FINANCIAL PRODUCTS—AN INTRODUCTION

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The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act ushers in a new era of financial regulation and establishes a new watchdog agency, the Bureau of Consumer Financial Protection. As this issue goes to press, the SEC is inviting public comment on its new rulemaking initiatives, and the Senate awaits the President's nominee to head the new Bureau. In the midst of the government's efforts to step up regulation of financial institutions, it is worth taking stock of how certain financial markets and products have grossly failed to serve the consumer.

Almost any person with vague knowledge of the payday lending industry is aware of its extraordinary interest rates. And yet it has been one of the fastest growing segments of the consumer-credit market. Professor Nathalie Martin's curbside interviews with borrowers at the point of sale suggest that the key to the industry's success is consumers' lack of understanding of the true costs of these loans and the inability of many borrowers to compare them with other forms of available credit. Her research also indicates that the business model of payday lenders is to get customers on a debt treadmill, belying industry claims that payday loans are an innocuous way for consumers to deal with emergencies. Tying Martin's article to developments in Arizona, Allison Woolston provides a Law & Policy Note on Arizona's ten-year experiment with authorized payday lending.

On the other end of the financial marketplace, innovation has led to a proliferation of complex hybrid debt securities. Professors Ann Morales Olazábal and Howard Marmorstein reveal how the prospectuses' sample investment return formulas portray unlikely results for these products. The numeric disclosures capitalize on target investors' innumeracy to create a skewed picture of an investment's potential return. Thus, while the market for structured products is more financially sophisticated than that of the payday loan industry, the issuing firms similarly provide misleading information to capitalize on investors' cognitive biases.

Government funded financial products in the form of Medicaid and Title IV Foster Care grant-in-aid benefits are not immune from predatory conduct. Professor Daniel Hatcher exposes the organizational conflict-of-interest within a "poverty–industrial complex." Hatcher reveals a poverty industry that

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simultaneously contracts with state governments to maximize federal-aid claims and with the federal government to reduce payout of federal funds for those claims. Additionally, these contractors can take as much as 25% of grant-in-aid funds in fees and may help states to divert aid dollars into their general revenue, reducing the amount available for the programs' intended recipients.

Each of the above authors illustrates a failure to prevent potentially serious harm to financial product consumers. In the wake of the subprime mortgage frenzy and the bursting of the housing bubble, the Obama administration attempted to mitigate the foreclosure crisis with a mortgage modification program. Professor Jean Braucher examines the reasons behind the limited results in the first year of the Home Affordable Modification Program. Because the administration feared alarming the capital markets and making the crisis worse, the program depended on voluntary participation of mortgage servicers and investors, who resisted accepting that they must take losses. Meanwhile, it was very hard for struggling homeowners to get modifications, and even when they did, most remained under water and at high risk of redefault. Braucher's article reminds us that we are well-served by ex ante regulatory constraints, because it is very difficult to cure a crisis once it has occurred.

The Dodd–Frank Act establishes a watchdog. It remains to be seen on how long a leash its regulators will be kept.