korobkin, *supra* note 27, at 1249–51.

To begin, with regard to the method of supervision, I suggest that policy should not focus on banning specific contractual terms (which might be too aggressive intervention), but rather on creating contradictory presumptions with regard to different types of terms that might abuse consumers' right to understand financial products or place them at undue disadvantage, despite explanations provided by financial institutions.¹³⁴ By basing contract terms supervision on contradictory presumptions, I support the creation of a balanced mechanism that prevents automatically banning certain terms, on the one hand, while, on the other hand, shifts the burden to financial institutions to prove why a specific term is not abusive or unduly disadvantageous to consumers. In this way my proposal also prevents the continuous practice by which financial institutions find ways to adapt their terms to be excluded from regulatory restrictions, as the suggested policy targets types of terms, rather than specific ones. Moreover, my proposal would create an ex-ante mechanism that could deter financial institutions from using certain debatable terms in their contracts, as they might not wish to take the risk that those terms will be determined void at a later stage.

Second, with regard to the scale of supervision, I do not believe that supervision should be restricted to non-salient terms.¹³⁵ As we have seen, financial product incomprehensibility is not limited to non-salient terms, but in many cases involves consumers who cannot correctly understand basic salient attributes of their products, including their uses and price structures (even though we believe they consider those terms when purchasing the product).¹³⁶ When all else fails I believe that regulators and courts should have the tools to resolve this situation and the inefficiency arising from it, even if it means intervening in contract design more intensively. Furthermore, the main reason not to regulate salient contractual

¹³⁴ A similar approach was taken by the Israeli legislator in Standard Contracts Law, 37 LSI 6. According to article four of the law, terms that would be presumed as abusive or unduly disadvantage consumers are, for instance: a term that allows the supplier to shift his liability to a third party, a term that allows the supplier to change salient features of the contract (without the consumer consent) after its enactment (except if the change acquires from changes which are not in the supplier control), a term which changes the default burden of proof as it was define by law, etc.

¹³⁵ *But see* MANN, *supra* note 1, at 143–48 (supporting only the regulation of non-salient contract terms in credit cards contracts); Korobkin, *supra* note 27, at 1254–55 (supporting the regulation of salient terms by the market).

¹³⁶ *See supra* Part III (consumers are unable to understand basic terms in their recently obtained mortgage agreements).

terms is that market forces are often the most efficient means of doing so.¹³⁷ Nevertheless, I think that my discussion so far proves that the market force's ability to resolve the complexity issues of financial products for consumers is exaggeratedly over estimated. Therefore it will be up to policy makers and courts to take the initiative in proper cases. However, due to the risks involved in influencing product design in an overly aggressive manner that may be a result of banning salient terms, this kind of action should be considered with more attention to its influence on product design and market efficiency.

Finally, if a term is banned, it is only reasonable that the banning body (regulator or courts, as I will elaborate below) will have discretion to offer new appropriate designs of the term, and in severe cases, even to impose a replacement term. As such the market can apply the wide default rule which places the burden of comprehension on financial institutions, but also allows for the necessary flexibility for the market to apply exceptions when needed.

D. Is There a Downside?

The main consideration that may be raised as a downside to my proposal is the risk of increase of consumer financial product costs. Arguably, as a result of imposing "comprehension duties" on financial institutions, they are liable to factor the "comprehension costs" into their pricing calculations. While this result is likely to some extent, I believe that several considerations—economic and moral—may reduce its probability and undermine its negativity.

First, as consumer trust in financial institutions will increase under my proposed policy, the amount of consumers who use those institutions' products will increase as well.¹³⁸ This will increase financial institutions' profits, which may in turn undermine the need for a high increase in product prices.¹³⁹

¹³⁷ Korobkin, *supra* note 27, at 1254–55.

¹³⁸ BURHOUSE & OSAKI, *supra* note 12, at 27 (at least 7.1% of unbanked consumers do not engage the services of banks since they do not trust them).

¹³⁹ Ayres & Nalebuff, *supra* note 111, at 27–28.

Second, as service quality and trust will become measurable, the search and switching costs borne by consumers will decrease, rendering the consumer financial product market more competitive, bringing with it more efficiency and further reduction in financial product prices.¹⁴⁰

Third, as product comprehension will become a norm within financial institutions, costs will be able to streamlined as much as possible and enjoy the benefits of economies of scale, leading to a decrease in costs. Increased competition from institutions that support the production of much more comprehensible financial products can also foster market efficiency and bring upon further reduction in costs.

Fourth, and on a more moral note, there are simply some social values that are worth paying for. Social cohesion and consumer trust in financial institutions are two of them. Those values become meaningless if, given a need, society is unwilling to take the necessary steps to maintain them. Under this assumption, even some reduction in profits is not necessarily a loss.

VI. RECOMMENDATIONS

The following discussion leads to very specific policy recommendations on two planes—enactment and enforceability.

Among the existing regulators, the supervision and regulation of the subject should be delegated to the CFPB as it is the body in charge on enforcing a “*fair, transparent, and competitive*”¹⁴¹ consumer financial product market, and whose stated goal is to ensure that “*consumers are not subject to deceptive, unfair, abusive, or discriminatory practices.*”¹⁴²

In the course of its duty, the CFPB should issue guidelines for financial institutions to maintain their duty to insure comprehension of financial products among consumers. These kinds of guidelines particularly could help to relieve some vagueness that might accompany my proposal in its first stages. Nevertheless, as I discussed previously, the final measure of how best to implement those guidelines will be determined on a case-by-

¹⁴⁰ See *supra* Part IV.A.3.

¹⁴¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 1021, 124 Stat. 1376, 1980 (2010) (emphasis added).

¹⁴² CONSUMER FIN. PROT. BUREAU, *supra* note 74, at 9–10 (emphasis added).

case basis by the financial institutions, who will also decide whether more steps need to be taken to ensure each consumer comprehension.

Additionally, the CFPB should issue regulations with regard to the types of contractual terms that are presumed to be abusive to consumers or to place them at an undue disadvantage. The Bureau should then take measures to abolish those terms, to ensure they are amended, and in severe cases to impose more efficient and just ones.

Furthermore, the Bureau should announce a series of periodical inspections designed to form an index of “service and trust” or “trustworthy practices.” As was explained above, those inspections will evaluate the professionalism, comprehension and training levels of financial institution employees, as well as their level of justified law suits and complaints. It might also consider consumer satisfaction from a particular financial institution and the level of correlation between institution (or branch) products and its specific types of consumers. The index should be given as a certificate of the Bureau, and it should be made mandatory that the index be published in every entrance and counter of financial institutions. In order to implement its roles in this context, the Bureau should continue to search for new ways to obtain consumers’ feedback on the services they have received and expose cases in which they have used products that were not clear to them. A useful way to obtain such feedback might be to contact consumers directly regarding a financial institution about which the Bureau has reasonable suspicion (from inspection or complaints) that those consumers’ rights were abused.

Lastly, the Bureau should cooperate with other regulators to determine the means of factoring trustworthy practices into the licensing procedure of new applicants. In this way it would foster the inclusion of new appropriate institutions in the market of complex financial products.

Beside the important job of the Bureau a very important role in the implementation of my proposal is reserved for the courts. As I suggested before, following Ben-Oliel’s work, it seems that courts will have to implement the concept of fiduciary duty as a broad concept that applies to every financial service and product. Furthermore, it will be up to the courts to determine in each and every case whether financial institutions have indeed *ensured the result* of financial product comprehension by consumers. Failure to do so will render financial institutions liable for breach of their duties. Furthermore, I believe courts should apply the principle of fiduciary duties to determine whether a contractual term is

abusive to a consumers or whether it places them at unfair disadvantage.¹⁴³ In such a case those terms should be declared void by the court.

I strongly believe that a combined move by the appropriate regulator and courts finally could steer the market of financial products for consumers into a much more comprehensible and competitive era that will benefit us all.

VII. CONCLUSIONS

This Article deals with complex financial products; however, its fundamental message is not incomprehensible at all. Consumers should be able to understand their financial products without taking disproportional measures and incurring high personal and social costs in the process. My analysis identifies product complexity as a primary cause of several failures in the market of consumer financial products. It also identifies a mismatch between the current policy measures which allocate the high costs of complexity to the demand side of the market, and its efficiency in resolving market failures. My thesis is that a revision of the policy framework such that financial institutions are designated as the primary body responsible for achieving consumer comprehension holds a crucial role in promoting a more efficient, trustworthy, and equitable financial market. At the same time we can have more confidence that decisions made by consumers who understand the nature and attributes of their financial products will bring upon a more competitive, stable and sound financial market.

While some might disagree with my suggestions, I hope that at the very least, most can agree that the analysis of this pervasive issue should raise considerable discussion with regard to the importance of its resolution.

¹⁴³ As it well known, fiduciary duty supports higher standards of conduct by the obligated side. See SHEPHERD, *supra* note 119. Therefore, applying the fiduciary duty's standards to analyze contractual terms in the financial market will allow the court to impose a wider test than the one currently applied by other doctrines, such as the unconscionability doctrine. For implementations of the concept of fiduciary duties in Banking Law see: RUTH PLATO-SHINAR, THE BANKS' FIDUCIARY DUTY 31-71, 351-453 (2010).