Between Financial Balance and Bankruptcy

Better options for consumers struggling to manage unsecured debts

November 25, 2008

Introduction

Debt-ridden consumers are struggling in today's difficult economic times. Their struggles are so severe and sweeping that their burden is impacting the institutions that provided them with the credit which for decades has enabled a new standard of living. The economy today is hurting both consumers and their creditors.

Creditors offer debt management programs through credit counseling agencies that can assist consumers who have fallen behind on their obligations to become current and recover with minimal long-term impact to their credit. For several years, states have passed laws to ensure those entities that offer such programs are licensed and qualified, and consumers who utilize such programs are sufficiently protected. Today, more than 40 states have laws regulating debt management services.

The traditional Debt Management Plan (DMP) supported by creditors is not sufficient to help many consumers impacted by the downturn in the economy and the increased availability and use of unsecured debt. For these consumers, there is a wide gulf between good credit and bankruptcy – and there is little in the way of protection for consumers seeking assistance outside of the established Debt Management Plan product.

Debt settlement has emerged as a popular service for consumers who fall between DMPs and bankruptcy. For consumers who cannot afford a traditional DMP, debt settlement may be their only option before bankruptcy.

While debt settlement may assist debtors, there are very few "rules of the road" for consumers, intermediaries and creditors to abide by. Today, only four states have comprehensive licensing laws that regulate debt settlement.

As settlement becomes an increasing popular and often necessary alternative to bankruptcy, elected officials and regulators should take steps to establish fair rules that protect consumers and operate within the construct of existing debt management laws and regulations at the state and federal levels.

Defining the Debt Management Industry
Tax status is a false distinction

As unsecured credit has exploded over the years, the industry that serves as the intermediary between debtors who need assistance and their creditors has changed significantly. It is no longer accurate to define the provision of DMPs, counseling and education as "nonprofit credit counseling." Nor is it accurate to define debt settlement providers as "the for-profit debt management industry." The lines have blurred considerably and the elimination of these categories can be beneficial to consumers and creditors alike.

Today, 41 states allow the provision of "traditional" credit counseling services – DMPs, credit counseling and financial education – by for-profit providers. In many cases, the regulatory structure is silent on the tax status of a provider and establishes its foundation in well enumerated protections for consumers and operating requirement for providers. This, rather than a false distinction between taxable and tax-exempt providers has proven to be the best approach for establishing the rules of operations for the industry.

After several years of drafting, the National Conference of Commissioners on Uniform State Laws (NCCUSL) is promoting the Uniform Debt Management Services Act in the states. This Act, already enacted in four states, regulates both traditional credit counseling services and debt settlements under the same structure, calling both "debt management services." Thus, a licensee under the Act could be taxable or tax-exempt and provide traditional credit counseling services, debt settlements, or both.

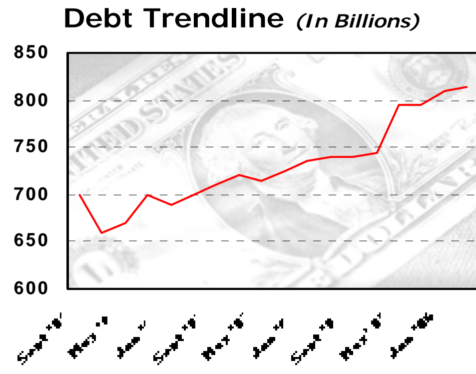
Recently, the traditional nonprofit credit counseling industry has been working with creditors to develop a debt settlement product known as the "60-60" plan (the repayment of 60 percent of the principal balance over 60 months). The traditional industry and the creditors recognize the need for this type of product and are exploring ways to offer it on a broad scale to consumers in need of an alternative to a DMP.

The movement away from bright line definitions of providers within the debt management industry based on their tax status is a positive evolution. The adoption of a regulatory structure reflective of the NCCUSL Model Act for the overall debt management industry is the best approach to safeguard consumers and police providers in this dynamic industry.

The Federal Trade Commission should define the industry and its services based on a tax neutral model to ensure consistency with state law and the true nature and structure of the debt management industry.

Expanding the Safety Net
establishing the need for better debt management services

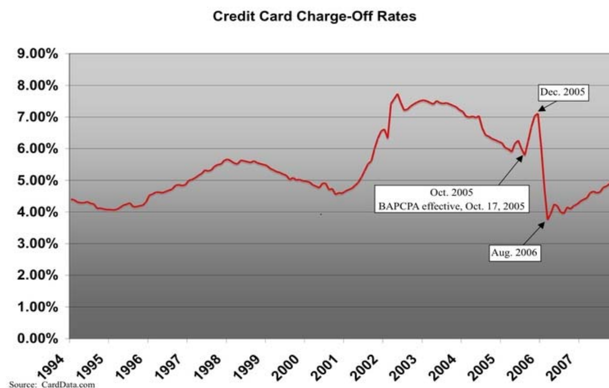
Consumer debt in America has risen significantly over the past two decades. The increased usage of unsecured credit has challenged both consumers and creditors alike. According to the Federal Reserve, 12.2 percent of American families are overburdened by debt, meaning their debt to income ratio is 40 percent or greater – that's 13 million households.



Source: Federal Reserve

The proliferation of easy credit was accompanied by sophisticated financial models and new technologies to identify the most profitable debtors and mitigate the risk of charge-offs. Maximizing recoveries from debt-ridden consumers has become an equally sophisticated business.

However, the basic assistance programs offered by creditors have not kept pace with the innovations in credit granting and collections over the past decades. Debt Management Plans (DMPs) provided by credit counseling and debt management organizations have remained relatively unchanged for more than 30 years.



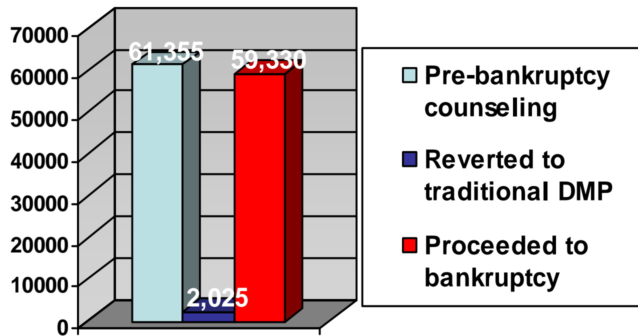
Limitations of the Traditional Debt Management Plan

Each year nearly two million consumers enroll in DMPs, which are well established, cost effective collection vehicles for creditors and beneficial repayment programs for consumers needing assistance. However, even with the broad reach and sophistication of credit counseling organizations, these inflexible full principal programs will work for only about 25 percent of consumers who seek credit counseling assistance because they require a payment beyond a consumer's ability to manage over the life of a program.

Each year, more than six million consumers interested in the traditional DMP either opt for another solution or do not meet the repayment criteria. And, many of the consumers who cannot qualify for DMPs end up being the bankruptcy filers who return little or nothing in obligation to their creditors and experience the difficulties and hardships of bankruptcy. The vast majority of these individuals have the willingness to repay their debt, but the system's inflexibility leaves them unable to do so.

The Rise of the Debt Settlement Industry
filling the gap

The gap between consumers who can afford a traditional DMP and those who ultimately file bankruptcy is wide. Creditors recognize that DMP's offer a repayment option for some, but those who qualify for a traditional DMP represent only about 25 percent of those consumers who need assistance. The challenge lies in helping the other 75 percent before bankruptcy becomes the only option.



Analysis by the National Association of Consumer Bankruptcy Attorneys February 22, 2006

Creditors know they must pursue other recovery methods to ensure a reasonable return on credit extended to individuals who have fallen behind on their payments. While the creditor community publicly criticizes the debt settlement industry, it exists and is thriving because it benefits creditors, and when done right it is a valuable alternative for consumers.

This dynamic of creditors accepting settlements in an unregulated environment fosters the potential for consumer abuse by debt settlement organizations. This is a policy issue that must be addressed for the benefit of the consumer. In doing so, the framework of a cooperative program between creditors, debtors and reputable intermediaries will emerge in the same manner that exists with traditional credit counseling services.

Debt Management Plans
...and beyond

Just as indebted consumers need options, so do creditors. Many indebted consumers are truly willing to make, yet unable to meet the minimum DMP payments. Currently, the choice many creditors make is to drive these consumers through the collection process and possibly towards bankruptcy. That means costly collection fees and a risk of total loss. Consumers in this situation often become the prey of unscrupulous debt settlement providers and other "debt consolidators" offering costly solutions that may not be in the best interest of the debtor.

This category of indebted consumers – those who cannot afford a DMP - represents both a vulnerable consumer class, and an untapped segment of recovery that could be protected and maximized through the established debt management system. Today, consumers who are unable to meet the DMP payment are tossed into an uncharted, unregulated environment where debt settlers maximize returns for themselves that should go to creditors and leave debtors worse off than before.

Assisting consumers in this gap requires an agreement on a less-than-principal balance repayment plan – or settlement plan. For creditors to accept a less-than-principal repayment plan, they must be confident that their debt's interest is fairly represented and that they are dealing with a reputable provider. For consumers to be protected in these arrangements there must be a robust regulatory structure to police the conduct of third party providers.

A New Approach to Debt Settlement
licensing equals legitimacy

Debt settlement today is often a confrontational rather than a complementary service for consumers and creditors. Lacking a regulatory structure, unscrupulous settlement providers can and do harm consumers in need of this service. Debt settlement as a debt management strategy must be legitimized through regulation and licensing. A legitimate debt settlement service can benefit consumers and creditors.

Today, only four states have comprehensive debt settlement laws. In contrast, nearly every state and the federal government have a strong statutory framework to oversee traditional debt management and credit counseling services such as Debt Management Plans and financial education standards. Until the enactment of a strong regulatory framework at the state or federal level, consumers will remain vulnerable to bad actors and creditors will remain skeptical of the settlement offers they evaluate.

Any legislative or regulatory approach at the state or federal level must include the following requirement for debt settlement providers:

- Licensing as a debt management services providers
- A surety to bond to pay damages and penalties to consumers harmed by a violation of licensing requirements
- Analysis that the plan is "right" for the debtor
- Meaningful disclosures and annual reporting requirements
- Fair and reasonable fees – low start-up and maintenance fees/"success fees" claimed only after a settlement is reached
- Written agreements and disclosures for consumers
- Consumer right to cancel with appropriate refunds
- Trust accounts and other financial management safeguards to protect consumer funds
- Prohibition on false and deceptive advertising
- Ongoing financial education and counseling

Conclusion

The debt management industry should not be considered a segmentation of nonprofit and for-profit providers where nonprofits provide traditional counseling and debt management plans and for-profits provide settlement services. The lines are blurring daily. The traditional credit counseling industry is exploring debt settlement structures -- often referred to as "60-60" plans -- with willing creditors. Settlement companies are licensed under credit counseling laws in several states.

The National Conference of Commissioners on Uniform State Laws (NCCUSL) spent several years drafting the "Uniform Debt Management Services Act" which has been adopted in four states with more than 25 introductions expected in 2009. This legislation creates one licensing structure for credit counseling and debt settlement establishing fee caps and disclosures that align with the differences between a debt management plan and a debt settlement plan. This model is the best approach for establishing a regulatory structure that is flexible for an evolving industry, and provides significant protections for consumers and penalties for unscrupulous or unlicensed providers.

In many states that have tough debt management plan and credit counseling laws, debt settlement escapes licensing and registration due to definitional loopholes. This patchwork must be addressed. The NCCUSL model Act would fix this problem.

Debt settlement services will continue to grow as other debt management services fail to meet the needs of debtors and creditors. Several years ago states and the federal government embarked on an effort to develop a regulatory framework for debt management services which has largely eliminated the consumer abuses associated with traditional credit counseling and debt management plan services. It is time for the same effort to occur regarding debt settlement.