Growth of the Debt Settlement Industry

Challenges & Solutions

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October 17, 2008

Executive Summary

The growth of the debt settlement industry directly correlates with the size and scope of consumer debt in American society over the past two decades. As more and more Americans have become unable to pay their debts, the option of debt settlement has become more attractive.

The expansion 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 enforceable standards and regulations, which has eroded 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 over the long-term, the industry must adopt enforceable standards and seek appropriate oversight from regulators. The Federal Trade Commission (FTC) hosted a workshop on this very topic in September 2008. As regulation of the debt settlement industry progresses on both the federal and state levels, debt settlement companies will need to be a part of this discussion by engaging the necessary stakeholders and embracing enforceable standards.

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Understanding Debt Settlement

The debt settlement industry in America has grown from an explosion of unsecured consumer debt, particularly from credit cards. According to the Federal Reserve, outstanding consumer credit reached a historic high of nearly $2.6 trillion in July 2008. To get a sense of the magnitude of this debt, that averages nearly $8,500 per person or more than $22,000 per household.

Debt settlement companies have become an increasingly important option for consumers because they can effectively negotiate settlements with creditors for a portion of the outstanding debts. A legitimate debt settlement program helps consumers clear up their debt more efficiently, provides a viable alternative to bankruptcy, and helps consumers get their financial lives back on track.

Many consumers who turn to debt settlement companies are experiencing financial hardships due to life events such as divorce, job loss, or illness. These challenges often limit a consumer's available cash flow to pay down or continue servicing the minimum payments on their debts. In short, these consumers are incapable, rather than unwilling, to pay their debts. While financial hardships stemming from unexpected life events are not contained within a single income level, those in the lower-to-middle income bracket, or who lack assets to borrow against or savings to draw from, are more susceptible to falling into severe debt and are most in need of the relief provided by debt settlement. Consumers who are able to pay their debts, however, may not find debt settlement the most appropriate debt relief option, which is why legitimate debt settlement companies carefully screen prospective clients seeking to participate in their program.

For those experiencing severe financial hardship, debt settlement can provide a better alternative to consolidation loans, bankruptcy, or avoiding creditors altogether. By using debt settlement to reconcile their debt, consumers can 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, and help them to get out of and stay out of debt.

According to the Administrative Office of the U.S. Courts, in the 12-month period ending June 30, 2008, bankruptcy cases filed in the United States topped nearly 1 million – a nearly 29 percent increase over the same period last year. 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 a consumer's unsecured debt. In addition, bankruptcy will remain on a person's credit bureau report for as long as ten years, severely impacting their access to credit. By contrast, the credit bureau report of a customer who successfully completes a debt settlement program will reflect more favorable terms such as "Paid as Agreed" or "Settled as Agreed." Additionally, negative items will not remain on the customer's credit report as long as a bankruptcy, thereby improving their credit worthiness more quickly.

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. 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 a consumer's creditors to help them also recover their losses. In comparison, debt settlement negotiators only work for the consumer, making them more effective in negotiating the best arrangement with their creditors.

Furthermore as a debt ages, debt consolidation becomes increasingly impractical because the ability to collect on the account becomes less certain over time. 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 a 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 a consumer is in a much better position to negotiate with their creditors through the expert help of a debt settlement firm.

Lastly, some consumers choose to negotiate settlements with their creditors on their own. However, the advantages of working with a debt settlement company far outweigh this go-it-alone strategy. It takes a great deal of time and effort to negotiate a debt. Debt settlement firms often call a creditor dozens of times before a settlement is reached. Consumers who are financially stressed may not have the time required to negotiate with their creditors. Moreover, creditors are usually unwavering in negotiating with the consumer themselves. Legitimate debt settlement firms have teams of skilled debt negotiators who represent consumers as a third party to put direct pressure on the creditor to settle the debt, often at a significantly lower rate. Additionally, debt settlement firms help hundreds of thousands of consumers every year, so creditors understand that the best way to recover some of their losses is to be responsive to the debt settlement firm's negotiation efforts, rather than engaging the costly services of an outside collection company or take the risk of getting nothing through bankruptcy proceedings.

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 credit liabilities, paving the way for eventual trouble. When a financial hardship event does occur, like illness or job loss, a consumer is not only faced with insurmountable debt, but has no way to pay it off.

As more and more consumers find themselves over their heads in debt, or are left with nowhere to turn except bankruptcy after a serious financial hardship, they have increasingly found debt settlement to be a viable alternative. 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 also 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.

Another major contributing factor 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, 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.

Increased scrutiny of credit counseling agencies in recent years, coupled with diminished benefits offered by creditors to consumers working through these agencies, is another significant factor in the growth of the under-regulated debt settlement industry. Congressional scrutiny and tightened oversight by the IRS resulted in many non-profit agencies having their non-profit status revoked, placed in the administrative process for revocation, or forced out of business altogether. The diminished size of the non-profit credit counseling industry has resulted in more room for debt settlement firms to grow and operate.

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 consumers. This becomes a major problem when, unaware of this third party relationship, consumers provide 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 consumers and do not take any fees from loan consolidators, collection agencies, attorneys or other biased third parties. This also ensures that consumers are protected from third party disclosure issues.

Fraudulent firms also regularly fail to provide the services promised to consumers by claiming that they can help them become debt free in an unrealistically short amount of time and/or promise too low of a settlement. These claims are usually communicated to consumers through marketing and advertising campaigns, which often contain unqualified statements and lack transparency into costs, program success, and completion rates. Such marketing practices misinform consumers and are undermining the debt settlement industry as a whole. Consumers who consider debt settlement services are already desperately trying to avoid bankruptcy and financial ruin. False marketing claims play on consumers' emotions and desperation, and are often open to interpretation. A desperate consumer is more likely to believe the interpretation most beneficial to them.

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. The two dominant service fee models for the debt settlement are on the front and back ends of the program. Legitimate debt settlement companies fully disclose their fee models and tell the consumer the costs of the program upfront. Companies that engage in fraudulent practices, however, manipulate customers through their fee structures to make as much profit as possible off of their clients. They often do this through hidden fees that take advantage of escrowed funds, or charge a large portion of the settlement as a fee for their service. Some fraudulent firms have pre-arranged fees with the creditors they are negotiating – all without the consumer's knowledge.

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 a creditor and a consumer through the negotiation process, creditors may still use litigation to recover their losses. Consumers should always pay what they can to their creditors throughout the negotiation process and be aware that they can still be sued by their creditor until a settlement is reached.

Potential tax consequences are also 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 $600 or greater in value, 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 "risk price" 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 debt settlement 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 will probably 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 enforceable industry standards. As a result, consumer complaints against the debt settlement industry have increased, class actions lawsuits have been filed against fraudulent companies, and the industry has suffered from a substantial amount of negative media coverage and erosion of public trust.

Enforceable and relevant industry standards are needed to make certain that consistent and effective compliance are in place to protect consumers and that legitimate debt settlement survives as an effective solution for Americans facing financial hardship. The industry must insist on reasonable and germane 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.

Additionally, 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 establish enforceable industry standards. Doing so will help to eliminate companies that are not operating within ethical boundaries or fail to adequately represent the consumers’ interest.

Oversight by the federal government will achieve desperately needed interstate consistency regarding debt settlement services. Uniformity will ensure that standards are enforceable and adequate disclosure requirements are in place to protect consumers. Many states are pursuing stronger state regulations as well, but this approach has thus far failed to put in place the uniform and enforceable standards needed to protect consumers – and ultimately putting fraudulent debt settlement companies out of business

In September 2008, the Federal Trade Commission (FTC) held a workshop on consumer protection and the debt settlement industry, which provided an opportunity for industry stakeholders to sit down together and discuss a broad range of issues facing the industry, including regulation, oversight, consumer disclosure, marketing practices, and relevant fee-for-service models. The workshop included participants from debt settlement companies, credit counseling organizations, industry groups, consumer advocates, academia, and regulatory bodies. The meeting served as a first step toward identifying key issues and creating a roadmap for the future of the industry. There was overwhelming consensus among the workshop participants that legitimate debt settlement offers a valuable service to consumers facing financial hardship. They also agreed that enforceable industry standards are critical to ensuring legitimate debt settlement firms continue their growth in an industry long beset with problems, but in high demand from consumers.

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