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Debt Settlement:

Fulfilling The Need for An Economic Middle Ground

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INTRODUCTION: AN OVERVIEW OF RECESSION AND RISING CONSUMER DEBT BURDENS

For the past two years, the American economy has endured the most severe contraction since the Great Depression of the 1930s. Many bellwether companies have been forced into bankruptcy, home prices have fallen on average more than 20 percent, the equity markets remain 35 percent below their 2007 highs, and in excess of seven million workers have joined the ranks of the unemployed. As a consequence of what has come to be called the Great Recession of 2008-2010, household net worth has declined by more than 10 trillion dollars ($1.3 trillion in the first quarter of 2009 alone), home foreclosures have more than doubled, and personal bankruptcy filings have increased 100 percent over the past 18 months[1] (see *Figures 1, 2 and 3*).

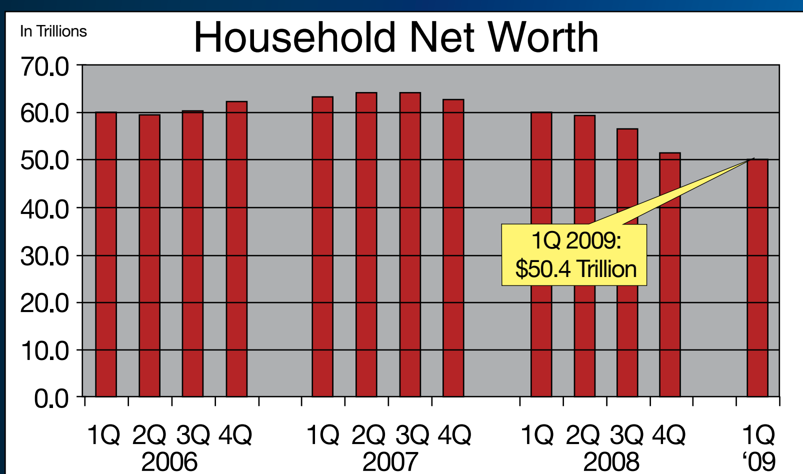

Figure 1 *Source: Federal Reserve Board*

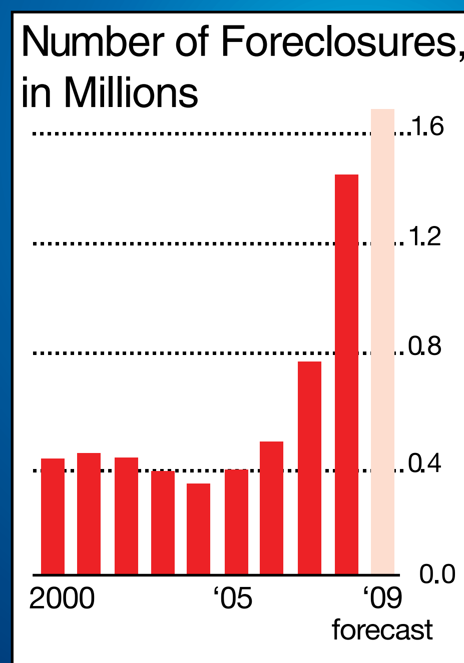

Figure 2 *Source: American Bankruptcy Institute*

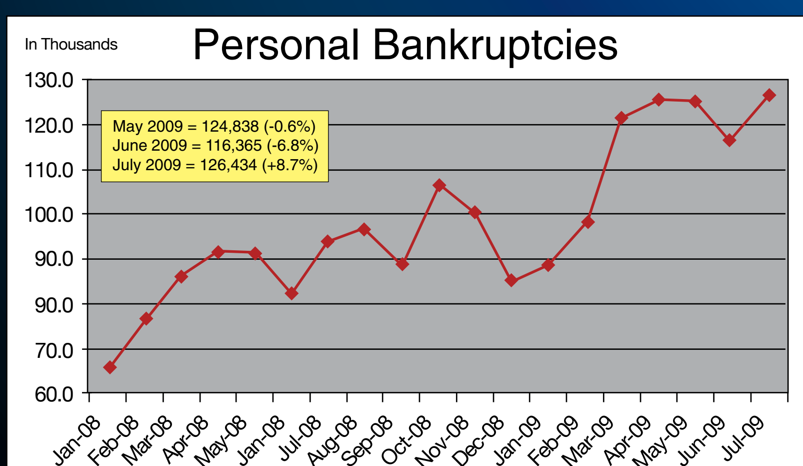

Figure 3 *Source: Wall Street Journal*

[1] 1,416,902 people filed bankruptcy in the year ended Dec. 31, 2008. And July 2009 filings were the highest since bankruptcy reform was implemented in 2005

The recession has also impaired the ability of many Americans to service their consumer debt. At the end of 2008, average outstanding credit card debt for U.S. households stood at an all-time high of $10,679.[2] Last year, 15 percent of American adults, or nearly 34 million people, were late making credit card payments while eight percent—18 million people—missed a payment entirely.[3]

At this writing, there is some evidence that the economy may have hit bottom. The nearly $800 billion federal stimulus plan, coupled with the lowest interest rates in a century, appears to be having some positive impact—as indicated by the fact that the national economy *contracted* at an annual rate of only 1 percent in the second quarter of this year compared to 6.4 percent in the first quarter. Other economic measures, including home sales and the index of leading indicators, have turned positive in recent months. Still, the pace of economic recovery will be slow, and the unemployment rate is projected to exceed 10 percent by the end of 2009.

Though the economy may be showing signs of life, many consumers remain in financial distress, suggesting that foreclosures and bankruptcies are likely to remain high for the next year or two. For example, June 2009 consumer bankruptcy filings totaled 116,365, up 40.6 percent from June 2008, according to the American Bankruptcy Institute (ABI). "Consumers are under great financial stress, with no immediate end in sight," states ABI executive director Samuel Gerdano. "We expect the upward spike in personal bankruptcies to continue through 2009."[4] And a recent analysis by the International Monetary Fund predicts about 14 percent of the $2.5 trillion in outstanding U.S. consumer debt will turn sour over the next two years and the current 10 percent charge-off rate on credit card debt will soar even higher.[5]

The combination of high consumer debt burdens and growing bankruptcy filings will surely slow the pace of economic recovery because debt service takes precedence over new spending. Put differently, until household balance sheets are back in order, consumer spending will be severely constrained, and household spending typically accounts for about 70 percent of total economic activity.[6]

As discussed in the following pages, debt settlement companies can help correct some of the nation's financial imbalances, improve access to credit, and thereby contribute to the process of economic recovery. What's more, **debt settlement offers benefits to consumers as the most immediate form of debt relief available in today's tenuous economy.**

[2] *Nielson Report*, April 2009.

[3] National Foundation for Credit Counseling, 2009 *Financial Literacy Survey*, April 2009.

[4] "Consumer bankruptcies jump in 2008," *CNNMoney.com*, January 6, 2009.

[5] "US-style credit card crisis hits Europe," *Financial Times*, July 27, 2009.

[6] *Survey of Current Business*, Bureau of Economic Analysis, U.S. Department of Commerce, June 2009

THREE APPROACHES TO DEALING WITH EXCESSIVE DEBT: COUNSELING, CONSOLIDATION AND SETTLEMENT

Not surprisingly in today's economic environment, businesses and organizations offering assistance to debt-ridden consumers have proliferated. Bankruptcy excluded, these businesses can be classified into three types: (1) credit counseling, (2) debt consolidation, and (3) debt settlement.

1 CREDIT COUNSELING

Oftentimes, households find that their expenses and debt payments exceed monthly income. Warning signs include late or missed payments, using credit cards to cover day-to-day living expenses like groceries and gasoline, and utilizing a credit line on one card to make the minimum payment on another. Consumer credit counseling may also provide short-term relief for persons burdened with debt due to loss of employment, medical problems, or other short-term hardships. In some circumstances, credit counseling may be an alternative for bringing household income and expenses back into balance.

Credit counseling services are designed to educate the consumer while trying to provide a neutral recommendation that can lead to debt resolution. This is usually done through the preparation of a debt management plan (commonly known as a DMP) that requires the consumer's consent to a recommended monthly payment and an agreement to not open or utilize any new or existing credit lines. The DMP is intended to lower interest rates and fees, allowing the consumer to make progress on paying off the overall debt owed to each creditor. The length of time required to complete the process varies depending on the individual's financial situation but is typically 5 years—significantly lengthier than a debt settlement program.

Traditionally, nearly all credit counseling agencies have charged fees to offset the costs of setting up and administering the DMP. Sometimes, these fees are called "voluntary contributions." The creditors, in turn, kick back a percentage of the payments they receive to the counseling agency.

For the consumer, there are several downsides to using credit counseling agencies. Most important, the total amount of outstanding debt is not reduced.

At the same time, many credit card agencies have been hiking interest rates on outstanding balances. So debtors can find themselves running faster and faster just to stay in place while the timeframe for paying off creditors though the DMP is stretched out. Given this scenario, some consumers will drop out of credit counseling and simply declare bankruptcy.

2 DEBT CONSOLIDATION

Debt consolidation is a variant of credit counseling provided by private companies that operate for a profit. But rather than make payments to each creditor every month, the consumer makes one monthly payment to cover the total due to all creditors.
If total debt is $10,000 or less, typically the

consumer secures an unsecured "consolidation loan" that is used to pay off credit card debt and other small loans. These loans usually have slightly lower interest rates than those charged on credit card balances. Still, the rates can be quite high—16 percent or more. Plus, in order to obtain a consolidation loan, the consumer must still have reasonably good credit; and this option also means adding another line of credit that can reduce their credit score. When utilizing a debt consolidation loan, consumers are advised not to make new charges on their existing credit cards, since running up higher balances could result in obligations exceeding the amount of the loan.

As with credit counseling, debt consolidation does not reduce the total amount outstanding. And because the consumer must have a decent credit rating or access to a home equity loan, a consolidation loan probably isn't a viable option for most households with high levels of difficult-to-service debt obligations.

3 DEBT SETTLEMENT

Debt settlement is a totally different process than credit counseling or debt consolidation. In debt settlement, the consumer engages a third-party intermediary for the purpose of settling or altering the terms of the payment due. Simply put, it is the practice of settling an unsecured debt for less than what the debtor owes the creditor.

The great advantage of debt settlement over the alternatives is that the consumer can satisfy outstanding obligations while paying less than the full amount of the unpaid balances. In addition, after settlement the consumer's credit report no longer shows open, delinquent items. Furthermore, debts resolved through settlement are no longer subject to collection calls or legal action.

Debt settlement companies can help consumers avoid a bankruptcy filing, which can impair credit scores for many years. And unlike bankruptcy, the consumer does not have to turn over all of the household's non-exempt assets to a bankruptcy trustee.

IMPROVING HOUSEHOLD BALANCE SHEETS AND AVOIDING BANKRUPTCY: HOW DEBT SETTLEMENT COMPANIES HELP CONSUMERS

Debt settlement has only recently become a popular option for consumers who fall between DMPs and bankruptcy. The process is not only helpful to debtors but also benefits creditors and the economy. What's more, debt settlement companies help reduce the caseloads of overloaded bankruptcy courts by working with consumers to resolve their financial problems and thereby avoiding the bankruptcy option altogether.[7]

Creditors who work with debt settlement companies find that their liquidation rates improve while their overall expenses to work accounts decline. The consumer benefits by effectively eliminating his/her outstanding unsecured debt so that the household can focus on saving and servicing traditional secured debt, such as a home mortgage or a car loan. And the economy benefits by the creation of new jobs, employing a variety of skill levels, by debt settlement companies.

HOW DOES THE DEBT SETTLEMENT PROCESS WORK?

Most consumers begin the debt settlement process through various online search engines by typing in a phrase such as "debt relief", "debt assistance", or "get out of debt." Many debt settlement companies—as well as credit counselors and debt consolidators—advertise on search engines such as Yahoo and Google, so consumers will typically be offered a variety of links in response to their inquiry. Other means of advertising include national radio, television, newspapers, and magazines. But the Internet accounts for most customer inquiries.

Once a consumer has been qualified and decides upon a particular debt settlement company, he/she signs a service agreement and completes a number of forms including (a) creditor information, with balance due and payment history for each creditor, (b) a monthly household budget, (c) a limited power of attorney, and (d) a permission to communicate form. A designated debt settlement firm counselor then conducts a complete review of the client's accounts and makes a recommendation for a monthly payment.

The debt settlement process also involves consumer education and behavior modification. For example, upon acceptance into a program, the debt settlement company informs the client about company expectations as well as creditor expectations. Participants are also coached on how to handle credit and collection agency phone calls and letters. Most important, consumers who enter a debt settlement program are educated on how to boost their personal savings above and beyond the monthly amount required to settle the outstanding debts.

Once the debt settlement company has calculated the amount of funds the client has available to offer a creditor or a collection agency, it contacts the various creditors to negotiate a reduced payoff. In practice, many debt settlement companies have specific contacts at creditor offices or collections agencies. For these creditors, working with debt settlement companies allows them to handle a huge volume of accounts with less manpower, thereby minimizing the costs associated with collection activity.

[7] See Figure 3

The third-party debt settlement company notifies the client of every offer that a creditor or a collection agency makes. When a consumer and a creditor reach a mutual agreement, the debt settlement company provides a written agreement to the consumer. The consumer makes the payment to the creditor. This process is repeated until all the consumer's accounts enrolled with the debt settlement company have been settled or satisfied.

An important part of the debt settlement process is consumer participation and keeping open lines of communication between the settlement company and the customer. To that end, most debt settlement companies maintain a separate customer service department whose responsibility is to remain in constant, long-term contact with clients to ensure they make their payments on time.

CONSUMERS AND THE ECONOMY BENEFIT FROM DEBT SETTLEMENT

As discussed previously, the advantages of debt settlement are that it gives financially distressed consumers a chance to avoid bankruptcy, pay off their unsecured debt at a reduced amount, and eventually improve their credit scores. In the process, consumers learn how to develop good long-term savings habits and to live within their means. What's more, a large percentage of potential beneficiaries from debt settlement are low and moderate-income individuals and households. These are the households currently enduring the highest unemployment rates and, presumably, the most serious debt burdens. Until the financial balances of these households are improved, the prospects for national economic recovery will remain muted.

The current Great Recession was triggered by bursting asset bubbles that stemmed from the issuance of excessive corporate and household debt, including home mortgages and credit cards. Though some early "green shoots" of economic recovery have been detected, bankruptcies, credit card charge-offs, and unemployment are projected to continue rising at least through early 2010.

Debt settlement can be viewed as part of the healing process to get distressed U.S. households back on a sound financial footing and thereby improve the odds for a sustainable economic recovery in the years ahead.

THE NEED FOR SENSIBLE AND UNIFORM STATE REGULATION OF THE DEBT SETTLEMENT INDUSTRY

The Federal Trade Commission is exploring possible regulation of the industry, and some members of the U.S. House of Representatives are on record as supporting federal regulation of debt settlement firms. According to the National Conference of State Legislatures, 41 bills have been introduced at the state level this year that would regulate debt settlement, credit counseling, and debt management programs. Some of these bills impose fee caps or mandate that fees cannot be collected until the debt settlement process is completed. Since debt settlement companies are labor-intensive and incur substantial ongoing costs while helping clients through the payoff process, restrictions on the imposition or collection of fees could drive legitimate firms out of business.

Because barriers to entry are low and the economy is mired in a deep recession, hundreds of new firms have entered the marketplace in recent years. Six years ago, approximately 80 to 100 companies were engaged in debt settlement. Today, some 2,000 firms market themselves as providing "debt settlement services." Legislation should ensure that settlement providers put tremendous emphasis on legal compliance, client education, disclosure of program risks, and avoiding deceptive or misleading claims about their services.

However, to subject legitimate and well-managed companies to a complex and intrusive regulatory environment—especially at the federal level—would be extremely short-sighted and would likely do more harm than good for consumers in debt.

In a worse-case scenario, regulation could become so burdensome and profit-limiting that the industry disappears, in which case indebted households would have only two options: (a) continue to pay credit card interest rates between 15 and 20 percent with no negotiated balance reduction or (b) file for bankruptcy.

A better approach would be for the states to enact model legislation, such as California's AB 350 Debt Settlement Services Act, Colorado's SB 07-057 or Tennessee's SB 812, that would apply to all organizations and businesses engaged in helping households pay off their debts—i.e., counseling agencies and debt consolidators/managers as well as debt settlement companies. The Uniform Debt Management Services Act (UDMSA), for example, has been adopted by a number of states. It requires registration and licensing of all debt servicing companies operating in the state. To receive a license, a company must submit detailed information concerning the services to be provided, the company's financial condition, the identity of principals, and locations at which service will be provided. To register, the agency or company must have an effective insurance policy against fraud, dishonesty and theft in an amount no less than $250,000. In addition, the company or agency must provide a security bond at a minimum of $50,000 with the state administrator as a beneficiary.

Before entering into an agreement with debtors, the agency or company must disclose all fees and services to be offered, as well as the risks and benefits of entering into such a contract. The provider must offer counseling services from a certified counselor or certified debt specialist, and a detailed repayment plan must be crafted before the debt management service can commence. There is a penalty-free, three-day right of rescission on the part of the debtor, and the servicer may terminate the agreement if required payments are more than 60 days delinquent. Any payments received from a debtor must be kept in a trust account that may not be used to hold any other funds, such as service fees. With respect to debt settlement services, these model bills provide for an overall fee cap based on the amount saved by the consumer—30 percent of the difference between the gross principal amount owed and the final settlement level of the debt.

These model bills prohibit a number of specific actions including: misappropriation of funds in trust; settlement for more than 50 percent of a debt without a debtor's consent; gifts or premiums to entice customers into a program; and representation that settlement has occurred without certification from a creditor. To enforce the provisions of the Act, a state administrator would have investigative powers; the power to order an individual to cease and desist; the power to assess a civil penalty up to $10,000; and the power to bring a civil action. In addition, an individual debtor may bring a civil action for compensatory damages, punitive damages and attorney's fees if a debt servicer obtains payments not authorized by the Act.

Since 1986, the United Kingdom has had a standardized and regulated mechanism for assisting debtors who wish to avoid bankruptcy. Known as an "individual voluntary arrangement (IVA)," this process is similar to debt settlement in that it constitutes a formal repayment proposal presented to creditors by a licensed insolvency practitioner (LIP). An IVA is a contractual arrangement with creditors and can be based on income, capital, third-party payments, or a combination of these sources. The unsecured creditors agree to the payback terms, and all fees charged by the LIP are clearly spelled out in the IVA.

In the UK experience, the return to creditors has often been higher than they would have received in bankruptcy. Unlike bankruptcy in the UK, an IVA does not statutorily restrict a debtor from obtaining credit. What's more, an IVA is seen as more positive than bankruptcy in the eyes of creditors since it demonstrates a commitment by the individual to repay unsecured debt.

THE NEED FOR SENSIBLE AND UNIFORM STATE REGULATION OF THE DEBT SETTLEMENT INDUSTRY CONTINUED

What's significant about the IVA in the UK is that it ensures transparency throughout the debt settlement process. All parties to the agreement have a clear understanding of their obligations, payment amounts, fees, and length of time allowed to complete the debt settlement process. The debt settlement process in the UK is uniform, and all settlement companies—LIPs—are licensed by the government.

The experience of the UK over the past 23 years suggests regulation of the debt settlement industry can be effective without being onerous. In the case of the United States, the previously cited model legislation is preferable to federal regulation of the debt settlement industry because it sustains the states' long-standing prerogatives to oversee the provision of financial services to their residents. In addition, the model provides the best approach for establishing a regulatory structure that is flexible enough to accommodate an evolving industry while providing significant protections for consumers and penalties for unscrupulous or unlicensed providers.

In today's economic environment, debt settlement services are likely to grow as other debt management programs fail to meet the needs of debtors and creditors.

CONCLUSION

The U.S. economy has been in a tailspin for more than two years, with a net loss of seven million jobs, a huge drop in household net worth, falling home values in most parts of the country, and record levels of personal bankruptcy filings. Though some economic indicators have turned positive in recent months, the process of recovery and a return to sustainable growth will likely stretch over several years.

Consumer spending comprises about 70 percent of total economic activity. But with many households heavily in debt, domestic consumption of goods and services has fallen dramatically over the past year. Until household balance sheets are back in order, spending—and economic growth—likely will remain muted.

As discussed above, debt settlement is a viable means by which some households can satisfy outstanding obligations while paying off less-than-the-full amount of their unpaid balances. Moreover, debt settlement companies can help consumers avoid a bankruptcy filing that could seriously impair their credit scores. Finally, as part of the debt settlement process, consumers learn how to live within their means and develop a propensity for saving and budgeting.

Today, more than 2,000 firms offer debt settlement services.Though the Federal Trade Commission and some members of Congress are considering federal regulation of debt settlement, state regulation under the cited model legislation is a better approach because it preserves the states' traditional prerogatives of overseeing the provision of financial services while establishing a flexible regulatory structure for an evolving industry. Modeled on the 23-year experience of the United Kingdom with "individual voluntary arrangements" (IVAs), these bills provide significant protections for consumers and penalties for unscrupulous or unlicensed practitioners.

With unsecured consumer debt at $2.5 trillion, and the specter of financial ruin facing thousands—perhaps millions—of additional U.S. households, debt settlement serves an important market niche between credit counseling and bankruptcy. Without question, sensible regulation of the industry is long overdue. But if regulation impairs the ability of debt settlement companies to earn sufficient revenues to cover their operating expenses and provide a return to investors, the industry will disappear and many debt-burdened households will have no alternative but to turn to bankruptcy.

Clearly, there is a market need to help financially distressed households with a process that is not as lengthy as consumer credit counseling but not as far-reaching as bankruptcy. Debt settlement is a middle ground that provides welfare benefits to consumers while at the same time boosting the prospects for the nation's recovery from the worst economic downturn since the 1930s.

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The author or co-author of numerous books, monographs and articles on economic development, public policy and taxation, Dr. Weinstein's work has appeared in professional journals such as *Land Economics*, *Challenge, Society, Policy Review, Economic Development Quarterly, Policy Studies Journal*, and *Annals of Regional Science*. His work has also appeared in *The New York Times*, *The Wall St. Journal, The Los Angeles Times* and numerous regional newspapers and magazines. He is a former member of the editorial board of *Society Magazine* and currently serves on *The Dallas Morning News* Board of Economists.

Dr. Weinstein studied public administration at Dartmouth College and received his A.B. in 1963. After a year of study at the London School of Economics and Political Science, he began graduate work in economics at Columbia University, receiving an M.A. in 1966 and a Ph.D. in 1973. He has taught at Rensselaer Polytechnic Institute, the State University of New York, the University of Texas at Dallas, and Southern Methodist University. He also worked as a research associate with the Tax Foundation in Washington, D.C.; the Gray Institute in Beaumont, TX; and for several U.S. government agencies, including the President's Commission on School Finance, the Internal Revenue Service and the Federal Trade Commission.

A consultant to many companies, non-profit organizations and government agencies, Dr. Weinstein testifies frequently before legislative, regulatory and judicial bodies. His clients have included AT&T, Texas Instruments, Reliant, Entergy, Devon Energy, the Nuclear Energy Institute, the U.S. Conference of Mayors, the Western and Southern Governors Associations, the Cities of Dallas and San Antonio, and the Joint Economic Committee of the U.S. Congress.

He is a former Director of Federal Affairs for the Southern Growth Policies Board (1978-1980) and Director of the Task Force on the Southern Economy of the 1980 Commission on the Future of the South. From 1984-1987, he was chairman of the Texas Economic Policy Advisory Council and 1987-1988 served as visiting scholar with the Sunbelt Institute in Washington, D.C. He is currently a panelist with the Western Blue Chip Economic Forecast, a member of the Dallas Association for Business Economics and a director of Beal Bank, the largest locally-owned bank in Texas.

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In addition, he has performed consulting services to municipalities and companies in the electronics, telecommunications, and publishing industries. The focus of these activities has included rural development, labor relations, tax policies, and market performance.

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Dr. Clower received a B.S. in Marine Transportation from Texas A&M University in 1982, a M.S. in Applied Economics from the University of North Texas in 1992, and a Ph.D. in Information Sciences from the University of North Texas in 1997, specializing in information policy issues and the use of information resources.

*Views expressed are the authors' alone and not necessarily those of the university, its officers or regents.

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