Growth of the Debt Settlement Industry

Challenges & Solutions

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Executive Summary

The size and scope of consumer debt in American society directly correlate with the growth of the debt settlement industry over the past two decades. As more and more Americans become unable to pay their debts, legitimate companies that can negotiate with creditors on behalf of consumers are in greater demand than ever.

The growth of this industry, however, has come with its share of burdens. Legitimate debt settlement companies are being tarnished by the fraud and abuse that is rampant throughout the industry. Hundreds of debt settlement companies are operating in an under-regulated environment and lack standard policies and procedures, eroding confidence in debt settlement among regulators and consumers.

For the debt settlement industry to remain relevant and succeed as an effective option for Americans facing financial hardship, debt settlement companies must adopt meaningful voluntary industry standards and seek appropriate action from regulators.

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Understanding Debt Settlement

The debt settlement industry in America has grown from an explosion of consumer debt, particularly credit card debt, which reached historic highs in March 2008 of more than $2.5 trillion. Debt settlement companies negotiate a settlement with a consumer's creditor for a portion of their outstanding debt, often for 40 to 60 percent of the original outstanding balance. This method helps consumers clear up their debt more efficiently and expeditiously, avoid having to declare bankruptcy, and get back on track financially.

Many consumers who turn to debt settlement companies are unable to pay their debts due to a financial hardship such as job or income loss, divorce, and health problems. In short, these consumers are incapable, rather than unwilling, to pay their debts.

Debt settlement provides a better alternative to consolidation loans, bankruptcy, or avoidance. By using debt settlement to reconcile their debt, consumers can easily improve their debt-to-income ratio and have more control over the process of getting out of debt. Furthermore, legitimate debt settlement firms advocate solely for their clients to help them both get out of and stay out of debt.

While personal bankruptcies remain on the rise, recent reforms in U.S. bankruptcy laws have made it more difficult for consumers to declare bankruptcy. In April 2005, Congress passed The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA, P.L. 109-8). According to the non-partisan Congressional Research Service, the BAPCPA "included the most significant amendments to consumer bankruptcy procedures since the 1970s."[1]

The BAPCPA decreases eligibility for people to file Chapter 7 bankruptcy; this is the most popular form of bankruptcy because it discharges unsecured debt largely accrued by consumers from their credit cards. As a result, consumers are increasingly forced to file for the more burdensome Chapter 13 bankruptcy, requiring debt repayment within a five year period as their only option for bankruptcy.[2]

Unlike debt settlement where consumers have more control over the terms of their repayment, court decisions on bankruptcy cases are unpredictable. The resulting repayment terms can be challenging for someone already struggling from paycheck to paycheck. In fact, "roughly two-thirds of people who file Chapter 13 bankruptcy never make it entirely through their debt repayment plan outlined by the court" and "typically exit the bankruptcy system, never getting their debts discharged."[3]

Bankruptcy is generally viewed by creditors and lending institutions as a sign of financial disaster. This is particularly the case with Chapter 7, which often results in the discharge of one hundred percent of the consumer's unsecured debt. In addition, bankruptcy will remain on a person's credit bureau report for seven years, severely impacting their access to credit. By contrast, customers who successfully complete a debt settlement program will have their credit reports marked with more favorable terms such as "Paid as Agreed" or "Settled as Agreed."

Debt consolidation is another alternative to bankruptcy. Some consumers pursue debt consolidation because they prefer to pay off their existing debts by utilizing a fixed payment plan. However, unlike debt settlement, this method usually requires an existing asset to be used as collateral for a consolidation loan. Debt consolidation programs require consumers to transfer the debts from an unsecured to a secured loan that includes repayment of the entire debt in fixed installments over several years, plus interest and administrative fees.

When consumers choose debt consolidation over debt settlement, the consolidator often already has a preexisting arrangement with the consumer's creditors to help them also recover their own losses. In comparison, debt settlement negotiators only work for the consumer, making them more effective in negotiating the best arrangement with their creditors.

Finally, as a debt ages, debt consolidation becomes increasingly impractical because the ability to collect on the account becomes less certain with age. Creditors begin to utilize more aggressive tactics after a debt is unpaid for more than 90 or 120 days, and they usually write off loans more than 180 days past due. When the consumer's debt gets this old, it may be sold to a debt buyer at a discount, or the creditor will contract with a third party – like a collection agency or attorney – to aggressively collect whatever it can. It is at this point that the consumer is in a much better position to negotiate with their creditors through the help of a debt settlement firm.

Brief History of U.S. Consumer Debt

In 1856, former U.S. Senator Thomas Morris observed in his assessment of America's credit system, "in my opinion, we have too much, instead of too little credit; too many of our citizens are endeavoring to live on credit, instead of industry." [4] Senator Morris' comments came just as consumer credit was taking root in American society.

Throughout much of the nineteenth century, credit for personal consumption was largely stigmatized. Its growth during this period has been characterized as "capillary and secretive" [5] and was mostly limited to individuals borrowing against their existing assets to pay for the next planting season or for proprietors to provide locals the ability to buy goods from them and pay later.[6]

It was not until the turn of the twentieth century that consumer credit began to be accepted more widely in American society. In 1899, economists researching household money management discovered that trends in personal credit were undergoing significant changes. Installment debt was suddenly widespread among many Americans and was representative of all levels of the social economic ladder.[7]

This movement toward an increasing use of credit for personal consumption grew through the era leading up to the Great Depression. "By 1926 two of every three cars sold were bought on credit. Over the same period, outstanding consumer debt nearly doubled (in constant dollars), while household debt as a percentage of income rose from 4.68 to 7.25 percent."[8]

Consumer credit took a giant leap forward in the late 1980s and early 1990s with the deregulation of the banking industry and the economic expansion of the 1990s. In fact, starting in 1991 until the first quarter of 2001 when expansion finally came to an end, total household debt, consumer credit debt, and mortgage debt all doubled.[9] This along with a squeeze in finances, higher inflation, and a rise in unemployment stemming from economic recession, led to the current situation America finds itself in today.

The Debt Settlement Industry Today

The United States has transformed into a nation that hides their addiction to credit on their personal credit cards. In his book, *Credit Card Nation*, leading consumer lending expert Dr. Robert Manning says, "financial pressures that otherwise would require an explanation to family members or even bank loan officers can be temporarily concealed through the magic of plastic."[10] It is this concealment of debt that often leaves the debtor out of touch with the actual scope of their non-secured credit liabilities, paving the way for eventual trouble. Additionally, when a financial hardship event occurs, consumers are not only faced with insurmountable debt, but no way to pay it off.

As more and more consumers find themselves over their heads in debt, or left with nowhere to turn except bankruptcy after a serious financial hardship, they have increasingly turned to debt settlement. As a result, the debt settlement industry has grown to keep pace with demand.

The United States is currently in the most difficult credit environment in recent history. An unprecedented number of Americans are facing serious financial hardships and need help paying their debts. A downturn in the U.S. economy in 2008, which includes pitfalls in the mortgage market and banking sector, has resulted in enormous losses for lenders. The effect has been a tightening in the extension of secured credit. In May 2008, the Federal Reserve reported an increase of consumer credit at an annual rate of 3.6 percent with non-revolving credit only increasing by 1.6 percent.[11] As lenders and banks tighten their non-revolving credit products, consumers are increasingly using their credit cards to help make ends meet and to handle their larger purchases.

While non-revolving credit has seen stagnant growth, the Federal Reserve reported in May that revolving credit accounts are growing at a much faster annual rate of 7.1 percent. This credit increase boosted total consumer debt by $7.8 billion from the previous month to $2.57 trillion. It has also signaled a growing dependence on revolving credit which will amplify the number of consumers likely to get caught in a financial situation requiring assistance from a debt settlement company.

Also contributing to the growth of America's debt settlement industry is the lack of personal savings. America's personal savings rate began its steep decline following WWII. Since it's high of 13.6 percent in the 1940s, America's personal savings rate fell to 7.6 percent in the 1950s and 1960s, experienced a slight bounce in the 1970s and 1980s, only to be decimated by the end of the 1981-82 recession, and finally landing at zero by the end of 1998.[12]

As Americans save less and less, they are using more credit to finance any emergency or unexpected event that savings used to address. In the past, many Americans could draw upon their savings when they experienced the loss of a job or other negative impact on their financial situation. Now, many are not only without savings, but saddled with high-interest and unsecured revolving debt. As inflation and other variables change, so will the amount of that debt, making it even harder to recover and therefore making debt settlement an even more attractive option.

Industry Problems & Challenges

While the demand for debt settlement services has skyrocketed over the past several years, the debt settlement industry has been hampered by an increasing number of fraudulent companies that have taken advantage of vulnerable consumers. Today, hundreds of debt settlement companies function in an under-regulated environment, leaving consumers prone to fraud and abuse.

Few debt settlement companies operate with established policies and procedures or maintain enough staff to adequately service client needs. There is no standard operating model for the industry, and many companies focus predominately on the sales process rather than putting the customer first. Additionally, disclosure is often very inadequate, especially with regards to program fees and the possibility that creditors could seek legal remedies through the courts. Finally, the personnel managing many debt settlement firms lack necessary financial backgrounds, particularly in critical areas of consumer credit and compliance.

The fraudulent practices of some debt settlement firms have contributed to increased scrutiny from regulators, high-profile litigation cases, and an erosion of public trust of the entire industry. These companies often accept accounts from third party creditors or collection entities to settle debts. In this instance, they act more like conduits for collection agencies than advocates working in the best interests of the consumer. This becomes a major problem when, unaware of this third party relationship, the consumer provides the fraudulent firm personal financial information that can then be used to help the third party achieve their collection objectives.

On balance, legitimate debt settlement companies are consumer advocates who only represent the interests of the consumer and do not take any fees from loan consolidators, collection agencies, attorneys or other biased third parties. This dynamic ensures the consumer is protected from third party disclosure.

Fraudulent firms also regularly fail to provide the services promised to consumers by claiming that they can help the consumer become debt free in an unrealistically short amount of time and/or promise too low of a settlement. Fraudulent debt settlement practices have also included embezzling customer funds that are supposed to be held in escrow to pay settlements and requiring that unreasonable fees – sometimes as high as 30 percent of the outstanding balance –are paid before any work is completed for the customer.

Aside from the fraud and abuse committed by some companies in the industry, debt settlement as a strategy does have its own drawbacks, and it is critical that companies fully disclose both the positive and negative aspects of debt settlement to consumers. Failure to do so can be very misleading for a consumer who believes that because they are in the debt settlement process, they are immune from other factors.

For instance, some consumers believe that because they are working with a debt settlement firm, they are immune from legal proceedings by the creditor. Until an agreement has been reached between the creditor and the consumer through the negotiation process, creditors may still use litigation to recover their losses.

There are also potential tax consequences associated with debt settlement. When a debt is cancelled or negotiated to a lesser amount, the difference must be reported as taxable income. Specifically, the Internal Revenue Service (IRS) classifies any amount of settled debt above $600 and greater in value of the individual's assets as taxable income.

As mentioned earlier, debt settlement can still negatively impact a person's credit score. Many creditors have also developed their own internal credit scoring models that allow them to calculate a "risk price" on their consumer loan portfolios. A lower score can impact a person's ability to obtain credit, resulting in higher interest and fees for loans that they may obtain.

In order to ensure full disclosure, legitimate debt settlement companies should always explain the following information to prospective clients during the initial consultation:

- Prospective clients must be committed to saving money to fund settlements.
- Negotiations occur on an ongoing basis and all offers of settlement will be presented to the customer for their exclusive approval.
- Results of the debt settlement program cannot be guaranteed.
- Client funds are not escrowed by the company.
- The Internal Revenue Service (IRS) classifies any amount of settled debt above $600 and greater in value of the individual's assets as taxable income.
- Creditors may exercise the right of offset and its potential impact must be explained to the client.
- Payments are not made by the company to the client's creditors.
- Clients should continue making payments to their creditors if they have the means to do so.
- Creditors may continue to call even after receipts of a Limited Power of Attorney (LPOA) are signed between the client and the debt settlement company.
- Credit bureaus may still report "Settled for less than full amount" (or other similar language) even after paying settlements to creditors.
- A debt settlement program may have an adverse impact on the client's credit score.
- Clients should always review their budget to determine if they can afford to be in the program based on their expected income and expenses.
- The company only works for the clients, not any other third party from whom they might be receiving referrals or placements.

Next Steps for the Industry

Legitimate debt settlement programs can benefit both consumers and creditors by offering an ethical and honorable alternative to bankruptcy. However, hundreds of companies are operating in the under-regulated debt settlement industry. Often, they lack established policies and procedures, operate under ineffective service models, and do not have adequate disclosure requirements. As a result, consumer complaints against the debt settlement industry have skyrocketed, class actions lawsuits have been filed against fraudulent companies, and the industry has suffered from a substantial amount of negative media coverage and the erosion of public trust.

It is critical, therefore, that meaningful and relevant industry standards are put in place to distinguish effective and ethical debt settlement firms and protect their clients. Doing so will better protect consumers and ensure that legitimate debt settlement survives as an effective solution for Americans facing financial hardship. The industry must insist on reasonable and enforceable regulatory oversight, provide barriers to prevent fraudulent companies from entering the market, embrace greater transparency and disclosure, and allow audits and inspections by regulatory agencies.

Finally, consumers and creditors alike should review the practices of debt settlement firms prior to entering into an agreement with them. For starters, each debt settlement company should have the following:

- Written policies and procedures about their debt settlement program.
- Membership with the Better Business Bureau.
- Comprehensive "Debt Settlement Company Certification" that is similar to what creditors may require for their collection agencies and other vendors.
- Open door policy to regulatory agencies and vendor certification for creditors.
- Customer dispute resolution and review process.
- In-house legal counsel that has significant experience with credit industry compliance.

For the debt settlement industry to survive and grow over the long-term, it must be open to implementing the aforementioned regulatory measures and voluntary industry standards. Doing so will help to eliminate companies that are not operating within ethical boundaries or failing to adequately represent consumers' interests and protect them against the fraudulent practices that are so common throughout the debt settlement industry today.

References

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[5] Lendol Calder, *Financing the American Dream: A Cultural History of Consumer Credit*. (Princeton: Princeton University Press, 1999), 212.

[6] John P. Watkins, "Corporate Power and the Evolution of Consumer Credit," Journal of Economic Issues, Vol. 34, Issue 4, 2000, 909.

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[8] Martha Olney, *Buy Now, Pay Later: Advertising, Credit, and Consumer Durables in the 1920s*. (Chapel Hill: University of North Carolina Press, 1991), pp. 88–89, 96; quoted from Lendol Calder, 234.

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[12] Robert D. Manning, 31.