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Consumer protection in the banking sector: A behavioral economic approach

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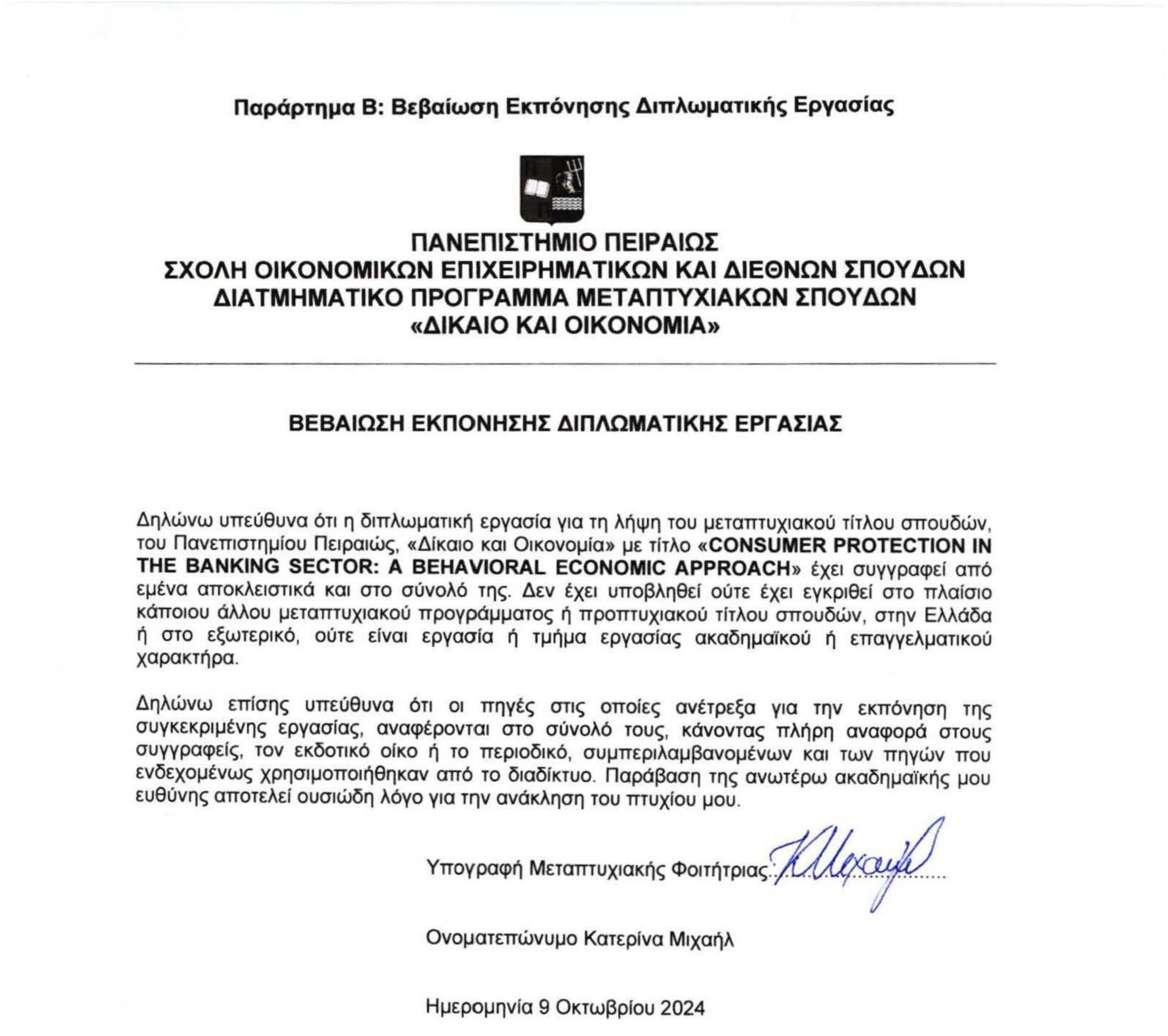

Παράρτημα Β: Βεβαίωση Εκπόνησης Διπλωματικής Εργασίας

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Υπογραφή Μεταπτυχιακής Φοιτήτριας..................................

Ονοματεπώνυμο Κατερίνα Μιχαήλ

Ημερομηνία 9 Οκτωβρίου 2024

To my parents, whose support and encouragement
has made this accomplishment possible.

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Abstract

This thesis explores the application of behavioural economics on consumer protection in banking contracts. It begins by examining the main issues surrounding the relationship between financial institutions and individuals. Subsequently, it provides an introduction to the field of behavioural economics, illustrating its main principles and how they can be applied in addressing consumer protection. Lastly, nudges are being presented as potential tools that could mitigate the identified concerns and eventually ensure better and more informed decision-making by consumers.

Introduction

Consumer protection in banking contracts has become an increasingly challenging issue in recent years, as banking products and services have become more complex, and consumers struggle to keep up. The tools provided by conventional economics fail to provide the necessary protections, as consumers continue to make suboptimal financial choices and fall victim to unfair terms and practices. As a result, there is a growing interest in tackling these issues using alternative approaches such as behavioural economics.

Behavioural economics provides a different viewpoint to traditional economics regarding how individuals make decisions, and how their biases and heuristics affect the decision-making process. By applying this approach to banking contracts, we are able to have a better understanding of where the system falls short to provide the necessary protections and we can also help consumers make better and more informed financial decisions.

This paper will attempt to provide a behavioural economic approach to consumer protection in banking contracts, with a focus on identifying the faults of the banking industry and the psychological elements that affect decision-makers, and on developing the tools that could mitigate cognitive biases.

My thesis will begin by highlighting the main issues regarding consumer protection in the banking sector, and the effect of cognitive biases in consumers' decision-making. It will also provide an introduction to the science of behavioural economics and the key concepts and principles that underpin this field. Lastly, I will review existing findings of the research on behavioural biases that influence consumers in their decisions regarding banking products and services and examine some of the tools that are used in order to address these biases.

The main contribution of this thesis will be to provide a clear set of recommendations for designing banking contracts that improve consumer outcomes, based on the insights that can be found from a comprehensive review of the literature on behavioural economics and nudge theory. These recommendations aim to become a useful tool for policy makers, legislators, financial institutions and consumers.

Part I: The main issues regarding consumer protection in banking contracts

The financial market presents several elements that affect consumers' choices leading to unfortunate results. Consumers, especially the more vulnerable ones, are easily affected by these factors, resulting in suboptimal financial choices that will affect not only the consumers' welfare, but the economy as well. These unique aspects of the banking industry render traditional protective tools ineffective and, in some cases, even harmful for the consumer.

A. Information asymmetry and bargaining power

a. The complexity of the banking contract

A banking contract is different from a traditional legal contract, and it should not be treated as one (Plato-Shinar 2013). Legal transactions are based on the fundamental principle of freedom of contracts, which includes the freedom to choose whether one will sign a contract and to freely negotiate the contractual terms (Stathopoulos 2004: 249).

To have true and full freedom of contracts, it is necessary to have some level of power balance between the two parties. However, in the case of banking contracts the disparity of power between the bank and the consumer is inevitable due to not only the significant difference in economic power, but also because of the asymmetry of information and the lack of bargaining power on the consumer's side.

Consumer protection is often hindered by this inherent power and information imbalance which makes it challenging for consumers to fully comprehend the terms and conditions, leaving them vulnerable to unfair practices, hidden fees and unexpected risks.

Asymmetry of information is a situation where one party of a transaction is not privy to all the information that the other has (Akerlof 1978). The average consumer significantly lacks in terms of power and information compared to the financial institutions that possess all the necessary expertise and resources and a significant amount of private information for their clients. This could easily be explained by several factors like the inexperience and financial illiteracy of consumers (De la Cuesta et al. 2021: 163-176) yet for the most part it is due to the complexity and excessive length of most banking contracts.

Contracts for financial products and services tend to be overly convoluted and long, riddled with complicated economic and legal terminology that is hard to follow, making it difficult for consumers to fully comprehend the terms and conditions, in spite existing protective regulation,[1] failing to exercise their rights and adequately prepare.

In the banking industry we come across standard form contracts that include a previously drawn up set of clauses and terms of services. Often, the individuals signing these contracts have little to no understanding of what they are actually agreeing to. The majority doesn't bother reading the fine print (Bakos et al. 2014), as it is too

[1] See Article 5 of Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts: "In the case of contracts where all or certain terms offered to the consumer are in writing, these terms must always be drafted in plain, intelligible language. Where there is doubt about the meaning of a term, the interpretation most favourable to the consumer shall prevail."

long, complex and it might even seem unimportant at the moment of signing. Moreover, even when people know well enough to be suspicious towards it, they still choose not to take action (Furth-Matzkin & Sommers 2020: 516).

This asymmetry of information threatens the freedom of contracts and combined with the low bargaining power of consumers, leads to contract failures.

b. Imbalance of negotiation power

In accordance with the principles of freedom of contract, it is suggested that the contracting parties come to a mutual agreement after they negotiate each individual term of their contract. Inequality of bargaining power refers to a situation where one party of a contract is unable to exercise their right to negotiate each term because the other party has a greater power to choose whether to move forward with the agreement and she can do so with more favourable terms.

Big firms and corporations with high revenues may have some bargaining power vis-à-vis the bank since they are more profitable from the bank while losing them as clients could be damaging for the institution. Yet the average consumer lacks in significance for the bank and as a result, has less bargaining power when negotiating a contract and banks adjust their strategies according to the level of the potential customers' bargaining power. (Wu & Wy 2007 : 20).

As is the case with most standard contracts within the banking industry, the consumer is typically compelled to consent to the terms and conditions outlined by the financial institution, with minimal opportunity to influence the content of the agreement.[2] The consumer has only two options regarding his contract, she can only take it or leave it with little to no room for negotiation.

Nobody reads these contracts in their entirety, it would be a long and tedious process, and even if they did, it wouldn't be worth it to spend the time and effort necessary to actually understand every term (Hatzis 2008: 47). This behaviour may seem irrational and it can prove to be harmful for the consumer, however when we take into consideration the time and effort needed to read and understand the fine print, we can see that the consumer in this case is being quite rational in his implicit cost-benefit analysis (Karampatzos 2016: 323).

Consumers are not given the opportunity to shop around for better terms, since most banks use identical clauses. Their only choice is nothing more than a subjection to terms dictated by the stronger party, terms whose consequences are rarely clear or understood by the consumer (Kessler 1943: 632).

B. Existing regulation

This imbalance between the two parties, in regard to their knowledge, resources and bargaining power, leads to one party being significantly weaker and an agreement made under unequal circumstances (Karampatzos 2016). The potential negative effects of this for the freedom of contract and the competitive market have created a need for regulation on a national and European level.

[2] C-453/10 - Pereničová and Perenič

According to EU law, each individual term of an agreement should be the object of thorough negotiations and if not, it is deemed as unfair when it causes significant power imbalance and obligations for the consumer contrary to the principle of good faith.[3]

In Greek national law, there are several provisions put in place to protect consumers against these unfair practices and the phenomena of bargaining imbalance and asymmetry of information. In addition to the EU directives, national legislature sets limits to the freedom of contracts in an effort to protect the weaker party in a transaction, such as the principles of articles 174, 178 and 179 of the Greek Civil Code,[4] articles 281 and 288 of the Greek Civil Code and law no. 2251/1994 (Consumer Protection Law) that regulates consumer rights in all sectors, including financial and banking services. The legislature aims to protect the weaker parties of contracts and consumers from unfair practices that seek to take advantage of their inexperience and naivety by enforcing abusive clauses. However, it is important to note that this protection only

[3] According to the Article 3 of Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts:
1. A contractual term which has not been individually negotiated shall be regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.
2. A term shall always be regarded as not individually negotiated where it has been drafted in advance and the consumer has therefore not been able to influence the substance of the term, particularly in the context of a pre-formulated standard contract. The fact that certain aspects of a term or one specific term have been individually negotiated shall not exclude the application of this Article to the rest of a contract if an overall assessment of the contract indicates that it is nevertheless a pre-formulated standard contract. Where any seller or supplier claims that a standard term has been individually negotiated, the burden of proof in this respect shall be incumbent on him.
3. The Annex shall contain an indicative and non-exhaustive list of the terms which may be regarded as unfair."

[4] See 184/2019 Multi Member First Instance Court of Athens where the surety agreement was found invalid due to the inexperience and naivety of the guarantor according to Articles 178 and 179 of the Greek Civil Code

applies ex-post and it does not offer any defensive tools to the consumer who is about to sign such a contract.

C. The issue of consent

As stated above, the imbalances in information and bargaining power in banking contracts are always on the side of the financial institutions. Despite the inclusion of clauses that aim to establish a fair transaction, such as the duty to act in good faith, and the existence of ex post mechanisms that seek to protect consumers, such as the judicial system or a national consumer protection authority, the need for a stronger defence remains.

The European Union has adopted a regulatory approach to this, where member states must ensure the existence of mechanisms that prevent the use of unfair terms in contracts[5] and financial institutions are obligated to be transparent and provide full disclosure. For instance, the GDPR and its predecessor, the Data Protection Directive

[5] According to Article 7 of Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts:
1. Member States shall ensure that, in the interests of consumers and of competitors, adequate and effective means exist to prevent the continued use of unfair terms in contracts concluded with consumers by sellers or suppliers.
2. The means referred to in paragraph 1 shall include provisions whereby persons or organizations, having a legitimate interest under national law in protecting consumers, may take action according to the national law concerned before the courts or before competent administrative bodies for a decision as to whether contractual terms drawn up for general use are unfair, so that they can apply appropriate and effective means to prevent the continued use of such terms.
3. With due regard for national laws, the legal remedies referred to in paragraph 2 may be directed separately or jointly against a number of sellers or suppliers from the same economic sector or their associations which use or recommend the use of the same general contractual terms or similar terms.”

of 1995, emphasize the significance of user consent regarding personal data. Similarly, in consumer protection, consent is fundamental (Remolina et al. 2020: 6).

However, while important, this approach fails to fully protect the consumers. On the contrary, the consumers′ consent seems to be a tool more beneficial for the institutions rather than an effective protection mechanism (*ibid*). For banks, consent is seen a safe harbour, a tool used to claim the consumer knew very well what they were signing, and it all takes place under the auspices of the principle of freedom of contracts. Consumers by signing the agreements and giving their consent, affirm that they voluntarily made the decision in question, even if in some cases it the result of manipulatory and opportunistic practices was.

Furthermore, banks may include unfair clauses such as hidden fees in their contracts, that would not normally hold up in court, yet the consumer blindly agrees to them, either because they are not aware of the clause or because they have no negotiation power, due to the way the market operates.

Moreover, this approach does not take into consideration the way consumers make decisions and their cognitive biases. Nowadays, corporations including financial institutions have a much better understanding of these aspects, and they design their products and services based on that (Chuah & Devlin 2011: 3). The inclusion of psychological insights into economics can be very useful to marketers of financial services (Chater et al. 2010: 383-395).

The existing consumer protection regulations focus on ex-post mechanisms and consent, considering that the consumer is in a state of inferiority in relation to the bank due to the asymmetries of information and the lower bargaining power of the individual (Becher 2008: 764). That said, it is important that the government and policymakers adopt a regulatory approach that also takes into consideration the consumers' biases and decision-making process and prevents their exploitation.

D. Lack of transparency

Transparency in the banking sector includes the availability for outsiders to access information about a bank's performance and its risk profile. Financial institutions may use misleading advertising to promote their products or services, and to attract new customers, without providing sufficient information to the consumer about possible losses. A lack of transparency can be described as an institution withholding information, misrepresenting information or failing to ensure that information that is given is adequate (Vishwanath & Kaufmann 1999: 3).

Just because information is available to consumers does not necessarily guarantee that it is also accessible to everyone in equal terms. Secondly, the information given to the consumers must also be relevant, reliable and honest. Consumers need to be able to easily access the information most relevant to their situation without having to jump through hoops and sort through pages of useless data and information that has no effect on their case.

The lack of transparency in such tactics can often lead to consumers unknowingly agreeing to unfavourable or unfair terms, such as high fees or interest rates, having been misled regarding the benefits or costs of a particular product or service. Some banks may offer incentives for opening accounts or signing up for credit cards, without considering the consequences for the consumers' wellbeing.

However, these practises can be damaging not only for the consumer but the institutions as well. Policy makers are forced to develop more and more guidelines to prevent these phenomena resulting in an endless cycle of regulation. The consumer complaints and court cases can be very costly for the banks. By ensuring transparency, central banks and governments can expend fewer resources to police full disclosure compliance creating sustainable economic growth (Nasution et al. 2020: 3). Transparency in conjunction with sufficient regulation can lead to less vulnerability of the financial market (Mendonça et al. 2012: 22)

Finally, financial institutions use the insights of behavioural economics, and they are well aware of the fact that the manner in which the information is being presented to the consumer can also affect their decision-making. The small print is small for a reason, encouraging consumers to quickly skim the text (if that), without even knowing what they agree to. The digital transformation of the banking industry has also enabled institutions to take advantage of the tools and knowledge provided by behavioural economics to increase sales (Yankov 2020: 313-314). For instance, most banks are offering loans online without needing to visit a branch, in a fast process. The simplification of such actions attracts more clients.

E. A different approach to banking contracts

Financial policy makers and legislators have focused their attempts to ensure consumer protection by introducing regulations regarding disclosing risks, obtaining consent and providing information. Naturally, these factors are indeed significant in order to ensure consumer protection, and it is important that the consumers who are the weaker party of the agreement and on the wrong end of an information asymmetry know what they are consenting to (Bar-Gill & Ferrari 2010). However, the current regulations rely on certain assumptions about the way humans behave and make decisions, and in today's overly complicated and fast-changing financial market, they are deemed insufficient.

The mere fact that consumers are provided with full information does not necessarily mean that they fully understand what they sign. Moreover, focusing on the amount of information instead of the quality and how it is being framed, can do more harm than good. Studies show that being confronted with too much information can be overwhelming for the average consumer, especially when the information that is being presented is complicated and difficult to comprehend, resulting in poor decisions (Benh-Shahar & Schneider 2014). Therefore, it would be perhaps in the best interest of the consumer to be presented with less information but in a clearer manner that is easy to follow and understand and does not burden the consumer with unnecessary legal jargon.

The truth is humans make bad decisions even with full information. Especially in the case of financial contracts, where the information is overly complex for most consumers. In addition, humans face various cognitive biases that may affect their decision-making process, preventing them for making rational choices. For instance, a risk-averse consumer will avoid purchasing a high-risk financial product, even when it could potentially give him great payoff. According to Kahneman, consumers are “influenced by all sorts of superficial things in their decision making, and they procrastinate and don't read the small print. You've got to create situations so they'll make better decisions for themselves.”

Part II: Behavioural economics: a different approach on how we make decisions

A. Behavioural economics

According to traditional economics, humans are consistently rational creatures, therefore they always make decisions based on their self-interest, seeking to maximize their profit and utility. Mill (1836) states that Political Economy proposes "an arbitrary definition of man, as a being who invariably does that by which he may obtain the greatest amount of necessaries, conveniences, and luxuries, with the smallest quantity of labour and physical self-denial with which they can be obtained in the existing state of knowledge".

Behavioural economists argue against the conventional approach, claiming that humans are not always this calculated. On the contrary, humans are rather irrational. In fact, according to Epstein, it is in our nature to "often make serious mistakes in deciding important matters" (Epstein 2006: 111).

Our decisions are driven by a range of psychological factors that can be easily manipulated. Moreover, we tend to make irrational decisions due to our cognitive biases. Our judgment can be easily affected by these biases, leading to suboptimal financial decisions.

Behavioural economics aim to give us a better understanding of how individuals make economic decisions based on their psychological profile. By achieving that, we can predict their movements and hopefully prevent them from making poor choices by guiding them towards the wisest option with the right tools. One such promising tool is nudging. Its effectiveness will be further explored in the third part of this thesis. Firstly, we need to have a better idea of the key concepts of behavioural economics.

B. Cognitive biases and effects

Cognitive biases or heuristics (or mental shortcuts; rules of thumb) affect our behaviour significantly, preventing us from thinking logically and leading us towards irrational choices. These errors play an important role in our decision making, often resulting in financial choices that are suboptimal, inefficient and costly.

1. Loss aversion bias

Loss aversion can be explained by prospect theory which states that individuals value losses and gains differently (Kahneman & Tversky 1979). People are more sensitive to losses than gains. They are more invested in avoiding a potential loss than making a profit. According to Kahneman and Tversky (Tversky & Kahneman 1992: 310) people can in fact be twice more sensitive to losses than gains.

This reluctance to accept losses leads to risk aversion and financial inertia. Due to this effect, loss averse consumers tend to be more hesitant and afraid towards financial risks and are more likely to be more conservative in their investments. A loss averse investor is more inclined to choose an investment with a low but relatively guaranteed return over a riskier one that would give him a higher return (Yang 2019: 4). This explains why there is a general reluctance from consumers to invest in high-risk assets like stocks.

2. Endowment effect

Closely related to loss aversion bias is the endowment effect, which is the tendency to value an object more if you own it than if you did not.

According to traditional economics, we should place the same price on an object when we are about to be deprived of it to what we paid to obtain it in the first place. However, studies show that we tend to ask for more money when we are parting with a good than what we would be willing to pay to buy it (Kahneman et al. 1990).

Moreover, the endowment effect is also related to pretium affectionis, the value placed upon an object by its owner caused by their personal attachment or sentimental affection towards it. The longer the owner possesses the object, the higher the value. The endowment effect applies to both goods and rights. When renegotiating the terms of an agreement, the endowment effect causes a reluctance in the parties to give in and yield their rights (Karampatzos 2016: 34-36).

Research shows that borrowers tend to choose loans collateralised by the assets being financed by the loan instead of their existing assets (Carney et al 2022 : 33). This behaviour is explained by the fact that the individual is already attached to the existing asset, thus reluctant to risk losing it. On the other hand, once the newly financed asset is acquired, the borrower becomes attached to and is more likely to repay the loan.

3. Sunk-cost effect

“The sunk cost effect is a maladaptive economic behaviour that is manifested in a greater tendency to continue an endeavour once an investment in money, effort, or time has been made (Arkes & Blumer 1985)” (Arkes & Ayton 1999: 591).

Traditional economic theory implies that historical costs should be irrelevant for an individual’s current options, our decisions should only be influenced by incremental costs and benefits. Nevertheless, research shows that humans tend to invest more resources in a situation where a prior investment has been made, compared to a similar situation where a prior investment has not been made (Arkes & Blumer 1985). The investment can refer to money, time, or effort.

According to Thaler (1980: 47), the sunk cost effect refers to the hypothesis that paying for a good or service increases the rate at which the good or service will be utilized, ceteris paribus. This is demonstrated in two given examples: i) A family has paid $40 for tickets to a basketball game. On the day of the game there is a snowstorm. They decide to brave through the snowstorm and go to the game anyway, but if the tickets had been gifted to them, they would have stayed home, and ii) A man has joined a tennis club with a $300 yearly membership fee. Two weeks into his membership he develops an injury, yet he continues to play (despite the pain) because he doesn’t want to waste the money.

In an experiment conducted by Arkes and Blumer (1985), participants were asked the following question:

> “Assume that you have spent $100 on a ticket for a weekend ski trip to Michigan. Several weeks later you buy a $50 ticket for a weekend ski trip to Wisconsin. You think you will enjoy the Wisconsin ski trip more than the Michigan ski trip. As you are putting your just purchased Wisconsin ski trip ticket in your wallet you notice that the Michigan ski trip and the Wisconsin ski trip are for the same weekend. It’s too late to sell either ticket, and you cannot return either one. You must use one ticket and not the other. Which ski trip will you go on?”

Over half of the participants responded saying that they would go to the Michigan trip in spite having a clear preference for the Wisconsin trip because they felt like going to the less expensive, albeit more desirable, Wisconsin trip, would “waste” more money (Arkes & Ayton 1999: 595).

Furthermore, the magnitude of the sunk cost fallacy can also depend on factors like the bundling of prices of multiple transactions (Soman & Gourville 2001: 42) or the temporal gap between the payment and the consumption. The more recent the payment, the higher the sunk cost effect and it decreases as more time passes between purchase and consumption (Reisch & Zhao 2017: 194). Both of these factors can be found in credit card spending where there is a temporal gap between the transaction and the payment and an aggregated payment of various purchases at the end of the month.

These factors tend to influence the psychological effect of spending, leading consumers to spend more when using a credit card than they would when paying with cash.

4. Cognitive dissonance

Cognitive dissonance is the concept that refers to a person's discomfort when there is a discrepancy between their beliefs and external information. According to Festinger (1957), individuals seek to reduce the discomfort caused by this discrepancy. The greater the magnitude of the inconsistency, the greater the need to limit the discomfort, which causes the individual to avoid information that could increase the dissonance (Harmon-Jones & Mills 2019). A decision, especially a difficult one, will create more dissonance i.e. more discomfort.

According to the free-choice paradigm, individuals after making a choice will attempt to alter the aspects of their choice and of the alternative, to reduce their dissatisfaction (Brehm 1956). They will try to increase the positive elements of the chosen alternative and minimize the ones of the rejected one, whilst simultaneously removing the negative aspects of their choice and focusing on the negative aspects of the rejected alternative.

According to the belief-disconfirmation paradigm (Festinger et al. 1956) when people are exposed to evidence that is inconsistent with their beliefs, and they are not willing to change their beliefs, they can end up misinterpreting the information or trying to reduce it, seeking support by those who agree with them and attempting to persuade others to do the same.

Moreover, studies show that if an undertaking is unpleasant and the reward is small, people are more likely to try to justify the effort (Akerlof & Dickens 1982). They will attempt to argue that the undertaking, whilst difficult, was worth it in the end and they will try to discard information that points to the opposite, since admitting such an error would mean that they made the wrong decision. The effects of this phenomenon can be long-lasting according to the same research.

5. Confirmation bias

Closely related to cognitive dissonance, is the effect of confirmation bias, the tendency to interpret or favour information in a way that affirms and supports one's prior beliefs. As stated above, when people are faced with information inconsistent with their beliefs, they don't change their minds. Instead, they dig in their heels and insist on maintaining their current beliefs (Olsen 2008).

Research shows that investors seeking information that affirms their existing beliefs, tend to be overconfident which affects their investment performance (Park et al. 2010). Overconfidence describes the effect where one overestimates the likelihood of a certain outcome, making extreme judgements that can end up being detrimental to their well-being.

Overrating one's performance in relation to others, can lead to suboptimal investment decisions. Moreover, overconfidence can inhibit learning and adapting to new information, and it can be a hindrance in the improvement of the decision-making process (Zacharakis & Shepherd 2001).

6. Framing effect

The way choices are being presented to us can have significant effects on our decision-making. How a choice is being framed can influence our behaviour and our decisions (Tversky & Kahneman 1981: 453).

People, including consumers, prefer positive frames. This can apply to presenting a positive element over a negative one, for instance saying something has a 25% discount instead of saying that customers will pay 75%. These are two pieces of information, but one has a positive connotation (the discount) and the other one a negative one (paying). However, framing can also apply to presenting the same information but in an alternative way. For example, expressing a fee as a percentage may cause a different reaction to the same information in monetary terms (Chuah & Devlin 2011: 11).

The framing effect is closely related to loss aversion bias and prospect theory. When asked to choose between a certain option and a risky one, people's decision will differ based on whether the choices were framed as losses or gains. A classic example of the framing effect is "the Asian disease problem" described by Tversky and Kahneman (1981) where decision-makers were told to choose between a certain outcome and a risky one to save lives (positive frame) or minimize deaths (negative frame):

> Imagine that the United States is preparing for an outbreak of an unusual Asian disease that is expected to kill 600 people. Two alternative programs to combat the disease have been proposed. Scientific estimates of the consequences of the programs are as follows:

Positive frame:

If Program A is adopted, exactly 200 people will be saved.

If Program B is adopted, there is a 1 in 3 probability that all 600 people will be saved and a 2 in 3 probability that no people will be saved.

Negative frame:

If Program C is adopted, exactly 400 people will die.

If Program D is adopted, there is a 1 in 3 probability that nobody will die and a 2 in 3 probability that all 600 will die.

As we can see, A is equivalent to C and B is equivalent to D. However, due to the framing of the choices, most people chose options A and D even though these choices are contradictory. This can be explained with prospect theory since people exhibit risk seeking behaviour when presented with negatively framed choices and they are risk averse when presented with positively framed choices. Since the initial experiment, several studies have replicated the problem with consistent results (Druckman 2001).

It is also interesting to note, that according to a study conducted by Gonzalez et al. (2005) using brain activation functional magnetic resonance imaging (fMRI), the framing effect occurs due to a trade-off between the cognitive effort needed to analyse the given options. Positively framed options are easier to decide on, they feel correct and effortless. On the other hand, in a negative frame, the decision-maker needs to analyse the risks before coming to a decision. The study shows that cognitive effort required to calculate the expected outcomes is a factor that will affect the decision-making, since if the process is lengthy i.e. costly, people are less likely to consider that option, especially when the alternative is or appears less unpleasant.

7. Present bias

Present bias refers to the tendency of individuals to favour short-term rewards over long-term gains, even when the latter offers greater benefits overall. Consumers with present bias are more inclined to prioritize immediate gratification leading to suboptimal choices that may not be in their best interest. Financial decisions such as the choice of the type of mortgage can be significantly affected by present bias (Gathergood & Weber 2017).

Myopic consumers have a difficult time visualising the future, choosing instead to satisfy their current wants with little to no consideration for their future self. They tend to procrastinate and they lack in self-control and commitment. Studies show that present-biased consumers have a tendency to spend more in the present and are more reluctant to save for the future (Xiao & Porto 2019).

Consumers who exhibit present bias are also more inclined to borrow to satisfy their current financial needs and they tend to have a higher amount of credit card debt (Meier & Sprenger 2010). Moreover, this behaviour is linked to personality traits consistent with present bias (Nyhus & Webley 2001 : 101), and the people to exhibit it tend to exhibit chronically, consistently spending more than what they earn and failing to save.

8. Anchoring effect

People can easily be influenced by the information given to them during the decision-making process. According to Tversky and Kahneman (1974), the anchoring effect occurs when decision-makers make biased judgements based on an initially presented value.

Anchoring effect is closely related to confirmation bias. The initial information given to us, i.e. the anchor, works as a reference point constantly pulling us towards it, rendering us unable to adjust and adapt to new information. We as decision-makers feel the need to insist on our initial impressions and we tend to seek and take into consideration information that aligns with the anchor and affirms our initial assessment, whilst ignoring or trying to minimize opposing evidence (Karampatzos 2016: 42).

In experiment performed by Russo and Schoemaker (1989) professionals were asked the following question:

"What is your best estimate of the prime interest rate six months from now?" The average answer was 10,9% (The actual prime was around 11%).

They then surveyed a second group with the following questions:

1) "Do you believe that six months from now the prime rate will be above or below 8%?" and 2) "What is your best estimate of the prime rate six months from now?"

The first question worked as a reference point, anchoring subjects towards the 8%. The average answer was now 10,5 %. When the researchers anchored a third group at 14% and asked for a best estimate, the average was 11,2%.

Knowing the effectiveness of anchoring, one can easily see how a simple manipulation tactic like the one mentioned in the experiment above, i.e. mentioning a number or statistic to encourage the other party to anchor on it, can affect contractual negotiations. In consumer behaviour, this can clearly be seen in relation to pricing. For instance, once a consumer is exposed to information regarding the price of a good or service, he will cling to the initial piece of information and that will be a deciding parameter of what he is willing to pay for that product or service (Chavaglia et al. 2011: 186).

In relation to contracts, anchoring effect is also connected to the tendency to renew agreements maintaining the current terms, seeing them as tried and true reference points. This can also be related to status quo bias, the tendency to preserve the current situation and sticking with the default option (Samuelson & Zeckhauser 1988: 10-11).

The sense of familiarity one has with the existing status quo and the fear of a potential regret or sunk cost leads to inertia and a reduced inclination to shop around, explore alternative options (even when they offer better terms) and renegotiate a contract. It explains why people tend to remain loyal to a specific bank and are reluctant to switch to a different one, even when it offers lower fees or better rates. Status quo bias is also closely related to procrastination in savings behaviour and in turn to poor retirement planning, whilst research shows that automatic enrolment (i.e. maintaining the status quo of the default choice) has a strong influence on the savings behaviour of 401(k) participants (Madrian & Shea 2001: 30-31).

Overall, it is clear that these biases can have a significant effect on a person's decision-making and behaviour and taking them into consideration when designing a contract or agreement would create an environment where consumers are able to make better decisions.

Part III: Nudging consumers in financial decisions

Nudge theory is built on the work of Kahneman and Tversky, and it is a concept in behavioural economics that proposes adapting the decision-making environment to influence the behaviour of people, whilst taking into consideration that humans are susceptible to the cognitive biases that cause them to make poor decisions. It became popular in 2009 thanks to economist Richard Thaler and lawyer Cass Sunstein, and since then it has been widely used to influence the decisions of groups or individuals. Nudge theory has been favoured in government policymaking, with nudge units being established on the national and the international level.[6]

A. Libertarian paternalism

In their 2009 landmark book, *Nudge: Improving people's decisions about health, wealth and happiness*, Thaler and Sunstein, building on the ideas and principles of behavioural economists, proposed that it is possible to steer people towards the most effective decision without dictating them, in order to achieve the desired outcome (Thaler & Sunstein 2009). This is called liberal or soft paternalism. Following this approach, instead of being coerced, people can be nudged towards the optimal choice overcoming their cognitive limitations whilst maintaining their free will, with low or even zero-cost interventions (Thaler & Sunstein 2003).

[6] https://knowledge4policy.ec.europa.eu/behavioural-insights/about_en

The concept of libertarian paternalism is distinct from the traditional paternalistic approaches of enforcing regulations and employing coercion to get people to follow the rules. According to Thaler and Sunstein, paternalism is inevitable, since at many cases a person or an organization must make a decision that will affect other people's choices. Moreover, they argue that paternalism does not necessarily involve coercion.

On the contrary, libertarian paternalism does not impinge on individual freedom of choice (Sunstein & Thaler 2003). It is a "softer" approach that is effective by integrating cognitive limitations, whilst maintaining personal liberty. The entire idea seems like an oxymoron, a contradiction, and it has been criticised as such, however for Thaler and Sunstein both aspects are inherent to the main purpose.

The libertarian aspect of this concept lies in the idea that people should be free to do as they please as long as they're not harming others or breaking the law. The paternalistic side is the claim that it is reasonable for policy makers or institutions to attempt to steer people towards the behaviour or decision that will improve their quality of life.

In libertarian paternalism, choices are not blocked off. If an individual does not agree with the proposed choice and wishes to choose differently, they are free to do so with minimal cost (Sunstein & Thaler 2003: 178), which would usually involve ticking a box or filing a form.

B. Choice architecture

The authors also introduce the concept of “choice architecture”, i.e. the decision-making environment, the way in which choices are being presented to us, and how that can affect our decisions. Our behaviour and decision-making can be influenced by the information and options that are given to us and the way in which it is being framed and presented. With the right design of choice architecture, policy makers and institutions can improve consumers’ choices thus promoting their overall welfare.

A choice architect is the person responsible for organizing the context in which people make decisions (Thaler et al. 2013). The choice architect is not always a regulator; she can be anyone who might not even understand her role. For instance, a doctor describing available treatments to a patient, a human resource administrator preparing healthcare or retirement plan forms, or a marketer designing a sales strategy, are all choice architects designing the environment in which people make decisions.

C. Nudging

The key instrument proposed by this approach is nudging, a tool that uses positive reinforcement and indirect suggestions as ways to influence the behaviour and decision making of groups or individuals. A nudge is defined as a tool “that alters people’s behaviour in a predictable way without forbidding any options or significantly changing economic incentives” (Sunstein & Thaler 2021: 6).

Ever since its introduction, nudging has been used by policy makers in several countries. It has been applied in fields like tax collection or organ donations with varying results (Antinyan & Asatryan 2019: 40-41)[7]. In 2010 the UK government established the Behavioural Insights Team whose goal is to gain an understanding of human behaviour and create better strategies for private businesses and the government using behavioural insights.[8] Similarly, the Obama administration established the Social and Behavioral Science Team in 2014, aiming to apply insights from social and behavioural science to policies for the benefit of the American people, however the team is no longer active.[9]

In recent years, in a fast-evolving financial market where new products and services keep being introduced, there has been a growing need for tools that will help consumers make the most optimal financial decision. Gathering insights from the science of behavioural economics, and taking into consideration the errors that cause people to make poor choices, it seems clear why currently the main way in which nudges are being applied in financial markets is to adjust how choices are being presented to consumers and investors and to provide information to them in a specific way (Cai 2020: 3358).

The objective of a good nudge should be to help the consumer navigate the financial market in a manner that allows them to know what they are getting, how to compare the products and services that are being advertised to them and if it is all

[7] See also: https://blogs.worldbank.org/governance/nudging-under-pressure-behavioral-insights-tax-compliance-during-global-pandemic

[8] See the BIT website: https://www.bi.team/

[9] See the SBST website: https://sbst.gov/

worth it in the end. The better understanding the consumer can have of the product or service they are purchasing, the less the policymaker or regulator must interfere.

1. Presenting the options:

The method in which information is being presented to consumers has significant effects on their decision-making. Research shows that information should be presented in a manner that is upfront and clear. It should also be presented early enough in the process and in a format that engages the consumer and encourages comparison·

It can be beneficial for the consumer to have the information presented in a format that is well-structured and simplified and to be given clear side-by-side comparisons of the offered products and services when asked to make a choice. This can be achieved by having charts and tables with all the potential choices, and by giving each option a rating of factors like risk. Moreover, it is important to make the presentation adjustable to the consumer's device. A comparison chart or table that adapts to the mobile device environment is especially beneficial since it makes the process easier, simpler and accessible to most consumers.

In regard to debt and spending, it is important for consumers to have a good understanding of how much money they spend and owe at an any given moment, in order to efficiently manage their finances and borrowing (FAWG 2020). Most people do not adequately understand percentages, they do not understand complicated financial terms and they have a hard time visualising the future. It would be helpful to them to be able to access simplified information about their credit.

Most people would benefit from receiving regular reminders and spending analysis to keep on top of their finances. For instance, it would be useful for all credit card users to be notified when they've reached a certain percentage of their credit, and making this the default option would achieve better results. Most banks already offer an analysis of one's purchases in certain categories like groceries, healthcare, entertainment etc. Giving the option to set a limit on a specific category, for example no more than 150€ on clothing, and getting notified when you reach the limit, could encourage saving.

Lastly, having too many options can be incredibly overwhelming for anyone and can place a greater cognitive burden on the consumer due to the additional need to evaluate all available options. Limiting the number of offered products and services would limit choice overload and encourage better decision-making. Being presented with a few choices, a consumer can make a reasoned consideration without being overwhelmed and, if the need arises, more alternatives could be offered (Johnson et al. 2012: 490).

2. Describing the options

The complicated language of financial contracts, the use of technical terms and legalese, affect the consumer's comprehension. Research shows that the use of simple language, the consistent use of vocabulary, the avoidance of overload and ambiguity, and the adaptation of the document structure to aid readers, may help improve reading comprehension (Van Boom et al. 2016: 2). Regulating towards the simplification of contracts may also inflate consumer expectations regarding the performance of the other party. These raised expectations could in turn affect the consumer's willingness to engage in conflict with the counterparty when such expectations are not met (Van Boom et al. 2016: 4).

Simply using plain language may not be enough to aid vulnerable groups like elders, those with low financial literacy or those in a difficult financial situation. For these groups, it would help to offer simplified products or services that are presented and described in a manner that is simple and easy to understand and compare.

The readability of a contract is also related to the font type, size and colour. In addition, the colour of the paper and the layout of the contract, for example the use of headers and references, also play an important role in the readability of the contract (Newman 2010). It is easy to spot the difference between these aspects of a contract and for instance, an advertisement meant to attract consumers' attention. In standard-form contracts the text is small and hard or even impossible to read. Companies or institutions tend to use faint colours for the font, like light grey on a white background, and long complicated sentences filled with legal jargon laid in dense paragraphs rarely including headers to help the reader (OFT 2011).

3. Managing the purchasing process

The purchasing process can also affect the decision-making. For instance, the effects of encouraging consumers during the contract proceedings to rush or take their time have mixed results on their decisions (Ipsos 2019: 2). Making the process of taking a loan or signing up for a credit card slower does improve consumers' decision-making, giving them enough time to process all the information and analyse their next move, however forcing them to jump through too many hoops and complicating the process too much can have the opposite results. Adding to that, research shows that when told to hurry, some consumers tend to be more alert thus taking more time and making a more careful decision.

The speed of the purchasing process should be monitored to ensure that consumers are not being pressured towards poor decisions. If the process is too slow and frustrating for the consumer, institutions are advised to simplify the process and make it fast enough that the consumer pays attention to what is taking place whilst having all the necessary data to make an informed decision and enough time to deliberate their options.

In addition, the development of e-contracts also affects the decision-making process shortening the proceedings to mere seconds. Despite reducing the stress of human interaction, and simplifying the process of purchasing products or services, online transactions can also cause consumers to over-relax. Particularly regarding signing a contract, people tend to perceive a regular signature as the most legally binding way to seal an agreement[10]. Yet, every day we enter legally binding contracts, simply by clicking "I agree", sometimes without even having to scroll all the way down on the terms and conditions. As a result, consumers attribute less significance to these contracts than they would in a contract with regular ink signature.

[10] See, e.g., Balloon (2001: 234) ("*That a signature is the central formality in contract formation – particularly in a consumer transaction–cannot be overstated. Most consumers equate their signature with being bound to the terms of an agreement.*") in Becher (2007: 163-164).

It may be worth it to address these concerns by mimicking the traditional contract proceedings online. For instance, requiring consumers to sign their names or initials when entering e-contracts could alleviate the problem and help them attribute the necessary significance on electronic contracts and remind them that they are equally legally binding to traditional contracts (Becher 2007: 163-164).

4. Personalised products and services

Providing consumers with targeted products and services can also have mixed results in their well-being (Ipsos 2019: 3). Individuals can benefit from purchasing personalised products that fits their needs and budget, whilst at the same time minimising the search costs. On the other hand, they can also be manipulated to buy something that they could benefit from, but they do not necessarily need, and at a high price.

Moreover, many consumers tend to be suspicious and sceptical towards targeting and personalisation. Delivering personalised products requires personal data. For this reason, it is important to increase transparency around this practice. To achieve this, policy makers need to ensure that institutions comply with the relevant legislation and inform the consumer of the use of personalised offers.

The development of AI will also affect the banking sector, since many banks and FinTech companies have been investing in AI technology, expecting to deliver a more efficient, personalised banking experience (Lui & Lamb 2018: 12). These innovations will require time and a lot of work to be reliable and they will certainly need to address known AI challenges such as bias, discrimination and privacy protection.

D. Concerns about libertarian paternalism and nudging

The concept of libertarian paternalism has been the subject of much criticism. The main criticisms of libertarian paternalism are (i) whether it infringes civil liberties and (ii) whether we can be sure that the government is always benevolent in its attempt to manipulate choices to get a desired result (Cai 2020). Hausman argues that the entire concept of libertarian paternalism is neither libertarian nor paternalistic (Hausman in Hausman & Welch 2009: 135-136). The individual may be free to choose any option, yet the choice architect is the one who presents the options thus manipulating the probabilities of each alternative being chosen.

As nudges are the main tool employed by libertarian paternalism, the ethical quality of nudges can also be debated, especially by arguing that a nudge is inherently an instrument of psychological manipulation.

The entire goal of nudging is to achieve the optimal result. Yet, the question arises, who is the judge of that? Thaler and Sunstein (2021: 7) state that the goal is to "influence choices in a way that will make choosers better off, as judged by themselves". Therefore, according to the authors, the judge is not the choice architect, the policy maker or the financial institution. The judge is the individual making the decision.

However, the option that seems optimal may not always be the best option for the individual consumer (Sugden 2017: 116). For instance, a nudge that encourages people to save more money today or put money towards their retirement fund, may seem ideal and universally beneficial for the individual, yet it might affect other aspects of the person's life negatively. Saving more money today may lead to providing less for one's child, opting out of health insurance, or even simply depriving yourself from joys like a holiday thus resulting in poorer mental health and overall quality of life. The effectiveness of a nudge in terms of increasing a person's general wellbeing is an extremely subjective criterion that cannot easily be calculated.

The overall effectiveness of nudging in the financial sector can also be debated. Especially in regard to vulnerable consumer categories such as elders or individuals with low levels of financial literacy, nudging can offer little to no protection (Agarwal et al. 2009 : 28). In spite the existence of benevolent nudges introduced by policymakers and the government, vulnerable consumers can still make poor financial decisions if they're nudged in such a direction by marketers.

Similarly, in an investment experiment set in Spain, Gomez et al. argue that the proposed nudges which consisted of (i) a numerical label that rated the product from lowest to highest risk and (ii) a graphical label imitating traffic lights that indicated the risk level using colours, green being low risk and red being high risk, had questionable effects on the consumers' decisions (Gómez et al. 2016: 370-372). The findings suggest that the labels lead to people having increased risk-aversion, thus making poor investment decisions.

Another criticism of nudging refers to the slippery slope in which multiple soft interventions in people's decision-making, can over time lead them to accept more and more external influence over their behaviour (Selinger & Whyte 2011: 929). Thomas Nagel (2011) also argues that our automatic system of thinking is useful and necessary, and some of our cognitive biases should not be nudged. Instead of simply seeking to control others' behaviour with nudging, he suggests that we should firstly seek to truly understand cognitive biases and determine which ones should be nudged, maintained or abandoned.

Overall, nudging individuals to make better financial decisions can be very complicated, since the desirable outcome is subjective. The choice architect in financial contracts is none other than the financial institution or advisor, and a decision that is better for their client is not always in their best interest. The findings of the 2017 Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, show that there is a conflict of interest when financial institutions are providing financial advice to their clients while also selling them financial products and services. The bank representative is the one presenting the products and advising the client on what they should be choosing, thus blurring the lines between the interests of the client and the bank.

Adding to that, the nature of the banking industry is such that does not allow for true free choice. As stated above, consumers have no negotiation power when dealing with financial institutions and they are usually faced with "take it or leave it" situations. In addition, they tend to stay loyal to one specific institution instead of researching the market and shopping around.

For these reasons, it is fundamental that legislators and policy makers take measures to ensure full transparency in financial contracts to protect consumers, especially those who are more vulnerable. The instruments provided by choice architecture, albeit useful, are not enough by themselves.

Conclusion

The insights of behavioural economics have been proven to be significantly useful and enlightening in regard to the behaviour and decision-making of groups and individuals. Relating to the financial sector and banking contracts, traditional consumer protection strategies often fail to provide consumers with the necessary means to defend themselves. The nature of the banking contract is such that requires individualised measures that take into consideration the unique elements of the banking contract and the cognitive errors and biases of humans.

Nudges can be a helpful instrument to reduce disparities, but they should not be the only tool equipped to address them. Many of these disparities, such as the lack of transparency, are systemic and deeply entrenched in the financial market and they require stronger interventions.

It is essential to introduce legislation that requires financial institutions to be as straightforward and transparent as possible in their practices, to provide clear and adequate information to all customers at the early stages of a financial contract, and to ensure that existing legislation that aims to protect consumers is being applied.

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