



STATE OF LENDING: DEBT SETTLEMENT

The State of Lending in America &
its Impact on U.S. Households

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AN INTRODUCTION TO DEBT SETTLEMENT

Debt-settlement companies promise to reduce consumers' debt by negotiating with their creditors for a fee.¹ However, this promise comes with a serious risk—consumers enrolling in debt-settlement programs must first default on their debts and then see whether the debt-settlement company can successfully negotiate a reduction in some or all of the amount owed. Most often, clients of debt-settlement firms seek to settle credit card debt,² although the firms may also negotiate other forms of unsecured consumer debt, such as private student loans and medical debt.

Debt-settlement advertisements claim that typically consumers see “over 50% of their debt written off...” and are “...debt free in as little as 36 months” (DMB Financial, 2013). Debt-settlement companies promote themselves as being faster and less expensive than slowly paying off credit card debt through minimum payments and as providing a less drastic strategy than filing for bankruptcy (Freedom Debt Relief, 2013a and 2013c; US Financial Options, 2013). However, research suggests that these claims may not deliver for the typical borrower.

Modern-day debt settlement is just one of several ways that consumers can address unmanageable credit obligations.³ For legal debts, consumers may obtain concessions from their creditors to make debt repayment more manageable, either directly or through a credit counseling agency. In addition, consumers can try to secure a resolution from a court, such as when they file for bankruptcy. Consumers whose credit was provided illegally, e.g., by a payday lender providing a loan in a state in which this type of credit is prohibited, can take legal action against the creditor to have the obligation extinguished. Two key differences between debt settlement and these alternative approaches is that the alternatives (1) do not require consumers to default on their debt and (2) give consumers an up-front agreement, either through the legal process or with the creditor, about how the debt will be handled, thus limiting their risk and uncertainty.

The Debt-Settlement Process

A consumer who enrolls in a debt-settlement program is typically required to stop paying her debts, thereby defaulting on these obligations and accruing late charges and penalty fees. Instead of directly paying down debts, she makes regular deposits into a dedicated third-party account. Once this account accrues enough funds, the debt-settlement company begins to negotiate agreements with each creditor for the consumer to pay a percentage of the total amount owed.

These settlement agreements can be structured to be paid from the dedicated account in a single lump-sum payment or, more frequently, as a “term settlement” with a series of payments made over time from the dedicated account. Term settlements can range in length from just a few months to over a year.⁴ One risk for the consumer of a term settlement is that, if she is not able to make all payments as agreed, the creditor will consider her to be in default on that debt and may revoke any

1 Debt settlement differs from debt management plans offered by credit counselors. In the case of the latter, the credit counseling agency gets an up-front agreement from the consumer's creditors to allow the consumer to repay her debts over 3-5 years with modified terms, such as a significantly reduced interest rate and/or the elimination of late or other penalty fees.

2 Nearly \$850 billion in total credit card debt is outstanding today (Chen, 2013). The average household carrying a credit card balance from month-to-month owes over \$15,000 across all of their credit cards (Chen, 2013).

3 For more information on other options for paying down debts, see the Appendix.

4 See, for example, settlement letters posted on a debt-settlement company's website at <http://clearoneadvantage.com/testimonials/debt-settlement-letters.php>, which show term settlements of varying lengths.

concessions or principal reductions previously granted. While payments on any settlement agreements are made from the dedicated account, the consumer continues making deposits, which can be used to pay for any additional settlement reached in the future.

Fees paid to debt-settlement companies can be high, even when the debt-settlement company is not ultimately successful in settling most or all of the consumer's debts. The debt-settlement company earns its fee once the consumer agrees to the settlement agreement negotiated with the creditor and makes at least one payment to the creditor from the dedicated account, regardless of whether it is the sole settlement payment or the first in a series. Typically, fees are based upon a percentage of the debt at the time the consumer enrolled; occasionally they are based on a percentage of the savings negotiated by the debt-settlement company.⁵ The Center for Responsible Lending (CRL) previously reported that typical fees range from 20-25% of enrolled debt (Harnick & Parrish, 2013). As discussed later in this chapter, several states that authorize debt settlement have limited the fees that may be charged.

In addition to the fees paid to the debt-settlement companies, consumers face other fees from this arrangement, such as set-up, monthly, and/or other fees paid to the third party maintaining the escrow account (*Carlsen v. Global Client Solutions*, 2011).⁶ Further, a consumer may have to pay income taxes on any debt reduction, if she is not insolvent and the debt's outstanding principal balance is reduced by at least \$600 (Prater, 2013; IRS, 2013).

Consumers often enroll multiple debts from various creditors, leading debt-settlement companies to attempt to negotiate separate agreements with each creditor over time. Although there is no guarantee that any debts enrolled will ultimately be settled, the American Fair Credit Council (AFCC), a debt-settlement trade association, notes that consumers should expect to remain in a debt-settlement program for three to four years before most or all of their debts can be settled (Regan, 2013).

⁵ Companies that set fees as a share of the savings typically calculate this by subtracting the amount the creditor will accept from the consumer per the settlement agreement from the current outstanding balance at the time the settlement agreement is reached. The current outstanding balance of the debt has likely grown from the initial balance at the time of the consumer's enrollment in a debt-settlement program because of interest and fees.

⁶ As of 2009, a large national account management company used by debt-settlement companies and their clients, Global Client Solutions Inc., charged a \$9.00 account set-up fee, a monthly service fee of \$9.85, and fees for certain transactions, such as a \$15 wire transfer charge (*Carlsen v. Global Credit Solutions*, 2011).

MARKET AND INDUSTRY OVERVIEW

Modern-day debt settlement experienced strong growth in the early 2000s, when several states authorized the practice based on a model bill, the Uniform Debt Management Services Act, promoted by the debt-settlement industry (Association of the Bar of the City of New York, 2012). At the time, the two debt-settlement trade associations—the United States Organizations for Bankruptcy Alternatives (USOBA) and the Association for Settlement Companies (TASC)—represented approximately 200 and 265 companies respectively (Association of the Bar of the City of New York, 2012).

As discussed in more detail later, the Federal Trade Commission (FTC) in 2010 implemented new regulations that required the debt-settlement industry to change its fee structure and instituted other reforms. Before these reforms, debt-settlement companies typically charged high set-up fees and significant monthly fees before settling any debts. Investigations of the industry revealed that very few settlement agreements were actually reached on behalf of debt-settlement clients. As a result, consumers who enrolled in debt settlement paid substantial fees—often thousands of dollars—to the debt-settlement provider, faced all of the negative consequences of defaulting on their debts, and still owed many or all of their creditors the full outstanding debt balance. In fact, clients often owed more than when they started the program because their debt grew from penalty interest rates and fees.

The FTC's 2010 reforms dramatically changed the scope and size of the industry. While many companies changed their business models to charge fees only when debts settled, others chose to leave the industry entirely. In addition, some firms argued that they were not subject to the advance-fee ban and continued to charge fees upon enrollment. USOBA's membership dropped to 30 firms, and eventually the trade association folded (Ody, 2011). TASC re-branded itself as the American Fair Credit Council (AFCC) and asked that members be in compliance with the FTC's ban on advance fees. Membership in AFCC now consists of just 33 debt-settlement companies (AFCC, 2013).

Two of the largest AFCC-member firms are Freedom Debt Relief, which reports having settled \$2 billion in the past decade, and Century Negotiations, which claims to have settled over \$600 million in debt in about that same timeframe (Freedom Debt Relief, 2013b; Century Negotiations, 2013). These two companies currently report a combined 53,000 customers—40,000 for Freedom Debt Relief and 13,000 for Century Negotiations (Freedom Debt Relief, 2013d; Century Negotiations, 2013).

The debt-settlement companies that continue to charge advance fees despite the FTC rule are said to be using an “attorney model” of debt settlement, in which the presence of a loosely-affiliated attorney is used to justify collecting advance fees, even though non-attorneys provide the actual debt-settlement work (Becker & Harnick, 2013). The FTC's rule does not cover in-person communications, so some companies employ attorneys or paralegals to hold face-to-face meetings with consumers. The companies claim that doing so exempts them from being covered by the rule.

One large firm that has adopted the attorney model, Morgan Drexen, contracts with attorneys who charge up-front fees in return for minimal work on debt-settlement cases while Morgan Drexen's own non-lawyer employees actually provide the bulk of the work and consumer communications (Becker & Harnick, 2013). Morgan Drexen is currently the subject of a lawsuit by the Consumer Financial Protection Bureau (CFPB) that alleges the company is charging up-front fees illegally (in violation of the FTC's rule) and engaging in deceptive acts and practices (CFPB, 2013a). Similarly, Legal Helpers Debt Resolution is a company that includes attorneys but contracts out debt-settlement work to third-party non-lawyers (Becker & Harnick, 2013).

ABUSES AND PREDATORY PRACTICES

Despite the recent changes to the debt-settlement business that prevent consumers from being charged up-front fees, clients enrolled in debt-settlement programs still face significant risks. Notably, when a consumer is considering enrollment in a debt-settlement program, it is impossible for her to assess the probability of obtaining a positive outcome because many factors are beyond her control. In addition, if even one defaulted debt remains unsettled, collection activity and the risk of a lawsuit remain. These and other risks and harms are outlined in more detail below.

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Implications of defaulting on debts. When a consumer ceases to make payments on a debt, the account becomes delinquent, typically spurring a penalty interest rate on the outstanding balance as well as late fees. The reporting of this delinquency to credit bureaus will have a negative impact on the consumer's credit score for up to seven years (CFPB, 2013b). The impact will vary depending on the consumer's credit score before the delinquency or defaults, but the score may fall 60-100 points (FICO, 2013). The effect can be wide-ranging: credit reports and scores are used not just to determine eligibility for future loans but also in insurance applications and employment screening.

A delinquency and eventual charge-off of the debt will also cause collection activity to commence, either by the consumer's creditor, a third-party collection agency working on behalf of the creditor, or—if the debt is sold—by a debt buyer.⁷ The consumer's creditor (whether the original lender or a debt buyer) may eventually file a lawsuit, which could lead to a judgment that calls for wage garnishment or automatic bank account levy. The Association of the Bar of the City of New York (2012) found that one-third of consumers enrolled with a particular debt-settlement company faced lawsuits from their creditors; in some cases, consumers were not even aware of the legal action until their wages were garnished. More recently, the Maryland debt-settlement regulator reported that among those consumers who enrolled in a debt-settlement program after October 2010, when the advance-fee ban took effect, one-quarter had already had a lawsuit filed against them by at least one of their creditors by the end of 2011 (Maryland Office of the Commissioner of Financial Regulation, 2014). Judgments may have a further negative impact on the consumer's credit score.

Unlikely to settle enough debts to benefit. Before the advance-fee ban took effect, numerous data on debt-settlement programs showed large shares of consumers dropping out of programs (often after having paid high fees) and dismal completion rates. The former TASC trade association (now AFCC) conducted a survey of its members that showed that more than 42% of consumers had none of their debts settled, and nearly two-thirds failed to have most of their debts (70% or more) settled (FTC, 2010).⁸

Independent investigations of the industry have revealed even lower program completion rates. The Government Accountability Office (GAO) (2010) concluded that debt-settlement companies overstate their success rates, noting: "The success rates we heard [from debt-settlement companies]

⁷ For more information on debt buying, see CRL's Debt Collection & Debt Buying State of Lending chapter, available at <http://www.responsiblelending.org/state-of-lending/reports/11-Debt-Collection.pdf>

⁸ In a discussion of outcomes for consumers who drop out of debt-settlement programs in its Final Rule, the FTC notes that the TASC survey found that 65.2% of dropouts had no debts settled, the equivalent of over 42% of all debt-settlements clients.

are significantly higher than is suggested by the evidence obtained by federal and state agencies. When these agencies have obtained documentation on debt-settlement success rates, the figures have often been in the single digits.” Data obtained through litigation by states’ Attorneys General similarly found completion rates in the low single-digits before the advance-fee ban took effect (Association of the Bar of the City of New York, 2012).

AFCC often contends that completion rates have improved now that fees are only paid once debt-settlement companies perform. The association's preliminary analysis of debt settlement after the advance-fee ban went into effect shows that a higher percentage of debts settled in the first two years after the ban than in the years prior to the reform. According to the AFCC report, approximately 35-40% of debts enrolled in 2011 were settled by the end of 2012, and an additional 20-25% remained active (Regan, 2013). It is unclear, however, how these settlements are distributed among consumers (because each consumer typically enrolls multiple debts) and what percentage of a given consumer’s debts will eventually settle. We are not aware of any industry analyses that report completion rates (or even partial completion rates) for consumers who enrolled after the advance-fee ban took effect.

At the state level, annual reports published by the Colorado Attorney General’s office, which regulates debt-settlement firms in the state, suggest that the advance-fee ban may not lead to improved outcomes for consumers. These data allow us to compare preliminary outcomes 12-24 months after enrollment for two groups of consumers: (1) clients who enrolled in 2009, the last full year in which debt-settlement companies operated without the advance-fee ban and (2) clients who enrolled in 2011, the first full year in which the advance-fee ban was in effect. For both groups, the proportion of consumers who terminated their debt-settlement program, settled all debts, or remained active in the program after 12-24 months was virtually unchanged (Colorado Attorney General, 2011; Colorado Attorney General, 2013). The marginal difference observed could be due to the rule change or other factors such as consumers enrolling fewer debts due to general de-leveraging during the Great Recession.

Figure 1: Distribution of Colorado consumer debt-settlement outcomes 12-24 months after enrollment

	After Advance-Fee Ban (Outcomes at year-end 2012 for consumers who enrolled in 2011)	Before Advance-Fee Ban (Outcomes at year-end 2010 for consumers who enrolled in 2009)
% Terminated	54.3%	56.5%
% Remaining active in debt-settlement program	38.1%	38.3%
% Settled all debts	7.6%	5.2%

Source: Colorado Attorney General, 2011 and Colorado Attorney General, 2013

The negative consequences consumers endure as a result of defaulting on their debts help explain at least part of the high termination rates. In particular, a consumer may have to drop out of a debt-settlement program to deal with creditor lawsuits. Although consumers who terminate no longer pay up-front fees for unsettled debts, they do incur increased debt balances.

A substantial share of consumers will likely be unable to settle enough debts to experience a positive change in financial position relative to their condition at the time of enrollment.

Given the industry's historical completion rates and the preliminary outcomes observed after the advance-fee ban took effect, a substantial share of consumers will likely be unable to settle enough debts to experience a positive change in financial position relative to their condition at the time of enrollment.

Risk that creditor will not negotiate. Consumers may have no chance of settling all of their debts regardless of a debt-settlement company's efforts because a significant portion of creditors are not willing to negotiate with debt-settlement companies. Some creditors prefer to deal directly with consumers having difficulty paying their debts or to have these consumers enroll in debt-management plans offered by credit counselors. For example, a 2012 survey of credit card issuers, debt buyers, and debt collectors found that only half of respondents would engage with debt-settlement firms (InsideARM, 2013). The responses vary by creditor type, with 63% of credit card company respondents reporting that they will work with debt-settlement companies, compared with 40% of collection agencies and 59% of debt buyers (InsideARM, 2013).

Debt-settlement companies do not tell consumers whether creditors will work with their firms at the time of enrollment. However, even if debt-settlement companies were required to disclose whether a particular creditor routinely works with their firm, this provides no real guarantee. In many cases, the party who owns a debt changes over time, since a debt may be sold successively to multiple parties.

Inability to complete a term settlement or continue saving into dedicated account. Consumers who enroll in debt settlement must make regular contributions into their dedicated account for several years. However, these consumers are likely to be financially stressed already and unable to withstand further financial shocks, such as a lawsuit, job loss, or an unexpected medical expense. If a consumer is unable to continue making her deposits, there may not be enough funds to complete any earlier term settlements. She may no longer be entitled to repay only the negotiated settlement and instead may have to pay the fully accreted balance. If this occurs, the settlement agreement is breached, and the consumer will again be in default on the debt. Nevertheless, she will owe the debt-settlement fee as long as she has made at least one payment toward the settlement. The consumer may also have other unsettled debts in default that continue to grow. It seems unlikely that a consumer in this situation would end up better off from having enrolled in debt settlement.

In a survey of creditors dealing with term settlements, approximately 40% of respondents reported that term settlements fail infrequently (20% of the time or less); however, another 29% of respondents reported "breakage" rates in which the consumer does not complete all payments that are far higher (40% of the time or more) (InsideARM, 2013).

IMPACT ON U.S. HOUSEHOLDS

In order to determine the risks and harms to consumers who enroll in debt-settlement programs, CRL undertook an analysis to determine how many debts a consumer would need to settle in order to improve her financial position relative to her situation at the time of enrollment. This analysis relies on data from a few large debt-settlement firms that represent a substantial share of total industry activity as reported by AFCC (Regan, 2013). Based on these data, CRL estimates that the average debt-settlement customer enrolls six debts totaling \$30,357 (Harnick & Parrish, 2013).

Figure 2: An average consumer's debt at enrollment in a debt-settlement plan

Total debt enrolled after advance-fee ban* (at participating companies)	\$1.7 billion
Average number of debts enrolled per consumer*	6
Total consumers enrolled after advance-fee ban*	56,000
Estimated average total debt enrolled per consumer (\$1.7B/56K)	\$30,357
Estimated average size of each debt enrolled per consumer (\$30,357/6)	\$5,060

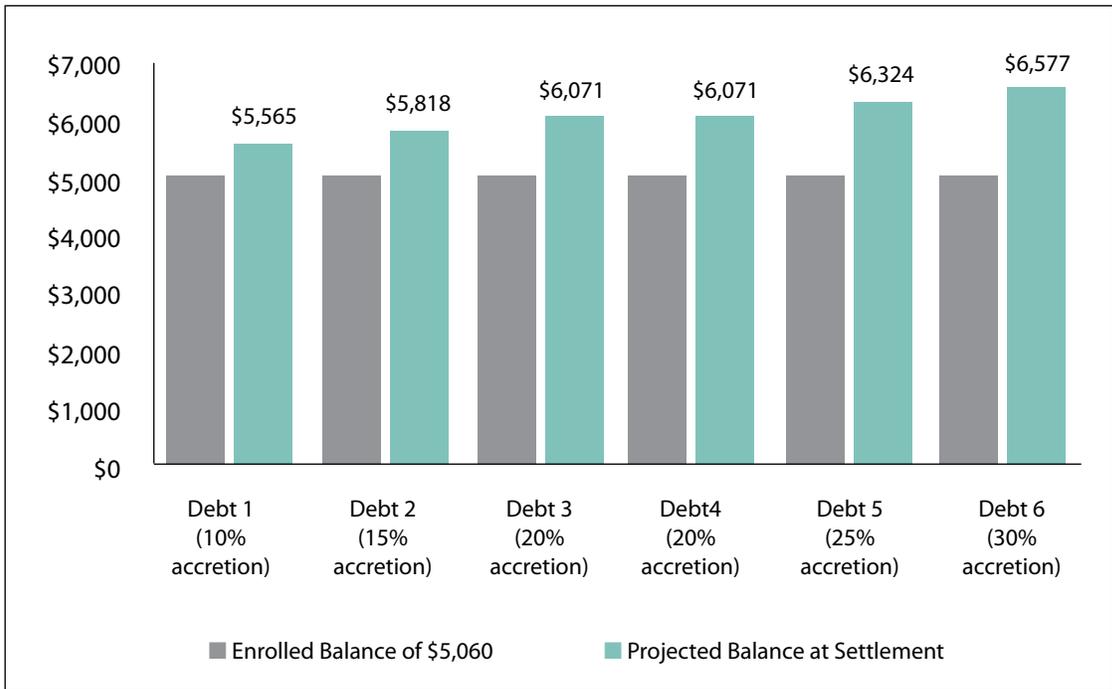
*data reported from participating companies

Source: Harnick & Parrish, 2013

AFCC data show that debts tend to settle at 48% of their current outstanding balance (Regan, 2013). That balance, however, is typically higher than it was at the time of enrollment because of the interest, late fees, and other charges a creditor may impose once the consumer defaults and enrolls in a debt-settlement program. This growth in the consumer's debt balance—called “accretion”—averages 20% across all debts from the time of enrollment until an eventual settlement (Regan, 2013). Because debts settle at different times, a debt settled shortly after enrollment may settle after increasing only 10%, while another settled after several years may grow 30%.

Figure 3 provides an example of how the average consumer in a debt-settlement program would see her six debt balances grow over three years, assuming that each debt is settled sequentially and there is an accretion rate of 20% (both of which are typical). It is important to note that this figure represents the best-case scenario in which each debt is settled, and as previously mentioned, this is likely rare, since some creditors will not negotiate with debt-settlement firms at all.

Figure 3: Projected growth in consumer account balances from time of enrollment until settlement (assuming all accounts settled within 36 months)



Source: Harnick & Parrish, 2013

Using these assumptions and data reported in the AFCC analysis, CRL found that consumers must settle at least two-thirds of all debts in order to benefit from enrolling in a debt-settlement program (Harnick & Parrish, 2013). In this model, we considered consumers who experienced a positive change in financial position after three years (the typical length of time that AFCC says consumers should expect to be in a debt-settlement program) relative to their condition at the time of enrollment to have benefited from debt settlement. This weighs the cost of debt-settlement enrollment (accretion on debt balances on settled and unsettled debts, and the amounts owed to creditors and the debt-settlement company on accounts that settle) against the principal reduction that is negotiated on settled accounts. Figure 4 provides a summary of the relative negative or positive change in financial position associated with settling none, some, or all of debts enrolled in a debt-settlement program.

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Figure 4: Change in financial position 36 months after enrollment

	Unable to settle any debts	Settle 1 debt (5 of 6 debts not settled)	Settle 2 debts (4 of 6 debts not settled)	Settle 3 debts (3 of 6 debts not settled)	Settle 4 debts (2 of 6 debts not settled)	Settle 5 debts (1 of 6 debts not settled)	Settle all debts
(A) Total debt enrolled	\$30,357	\$30,357	\$30,357	\$30,357	\$30,357	\$30,357	\$30,357
<i>Costs associated with settled debt(s)</i>							
(B) Total due to creditor on settled debts	N/A	\$2,671	\$5,464	\$8,379	\$11,293	\$14,329	\$17,486
(C) Total debt-settlement fees due	N/A	\$1,138	\$2,277	\$3,415	\$4,554	\$5,692	\$6,830
<i>Costs associated with unsettled debt(s) and outstanding balance</i>							
(D) Original balance of total unsettled debt remaining	\$30,357	\$25,298	\$20,238	\$15,179	\$10,119	\$5,060	N/A
(E) Accretion on unsettled debt, over 36 months	\$9,107	\$7,589	\$6,071	\$4,554	\$3,036	\$1,518	N/A
<i>Total costs and financial position 36 months after enrollment</i>							
(F) Total debt balance plus costs (B+C+D+E)	\$39,464	\$36,697	\$34,051	\$31,526	\$29,001	\$26,598	\$24,316
Change in financial position 36 months after enrollment (A-F)	(\$9,107)	(\$6,340)	(\$3,693)	(\$1,169)	\$1,356	\$3,759	\$6,041
# debts that remain in default	6	5	4	3	2	1	0

Note: figures may not add up exactly due to rounding

Figure 4 shows that on average, consumers need to settle at least four debts to receive a net benefit from debt settlement. However, consumers who face other costs—such as potential tax liability and third-party fees to maintain the dedicated account—would have to settle nearly all (five of six) debts to benefit from debt settlement. Further, Figure 4 does not monetize other potential costs, such as a creditor filing a lawsuit on a defaulted debt or negative impacts to a consumer’s credit score.

As described in a previous section, many consumers will likely be unable to settle enough debts to experience a positive change in financial position relative to their condition at the time of enrollment. Thus, although debt settlement may first appear attractive to a desperate consumer trying to find a way out of unmanageable debt, harms stemming from defaulting on debts may leave consumers even worse off. These harms include damaged credit; aggressive collection attempts from creditors (including lawsuits which may lead to added costs and wage garnishment); and continued growth of debt balances through default interest rates, late fees, and other charges.

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LEGISLATION AND REGULATION

The debt-settlement industry has grown as multiple states authorized the practice through changes in state law. With this growth came increasing concerns regarding industry practices, leading to investigations and hearings by state Attorneys General and federal agencies. One of the most troubling of these industry practices was charging high fees at the time of enrollment and continuing monthly charges even before debts had settled. AFCC notes that, historically, companies would charge fees of around 15% of the amount of debt enrolled in the beginning of a consumer's tenure in a debt-settlement program (Regan, 2013). Thus, many consumers paid thousands in fees yet had no or very few debts settled. Paying these fees up-front also slowed the process of consumers saving into accounts used to negotiate with their creditors. Despite these programs' limited success in negotiating debts, debt settlement-companies frequently made deceptive claims as to the benefits of their services.

As a result, multiple state Attorneys General and regulators have successfully sued debt-settlement companies for fraudulent and deceptive acts and practices. State Attorneys General and their Regulators took at least 127 enforcement actions against debt-settlement by 2010 (FTC, 2010). In addition, several states have either refused to authorize the debt-settlement practice or strongly limited it and the fees that may be charged. For example, Connecticut, Illinois, and Maine limit fees to 10-15% of the actual savings debt-settlement companies achieve for the consumer.

In 2008 and 2009, the FTC hosted public meetings on the debt-settlement industry, and the Government Accountability Office (GAO) issued a report outlining its concerns about the industry in 2010. This culminated in the promulgation of the new FTC rules in July 2010, which became effective in October of that year. As discussed earlier, among the most significant provisions is the advance-fee ban, which only allows firms to collect fees when a settlement agreement has been reached and at least one payment has been made by the consumer to the creditor. The FTC rule also provides greater protections for the dedicated accounts in which consumers save for future settlement agreements and standards for what debt-settlement companies must disclose to prospective customers. Additionally, it prohibited particular marketing tactics, which it found to be misleading.

After the 2010 FTC rulemaking, the Consumer Financial Protection Bureau (CFPB)—a new federal financial regulator—opened its doors. As a result, the CFPB and the FTC now share jurisdiction over debt-settlement companies. The CFPB has been active in conducting investigations of debt-settlement companies and their affiliated service providers. The CFPB has placed particular focus on those firms that use the attorney model to continue to charge advance fees, as well as firms that make misrepresentations about the success of debt-settlement programs to consumers. To date, the CFPB has successfully taken actions against several debt-settlement companies and one payment processor; in addition, it is currently in litigation with Morgan Drexen (CFPB, 2012; CFPB, 2013a; CFPB, 2013c; CFPB, 2013d; and CFPB, 2013e). These cases typically involve the charging of illegal up-front fees, as well as deceptive practices. The investigations have revealed low settlement rates: In one case, the CFPB found that nearly 90% of consumers enrolled in the program had not had any debts settled (CFPB v. American Debt Settlement Solutions, 2013). In another, the CFPB concluded that “the vast majority of consumers do not have any enrolled debt renegotiated, settled, reduced, or otherwise altered” (CFPB v. Morgan Drexen, 2013).

DEBT SETTLEMENT POLICY RECOMMENDATIONS

Consumers overwhelmed by their credit card and other forms of unsecured consumer debt face tough decisions when determining whether to continue paying on those debts as agreed. If they are unable to do so, options such as negotiating directly with a creditor, entering into a debt-management plan, or filing for bankruptcy can at least provide the consumer with the certainty that as long as they complete the program, their creditors will not pursue collection activities or initiate lawsuits. By comparison, debt settlement is a risky gamble in which consumers cut off communications with their creditors and stop making payments, thus facing penalty interest rates and fees and resulting higher balances. They hope that negotiations conducted on their behalf are successful in settling most or all of their debts.

To ensure consumers are not faced with the inherent risks of debt settlement, [states that do not currently permit debt settlement should not authorize the practice](#) until the industry can demonstrate that a large majority of their clients are able to realize a positive change in financial position. Additional protections should also be incorporated at the state and federal level to lessen the inherent risks associated with debt settlement. The CFPB and states that already authorize debt settlement should:

- [Require screening before enrollment.](#) There is a substantial risk that consumers may not complete debt-settlement programs because of factors both in and beyond their control. As a result, debt-settlement providers should be required to conduct a personalized evaluation of a prospective client and conclude that the debt-settlement program is likely to provide a net benefit and is affordable, given the prospective client's current income, expenses, assets, and liabilities. The written analysis should also review whether the client's creditors are likely to settle and whether the consumer's particular circumstances—such as whether her income is protected from wage garnishment or lawsuits (as is the case with Social Security income)—make debt settlement unsuitable.
- [Include a “not-worse-off” provision.](#) To discourage debt-settlement companies from enrolling people who have a significant chance of ending up worse off, provisions should be enacted that provide consumers with some form of refund or concession if they end up worse off after they enroll in a debt-settlement program. Such a provision could require debt-settlement firms to provide refunds to clients who ultimately have to file for bankruptcy to cover some or all of their associated expenses. Debt-settlement firms could similarly be required to refund all fees paid if the client's total expenses (settlements owed to creditors, fees owed to debt-settlement firm, and balance on any unsettled debt, etc.) exceed the original principal balance.
- [Require detailed data reporting.](#) Debt-settlement companies should be required to report on the outcomes achieved for their clients, at a minimum indicating for each consumer the number and amount of enrolled debts and—for each such debt—the date and amount of settlement (if any), the structure of each settlement (and whether term settlements are completed), the fees charged, and whether any of these debts is the subject of a creditor lawsuit. This data reporting is most helpful when provided by “vintage,” allowing outcomes to be assessed over time for groups of consumers who enroll in a given year.

- **States that allow debt settlement should establish meaningful limitations on fees.** Debt-settlement fees should be calculated based on the amount of savings achieved, comparing the settlement amount with the amount of the debt *at enrollment*. Setting the fee in this manner aligns the debt-settlement firm's incentives with the interests of the consumer, since they are paid more if they negotiate a larger debt reduction. It also ensures that a fee is not larger than the debt reduction achieved, which may occur when fees are set as a percentage of the debt balance at enrollment.

The fee limit should be set at a rate that ensures that the majority of clients will achieve a substantial reduction in debt load (taking fees into account) compared with the debt balance at enrollment. For example, states such as Connecticut, Illinois, and Maine limit fees to 10-15% of savings to achieve this result.

- **Ensure broad coverage of the law.** Finally, any debt-settlement laws and regulations enacted at the state or federal levels should include all debt-settlement providers, including attorneys and others whose activities are not covered by the FTC rule, in order to establish a level playing field and to ensure that consumers can be confident that they are receiving the same level of protections regardless of the company they choose. This would be consistent with how the Fair Debt Collection Practices Act covers attorneys who engage in debt-collection work. In addition, the CFPB, FTC, and states should continue investigations of debt-settlement companies to ensure compliance with existing and any new regulations or laws that are promulgated in the future.

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APPENDIX

Other strategies for dealing with unmanageable debt

Consumers have other options available in situations in which they become over-indebted and are no longer able to make regular payments to pay off debt as agreed. These options are discussed in turn below.

Negotiate directly with creditors. One option is for consumers to negotiate directly with a creditor to reduce the principal balance, seek relief from late fees and other penalty charges, or obtain a reduced interest rate. Many credit card companies offer hardship programs to consumers who can document a financial hardship (Dratch, 2010). These hardship programs may even be available to consumers who have yet to become delinquent or default on their debts and thus would not adversely affect a consumer's credit history and score. In addition, once a default occurs, the debt's servicer—whether the original creditor, a debt buyer, or collections agency—may offer concessions to a consumer. For example, a debt buyer who has purchased a consumer's debt at a heavily-discounted rate may be able to offer a substantial savings and still benefit from the settlement. Staying in communication with creditors and expressing a willingness to pay at least some of the debt owed may also decrease litigation risk.

Debt-management plan from a credit counseling agency. Consumers who prefer not to engage directly with their creditors may seek the assistance of a non-profit credit counseling agency that offers debt-management plans. The credit counseling agency negotiates an up-front agreement from the consumer's creditors to allow the consumer to repay her debts within 3-5 years with modified terms such as significantly reduced interest rates and the elimination of late or other penalty fees. Debt-management plans are generally suitable for consumers who have sufficient income to pay down their debt under these terms within 3-5 years.

Bankruptcy. Consumers who do not have sufficient income to take advantage of concessions offered by a creditor or credit counselor still have the option of filing for bankruptcy. Bankruptcy provides relief from almost all consumer debt—not just the unsecured debts eligible for a debt-settlement program. Once a consumer files, all collection activities are halted, and no new late fees or default interest rates can be imposed.

Consumers filing for bankruptcy can do so through a Chapter 7 liquidation or a Chapter 13 repayment plan. Chapter 7 bankruptcy typically takes 3-4 months to complete, at which point outstanding debts are extinguished. Consumers who do not qualify for Chapter 7 can file under Chapter 13. In Chapter 13, the consumer pays all disposable income beyond court-approved living expenses into a court-supervised fund to repay debts over a 3-5 year period.

A bankruptcy leaves a negative mark on the consumer's credit report for 7-10 years from the date of filing, which is somewhat similar to the duration of debt settlement's impact on credit scores (Sweet, 2013). Relative to debt settlement, bankruptcy is likely to be a more cost-effective and successful way to deal with unmanageable debt.