Economic Factors and the Debt Management Industry

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EXECUTIVE SUMMARY

The current economic climate makes the need for debt management programs even more acute. More consumers are finding themselves in financial hardship due to high unemployment, low home equity rates, lack of access to bankruptcy protection, and the "credit crunch" so well documented in the press and by legislators. This economic climate implies that many consumers are one emergency away from financial hardship. There is no question that the multitude of people currently in financial distress need programs that reduce the principal of their debt to stave off bankruptcy (Manning 2009, Plunkett 2009).

Debt management programs (DMPs) come in several forms, but their basic structure is similar: they require some sort of consumer education if they are accredited by national trade associations (Keating 2008, USOBA 2008), consumer participation is voluntary (Hunt 2005, Plunkett 2009) and a plan is set up to make the consumer debt-free in two to five years. The key differences in the organizations are the mechanisms they use to finance the organization and to help consumers pay off their debt (Hunt 2005, Plunkett 2009). In this paper, I refer to organizations that help consumers pay off their debt by reducing interest rates as consumer credit counseling services (CCCSs) and organizations that help consumers pay off their debt by reducing principal as Debt Settlement Programs (DSPs). The efficacy of these different approaches has been discussed by a variety of authors, but these discussions have lacked a clear and detailed consumer welfare analysis, which is provided in this research.

One of the most important findings of this research is that the different approaches (CCCS or DSP) help consumers by increasing their economic welfare as compared to paying off the debt under the original conditions. However, the consumer welfare analysis suggests that DSPs create the greatest consumer welfare of any approach. In fact, consumer welfare is higher under DSPs than under the 60-60 rule (repay 60 percent of the debt principal in 60 months) suggested in the literature (see e.g., Keating 2008, Manning 2009). If consumers are allowed to repay their debt over three years, the affordability of the DSPs (as measured by monthly payments) is similar to the affordability of a program based upon the 60-60 rule. Additionally, creditors are helped by both CCCSs and DSPs as their losses are lower when consumers use DMPs as opposed to other alternatives.

This research empirically examines the efficacy of one DSP company in this industry. Key findings, which are consistent with the observation that programs which reduce the principal of the debt may be the only means to keep a growing number of consumers out of bankruptcy, include:

1. Accurate measures of consumer completion and cancellation cannot be calculated from the data, as almost 30% of the cancellations are due to the consumers either directly paying off the debt or being forced into bankruptcy. Further, the cancellation data does not contain information regarding offers received or debt repaid, so it does not accurately reflect value generated by the company. That said, the raw cancellation rate (60% over two years) is much less than speculated (85% within one year) and is similar to or better than other subscription-based service industries (e.g., mobile telephone and cable television companies) that have Better Business Bureau certified members.
2. Conditional on the consumer receiving an offer or settlement, the firm had mean, median and mode settlement offers at or below 50% of the original debt. This number beats the 60-60 rule and suggests that the firm is generating significant consumer benefits.

3. The debt settlement company generates tremendous value to its clients, as more than 57% of the clients have offers to settle at least 70% of their original debt, and the most common situation (almost 30% of the clients) having settlement offers for at least 90% of their original debt.
4. The debt settlement company has an increasingly higher value to customers with higher account balances and higher total debt, but lower number of accounts.
5. Once "fair share" payments are taken into account, CCCS fees and payments for a consumer account can exceed 29% of the consumer debt, levels which Plunkett (2009) calls "exorbitant." This finding suggests that regulation is required to ensure transparent reporting of all fees and payments is required for all companies offering Debt Management Programs.
6. Reasonable upfront fees by DSPs (before settlement) should be allowed because DSPs generate value for consumers and incur expenses generating this value. This fee structure is similar in nature to the one used by CCCSs, attorneys and other service-providing firms.

These findings suggest that a "common sense" approach should be used with the DMP industry. A common sense approach implies that regulatory and other consumer advocacy groups focus on ensuring that there is sufficient regulation to be able to identify and, if necessary, prosecute bad actors without harming economic competition which increases consumer welfare. The industry analysis also suggests several regulatory recommendations which could further benefit consumers:

1. Focus on making alternatives transparent so consumers can make better decisions: disclose total fees including "fair share" and all other consumer fees, success metrics of offers received, settlements accepted and percent of debt settled. This disclosure has the additional benefit of allowing interested third parties, e.g., consumer advocacy groups and government agencies, to calculate the economic impact of this industry on consumers and other industries.

2) Provide guidance for handling of client monies in "fiduciary" accounts, especially in terms of timing between audits, what happens if a consumer cancels service, appropriate interest rates, and whether or not (and under what circumstances) companies can make payments on behalf of consumers. The regulators should allow DSPs to establish trust accounts with their clients, which would include:
   a. Requiring consumers to save money every month as one condition of making "satisfactory progress" in the program. DSPs should have the ability to monitor, but not control (or make disbursements from) these funds.
   b. Proving regulatory protection for consumers from litigation and creditor calls while consumers are making "satisfactory progress." Other protections to ensure that consumers are protected from cancellation fees paid to DSPs and unethical business practices, e.g., ensure that the financial institutions holding the funds are independent of the DSPs and no fees are disbursed from the accounts without full disclosure and regulatory oversight and approval.
   c. Allowing disbursements from these accounts only with consumer and DSP approval and for payment to creditors, approved fees, and to the consumer if they cancel the program or for new financial hardships.

3) Require financial education of consumer, and require specific metrics in terms of meeting short-term and long-term education and outcomes (see, e.g., Clancy and Carroll 2007, Keating 2008, Staten and Barron 2006).

INTRODUCTION

While the current economic climate (discussed below) provides strong support for programs which help consumers get out of debt, the strongest arguments for programs which take the approach of reducing the principal comes from organizations and individuals who are either antagonistic or agnostic to this approach. For instance, the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (or BAPCPA) suggests a "60-60" standard for debt repayment outside of bankruptcy, where the 60-60 refers to the consumer entering into an agreement with their creditors 60 days prior to bankruptcy to repay 60 percent of their debt within a "reasonable" time frame. Additionally, both Plunkett (2009) and Keating (2008), who use pretty strong rhetoric in denouncing companies using this approach, support a 60-60 rule that allows consumers to repay 60% of their debt within 60 months and acknowledge that a growing number of consumers may be forced into bankruptcy without access to ethical and proconsumer companies offering this alternative. For the remainder of this document, the term "60-60 rule" refers to repaying 60 percent of the debt within 60 months, not the BAPCPA plans.

Within the debt management industry, firms have taken two different approaches in their debt management programs (DMPs). The first approach, called Consumer Credit Counseling Services (or CCCSs), helps consumers by reducing the interest payments and, potentially, fees on the debt, but still has consumers pay 100% of the principal. The second approach, called Debt Settlement Programs (or DSPs), helps consumers by reducing the principal on the debt (Hunt 2005, Plunkett 2009). These approaches also differ in how the firms are funded and their taxable status. CCCSs are generally nonprofit firms and are funded by both account maintenance fees from consumers as well as "donations" from creditors which may take the form of "fair share" payments and/or direct grants (Boas et al. 2003, Plunkett 2009). DSPs, on the other hand, are generally for-profit firms, and are funded through fees charged directly to consumers without any payments from the creditors (Hunt 2005).

Before proceeding further, I acknowledge that both types of organizations have had firms which have taken advantage of vulnerable consumers (US Senate Hearings 2005, Clancy and Carroll 2007, Plunkett 2009), so some of the heated rhetoric directed at different approaches by organizations with vested interests is not only self-serving, but is also counterproductive. The focus of legislative efforts should be to protect consumer welfare by ensuring that the goals of the industry (consumer education and debt relief) are met, to ensure that organizations act in ethical and transparent ways and to impose appropriate sanctions on any company that willfully take advantage of consumers, i.e., "bad actors."

One of the reasons that I argue that the heated rhetoric and trying to use regulation to eliminate other approaches are counterproductive is based on the notion that competition produces efficiencies, which, in turn, increase consumer welfare and economic growth. A fundamental principal of the Federal Trade Commission is that competition benefits consumers through lower prices and increased variety. This philosophy is summarized as:

> *Competition in America is about price, selection and service. It benefits consumers by keeping prices low and the quality and choice of goods and services high (FTC 2009a).*

Therefore, rather than take the position of being an advocate for a specific approach to helping consumers to get out of their situation, this research is focused on understanding the different approaches and calculating the consumer benefits associated with each approach. The benefits are measured in terms of both total consumer welfare

(i.e., how much will consumers pay in total for different approaches) consumer affordability (how much must the consumer pay each month), and how much are firms collecting as a percentage of the original debt from the consumers and creditors. It is important to include payments from creditors to the firms, as they represent indirect fees charged to consumers because the creditors should be indifferent between giving consumers a discount of the same amount that they pay the firms in "fair share" payments or any other way the firm is compensated.

Probably the most important finding of this research is that both CCCSs and DSPs increase consumer welfare over the alternative of the consumer paying off their debt using a fixed payment of 2% of their original debt every month (the recommended minimum payment). However, DSPs increase consumer welfare much more than CCCSs and have similar affordability to CCCSs when the payments can be made over three years (instead of five years for CCCSs). Given the findings in the extant literature that creditors are also better off when consumers use DMPs, it appears that DMPs are a "win-win" for both consumers and creditors, so regulators should be encouraged to use a common sense approach to this industry: protect the vulnerable consumers while supporting competition among the different approaches to getting rid of consumer debt. This competition is consistent with the Federal Trade Commission's approach to other industries and would result in increased consumer welfare over the long term.

Some of the key recommendations for regulatory agencies include: 1) protecting consumers from litigation and calls/threats from creditors while they are making "satisfactory progress" in accredited DMPs. Satisfactory progress needs to have measurements related to educational goals as well as financial goals (i.e., being current on payments for CCCSs and saving enough for DSPs); 2) providing DSPs with the ability to set up trust accounts for their clients that have very specific limitations on disbursements (i.e., approved payments to creditors, approved fees to DSPs, payments to consumers for cancellation or new hardships, etc.); 3) require full disclosure of all fees consumers directly or indirectly (e.g., "fair share" payments, grants from creditors, etc.) pay and 4) provide guidance of how companies can accurately measure program effectiveness, e.g., does receiving offers for all enrolled debt constitute program completion?

The remainder of this document is organized as follows. In the next section, the economic factors which are increasing the necessity of this industry are briefly reviewed. Next, the different alternatives are provided with an eye towards understanding the economics and limitations of the alternatives. In section three, the performance of a specific DSP is analyzed. This firm provided a significant dataset, the details of 4,500 randomly selected clients. In analyzing the clients, we use a stratified sampling approach, also called a "strata approach." The clients are combined into different groups, based upon their debt levels. These different stratums are then analyzed to see if consumer behavior or firm performance differs between the groups. As far as we know, this type of analysis of the efficacy of Debt Settlement Programs has not been published.

In the next section, the economics (both for consumers and the firms) of the debt management programs is analyzed in more detail. Specifically, consumer welfare is estimated and compared under a variety of assumptions. This paper concludes with public policy and industry recommendations.

CURRENT ECONOMIC CLIMATE

The importance of the consumer debt management industry has become increasingly important as the U.S. economic recession continues. Table 1 shows the seasonally adjusted unemployment rate in the United States, which has reached 9.4 percent as of May, 2009.

Even worse, the long-term unemployment rate (those unemployed more than 27 weeks), rose in May by 268,000 to 3.9 million U.S. Households, roughly triple the number at the start of the recession (U.S. Bureau of Labor Statistics 2009). Note that employment is generally a lagging indicator (e.g., it improves after the economy improves), an uptick in the U.S. economy will not provide immediate relief for these households.

The high unemployment rate coupled with the fact that the average credit card balance at the end of 2008 was more than $10,000 for approximately 91 million households (158 million individuals or 78 percent of all households) who have credit cards (Woolsey and Schulz 2009). A silver lining is that in April of 2009, seasonally adjusted total consumer debt was decreasing at a 7.5 percent annual rate (Federal Reserve 2009). However, household leverage (total debt to disposable income), while decreasing, still remains at 130% from a high of 133% in 2007. This number can be contrasted to the 55% leverage in the 1960s and 65% leverage in 1980s (Zuckerman and Todd 2009).

An implication of these statistics is that many consumers are barely able to pay their debts and are one emergency away from financial hardship – a recent study found that medical bills were a contributing factor in more than 60% of all bankruptcy filings (Himmelstein et al. 2007). From this hypothesis, one would then expect consumer credit card and personal loan default rates to be increasing. Figure 1 confirms this belief, as consumer default rates on credit cards stands at 7.49 percent in the first quarter of 2009, and

Table 1 —U.S. Unemployment Rate

Year	Month	Percent
2008	May	5.5
	Jun	5.6
	Jul	5.8
	Aug	6.2
	Sep	6.2
	Oct	6.6
	Nov	6.8
	Dec	7.2
2009	Jan	7.6
	Feb	8.1
	Mar	8.5
	Apr	8.9
	May	9.4

Source: U.S. Breau of Labor Statistics (http://www.bis.gov/opub/ted/)

consumer defaults on personal loans stand at 2.93 percent in the same period. If anything, these numbers understate the problems consumers are having. In a report prepared for the National Foundation for Credit Counseling, Harris Interactive (2009) found:

- 26 percent of households admitted to not paying their bills on time. Minorities may be more severely impacted, with this number rising to 51 percent for African American households.
- In the last 12 months, 15 percent of individuals were late paying a credit card and eight percent admitted to missing at least one payment, and six percent have their debts in collection.
- 32 percent admit that they have no savings, and only 23 percent state that they were saving more than a year ago.
- 57 percent of households do not have a budget, and 41 percent give themselves a grade of C, D, or F in their financial knowledge.

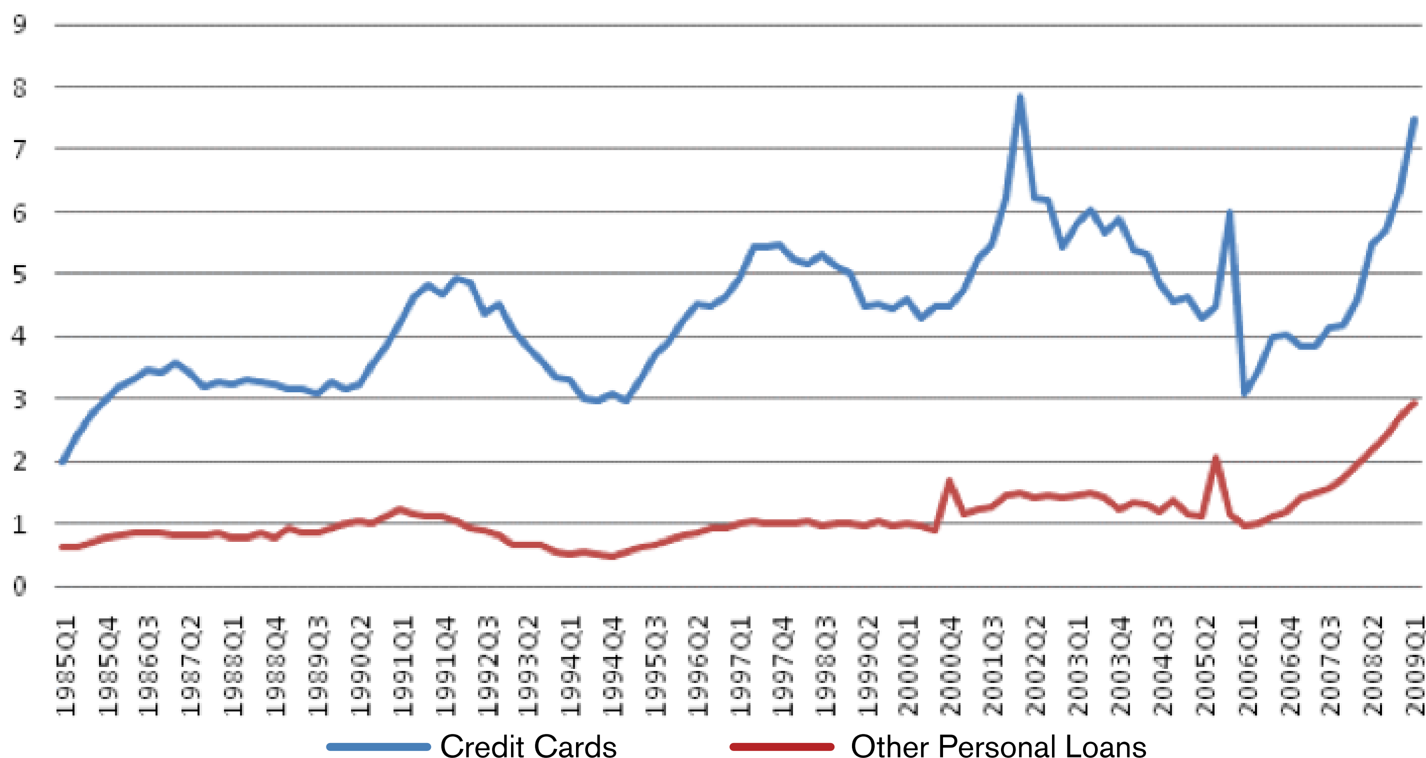
One may conclude that given the financial turmoil

in this market, credit card companies may be hurt as well. However, a recent study found that since the bankruptcy law was reformed in October 2005 (2005 Bankruptcy Abuse Prevention and Consumer Protection Act or BAPCPA), the credit card industry has recorded record profits, although more factors (e.g., interest rate spreads, increased fees, etc.) enter into this profitability than simply the increased difficulty of entering into bankruptcy (Simkovic 2009).

A recent study estimated that as many as 800,000 households have been precluded from entering bankruptcy due to BAPCPA (Lawless et al. 2008). Therefore, the need for a service which helps consumers manage and pay down their debts and to work with the credit card companies is more acute than ever. In fact, recent legislation requires credit card companies to recommend credit counseling education and debt management programs to consumers in financial trouble (Reddy 2009). So what are consumers' alternatives when they find themselves in financial hardship? Their alternatives are grouped into four broad categories (Hunt 2005) that vary in terms of a continuum of how much of the debt can the consumers afford to repay (all, partial or nothing):

1. Bankruptcy – either chapter 7 or chapter 13.
2. Debt Management Programs – This includes any service which tries to help the consumers pay off their debts (outside of bankruptcy) either through reduction in interest rates, debt reduction or other means.
3. Other financing – This includes raising money through sales or refinancing of current assets (e.g., home equity loan).
4. Repayments on original terms.

Figure 1 — Bank Charge Off Percentages



Source: U.S. Federal Reserve Bank

OVERVIEW OF CONSUMER ALTERNATIVES

This section provides an overview of the different alternatives that are available to consumers who are in financial hardship. Before discussing the alternatives, a brief discussion of the process or stages involved is provided (based on Mojica 2009).

1. Financial Hardship

First, consumers have some financial hardship which limits a family's ability to continue paying their debts. For instance, Himmelstein et al (2007) found that medical bills were a contributing factor in more than 60% of all bankruptcy filings and that medical portion of the debt was more than $5,000 or 10% of family income. A creditors willingness to work with a consumer, e.g., give grace periods, reduce interest rates and/or debts, is directly linked to the consumer's ability to demonstrate that a true hardship was the cause of the household's financial crisis (Dash 2009)

2. 30 days

Once the consumer is at least 30 days late in payment, and for every 30 days thereafter, a notice is sent to credit bureaus indicating delinquency. At this point the consumer usually starts receiving calls from the creditors requesting payment. Eventually, credit cards and other revolving credit are cancelled for the consumer. Once the account is delinquent, credit card fees may be dramatically increased, although new federal legislation has put curbs on credit card companies in terms of fees and interest rate changes (Reddy 2009). Reddy did cite a consumer whose interest rate jumped from 12% to 24% due to late payments even though the credit card company did agree to work with the consumer.

In the current economic crisis, credit cards are willing to extend the grace periods for consumers who have true hardships, even reducing the total debt amount. However, these deals come at a price—a consumer's credit score may drop 70 to 130 points as a result (Dash 2009).

3. Six months

The creditor writes off the debt. At this point, the account may be sold, sent to a collections agency or a law firm. Generally, the amount of debt collected by these agencies varies, but examination of 10 K reports from various creditors indicates that credit card companies are receiving about 10% of the outstanding debt when it is sold.

More recently, credit cards have become more willing to negotiate terms with consumers, but they generally require that consumers be at least 90 days delinquent and are accepting "dimes if not pennies on the dollar" (Dash 2009). Given the relatively low recovery rate, it suggests that other alternatives (e.g., lawsuits, selling debts to collection agencies) provide even lower returns for the creditors.

4. Lawsuit as option

Creditors may sue consumers to collect bills. From a consumer standpoint, this option adds legal fees to the debt they already cannot afford. Assuming that the creditor gets a judgment, it may be enforced by garnishing wages, sales of assets, etc.

From a consumer standpoint, there is a mine field waiting for them once they get into financial trouble. Generally, the creditors will not work with a consumer until they are at least 90 days delinquent, and they may increase interest rates or fees simply because the consumer contacts the creditor for help (Dash 2009). Further, creditors are more likely to help consumers who do not have a history of financial troubles, so they are less likely to help those most in need (Dash 2009). Under a practice known a "global default", creditors can move an account that is current into default because the consumer is delinquent to a different creditor, (see, e.g., testimony U.S. Committee on Financial Services 2007). Once the credit card is in default, legislation limiting harassing calls really does not apply to the original creditors, only third party collectors. One would expect very high dropout or cancellation rates for the first six months a consumer is enrolled in a

Sources: Bank of America 2008 10K;page 127-Table 15,page 128-Table 16,page 172-Table 37; American Express 10K;page 50,page 56; Chase 2008 10K;page 155,page 81,page 128; CapitalOne 2008 10K;page 73-Table C,page 76-Table F.

program, until the regulatory protections take effect. Therefore, some sort of protection for consumers who want to settle their debt and have enrolled in certified debt management programs is required. Ironically, studies have found that credit card losses are 32 percent lower for the clients who enter DMPs before fair share payments are included (Hunt 2005), so it is against the creditors own best interests to force the consumer into litigation. England has solved this problem for their consumers in financial difficulty using the insolvency act of 1986. In this act, if enough creditors (generally 75%) agree to the debt reduction plan, the other creditors are legally bound by the repayment plan even if they did not agree to the plan.

Bankruptcy

Both Chapter 7 and Chapter 13 bankruptcy are legal means of settling debts. Chapter 7 is a liquidation of assets, and the reform act of 2005 (2005 Bankruptcy Abuse Prevention and Consumer Protection Act or BAPCPA) placed many hurdles for consumers to use Chapter 7 (and instead force them to use Chapter 13). These hurdles includes means testing, higher fees and increased costs and risks for those assisting consumers filing Chapter 7 (Simkovic 2009). Once a consumer uses chapter 7, they cannot file again for eight years and are limited in filing for other legal remedies for several years. Additionally, the filing stays on their credit report for ten years (Hunt 2005). One unfortunate side effect of filing bankruptcy is that many employers check potential employee credit history, so this may have an effect on future income and job prospects.

Chapter 13 filings on the other hand are considered "wage earner plans" where the debt amount is reduced based on the consumer's ability to pay, and a plan is set up so that consumers pay their debts in three to five years (Hunt 2005). Hunt (2005) suggests that attorney and trustee fees amount to approximately 14% of the debt, and creditors' average about 35% recovery of the debt. However, he also suggests that only 33% of consumers finish the program, less than the average for voluntary debt management programs. In a white paper, the United States Organization for Bankruptcy Alternatives suggests that the completion rate is much lower, only 20% to 25% (USOBA 2008). As with Chapter 7, Chapter 13 filings go on a consumer's credit report (although for a shorter period of time), and their ability to file in later years is limited.

Bankruptcy as an alternative for most consumers has become much more limited since BAPCPA was passed in 2005 (Lawless et al. 2008). They estimate that as many as 800,000 US households have been prevented from filing bankruptcy in the last few years.

However, this does not mean that total bankruptcy filings are down, only that consumers are being moved from Chapter 7 (liquidation) to Chapter 13 (partial payment) to move this option away from paying nothing towards paying something. When these settlements are sold on the open market, they generally receive only 18-21 cents on the dollar (Manning 2009). Given the above estimates that the judgments only return 35 cents on the dollar, the net effect to the creditors is that they only receive pennies on the dollar through this route. One would expect that creditors would attempt to stay away from this alternative.

However, once there is more than one creditor, they face a classic "prisoner's dilemma" (Poundstone 1992). The basic idea is that even though all of the creditors are better off by avoiding bankruptcy and legal judgments, each individual creditor is better off by cheating (e.g., initiating legal judgments to be the first one in line). This problem has also been called the creditor's dilemma (Bainbridge 1986). Therefore, some regulatory guidance is required beyond BAPCPA, which suggests the 60-60

Source: Fair Debt Collections Practices Act (FDCPA) at http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre27.pdf.
see http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/legislation/uk/insolvencyact.pdf , for a description of the insolvency act of 1986 which established this system.

(pay off 60% of debt in 60 months) as a standard, and would limit creditors to 80% of the debt principal if they do not reach an agreement (Manning 2009). Assuming that they collect on the judgment, this 80% rule provides the wrong incentive to the creditors, as they are better off using litigation. Therefore this 80% standard should be lowered to 60% to match the 60-60 rule.

Consumers must also go through counseling services (regardless of whether or not they enroll in debt management programs) prior to filing for bankruptcy. The National Foundation for Credit Counseling estimated that their members provided 1.26 million education sessions for bankruptcy in 2007 (Keating 2008). Some recent research has suggested that the educational component may be important for consumers (Staten and Barron 2006). Staten and Barron find that consumers who enter counseling are significantly less likely to file for bankruptcy in later years, and have significantly lower risk scores than consumers who choose to not enter counseling.

A nagging concern is whether the reason for the good outcomes is self-selection (e.g., motivation of consumers) or efficacy of the program (Clancy and Carroll 2007; Hunt 2005). That said, academic arguments over the source of the outcomes of these programs miss the key point. Regardless of the underlying cause, if consumers are more successful once they enter the programs, shouldn't those programs be encouraged and protections for consumers who are making satisfactory progress enacted, so that their chance of finishing the programs and gaining their benefits are enhanced? This is a classical agency problem where the credit card companies (and public policy) should not care about why clients are more successful, only that they are more successful once they enter into the educational programs. While it may be difficult to determine measures of the program outcomes, an approach similar to that used in Stanten and Barron (2006) where consumers are surveyed years after exiting the programs to determine financial health through risk scores, credit scores, bankruptcy rates and other measures would seem to be a good start and should be required for all organizations offering counseling services.

Refinance

Refinancing the debt using assets is a viable alternative for only a few consumers, as it requires consumers to receive appropriate interest rates and to have sufficient equity in their home or other assets to pay down the debt. The second criteria can be a very high hurdle given that the median household filing bankruptcy has a negative $25,000 net worth (Lawless et al. 2008) and that household home equity is at historic lows – below 50% - and economists expect this trend to continue (AP 2008, Keating 2008).

The other problem is that some consumers may have already used this option to pay off debts or to get needed cash for ongoing expenses, even education (Chu and Achohido 2008). Given the current crisis in getting loans, declining home values and variable interest rate mortgages that are getting ready to reset, this option is becoming less viable for most consumers (Manning 2009).

The problem is that the credit cards use risk assessment to set interest rates, implying that consumer interest rates increase once delinquencies are noted on their credit reports (Chu and Achohido 2008, Plunkett 2009). A clear consequence is that consumers may not receive good interest rates, even on a home equity loan due to the credit problems. In addition, by refinancing, a consumer can lose their assets (e.g., their homes and cars) if they default on the loan as they have converted unsecured debt into secured debt.

Debt Management Programs

Debt management programs (DMPs) come in several forms, but their basic structure is similar: they require some sort of consumer education if they are accredited by national trade associations (Keating 2008, USOBA 2008), consumer participation is voluntary (Hunt 2005, Plunkett 2009) and a plan is set up to make the consumer debt-free in two to five years. The key differences in the organizations are the mechanisms they use to finance the organization (consumer fees vs. "fair share" payments from credit card companies) and to pay off consumer debt (reduce interest rates and fees vs. reduce debt principal) (Hunt 2005, Plunkett 2009). In this paper, I refer to organizations that reduce interest rates as consumer credit counseling services (CCCSs) and organizations which reduce principal as Debt Settlement Programs (DSPs). It should be noted that neither of these organizations can force the creditors to accept their terms. It is the case that some creditors do not work with DMPs (of either type) or only make very small concessions (Hunt 2005). Given the national organization's call for debt principal reduction as part of DMPs, it appears that, over time, the distinction between these two types of organizations may blur (Keating 2008), making a stronger case for the strong value of DSPs to consumers.

The importance of full disclosure of the funding sources cannot be overstated. Because the CCCSs receive some of their funding from the creditors (Keating (2008) estimates that about 50% of the funding for CCCSs come from creditors), there is a conflict of interest for these organizations, especially when the funding is tied to the amount of debt under management (Boas et al. 2003, Hunt 2005, Manning 2004). Second, because the CCCSs receive some of their fees indirectly, there may be an impression that they are less expensive than DSPs. However, the economic welfare of the creditors is unchanged if they give these fees to consumers as a reduction in the debt principal instead of to the CCCSs in the form of grants or "fair share" payments. Therefore, consumers are paying increased and undisclosed fees in their monthly payments. Further, the FTC recommends consumers ask about the funding sources as part of their consumer protection program (FTC 2009c). I believe that stronger action should be taken, requiring disclosure of the fees, as information is the basis of education, and education is the first line of defense against fraud and deception, it can help you make well-informed decisions before you spend your money (FTC 2009b).

Consumer Credit Counseling Services (CCCSs)

CCCSs generally try to get rid of a consumer's debt over five years and generally receive the majority of their funding from credit card companies (Boas et al. 2003, Hunt 2005), although the terms of the agreements have been evolving over time. Hunt states that the average account set up fee is $25 and monthly maintenance fee is $15. Over five years, this translates into $910 paid directly to the CCCS. Additionally, he notes the firms receive "fair share" payments (or even grants) from the credit card companies which average six percent of the amount that the credit card receives – which is more than six percent of the debt. For instance, assuming equal payments over five years and a ten percent interest rate, a consumer with $10,000 in debt will pay $12,748.23 to the credit card company, which implies that the consolidator would receive another $764.89 in fees (for a total of 16.7% of the debt). The levels of the fees in this example appear to be similar to those in Chapter 13 bankruptcy noted above.

It should be noted that CCCSs collect the money from the consumers and distribute the money to the creditors (Boas et al. 2003), which implies a fiduciary duty is accepted by these organizations. However, they implicitly assume that consumers will pay back 100% of the debt, only at a reduced interest rate and potential reduction of some or all of the fees.

Therefore, not only do they not conform to the 60-60 rule noted above, but this alternative may not be viable for some consumers who could pay back the debt under the 60-60 rule, forcing them into litigation and/or bankruptcy (Manning 2009).

From a consumer welfare standpoint, the key drivers of consumer welfare are the terms of the agreement: how much are the interest rates reduced, and how many payments are required? Plunkett (2009) suggests that these terms vary widely by creditor and by CCCS, so one area of needed disclosure are median terms negotiated by the CCCS for each creditor, as well as median consumer fees and "fair share" payments and/or grants from creditors. Clearly, the CCCS would need to disclose to their customers if a creditor did not accept the terms presented and would need to adjust the required payments.

In terms of calculating efficacy of the programs, both measures and approaches for the educational component are discussed above, so I focus on the debt reduction portion of the business. One set of measurements relate to the terms negotiated with the creditors. For instance, in the settlement offers and final settlements, how much is the original debt amount reduced? And how much of the original debt receives settlement offers? A second set of measurements are the successful completion rates of the program, although without some regulatory protection of consumers enrolled in these programs, these are not accurate measurements of firm performance because consumers can always be forced out of the programs through litigation by one or more creditors.

Debt Settlement Programs (DSPs)

For DSPs, the general idea is to have the consumers save money and pay the creditors in one or a few payments (depending upon the size of the debt) with the goal of paying off the debt in two to four years. Instead of focusing on interest rates, DSPs negotiate to reduce the principal of the debt, which implies one set of metrics is their ability to meet or beat the 60-60 rule noted above. Details of the size of the principal reduction are missing in the literature (although they are examined in the next section for one company), but companies claim to be able to reduce up to 50% of the principal. Instead of taking money from the credit card companies, these organizations generally receive their fees from consumers. Plunkett (2009) writes that these fees average somewhere between 14 and 20 percent, and Manning (2004) claims that these fees can include a set up fee ranging from 2-4%, and service fees range from 15-25%.

Without defending the veracity of the assumptions, if we take the same consumer above, who has $10,000 in debt, receives a 20% reduction in the debt principal and pays a lump sum at the end of two years? The consumer would end up paying $8,000 to the Credit Card Company or $4748 less than they would have under the CCCS example above. Whether or not the consumer is better off would then depend upon the fees charged – the consumer would be indifferent (i.e., pay the same amount) if the fees were $4748+$910 or $5658 (56.6% of the original debt).

As with the CCCSs, consumer welfare is strongly influenced by the key assumptions of the model, i.e., number of years before lump-sum payment, interest rate and the principal reduction amount. This example also shows where some confusion may enter into marketing and other communications: the consumer received a 20% reduction from the initial debt, but did they still have to pay interest on the debt while saving for the payment (note the results are the same as making payments for two years). So, a consistent method of communicating the principal reductions is required, where the amount of the final payment in relation to the

initial debt is reported. Similar to CCCSs, transparency implies that median settlements for different creditors and credit status (e.g., in litigation) would have different principal reductions and would need to be disclosed.

This model has some unique difficulties as well as common problems with the CCCSs. A key difference would be that consumers (or clients) are not required to accept settlement offers from the creditors. Therefore, any metric which attempts to only look at settlements would tend to underestimate (i.e., bias) the effectiveness of DSPs, meaning that a second set of metrics related to offers received from creditors would also be required.

A second problem for DSPs is whether or not they should put client money into fiduciary accounts. In the data provided by the DSP analyzed in the next section, 6.8% of the cancellations gave the inability to save as the reason that they cancelled the service. On one hand, one could argue that the consumer must learn how to handle their savings to really get out of the cycle of debt, so no fiduciary accounts should be necessary. However, one could use the analogy of learning to crawl before learning to walk to analyze this situation. The end goal of the program is to have consumers self-sufficient, but they may need to learn how to save, and how to not dip into these savings for luxury items while paying off their debt. Therefore, it seems, at least at the beginning, the companies should at least monitor the savings of their clients to ensure that they are making progress.

In a similar vein, one could argue that the companies should establish fiduciary accounts for their clients to ensure that they can actually pay off the offers once they are received. Otherwise, what should the company do with their clients who are not saving? However, the extant literature is ripe with examples of abuses for these accounts (see, e.g., Plunkett 2009). Therefore, guidance from regulatory, consumer advocacy and industry groups would be helpful in this area.

My recommendation in this area is to strike a balance from the different approaches. First, allow DSPs to set up "trust" accounts where monies can only be released to pay creditors (with a signed letter from the creditor and consumer), to pay agreed upon reasonable program fees (agreed upon on the creation of the account) or refunded to the client upon termination of the program or upon demonstration of a new financial hardship (e.g., medical bills). Second, the DSPs should be allowed to monitor these accounts to ensure that their client is saving, and consumer saving being one condition of making "satisfactory progress" in program. If the protections noted above were in place for consumers making "satisfactory progress," the effect of not saving would remove their protections from creditors and litigation, creating a very strong incentive to save. It would be an interesting area for future research to investigate the savings rates for consumers who are enrolled in programs which have trust funds as an aspect of their programs.

Finally, both CCCSs and DSPs suffer from the same problem where the original creditors (but not third parties) can continue calling them after they have signed up for a program and have asked (or the DMP has asked) for the creditors to stop calling (source: Fair Debt Collections Practices Act or FDCPA). Even worse, even though the consumer is trying to avoid bankruptcy and litigation, it can be forced upon the consumer by only one out of many creditors. This phenomenon has been called the "creditor's dilemma" (Bainbridge 1986). In conversations with the DSP analyzed below fully 20.5% of the consumers who cancelled the service gave bankruptcy as the reason for cancelling the program, and another 19.3% who cancelled the service gave a reason that was categorized as an "outside influence."

The problem is that consumers may be acting in good faith and trying to climb out of debt, the DMP may be acting in good faith to help the consumer

and most of the creditors can be acting in good faith working with the DMP and the consumer, but one creditor can force failure of the entire process. To be honest, I can't see a way out of this problem without regulatory action, as similar problems (called "prisoner's dilemmas") have been extensively studied and the solutions generally require modifying incentives of the actors (Poundstone 1992). The clear implication is that consumers need regulatory protection from litigation and harassing calls while they are making satisfactory progress in these programs.

Timing of Fees

Throughout the above discussion, the issue of when DMPs should receive fees has not been addressed, so this issue is addressed in this section. This issue is one of the most contentious for DSPs where Plunkett (2009) and others have suggested that other than small account set up fees, DSPs should not receive any fees until the debt is settled. A general response to this recommendation is that this requirement is analogous to forbidding insurance companies from collecting premiums until a claim is filed, or forbidding attorneys from collecting fees until the matter is settled or forbidding doctors or hospitals from collecting fees until the patient is healthy.

The recommendation also ignores when value is created for the customers and when expenses are incurred by the DSPs in creating the value. DSPs create value for their clients in multiple ways. First, they offer financial education, budgeting, etc. as part of the program. Given that CCCSs charge consumers for this education (and receive federal funding to support the education) (Keating 2008), there can be no argument that this provides value to the customers. Also, DSPs create value for the customers (and incur expense) when offers are received from creditors to reduce their debt (see empirical section below for quantification of this value) whether or not the consumers actually accept the offers. As shown in the next section, offers are received on some accounts within two months of enrollment in the program.

This recommendation is also inconsistent with the way that CCCSs receive their fees. An analogous situation would require that CCCSs receive no fees (including grants and "fair share" payments from creditors and monthly account maintenance fees) until the debt is paid off (generally in five years), which would make the business economically unviable without massive government funding. Given the current federal and state deficits, this funding is unlikely.

Finally, the fact that consumers have to make payments, in and of itself, is educational. It forces consumers to get in the habit of saving and making payments. If the DSP has a "trust" account or is otherwise monitoring the savings of the client, similar expenses to those of CCCSs are incurred. Therefore, DSPs should be allowed to charge consumers fees prior to the final settlement because value is generated for the clients and expenses are incurred by the DSP to generate that value. That said, to help protect consumers, any fees before settlement should reflect actual value generated and expenses incurred. As noted above, full disclosure of fees is required for consumers to make good choices.

Repayment on original terms

The problem with this alternative is that consumers are already delinquent and cannot afford the payments. The delinquency may be temporary, but even under the new credit card rules, consumers would still have six months of increased interest rate payments due to the late payment (Reddy 2009).

In this section, we analyze data from a DSP firm. The purpose of this section is to analyze specific performance metrics for the firm to establish as a basis for estimating consumer welfare in the next section. Given that the firm has not tracked education and financial health after a consumer leaves the program, these metrics are not analyzed. The remainder of this section is organized as follows: the next part provides a brief description of the data. Next, specific performance metrics are analyzed taking care to control for when a consumer enters the program.

Description of Data

The firm† provided three cohorts of random, stratified samples of their data. The data was stratified into the lowest quartile, middle 50% and top quartile in terms of total indebtedness of the client with a random sample of 500 clients drawn from each stratum. Three cohorts were also drawn from the data: clients entering 24 months, 18 months and 12 months prior to the date of the data being accessed. Therefore, the database contains 4500 clients – a very significant sample of consumers in this industry. The client confidentiality is maintained through no identifying information (e.g., demographics, names, credit card account numbers, etc.). One limitation of this data is that once a consumer cancels their account, no information is retained regarding offers, settlements, etc. That said, the sampling methods imply that the results can be applied to the entire database of clients for this firm. While the results may not be applicable to the industry as a whole without some strong assumptions, they are likely applicable to similar firms in industry and allow several conjectures to be examined in detail.

All creditor accounts, offers to settle (whether or not the client accepted the offer), offer amounts, date of the offer, whether or not the offer was accepted and if/when the client canceled the account are included in the data. In addition, the original creditor was provided so the question of whether or not there are differences in settlement offers due to the volume of accounts could also be tested. Table 2 provides simple descriptive statistics for the data.

Several points are obvious in the table. First, the median weeks are similar for the three stratums. Therefore, from a time in program standpoint, it appears the strata are identical. Secondly, as expected, the number of accounts increases as the total debt increases. Finally, the cancellation percentages are roughly similar across the different stratums. However, the top stratum appears to cancel at a much higher rate. We can calculate the weighted average cancellation rate to be approximately 60%, this rate is comparable to cell phone companies that average 2-3% monthly churn, or cancellation, rates (Mozer et al. 2000). Clearly, this rate is high, but it does compare very favorably with the 84% yearly churn rate (Plunkett 2009). However, further analysis of the reasons for cancellation point to the difficulty in calculating accurate cancellation and/or completion rates.

Table 2 — Descriptive Statistics for Strata

	Stratum 1 (Lowest 25%)			Stratum 2 (Middle 50%)			Stratum 3 (Top 25%)		
	Mean	Median	Std Dev	Mean	Median	Std Dev	Mean	Median	Std Dev
Total Debt	7927	8000	1223	16966	16138	6788	47404	40201	21884
Num Accts	3.7	3.0	1.7	4.6	4.0	3.3	6.3	6.0	3.3
Weeks in Program	49.9	49.0	33.4	49.4	50.0	46.1	46.9	46.0	32.4
Pct Cancelled	59.1			58.1			64.5		

† Credit Solutions

The reasons for cancellation for the customers in the database are summarized in the five reasons provided in **Table 3**. There are several striking results from this table. First, if the outcome of paying off debts is considered a success, then the cancellation rate is overstated because 14% of the consumers included as cancellations actually paid off their debt.

Second, a significant portion of the consumers (13.5%) are being forced out of the program due to litigation. Therefore, protection of consumers from litigation is required for those consumers making satisfactory progress in the program. Third, a significant amount of the cancellations (6.8%) are due to consumers not being able to save. Because the DSP does not monitor/require savings, a significant portion of the cancellations could have been prevented by significant incentives for the consumers to save.

Therefore, the aggregate cancellation rate is a poor measure of the quality of the service provided. To help put the cancellation rate into context, **Table 4** provides yearly and monthly churn rates across a variety of industries, companies and time periods (selected sample from Kohs 2006) and shows that the churn rate is lower than or comparable to some companies and subscription-based industries which also have Better Business Bureau (BBB) certified members.

Table 3 — Reasons for Cancellations

Reason	Percentage
Bankruptcy (Chapter 7 or 13)	13.5%
Can't Save	6.8%
Buyer's Remorse [a]	9.2%
Settle/try to settle on own	14.0%
Other	56.5%

Note: [a]Buyers remorse is limited to those customers who cancel within 30 days of the initial payment to the DSP, which can be 30-60 days from the initial enrollment date.

Table 4 — Churn rates in other industries

Annual Churn	Monthly Churn	Company	Industry	Data Year
7.20%	0.62%	Sirius	Satellite Radio	2006
10.00%	0.88%		Web Hosting	2003
10.00%	0.88%	Western Wireless	Wireless	2001
11.00%	0.97%	Alamosa PCS	Wireless	2001
15.00%	1.35%	Nascar.com (premium subscribers)	Sports Media	2004
16.00%	1.45%	Nextel	Wireless	2005
17.00%	1.55%	Colorado teachers in 'excellent' schools	Education	2004
17.00%	1.55%	Schnader Harrison (lawyers)	Legal	2003
17.00%	1.55%		DBS TV	2002
18.00%	1.65%	DirecTV	DBS TV	2003
19.00%	1.76%	Alltel	Wireless	2005
22.00%	2.07%	Analog cable subscribers	Cable TV	2002
23.00%	2.18%	Cingular	Wireless	2005
23.00%	2.18%	Colorado teachers in 'unsatisfactory' schools	Education	2004
26.00%	2.51%	Sprint	Wireless	2005
26.00%	2.51%	Subscribers	Cable TV	2002
31.00%	3.09%		Pagers	1998
34.80%	3.56%	T-Mobile	Wireless	2005
35.00%	3.59%	Maricopa County (anglers)	Recreation	2002
45.00%	4.98%		E-mail addresses	2004
46.00%	5.13%		Prepaid Calling Cards	2004
46.00%	5.13%	Digital cable subscribers	Cable TV	2002
51.00%	5.94%	Globe	Prepaid Wireless	2004
52.00%	6.12%	Florence (AL) Times Daily (readers)	Newspapers	2005
58.00%	7.23%	Snowball.com	E-mail newsletter	2000
78.00%	12.62%	Touch Mobile	Prepaid Wireless	2004
93.00%	22.16%	VOOM	HD TV	2004
93.00%	22.16%	Runoff at time of sale	Home Mortgage	2002

ANALYSIS OF DATA

In this section, different performance metrics are examined for the firm at the client-level.

The first set of metrics in Table 5 provides performance metrics that can be used to calculate consumer welfare. The first column represents the conditioning of the metric: Settle - did the client settle at least one account, Offer - did the client receive at least one offer on the account, Cancel - did the client cancel all of their accounts. Note that the company did not retain offer and settlement information once the accounts were cancelled.

The second column represents the metric and the remaining columns report the mean, median and standard deviations for the metrics. Medians are included as a second measure of central tendency. The percent debt metric measures what percentage of the original debt the consumer paid when the account was settled. There are not significant differences between the strata, although the results indicate that the median is less than 48%, or that the households received an average discount more than 50%. The percent of total metric indicates the percentage of the original debt that has a settlement (conditional on the client settling at least one account). Once again there are no significant differences between the strata, but the median across the three stratums is around 50%. The percent of accounts settled is not different between the strata, and hovers around 50%. This indicates that the size of the debt is not a driving factor in getting the account settled. Interestingly, the only significant effect conditional on settling one account is the number of days until the first settlement, where the smaller accounts take longer than the other two. However, the medians for all three strata hover around six months. Note that, conditional on settlement, this organization beats the 60-60 rule noted above.

But when the offers are examined, they suggest a slightly different story. First, there are no significant differences in the average amount offered (% Debt) for the three strata. However, the median offer is around 56%, much higher than the 48% settlement, although both numbers beat the 60% of debt rule noted in the introduction. Hence, it can be concluded that the negotiations work for the clients. In terms of the percent of the original enrolled total debt (% total debt) that receives an offer, the highest quartile (median 72%) is significantly different than the lowest quartile (median 51.5%), but neither quartile is significantly different from the middle 50% (median

Table 5 — Consumer welfare metrics

		Stratum 1 (Lowest 25%)			Stratum 2 (Middle 50%)			Stratum 3 (Top 25%)		
Condition	Metric	Mean	Median	Std Dev	Mean	Median	Std Dev	Mean	Median	Std Dev
Settle	% Debt	51.0	48.8	0.19	48.5	46.7	0.27	49.2	47.5	0.19
	% Total Debt	54.7	50.7	0.30	54.1	50.6	0.45	53.1	49.4	0.32
	% Accounts	52.0	50.0	0.27	51.5	50.0	0.39	53.0	50.0	0.29
	Days first settlement	211[a]	189	116	196[a,b]	177	154	183[b]	163	99
Offer	% Debt	62.2	64.2	0.29	56.6	52.2	0.39	56.8	55.7	0.17
	% Total Debt	56.5[b]	51.5	0.18	63.7[a,b]	67.8	0.43	67.7[a]	72.1	0.29
	% Accounts	57.3[b]	50.0	0.28	59.6[b]	50.0	0.40	64.7[a]	66.7	0.28
	Days first offer	210[a]	188	126	186[b]	172	148	168[c]	148	95
Cancel	Days Cancel	196	168	145	197	163	207	202	171	155

Notes: Superscript a>b>c with probability less than or equal to 5% than they are the same. Values with same letter are not significantly different.

67.8%). This result (as well as the differences between means and medians) suggests high variance in the percent of debt settled, and that the significance on this metric may be spurious. If it is not spurious, it then appears that the creditors are more willing to make offers on higher debts, which is consistent with the analysis of Dash (2009). The results for the percent of accounts and days until the first offer support this hypothesis, where the highest quartile receives their first offer sooner than the lowest quartile and median strata, and the highest quartile has a larger percentage of accounts receiving offers than the other two strata.

Figure 2 provides a histogram of the percent of total debt that has either been settled or offered combining all three strata. There are a couple of striking elements to this figure. First, the most frequent value (also called the "modal value") for both settlements and offers is between 90 and 100%, indicating that the firm is generating value for their customers. Second, the distribution for both appears to be uniformly distributed (ignoring the mode). This seems to imply that consumers are progressing through the program; otherwise I would expect to find another mode where the clients get "stuck" in their progress. That said, the firm should strive to have 100% of the debt with offers. This figure also points to the difficulty in calculating a completion rate. Given that consumers are receiving offers on their debt but not accepting all of the offers, how should the accounts be counted?

Figure 3 provides a histogram of the percent of the enrolled debt (i.e., original debt amount) that was either paid during settlement or had a settlement offer, conditional on settlement or receiving an offer. The settlement data appears to be normally distributed with the mean, mode and median slightly less than 50%, much better than that 60-60 rule noted above. A striking feature is that the average offers are almost normally distributed, but have a positive skew. This positive skew implies that the creditors tend to make more offers above the mode than below the mode. Given the distribution of the settlements is more balanced; it implies that the firm does a good job in negotiating better terms for their clients. Specifically, we see that the absolute frequency (not just percentage) is much higher for settlements below the mode than for offers. Similarly, the frequency for offers above the mode (and median) is much higher for offers than for settlements.
The mean, median and mode (all measures of central tendency) appear to be the same, suggesting that the

Figure 2 — Histogram of Percent of Debt Settled and Offered

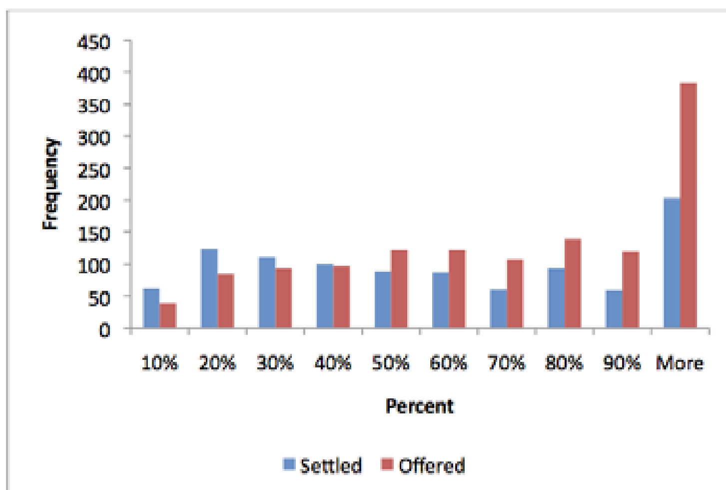
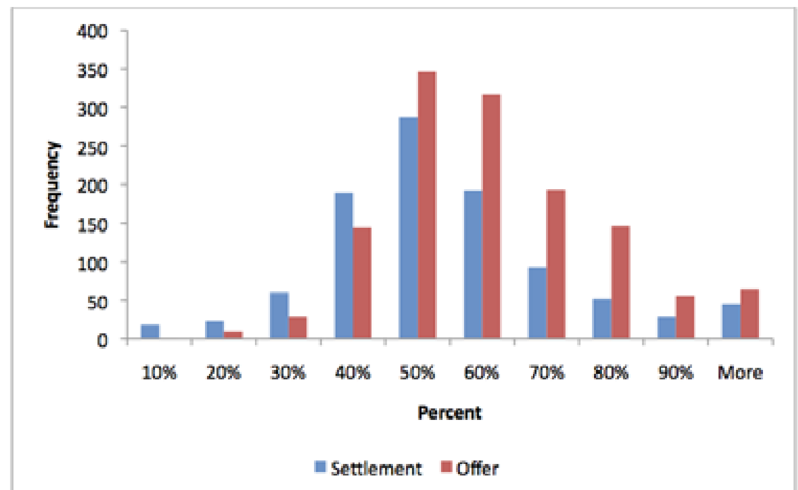


Figure 3 — Histogram of Percent of Debt Paid for in Settlements and Offers



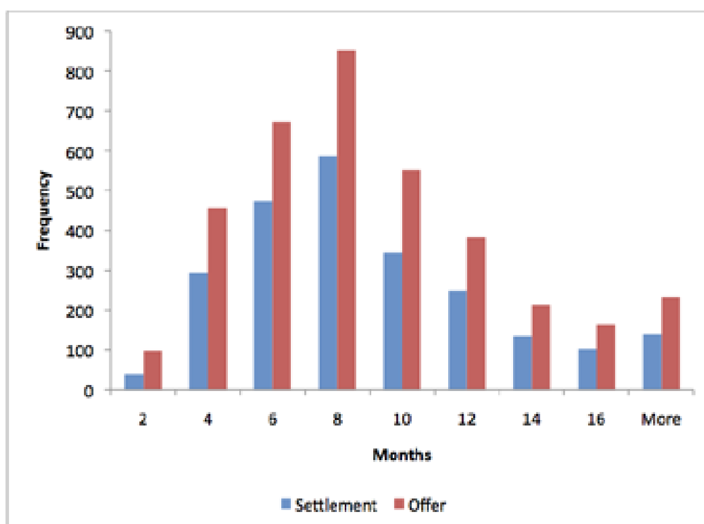
firm generates value to their clients by beating the 60-60 rule. However, to manage client expectations about possible benefits from the program, the firm should be transparent about the median and 75% quartile (i.e., 25% percent quartile in terms of discount) when calculating savings for the consumer. Given the convergence of mean, median and modes, a standard deviation should also be reported.

Next, we look at the cancellation data. There are no significant differences between the three strata. However, the median time to cancel hovers between five and six months. Even though there is no data on the offers and settlements for these clients, I find it highly unlikely that this group received no offers in this time, as the median time approximates the median time for offers and settlements. It is much more likely that other, unobserved factors were more influential in this decision. Figure 4 combines the data from the three strata, and provides a histogram of the time it takes an account to be settled or the time it takes for an account to receive the first offer. For both settlements and offers, a negative skew is observed for the distribution.

Interestingly, this implies that the creditors are generally very interested in settling the account, with the modal offer time being between 6 and 8 months. The firm can clearly improve in their performance by reducing the right tail of the offer distribution, i.e., ensuring that all accounts receive offers in a timely manner. This graph also depicts how the firm generates value for their customers in the negotiations. By receiving many offers quickly, they can make the creditors compete against each other for the lump sum payment from the consumer. This competition is in the form of reducing the principal of the debt.

A problem with this distribution is that, without some sort of regulatory protection, the spurned creditors (i.e., those who do not offer good enough discounts on the debt, so they are not selected for the lump sum payment) can initiate litigation that would drive the consumer into bankruptcy, creating unnecessary cancellations for the firm. A second challenge for this firm is that the savings plan ought to require their clients to save enough in the first 6-8 months to pay off one of their creditors, potentially the creditor with the smallest balance. This finding supports the call for protection of consumers making "satisfactory progress" in paying their debts through Debt Management Programs.

Figure 4 — Histogram of Time for Settlement or Offer to be Received



In summary, this analysis has several key findings:

1. Creditors seem to make lower offers sooner to consumers with higher balances,

2. The median cancellation time is between 5 and 6 months, implying (due to a lack of data) that the clients likely received offers, as the median is not very different than the median offer time. However, it is very difficult to calculate accurate cancellation rates (often used as a measure of "failure" of the programs) due to the fact that almost 30% of the clients cancel due to paying off their debts or going into bankruptcy.

3. Both the median offer (approximately 56% of debt) and median settlement (48%) are better than the proposed 60% rule, so the firm is offering value vis-à-vis the proposed 60-60 rule. Further, the difference between the settlement and offer percentages implies differences between households (potentially due to hardship) and that some households receive tremendous value from the negotiations and relationships of the firm.

4. Conditional on a client settling at least one account, the client seems to settle more than 50% of their debt and 50% of their accounts. This statistic is impressive as the program lasts 36-48 months, whereas the data only captures the first 12-24 months for the client. One would expect that at the end of the program, the settlement rate would increase.

5. Conditional on receiving at least one offer, clients seem to receive offers for more than 67% of their accounts and debts.

6. The figures seem to indicate that clients are progressing and paying off their debt, as the mode for the number of offers and settlements is between 90 and 100% of the enrolled debt. However, the firm does have room for improvement, as the optimal graph would have 100% of the debt with offers.

CALCULATION OF CONSUMER WELFARE

In this section, the empirical results are used to calculate consumer welfare under a variety of assumptions and conditions.

Table 6 provides the initial base-line estimates for consumer welfare. We use assumptions of 18% annual interest rate and minimum fixed monthly payments of 2% and 3% for debts of $4,000 and $10,000 (for similar assumptions, see, e.g., Warnick 2005). The fixed monthly payment of 2% is similar to current minimum monthly payments as noted in Warnick (2005). Affordability is measured using monthly payments, and consumer welfare is measured by the length of time required to pay off the debt and total amount paid by the consumer. By doubling their payment, consumers are able to cut the time to repay the loan in half and increase their total welfare by paying less to the credit card company.

The first scenario examined is when the same consumer receives help from a CCCS, and the firm is able to cut the interest rate to 10% from 18%, and has 5 years to repay (this may be an optimistic assumption, as Plunkett (2009) says that creditors are becoming less willing to reduce interest rates). The results of the consumer welfare calculations are provided in Table 7. In order to calculate total payments (to credit card and the firm), we assume the industry average of $15 per month and a fair share payment of 5% of the payments to the credit card company (Hunt 2005).

Table 6 — Baseline Consumer Affordability and Welfare Calculations

Payment	2%	3%	2%	3%
Debt Level	$4,000	$4,000	$10,000	$10,000
Annual Interest Rate	18%	18%	18%	18%
Fixed Monthly Payment	$80	$120	$200	$300
Years to Pay	7.8	3.9	7.8	3.9
Total Payments	$7,488	$5,616	$18,720	$14,040
Percent of Original Debt	187%	140%	187%	140%

Table 7 — Consumer Affordability and Welfare Calculations for hypothetical CCCS

Debt Level	$4,000	$10,000
Annual Interest Rate	10%	10%
Years to Pay	5	5
Fixed Monthly Payment	$85	$212
Monthly Account Fee	$15	$15
Total Monthly Payments	$100	$227
% Baseline Payments	125%	114%
Total Payments	$5,999	$13,648
Percent of Original Debt	150%	136%
Percent of Baseline	80%	73%
Firm Fees	$ 900	$ 900
% Fair Share	5%	5%
Fair Share Fees	$255	$637
Total Revenue to firm	$1,155	$1,537
% Original Debt	29%	15%

In terms of affordability, both cases are less affordable, i.e., have higher monthly payments than the base case of paying off the debt using with fixed monthly payments of 2% of the original debt. However, consumers are better off with this solution as they end up paying much less overall (range from 73% to 80% of the base case payments), even when the monthly account fees are included. We can conclude that this alternative does help consumer welfare, but it is a generally less affordable solution.
If we examine total fees paid, they range from 15% to 29% of the total debt. Given Plunkett's (2009) description of 30% fees as exorbitant, his standard suggests that the CCCS charges exorbitant fees to lower debt consumers. Additionally, if it is assumed that lower income consumers have lower debt then CCCS charges higher fees as a percentage of the debt to lower income consumers than to higher-income individuals. In fairness, they can argue that cost of education is the same, regardless of the debt level, but it does not change the fact that they have a regressive fee structure.

The 60-60 rule is analyzed in the next scenario.

In this case, we assume 40% reduction in the debt principal, the interest rate remains at 18% and the firm has varying fees of 15% and 20% of the original debt balance. Table 8 provides the results of this analysis. This scenario is more affordable than both the base case and the hypothetical CCCS firm. Further, consumer welfare is highest where the consumer is paying 57-60% of the original base case scenario, even though the consumer ends up paying more than the original debt. The fees are now neutral in terms of percentages versus debt and/or income levels, and are progressive in terms of the total fees with respect to debt/income.

Table 8 — Consumer Affordability and Welfare Calculations for hypothetical 60-60 rule

Debt Level	$4,000	$4,000	$10,000	$10,000
Annual Interest Rate	18%	18%	18%	18%
Reduction	40%	40%	40%	40%
Years to Pay	5	5	5	5
Fees as % of Debt	15%	20%	15%	20%
Monthly Credit Payment	$61	$61	$152	$152
Monthly Fee	$ 10	$ 13	$ 25	$ 33
Total Monthly Payment	$ 71	$ 74	$ 177	$ 186
Total Payments	$4,257	$4,457	$10,642	$11,142
Percent of Original Debt	106%	111%	106%	111%
Versus baseline	57%	60%	57%	60%
Fee Payments	$600	$800	$1,500	$2,000

The next scenario is a simplified version of the DSP analyzed in the empirical section above. It is assumed that the fees on the account are 15% of the total debt, debt is reduced to 40, 50 or 60% of the original debt amount and the household makes a balloon payment at the end of one year (much shorter than normal estimates of three years). Table 9 provides the results of this analysis. First, this option creates the highest amount of consumer welfare among all of the different options: it is the only option where the consumer pays less than the original debt amount. It is also the least affordable of the options, with monthly payments three times the base case scenario. Therefore, we can conclude that the firm should carefully screen consumers for their ability to save and make this payment within one year. However, this finding is highly dependent upon the assumption that the consumer will repay the debt in one year, much less than the above scenarios.

Table 9 — Consumer Affordability and Welfare Calculations for hypothetical DSP

Debt Level	$4,000	$4,000	$4,000	$10,000	$10,000	$10,000
Reduction	40%	50%	60%	40%	50%	60%
Years to Pay	1	1	1	1	1	1
Fees as % of Debt	15%	15%	15%	15%	15%	15%
Monthly Credit Payment	$200	$167	$133	$500	$417	$333
Monthly Fee	$ 50	$50	$50	$125	$125	$125
Total Monthly Payment	$250	$217	$183	$625	$542	$458
% Baseline Payments	313%	271%	229%	313%	271%	229%
Total Payments	$3,000	$2,600	$2,200	$7,500	$6,500	$5,500
Percent of Original Debt	75%	65%	55%	75%	65%	55%
Versus baseline	40%	35%	29%	40%	35%	29%

Therefore, we analyze a scenario with a more reasonable time frame of three years, consistent with Manning's (2009) assumptions, but still shorter than the CCCS or the 60-60 rule. Table 10 provides the results of this final scenario where the only change from the previous scenario is that the time to repay the debt is increased from one to three years. Not surprisingly, consumer welfare has not changed from the previous scenario.

However, the affordability has increased to the point where it is comparable or better than the base- case and 60-60 rule scenarios, even though the consumers pay their debt in three years instead of five years. This result once again suggests that it would increase consumer welfare if they have protection from creditors and litigation while they are making satisfactory progress in a DSP. It also suggests that DSPs need a mechanism in their program to monitor client savings to demonstrate to the creditors that clients are making progress towards being able to afford settlements.

CONCLUSIONS AND DISCUSSION

Similar to most studies, this research has several limitations. First, the empirical analysis only examines a single company over a single time period and does not contain educational measurements or other behavioral measurements after the clients exit the program. Therefore, it is unclear whether or not the findings can be generalized beyond this firm to the industry as a whole. Second, the data does not include information on settlement offers for cancelled accounts, so it is very difficult to determine if value was generated for these customers. However, given that the median cancellation time is similar to the median time until the first offer, I find it unlikely that all of these clients received no offers if they stayed in the program long enough.

Probably the most important empirical finding is that this firm adds significant value to their customers where the median and modal settlement offers are less than 50% of the original debt, much better than the 60-60 rule. This finding confirms the assumptions in Manning (2009) and calls for programs which reduce the debt principal as an effective means of helping consumers (Plunkett 2009). Given the high rate of cancellations due to bankruptcy (13.5%), this finding also suggests that consumers need regulatory protection from creditors (i.e., the "creditor's dilemma") while they are making satisfactory progress in the program.

A second important empirical finding is that the upper bound for the cancellation rate is much lower than speculated (Plunkett 2009). However, accurate cancellation and completion rates cannot be calculated from the data, as consumers who cancel due to paying off their debt and who cancel due to entering bankruptcy are included in the cancellation rates. Further, completion of the program requires consumers to accept the offers. The data indicate that many more accounts have offers than are settled, with the modal client having more than 90% of their debt with offers. Even without adjusting the cancellation rate for these factors, the rate is comparable to or lower than other subscription-based businesses which have BBB-certified members. Therefore, excessive cancellation rates cannot be used as a rationale for excluding DSPs from certification.

Finally, a large portion of the consumers who cancel (6.8%) indicate that they are not able to save enough. This implies that the DSPs need to monitor consumer savings as part of their program. One effective means for doing this would be to establish third-party trust accounts that have consumer protections in place:

1. Require periodic audits of the accounts,
2. Require arms-length relationship with the DSPs,
3. Only allow disbursements to creditors (with signed letter from creditor and consumer), to DSPs (for pre-approved fees), to consumers who cancel the program or encounter new financial hardships.

If appropriate savings are pre-conditions for consumer protection from litigation and harassment from creditors, consumers will have very strong incentives to save and pay off their debts.
The policy simulations have strong implications as well. First, both CCCSs and DSPs increase consumer welfare versus the consumer paying off their debt. However, DSPs are the only option where consumers end up paying off less than 100% of their debt, so they create the greatest amount of consumer welfare of any option considered. Not surprisingly, the affordability of the DSP is dependent upon the length of time the consumer has to save to pay off their debt. If a three-year period is used, the DSP is comparable in affordability to the 60-60 rule and can be more affordable than CCCSs. This finding adds support to the recommendation of protecting consumers in the programs to ensure that they have enough time to build their savings to pay off their debts. This finding also supports the regulatory recommendation of establishing fiduciary accounts that can be monitored by the DSPs to ensure that consumers are saving enough.

The policy simulations also suggest that CCCSs may be overcharging some of their clients, where CCCSs receive 29% or more of the original debt amount in consumer fees and "fair share" payments. Even worse, their fee structure is regressive: where lower debt (and income) clients pay a larger percentage of the original debt amount in fees than higher debt (and income) clients. This finding suggests regulatory action to require CCCSs to disclose all fees, including fair share payments to consumers, is required to ensure transparency and that consumers can make good decisions. This finding also suggests that DMPs need to ensure that their fee structures are at least neutral or progressive in terms of the percentage and amount of the original debt amount to ensure lower income consumers are not paying unnecessarily large fees.

While not discussed in the empirical or policy sections, the extant literature suggests that education should be required to be provided as part of any certified DMP due to the positive outcomes. However, "satisfactory progress" in DMPs should also include satisfactory progress in the educational programs, which implies firms need to monitor and measure educational attainment. Technologies for this already exist, where consumers can already take driving educational courses over the internet.

Finally, we find that charging consumers reasonable "up-front fees," i.e., fees before settlement, is consistent with practices in other industries, e.g., legal industry, and can be justified based on value provided to consumers as well as expenses incurred generating this value. Any attempt to ban these fees would have a chilling effect on the industry and is inappropriate for this industry.

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Appendix A: Definition of Acronyms

BAPCPA – Bankruptcy Abuse Prevention and Consumer Protection Act
CCCS – Consumer Credit Counseling Service.
DMP – Debt management program - this term refers to a program that is intended to help a consumer pay off their debt, so it refers to both CCCSs and DSPs.
DSP – Debt Settlement Program.
Settlement – refers to when the consumer and creditor agree to terms (may be one or more payments, could be all or only some of the principal, fees and interest) to repay the debt.

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