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Meeting the Demand for Debt Relief

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Summary: *Each year, millions of financially distressed consumers in the U.S. face a difficult choice among the debt relief options available to them. This paper describes the options available to borrowers who seek assistance in managing their debts and discusses the information and incentive problems associated with these options. It also reviews the trends that contributed to the breakdown of the repayment framework and the responses to these trends. Among the responses is a reconsideration of the regulatory structure of the debt relief industry. The paper concludes with a discussion of the importance for debt relief providers and policymakers to evaluate the efficacy of workout options and to develop a deeper understanding of how consumers make decisions about incurring and repaying debt.*

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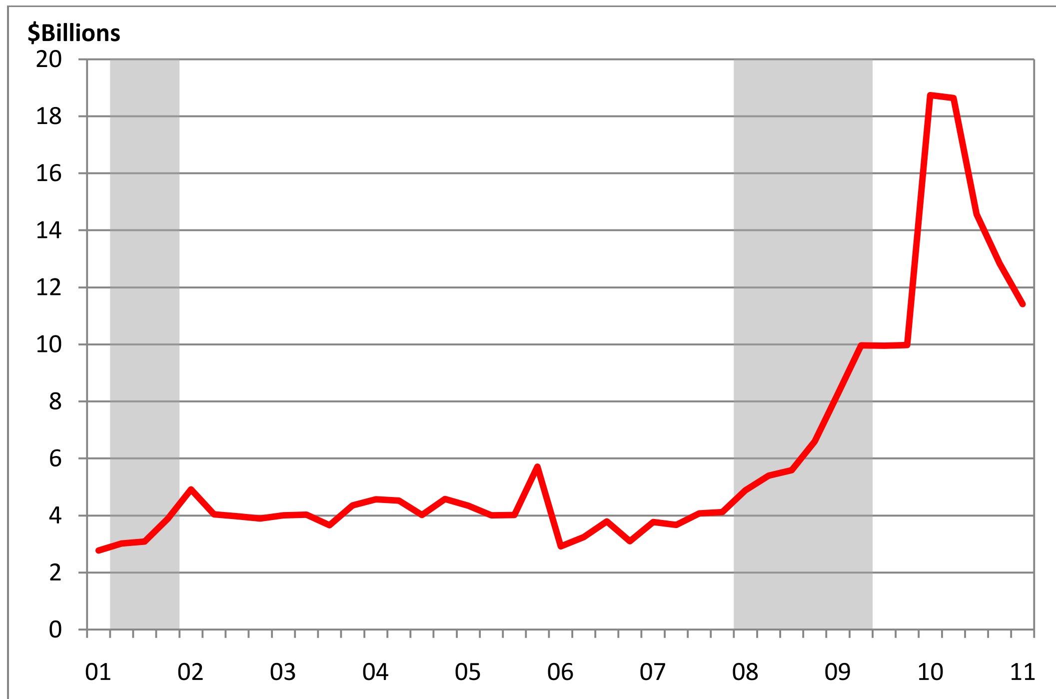
1. Introduction

The market for consumer credit in the U.S. is large, with revolving balances of approximately $800 billion as of the first quarter of 2011, down from $990 billion in 2008.[1] Most of the decline in outstanding balances was due to an unprecedented surge in defaults (Chart 1).

Chart 1. Net credit card charge-offs, 2001 to 2011



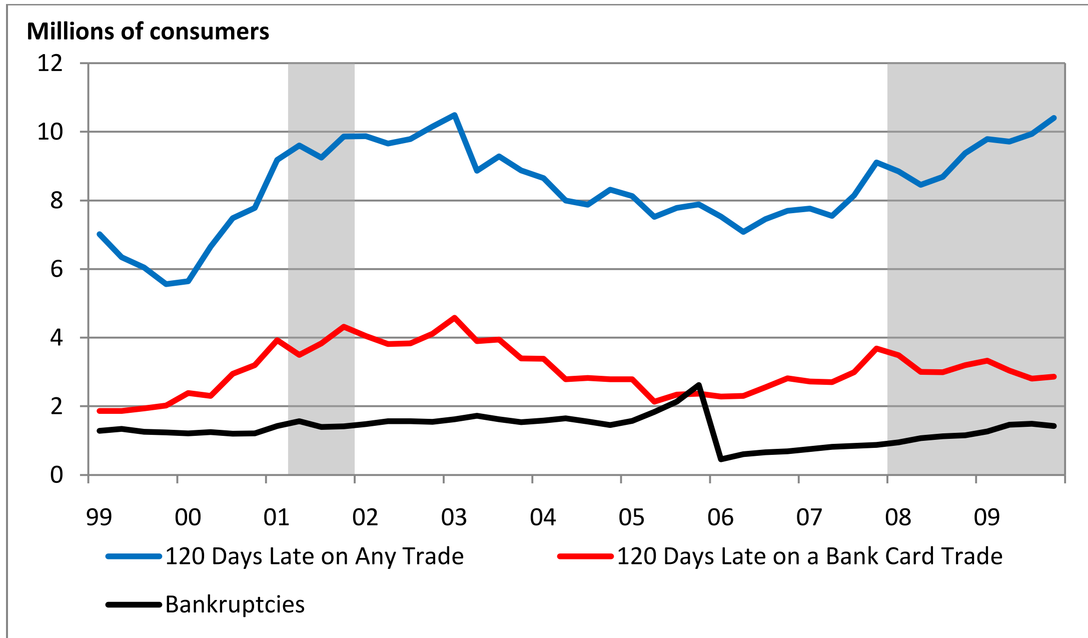
Source: FDIC.

To date, research has tended to focus on consumers who file for bankruptcy, but there is a much larger population that hasn't received as much attention (Chart 2). Government statistics show that consumer bankruptcy filings usually fluctuate in a range between 1 to 2 million per year. Bankruptcy reform legislation contributed to a spike in filings in 2005, followed by a sharp decline. More recently, bankruptcy filings have grown rapidly and have returned to

[1] Federal Reserve G19 statistical release. The 2007 Survey of Consumer Finances shows that nearly three-quarters of families have at least one general-purpose credit card and a median total credit limit of $18,000. Forty-six percent of credit card account holders, representing 40 million families, carry a balance. The median balance for revolvers is $3,000, while the average balance is $7,300.

their historical range. Nonetheless, this number is small relative to the 3 to 4 million financially distressed consumers who don't file for bankruptcy, at least not immediately.

Chart 2. Severe delinquencies and bankruptcy filings



Source: FRBNY Consumer Credit Panel and Administrative Office of the U.S. Courts.

The economic recession and resulting job losses, coupled with the devaluation of assets stemming from the foreclosure crisis, drove a record number of consumers to seek assistance in managing their debts. At a time of unprecedented demand for their services, nonprofit credit counseling agencies in the United States were unable to assist all financially distressed borrowers who sought their help. Many of those consumers lacked sufficient income to qualify for the single workout product that nonprofit credit counseling agencies offered —the traditional *debt management plan* (DMP).

There appears to be ample demand for a new form of workout product for the unsecured debts of highly leveraged consumers. At the same time, an increasing number of consumers are responding to the pervasive advertising by some for-profit credit counseling agencies and the re-emergence of for-profit debt settlement companies.

In choosing among debt relief options, consumers often rely on the expertise of others, but consumers typically have little or no experience evaluating that expertise. In addition, the features of some options are not readily observable in advance, which leaves consumers vulnerable to the practices of opportunistic firms. There have been numerous complaints about unfair and deceptive practices within the debt relief industry. Significant changes in state law governing debt relief services are already underway. Recent legislation and new regulations at the federal level are affecting both credit counseling agencies and debt settlement companies. Finally, implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is likely to result in fundamental change in the regulation of the debt relief industry at the federal level.

The need for careful assessments of existing and new counseling services could not be greater. It is imperative that in designing new products and treatments, service providers and policymakers develop a deeper understanding of how consumers make decisions about incurring and repaying debt and the long-run impact of those choices. However, there are methodological and organizational challenges to performing such research.

The next section of the paper reviews the options available to financially distressed borrowers. Section 3 discusses the information and incentive problems that may complicate both the choice among these options and the provision of them. Section 4 offers a consideration of the factors that have contributed to the breakdown of the equilibrium in the creditor-counseling agency relationship and the consequences of this breakdown. Section 5 describes the state and federal regulations with which debt relief service providers must comply. Section 6 considers the need for additional research to understand consumer decision making and for evaluation of the efficacy of workout options. Section 7 concludes the paper.

2. Classification of Options

There are three general options (with specific variations) available to borrowers who are having difficulty repaying their unsecured debts: filing for bankruptcy, simply defaulting

(which is often called informal bankruptcy), and entering into some form of workout program with lenders, either directly or through an intermediary. These options are reviewed briefly in the following sections.

2.1 Formal Bankruptcy

Borrowers can seek legal protection from their creditors by filing for formal bankruptcy. Doing so forestalls creditors' collection efforts while the judicial process works it course. Consumers can typically choose from a variety of bankruptcy options. The most common fall under Chapters 7 and 13 of the U.S. Bankruptcy Code. Chapter 7 bankruptcy entails the liquidation of borrowers' nonexempt assets and application of the proceeds toward the repayment of their unsecured debts. Any remaining unsecured debt included in the bankruptcy petition is then discharged. A bankruptcy flag can remain on borrowers' credit bureau files for up to 10 years, and consumers cannot receive another Chapter 7 discharge for eight years.

Consumers can also choose to file under Chapter 13, also known as a wage-earner repayment plan. To do so, they must prove that they have sufficient disposable income to support a court-administered repayment plan that will repay arrearages on secured loans as well as a portion of their unsecured debts over a period of typically three to five years. Borrowers who file for protection under Chapter 13 often make this choice in order to shield assets such as a car or home from seizure. As under Chapter 7, creditors' collection efforts must cease under Chapter 13, and the bankruptcy flag can remain on the consumer's credit bureau file for up to 10 years. Borrowers cannot obtain a Chapter 13 discharge within two years of a previous Chapter 13 discharge or within four years of a discharge under another chapter of the U.S. Bankruptcy Code.

The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005 amended the U.S. Bankruptcy Code. Among its provisions, BAPCPA implemented a means test to determine if a debtor has sufficient income to maintain a repayment plan and therefore must file under Chapter 13. If not, the consumer may file under Chapter 7. Other provisions of

BAPCPA include the requirement that debtors complete a course of credit counseling prior to filing for bankruptcy and file a certificate of completion issued by the counseling provider. BAPCPA also requires proof of the completion of a debtor education course before debts can be discharged. These counseling and education requirements have significantly changed the distribution of services provided by credit counseling agencies, as discussed in Section 4 below.

2.2 Informal Bankruptcy

Borrowers can choose to simply not repay their debts. In fact, the majority of charged-off credit card loans are written off for reasons other than an immediate bankruptcy filing. Without a formal bankruptcy filing, however, consumers are exposed to the ongoing collection efforts of their creditors. These efforts can range from telephone calls and letters demanding repayment to legal action, including garnishment of borrowers' wages. Another consequence of informal bankruptcy is the damage to borrowers' credit scores. Debts written off for nonrepayment can remain on borrowers' credit records for up to seven years.

2.3 Workout Options

2.3.1 Bilateral workout plans

In some cases, borrowers and creditors directly negotiate a workout plan. These conversations are typically initiated by an individual creditor. Bilateral workouts (also referred to as internal workouts) often defer or reschedule repayment of past due amounts in exchange for the consumer agreeing to make regular payments. These may involve creditor concessions on interest and fees charged to the borrower.

If the account has been charged off or is very likely to be charged off in the next few months, a creditor, or a collection firm acting on its behalf, might offer to settle the debt for less than the full balance owed. Some settlements involve one or just a few payments by the consumer. Others may involve payments scheduled over a period of years. There is little publicly available information about the frequency, terms, and outcomes of these arrangements.

In terms of concessions, bilateral workouts can be less expensive for creditors than a multilateral solution (described in the next section) because a lender can pursue its own interests rather than a collective solution. In addition, the creditor has more control over the terms of this workout option through direct contact with the consumer. The disadvantage of this approach, however, is that any bilateral repayment plan reached with a consumer is vulnerable to disruption from the collection activities of the consumer's other creditors.

2.3.2 Multilateral workout plans

For those borrowers with unsecured debts owed to multiple lenders, one alternative to bankruptcy (formal or otherwise) is to seek a repayment workout administered through an intermediary such as a credit counseling agency or, more recently, a debt settlement company.

Debt management plans

Historically, the debt relief workout solution for repayment of a borrower's unsecured debts has been the *debt management plan* (DMP). Traditionally arranged through an intermediary in the form of a credit counseling agency, a DMP involves the repayment of 100 percent of the debt owed in monthly installments usually over a term of three to five years. These plans typically include creditors' concessions on interest rates and fees charged to the borrower while he or she is participating in the plan. In addition, creditors participating in a DMP typically cease collection efforts against the consumer.

The distinguishing characteristic of the DMP is the simultaneous negotiation of concessions ideally with all of the borrower's unsecured creditors to address the borrower's liquidity constraints. This arrangement avoids what is called the creditor's dilemma in which the interest of each creditor and its effort to obtain repayment impede the ability of other creditors to collect and decrease the likelihood that a viable workout plan can be arranged. Creditor participation is voluntary. Creditors choose to include a consumer's debt in a repayment plan

because they expect that, in the absence of a plan, they are likely to recover less from the consumer.

Another important aspect of DMPs is that consumers are screened for eligibility, usually by the credit counselor. This is important for two reasons. First, the consumer must have sufficient cash flow to amortize the debts included in the plan over a period of five years. Otherwise, enrolling in a DMP may only delay an inevitable default. Second, in the long run, creditors will be willing to participate in DMPs only if they are confident that the plans do not include consumers who could repay their debts under the original terms of the credit contract.

At present, the credit counseling industry is highly diverse. Some credit counseling agencies are nonprofit entities, while others are not. Some agencies are integrated in the sense that they offer a variety of services in addition to DMPs, while others specialize in arranging workouts. Many credit counselors also provide budget counseling and financial education to help consumers understand how they ended up in their financial circumstances and how to avoid financial difficulties in the future.

Typically, consumers are charged a fee to enroll in a DMP and will often pay a monthly plan administration fee. Internal Revenue Service rules dictate that nonprofit counseling agencies cannot refuse to enroll a consumer in a DMP because of the consumer's inability to pay these fees.

Debt settlement programs

A more recent development on the debt relief landscape is the revival of debt settlement negotiated via an intermediary chosen by the borrower.[2] Debt settlement is billed as an aggressive debt relief option for those who cannot afford repayment under a traditional debt management plan. Debt settlement companies offer to negotiate with a borrower's unsecured

[2] Krumbein (1924) reviews the historical antecedents of the modern debt relief organizations that exist today. In addition, collection firms also regularly negotiate settlements of defaulted debts on behalf of creditors or debt buyers.

creditors to settle each debt for a fraction of its outstanding balance, generally with a one-time payment. Unlike a debt management plan, these negotiations are conducted with each creditor individually. There has been significant growth in this market recently.[3]

Debt settlement firms are typically for-profit companies. Until recently, many debt settlement companies derived much of their revenues by charging their clients an enrollment fee and monthly maintenance fees. It was often the case that the majority of fees charged to a consumer were paid before any of his or her debts were actually settled.[4] Borrowers must typically save up the funds that will be used to settle their debts, and this can take up to 24 to 36 months.[5] Most financially distressed consumers cannot afford to simultaneously service their unsecured debts and save for a settlement. As a result, during the period in which they are saving for a settlement, it is likely they will stop making debt payments if they have not already done so.

There are significant risks associated with participation in a debt settlement program. Borrowers' credit scores can be damaged due to nonpayment.[6] Borrowers can be subject to creditor litigation once they cease payment on their outstanding obligations. Settlement firms report high borrower drop-out rates, and not all creditors will accept settlement offers. Even successful settlements can have a detrimental effect on credit scores because a settled account is

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[3] In 2008, the vice president of the Association of Settlement Companies (a debt settlement industry trade association) estimated that the number of debt settlement companies in the U.S. had increased from 300 in 2006 to 1,000 in 2008. See 74 *Federal Register* (August 19, 2009), p. 42013.

[4] The Federal Trade Commission, in its 2010 amendments to the Telemarketing Sales Rule, reported that contracts used by a number of debt settlement firms would require consumers to pay nearly all their required fees to the settlement firm within the first year of the plan, but settlement negotiations typically would occur after this point. See 75 *Federal Register* (August 10, 2010), p. 48462.

[5] See Andrew Housser's testimony in Federal Trade Commission (2009). Housser, an executive board member of the Association of Settlement Companies (TASC), noted that, on average, it takes three years for a consumer to complete a debt settlement program offered by a TASC member company, with program fees typically recovered over the first 18 to 24 months.

[6] Of course, if the consumer has been unable to make payments prior to enrolling in a debt settlement program, the incremental effect on his or her credit score may not be so great. In other words, much of the damage would have already occurred.

often reported using a derogatory remark code on the borrower's credit report. There is little published information about the success of these settlements.[7]

2.4 Relative Frequency of Nonbankruptcy Options Employed by Consumers

Table 1 below provides one measure of the relative frequency of debt management plans, internal workouts, and settlements, as reflected in credit bureau data as of May 2011. Each workout option can appear as a remark code on specific accounts included in TransUnion's credit bureau files.[8]

Table 1. Frequency of unsecured credit workout options as reported to a credit bureau

Workout Option (Remark Code)	Number of Accounts May 2011	Number of Consumers May 2011	Arrangement Between Consumer and Creditor
Debt Management Plan (MCC)	3.3 million	1.6 million	Intermediated by Credit Counselor
Partial or Modified Payment Agreement (PPA)	150,000	145,000	Negotiated Directly between Consumer and Lender
Account Settled for Less than Full Balance (SET)	14 million	10 million	Intermediated by Debt Settlement Company or Collection Firm or Negotiated Directly Between Consumer and Lender

Source: TransUnion, LLC.

Of the three codes listed in Table 1, MCC represents the workout option that is most likely the only one arranged through a distinct organization — the credit counseling agency. It is important to keep in mind that this code is typically removed from the consumer's credit report

[7] Briesch (2009) cites a "raw cancellation rate" of 60 percent over two years in an analysis of one debt settlement company's performance metrics. The Association of Settlement Companies reports in a survey of its large member companies that 34.4 percent of consumers settled at least 75 percent of their enrolled debts.

[8] These data should be interpreted carefully. Little is known about potential type I and type II errors in these measures. For example, the proportion of accounts that are included in debt management plans that are reported as such by creditors and which produce a remark code in the credit bureau data is not known. In addition, these data, which represent the number of accounts and consumers reported as of May 2011, may represent activity that has occurred over more than one year.

upon successful completion of a debt management plan. The associated loans are reported as paid in full. Plan completion is therefore likely associated with an improvement in the consumer's credit score.

The PPA, or partial payment agreement, code reflects bilateral arrangements between consumers and lenders. A PPA code is a derogatory remark that can stay on a consumer's credit file for as long as seven years. The SET code applies to workouts in which the consumer has settled the debt for less than the full balance owed. These arrangements can be negotiated by debt settlement companies or directly between borrowers and lenders. Typically applied to charged-off credit card accounts, the SET code can also apply to accounts in collection. If accounts in collection were included in Table 1, the number of accounts with a SET remark code would increase to 18 million and the number of consumers to 12 million. As with a PPA, a SET code can remain on the consumer's credit file for as long as seven years.

3. Incentive and Information Issues

3.1 Screening and Performance Incentives

The structure and availability of debt resolution options can affect markets for unsecured credit. This is supported by empirical research on variations in bankruptcy law and collection remedies.[9] Theoretical research suggests that renegotiation of contract terms can reduce credit supply and possibly affect its pricing.[10] To minimize those effects on credit supply, debt relief should be targeted to consumers who either have defaulted or who are very likely to default. Even this approach is a second best solution, since conditioning the availability of relief

[9] See for example, Gropp, Scholz, and White (1997). For a review of the literature on the relationship between creditor remedies outside bankruptcy and the pricing and availability of consumer credit, see Hynes and Posner (2002).

[10] A classic reference on the effects of renegotiation on credit supply is Hellwig (1977). See also Bolton (1990).

on the likelihood of charge-off might encourage some borrowers to become delinquent (an example of moral hazard).[11]

Targeting relief to distressed consumers presupposes a process for screening consumers for eligibility. Information and incentive problems complicate the screening process. The classic problem in debt collection, for example, is to distinguish — in a cost-effective manner — between consumers who are not able to pay from those who are able but not motivated to pay. The availability of workouts, combined with criteria for determining eligibility for workouts, can potentially influence repayment and other behavior. Consequently, the potential for moral hazard makes screening difficult.

Depending on the type of workout program in which the renegotiation occurs, screening is conducted by different parties. Under bilateral workouts between the creditor and consumer, the creditor conducts the screening. For multilateral workout programs in which the creditor is relying on another party to assess a consumer's eligibility for relief, incentives must be provided to this intermediary to ensure proper screening.

In multilateral workout programs involving a credit counseling agency, creditors have historically given agencies incentives to screen through a combination of *fair share* payments and monitoring. Fair share is a portion of plan payments made each month that are returned to the credit counselor to compensate for the cost of establishing and maintaining repayment plans. These payments provide the counselor with an incentive to enroll consumers who will make payments on the plan. Creditors also monitor the characteristics of consumers enrolled in DMPs to ensure that consumers are enrolled only where appropriate, that is, when a consumer's participation in the plan increases the expected value of payments they are able to make relative to the outcome expected if the consumer was not enrolled in the plan. Ideally, the interests of creditors, counseling agencies, and consumers align when agency screening and other efforts

[11] For example, Mayer, et al. (2011) report that, all else equal, the adoption of a mortgage modification program for some of Countrywide's customers may have encouraged some borrowers to fall behind on their mortgage payments.

result in repayment plans with a high likelihood of completion for eligible borrowers, enabling consumers to repay debt under more favorable terms than the original contract and avoid bankruptcy.

Over time, however, for a variety of reasons described in the next section, creditors' confidence in the ability of counseling agencies to effectively screen consumers has diminished. Creditors have responded in a number of ways, including carrying out additional monitoring, tying fair share payments more closely to the final outcomes of DMPs, lowering fair share payments, and becoming more selective in choosing the agencies with which they collaborate. It is also possible that large unsecured creditors are devoting additional resources to negotiating bilateral workouts directly with consumers, but few data are publicly available to test this conjecture.

Similar concerns are raised about the efficacy of screening as performed by some firms engaged in debt settlement. The problem is not that effective incentives cannot be established, but rather that the revenue model used by some settlement firms was, until recently, potentially inconsistent with establishing those incentives. For their revenues, some debt settlement firms tended to rely on fees paid by consumers, and those fees often did not depend on the success associated with subsequent settlement offers. Creditors worried that such a revenue model encouraged settlement firms to be overbroad in seeking out potential clients, attracting consumers who were either capable of paying their debts or who might be able to do so under a traditional debt management plan offered by a credit counselor. This concern about a lack of screening would tend to make creditors less willing to enter into negotiations with settlement firms and possibly less generous in any offers reached through this channel.

Until recently, many settlement firms tended to collect the majority of their fees from consumers before the first settlement offer was made. This created a potential inconsistency in the timing of payments for services relative to when the primary service (a reduction in debt owed) was performed. As a result, a less than scrupulous settlement firm may not have had an

adequate incentive to engage in protracted negotiations on behalf of the consumer. In addition, much of the risk of failure remained with the consumer, who may not have been able to save a sufficient dollar amount over a sufficient period of time in order to settle a debt before a garnishment or some other shock forced the consumer out of the plan and possibly into bankruptcy.

A business model in which participation in intermediated arrangements and reimbursement are more dependent on the quality of screening (and the success of settlement negotiations) could mitigate the potential misalignment of incentives of the intermediary with respect to the interests of consumers and lenders. In other words, if the incentives are structured properly, it is possible that settlement negotiations initiated by an intermediary could be an appropriate solution for some consumers.

But an alternative to such an approach already exists in the form of the Chapter 13 wage earner plan. It enjoys the advantages of an automatic stay on collection activity and an attorney advising the consumer, as well as a trustee that approves and administers the plan. On the other hand, Chapter 13 plans are costly to administer and are not always successful. The existence of debt management plans and other privately negotiated workouts suggests that bankruptcy is not a perfect substitute for these arrangements. But in order for these private arrangements to function in ways that improve outcomes for consumers, the incentive to screen and to perform must be reasonably well managed.

3.2 Consumers' Ability to Shop for Workout Solutions

In most markets, low barriers to entry and vigorous competition make it possible for consumers to obtain high-quality services at reasonable cost. For a variety of reasons, this does not appear to be the case for debt relief services. The issues related to screening and incentives just described are compounded by the difficulties consumers face in choosing from a complicated menu of options offered by diverse providers. For most consumers, these are services obtained

just once or twice in a lifetime. As a result, consumers in financial distress often rely on the expertise of others, but they often have little or no experience in evaluating that expertise.

In some ways, the provision of debt relief services is an example of what economists call *credence goods*. In such markets, including automobile repair, consumers may not know what they really need, but they will eventually learn the value of what they get.[12] Unfortunately, this learning occurs too late to inform a good choice in the first place. Without some form of mitigation, markets for credence goods can function poorly. The result can be overtreatment, for example, costly and unnecessary repairs; undertreatment, that is, the easy repair is made even though it does not resolve the problem; or simply overcharging for the services provided. If these problems are sufficiently serious, many consumers may choose to abstain from participating in these markets altogether. The result is an inefficient quantity and quality of services provided. Such potential market failures suggest a role for government intervention, but they also suggest that effective interventions may not be easy. This problem is discussed further in Section 5.

4. (Dis)equilibrium

4.1 A Long-Run Equilibrium (1960s-1990s)

As described above, creditors historically funded the operations of nonprofit credit counseling agencies through fair share payments. These payments helped to align the incentives of creditors and agencies to ensure that agencies screened clients for suitability for enrollment in DMPs. In this way, all three parties — consumers, agencies, and creditors — benefitted from the successful completion of DMPs.[13]

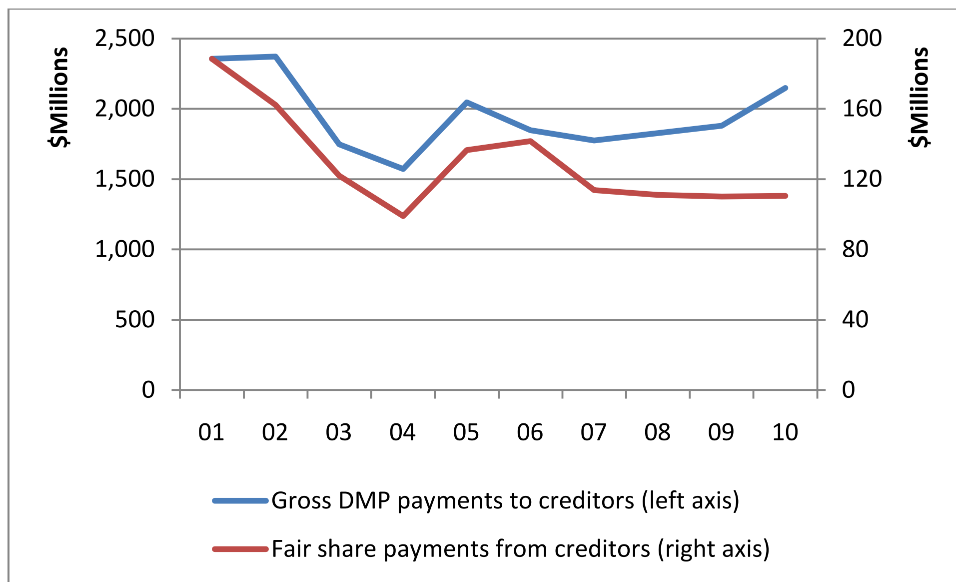
For decades, fair share was the primary source of funding for the financial education and budget counseling services that nonprofit agencies provided to all consumers who sought

[12] This description of credence goods was first articulated in Darby and Karni (1973). The discussion here is drawn from Dulleck et al. (2011).

[13] Some argue that it is possible for counselors' incentives to be too closely aligned with those of creditors. In that case, credit counselors might be reluctant to recommend that consumers seek out a bankruptcy attorney when it is the best option under the circumstances.

help, regardless of whether they enrolled in a DMP. For much of this time, approximately one-third of the clients seen by nonprofit agencies enrolled in DMPs. Nevertheless, fair share revenue derived from these consumers was sufficient to support the other services that agencies provided to all clients. Chart 3 below shows the widening gap between fair share payments to agencies by creditors and gross plan payments to creditors by agencies. In 2010, creditor contributions remained at 2009 levels, while disbursements climbed 14.3 percent to $2.15 billion.

Chart 3. Fair share payments received by NFCC member[14] agencies and gross plan payments to creditors



Source: National Foundation for Credit Counseling (NFCC).

4.2 Breakdown in Equilibrium

The long-standing equilibrium between creditors and nonprofit credit counseling agencies began to unravel in the 1990s. Traditional nonprofit agencies could not manage the increase in demand for their services that accompanied the surge in bankruptcy filings that

[14] The two major trade associations for the nonprofit credit counseling industry are the National Foundation for Credit Counseling (NFCC) and the Association of Independent Consumer Credit Counseling Agencies (AICCCA). The data in the chart are for NFCC member agencies and therefore do not span the entire nonprofit credit counseling industry.

occurred in the middle of the decade.[15] New entrants emerged to meet this demand by offering debt management plans on a much larger geographic scale. They could do this by relying heavily on counseling provided via telephone and the Internet. Creditors found themselves approached by many new agencies that had developed outside the traditional framework in which credit counseling had been offered via in-person sessions and having a local brick-and-mortar presence mattered. Many of the new entrants competed on price and volume by offering DMPs through call centers with national coverage. [16]

In many ways, the adoption of call centers and Internet delivery created both efficiencies and greater scale economies in the provision of some credit counseling services. When done well, credit counseling provided at a distance appears to be about as effective as in-person counseling.[17] Nevertheless, during the 1990s, these technologies were combined with heavy advertising to produce a different business model practiced by some of the newer counseling agencies. Unlike many credit counselors, these organizations focused almost exclusively on the provision of debt management plans. In addition, some of these organizations relied much more heavily on fees charged to consumers, rather than on fair share payments provided by creditors. This likely reduced their incentives to screen consumers' eligibility for enrolling in DMPs. Over time, creditors became concerned that not all consumers being signed up for DMPs actually needed assistance. If true, creditors would lose profits by making concessions but would not necessarily reduce losses resulting from defaults.

Creditors eventually responded to the surge in DMP proposals and concerns about the adequacy of screening. Fair share contributions became less generous over time, falling from a range of 12 to 15 percent during the 1990s to 8 percent in 2001 and to 5 percent in 2010. Creditors also revised their fair share models so that payments would depend on consumers'

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[15] See Hunt (2005) for a discussion of this history.

[16] See Staten (2006).

[17] Evidence for this perspective is found in Barron and Staten (2011a).

completion of debt management plans. Over time, fair share payments were no longer adequate to cover the non-DMP services provided by many credit counselors. Some creditors responded to this concern by establishing a program of grants to fund those activities.

4.3 Disruption Due to the Financial Crisis

For a period of time in the mid-2000s, many consumers with substantial unsecured debts had access to an attractive alternative to a DMP: the equity in their homes. Rapid appreciation in home values combined with low interest rates and relaxed credit underwriting standards made it possible for millions of consumers to pay off credit cards and other debts via cash-out refinancing of their home mortgages. At the peak of the real estate cycle in 2006, consumers used new mortgage debt to retire $175 billion in nonmortgage debt (about 2 percent of outstandings).[18] To put this number in perspective, American consumers had borrowed against their home equity in an amount equal to almost a year's worth of payments on their nonmortgage debt.

As real estate values peaked and then began to fall, this safety valve began to close in 2007. Many consumers were now faced with difficulties paying their mortgage as well as their other debts. This difficulty was reinforced by the subsequent contraction in economic activity as the financial crisis took hold. The U.S. economy experienced the largest persistent decline in the supply of private credit since World War II. This contributed to a deep recession, with the highest persistent rates of unemployment since the 1930s. Eventually, consumers began to default at unprecedented rates, initially concentrated in mortgages and subsequently affecting most forms of consumer credit. Nearly $70 billion in nonperforming credit card loans were

[18] These estimates are from Haver Analytics, based on the methodology of Greenspan and Kennedy (2005).

charged off in 2009.[19] For most consumers, home equity loans and unsecured consolidation loans were no longer available alternatives to filing for bankruptcy or entering into foreclosure.

4.4 Limitations of the Prevailing Workout Options

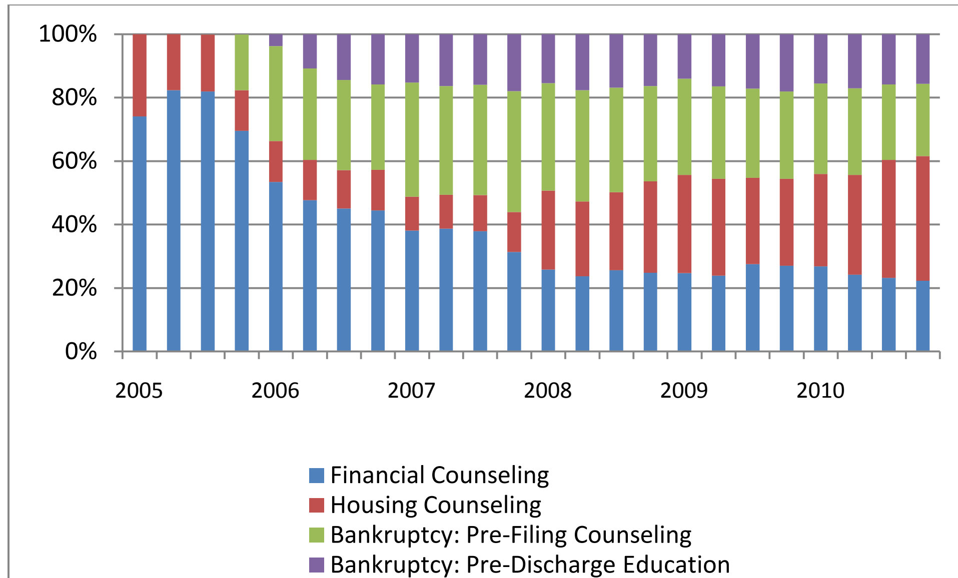
4.4.1 The changing mix of services provided by credit counselors

Over the last six years, in response to these and other shocks, credit counseling agencies have developed a more diverse line of product offerings. Nevertheless, important gaps remain. Recent legislation has resulted in an increasing share of nonprofit agencies' resources being devoted to mandatory credit counseling provided to consumers before they file for bankruptcy and mandatory financial education courses before their debts are discharged in bankruptcy. Additional resources are being devoted to voluntary pre-purchase mortgage counseling as well as foreclosure prevention programs.

Today, nonprofit credit counseling organizations devote the majority of their resources to housing counseling and bankruptcy counseling (Chart 4). In 2005, there were four ordinary budget counseling sessions for every housing counseling session. Within a year of the passage of BAPCPA, counseling and financial education sessions related to bankruptcy accounted for the majority of counseling sessions. As the real estate crisis worsened, housing counseling began to account for an increasing share of sessions. By 2010, ordinary budget counseling sessions accounted for only one in five sessions provided by nonprofit credit counselors, a nearly complete reversal of the pattern five years before.

[19] These are the charge-offs of credit card loans held by banks and loans held in asset-backed securities, as calculated by the Payment Cards Center for its "Consumer Credit Snapshots," which can be found at www.philadelphiafed.org/payment-cards-center/tools-for-researchers/consumer-statistics/.

Chart 4. Mix of counseling sessions offered by NFCC member agencies, 2005-2010

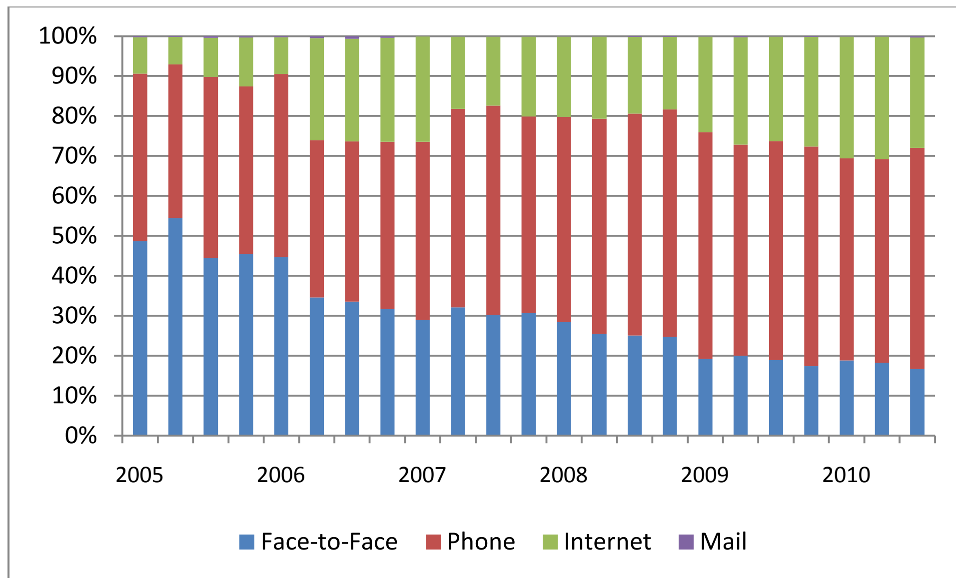


Source: National Foundation for Credit Counseling (NFCC).

Note: The data are for NFCC member agencies and therefore do not span the entire nonprofit credit counseling industry.

As noted earlier, delivery of counseling services via phone and the Internet became more common in the 1990s. Among NFCC member agencies as recently as 2005, about half of all counseling sessions were conducted face-to-face (Chart 5). This changed rapidly with the expansion of mandatory counseling sessions required prior to filing for bankruptcy. Only one in five counseling sessions is conducted face-to-face today. About one-half of pre-filing counseling sessions and about two-thirds of pre-discharge financial education sessions were conducted via the Internet in 2010. Almost one-fifth of housing counseling sessions were conducted over the Internet in 2010, compared to less than 5 percent in 2009.

Chart 5. Change in service delivery channel for NFCC member agencies, 2005-2010



Source: National Foundation for Credit Counseling (NFCC).

Note: The data are for NFCC member agencies and therefore do not span the entire nonprofit credit counseling industry. The percentage of counseling sessions conducted by mail is insignificant.

4.4.2 Debt management plans (DMPs) do not meet all needs

A 2006/2007 survey of financial counseling outcomes administered by the National Foundation for Credit Counseling (NFCC) and the Association of Independent Consumer Credit Counseling Agencies (AICCCA) found that 30 percent of clients could not qualify for a DMP because of insufficient income. More recent data from one of the member agencies that participated in the survey shows a decline in the percent of counseled consumers entering DMPs from 18 percent in 2005 to 6.5 percent in 2009. The agency also reported that in the first six months of 2009, nearly 60 percent of consumers seeking its assistance cited unemployment and reduced income as the reason.

Even at concessionary rates, some consumers could not repay 100 percent of principal over a maximum period of five years, as required with a DMP. Under existing regulatory guidelines, this amortization requirement cannot easily be relaxed unless the creditor is willing to

recognize the loan as impaired and write off a portion of the accumulated balance.[20] Creditors are generally unwilling to write down principal on debts included in a DMP. To date, this has been a limiting factor in introducing new workout products offered by credit counseling agencies. In other words, consumer financial conditions and debt relief needs had reached a point where workouts hit the regulatory constraints for treating loans as collectible on bank balance sheets. The consequence of consumers' relatively high leverage and DMPs operating at the boundary of regulatory guidance is that a higher share of consumers was being turned down for DMPs.

4.4.3 This product gap provided an opportunity for entry of for-profit firms

The lack of products available to serve the growing number of consumers who could not qualify for the traditional DMP has provided an opportunity for the entry of for-profit firms offering alternatives to debt management plans. In particular, this opportunity has been seized by debt settlement companies whose activities have grown considerably in recent years. Debt settlement firms promise to reach less-than-full-balance payment agreements with consumers' creditors, and consumers have responded to the heavy advertising employed by some of these firms.

There is relatively little information on the size of the debt settlement industry, the number of consumers who have entered into contracts with settlement firms, and the outcomes of those relationships. The most complete compilation of information available to the public is found in the submissions to the Federal Trade Commission for its recent revision to the Telemarketing Sales Rule (which is described in the next section).[21] Based on the information contained in this record, it appears that many thousands of consumers have entered into a contract with a debt settlement firm and a portion of these consumers have experienced a settlement of at

[20] See Retail Credit Classification Policy, Attachment 1 in "Uniform Retail Credit Classification and Account Management," 65 *Federal Register* (June 12, 2000), pp. 36903-36906 (http://ithandbook.ffiec.gov/media/resources/3677/occ-bl2000-20_ffiec_uniform_retail_credit_class.pdf) and "Account Management and Loss Allowance Guidance for Credit Card Lending," OCC 2003-1, January 8, 2003 (http://ithandbook.ffiec.gov/media/28315/occ-bl2003-1_account_manag_loss_allow_guid.pdf).

[21] This information is summarized in 75 *Federal Register* (August 10, 2010), pp. 48458-48523.

least one of their debts. In the aggregate, at least several tens of thousands of accounts have been settled. But there is considerable uncertainty about the magnitude of the debt forgiven, in part because of disagreements about how those savings should be calculated. Calculating the net savings to financially distressed consumers requires a comparison of the reduction in debt obtained (measured appropriately) and the fees consumers pay for the services provided by settlement firms.

The record amassed by the Federal Trade Commission (FTC) also suggests some significant potential concerns about the efficacy of the debt settlement model as it was being practiced by at least some firms at that time. For example, while there is considerable uncertainty about the exact proportions for the industry as a whole, it appears to be the case that a number of settlement firms experience dropout rates of 60 percent or more of their customers. According to information obtained by the FTC, some consumers who dropped out of settlement programs did have at least one debt settled, but in many instances, the fees paid by those consumers largely offset the debt reduction obtained. Even among consumers who did not drop out, it appears that the costs associated with those plans were large, and probably much larger relative to those incurred in Chapter 13 repayment plans — about 15 to 30 percent of the debt retired.[22]

While a DMP is a collective solution among borrowers, credit counseling agencies, and creditors, debt settlement is a relatively more adversarial practice. Since most distressed consumers do not have the cash flow to simultaneously pay their creditors and fund settlement offers, consumers typically stop paying their creditors in order to build a reserve of cash to pay settlement offers negotiated on their behalf by debt settlement companies. This may expose consumers to additional collection efforts by their creditors.[23] One of the advantages of a debt management plan is that participating creditors voluntarily refrain from taking legal action against

[22] These statistics are reviewed on pp. 48471-48474 of 75 *Federal Register* (August 10, 2010).

[23] Of course some, and possibly many, consumers may have ceased making payments on their unsecured debts before entering into agreements with debt settlement companies.

the consumer because they understand that such action would make it unlikely that the consumer could complete the plan.

The materials obtained by the FTC also suggest concerns about the nature and content of advertising as practiced by some debt settlement firms. In addition, in recent years, there have been a considerable number of enforcement actions against specific firms at the state and federal levels.[24] This raises the concern that relatively low barriers to entry, combined with consumers' difficulty in evaluating providers, may contribute to opportunistic behavior in the debt relief industry.

4.5 New Terms on Traditional Products

To address the needs of financially distressed consumers who have too much debt and too little income to qualify for the traditional debt management plan offered by nonprofit credit counseling agencies, in the fall of 2008, the NFCC issued its Call to Action (CTA), which asked creditors to offer debt management plans with deeper concessions. Rolled out in stages beginning in the spring of 2009, the Call to Action DMP was designed as a repayment vehicle for consumers who needed debt relief but could neither afford nor maintain a traditional DMP. The creditor concessions under the Call to Action DMPs included two tiers of monthly payments, a standard program offering a maximum monthly fixed payment of 2 percent of the outstanding balance and a hardship program with a maximum monthly fixed payment of 1.75 percent of the outstanding balance. Under both the standard and hardship programs, the annual percentage rate assigned to the plan must liquidate the enrolled balance within the 60-month regulatory guideline. The top 10 credit card issuers in the U.S. agreed to participate in the Call to Action, and the NFCC and AICCCA formed a strategic partnership to work with creditors to offer the plans through their member agencies. As with any new endeavor with multiple participants, there were coordination difficulties, including the implementation of a new selection criteria and the timing

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[24] A partial list of these actions can be found on pp. 48509-48516 of 75 *Federal Register* (August 10, 2010). See also U.S. Government Accountability Office (2010).

of when counseling agencies were operationally prepared (due to the necessary changes in their IT systems) to offer the new plans. There was no pilot testing of the Call to Action plans, and to date, there has not been an evaluation of the CTA to determine if consumers enrolled in CTA DMPs performed better than those enrolled in standard DMPs. In other words, did deeper concessions offered to the most distressed consumers make a difference? The lack of pre-launch pilot testing and post-launch evaluation of the Call to Action DMPs could be viewed as a missed opportunity to inform the design of future products.

Even with the Call to Action in place, it may still be the case that there is a missing product in the credit counseling portfolio to help those consumers who cannot qualify for a DMP, particularly if the CTA expires as economic conditions improve. To address this product gap, in 2009 a task force composed of NFCC and AICCCA member organizations and large credit card issuers was formed to create and pilot a less-than-full-balance product that would satisfy regulatory requirements and to which issuers would agree. The crucial questions for policymakers and industry participants include: should less-than-full-balance settlements outside of bankruptcy exist, and if so, why? If it is agreed that there is a need for such a product, how should incentives be aligned, and how should it be regulated?

5. Changing Regulatory Structure

For a long period of time, the distinction between for-profit and nonprofit organizations at both the state and federal levels was extremely important for understanding the debt relief industry and its regulation. Over the last 100 years, the locus of debt relief services regulation has been at the state level, where state laws addressed nearly all forms of these services. During the 1950s, however, a new pattern emerged in which most states prevented businesses from providing debt relief services for profit. At the same time, the new laws included exceptions that allowed for the development of a nonprofit model recognized today as consumer credit counseling services. For-profit businesses offering debt management plans eventually reemerged

in the 1990s and a number of states permit them to operate. The recent trend, at least in some states, has been the adoption of regulatory models that treat for-profit and nonprofit businesses in more similar ways.

At the federal level, the primary regulatory actors with respect to debt relief services include the Federal Trade Commission (FTC) and the Internal Revenue Service (IRS). The former engages in case-by-case enforcement of for-profit debt relief firms by using its powers to prevent unfair or deceptive acts or practices (UDAP). The FTC's authority does not apply to nonprofit organizations, and so the distinction between the for-profit and nonprofit status of providers remains important at the federal level. The FTC relies extensively on the precedent established via case-by-case enforcement because, with only a few exceptions, it is especially difficult for the FTC to establish consumer protections against unfair and deceptive acts and practices via rulemaking. The IRS governs the granting of tax-exempt status to agencies and conducts audits, and it can revoke an agency's federal nonprofit status if it finds that the agency is not operating for charitable purposes.

During the 1990s, the FTC took action against a number of organizations that enjoyed nonprofit status. To do so, it had to prove that these organizations were, in fact, operating as for-profit businesses. Starting in the early 2000s, the IRS began actively reviewing the nonprofit status of established credit counseling organizations and examining more thoroughly firms' new applications for nonprofit status.[25]

The most recent development affecting the debt relief industry is the creation of the Consumer Financial Protection Bureau (CFPB) as part of the Dodd-Frank Act of 2010. This effectively concentrates federal rulemaking authority over nonprofit and for-profit debt relief organizations in a single agency. In addition, it will be easier for the CFPB than it was for the FTC to write rules to prevent unfair or deceptive acts or practices because the CFPB will be able to use the Administrative Procedure Act to create rules and regulations to enforce legislative acts.

[25] For additional details on these efforts, see U.S. Senate (2005).

5.1 State Laws

States have enacted a myriad of laws governing the debt relief industry. Most state regulation was originally designed to address the roles played by credit counselors. The Uniform Debt-Management Services Act of 2005 sought to address the recent entry of for-profit credit counselors and debt settlement firms and to harmonize state regulation of participants in the debt relief industry.

A variety of state laws impose requirements as well as restrictions on the activities of credit counseling organizations. These laws are not uniform across states. State-level approaches to regulation include registration of agencies that provide debt management services. In the majority of states, credit counseling agencies must file a corporate registration to transact business. In addition, in most states, a corporation must maintain a registered office and agent and is required to pay annual fees and to submit annual reports about its activities. In 35 states, nonprofit credit counseling agencies are also subject to state charitable registration rules that govern the fiduciary duties of the organization's directors. These rules vary across states and can include annual financial reporting requirements.

The majority of state laws pertaining to credit counseling agencies address the practices of debt management plans. Most states require licensing for providers of debt management services. However, in some states, nonprofit credit counseling organizations are exempt from licensing and registration requirements. There is heterogeneity in the licensing requirements and restrictions across states. The requirements can include posting of bonds that range in value from several thousand to several hundred thousand dollars, depending on the state and the size of the organization. Additional requirements can include providing consumers with written contracts and maintaining consumer payments in separate trust accounts. Licensing restrictions may include prohibiting licensees from lending money to consumers, operating as a debt collector, offering legal advice to consumers, and making false, misleading, or deceptive statements in advertising.

State regulations often include limits on fees that can be charged to consumers for setting up and maintaining (participating in) debt management plans. The caps vary by state and can range from fixed amounts for plan set-up and monthly fees, to percentages of the monthly DMP payment amount, to recovery of "bona fide and reasonable" costs. A handful of states, including Indiana, Nebraska, Nevada, New Hampshire, New York, and South Carolina, also impose a cap (in months) on the term of a DMP. In some instances, the term limit is many months shorter than the standard 60-month term of a DMP. For example, the term cap is 24 months in Indiana and 36 months in both Nebraska and Nevada and necessitates the renegotiation of DMPs. This is one example of heterogeneous regulations affecting agencies that operate in multiple states.

5.1.1 Uniform Debt-Management Services Act

In July 2005, the National Conference of Commissioners on Uniform State Laws (NCCUSL) drafted the Uniform Debt-Management Services Act (Uniform Act or UDMSA) in an effort to provide a standardized approach to the rules that govern debt management service providers, that is, credit counseling agencies and debt settlement companies.[26] As of May 2011, the Uniform Act was the model code in effect in six states.[27] Registration of service providers, agreements between service providers and debtors, and enforcement are the three areas addressed by the UDMSA. In each state, a service provider must register as a consumer debt management servicer; registration requires a servicer to provide information about the organization's finances, directors, service locations, operating history in other jurisdictions, and a sample agreement with debtors.

[26] A summary of the UDMSA, including its purpose and state adoptions, can be found at www.udmsa.org. The complete text of the Uniform Act can be accessed at www.uniformlaws.org/Act.aspx?title=Debt-Management%20Services%20Act.

[27] Delaware adopted the Uniform Debt-Management Services Act in January 2007, followed by Rhode Island (March 2007), Utah (July 2007), Colorado (January 2008), and Nevada and Tennessee (July 2010). For-profit debt settlement companies are banned from operating in Arkansas and Wyoming.

The registration process also requires service providers to maintain an insurance policy in an amount of not less than $250,000 against fraud and theft and a security bond of at least $50,000 for which the state administrator is the beneficiary. Yearly renewal of certification to operate is required. However, proof of registration in one state can satisfy the registration requirements in another, under certain circumstances.

Service provider agreements with debtors must contain disclosures about the services offered, the fees associated with those services, and the risks and benefits of entering into an agreement. The services offered must include counseling services provided by a certified counselor or certified debt specialist and creation of a plan. The Uniform Act sets the terms for the contents of agreements and their fees. Debtors are granted a three-day right of rescission without penalty and may also cancel the agreement after 30 days with the possibility of incurring fees. The agreement may be terminated by the service provider if plan payments are 60 days or more delinquent. Additional requirements include accounting and reporting procedures for debtor payments to creditors, which must also be maintained in separate trust accounts.

With respect to enforcement, the Uniform Act prohibits a settlement with a creditor for more than 50 percent of a debt without the debtor's consent and representation of a settlement without creditor certification. State administrators have enforcement powers to investigate, issue cease-and-desist orders, assess civil penalties of up to $10,000, and bring civil action. The Uniform Act also grants enforcement authority to individuals in the form of a private right of action, which has a statute of limitations of two years.

Even among states that have adopted the Uniform Act, there are a variety of approaches to the regulation of debt settlement fees. For example, Colorado and Delaware place a cap on fees equal to 18 percent of the debt enrolled and require fees to be distributed over half the life of the debt settlement program. Utah, Tennessee, and Nevada cap fees at 17 percent of the debt enrolled while also allowing a "savings model" option under which fees are limited to 30 percent of the savings realized by the program.

5.1.2 State UDAP statutes

Consumer protection laws at the state level also include unfair and deceptive acts and practices (UDAP) statutes that prohibit deceptive practices in consumer transactions with businesses. However, the scope, prohibited practices, enforcement authority, and consumer remedies of UDAP laws vary across states. Many state UDAP statutes were passed in the 1970s and 1980s and often relied on categories of prohibited practices in the Federal Trade Commission Act of 1938. State UDAP laws provide state agencies with the authority to enforce these prohibitions and seek relief in the form of an injunction against unfair or deceptive practices, restitution of money wrongfully taken from consumers, and imposition of a monetary civil penalty on businesses for engaging in unfair or deceptive acts and practices. In addition, state agencies also have rulemaking authority in 27 states. However, limiting factors include the scope of each state's UDAP statute (that is, the industries to which it applies) and limited enforcement budgets relative to the size of some markets.[28]

5.2 Federal Laws

At present, there is no comprehensive federal regulation of the debt relief industry. Therefore, debt relief service providers must comply with a variety of federal laws administered by different federal agencies, including the Internal Revenue Service, the Department of Justice, and the Federal Trade Commission. Recent developments in the form of the Consumer Financial Protection Bureau will eventually change the regulatory oversight of participants in the debt relief industry.

5.2.1 IRS 501(c)(3) status and 501(q)

The tax-exempt status of nonprofit credit counseling agencies is governed by section 501(c)(3) of the Internal Revenue Code, which requires that agencies operate for exempt educational purposes. Counseling and education became the focus of 501(c)(3) exemption in

[28] For an assessment of each state's UDAP statutes, see Carter (2009).

2005 after the practices of several credit counseling agencies were found to violate their tax-exempt status. The IRS implemented an audit/examination program of counseling industry participants as well as a review process for new applications from organizations applying for tax-exempt status. Under the Pension Protection Act of 2006, the IRS issued guidance under section 501(q) of the Internal Revenue Code and its core analysis tool (CAT) to provide additional operational criteria for obtaining and maintaining tax-exempt status.

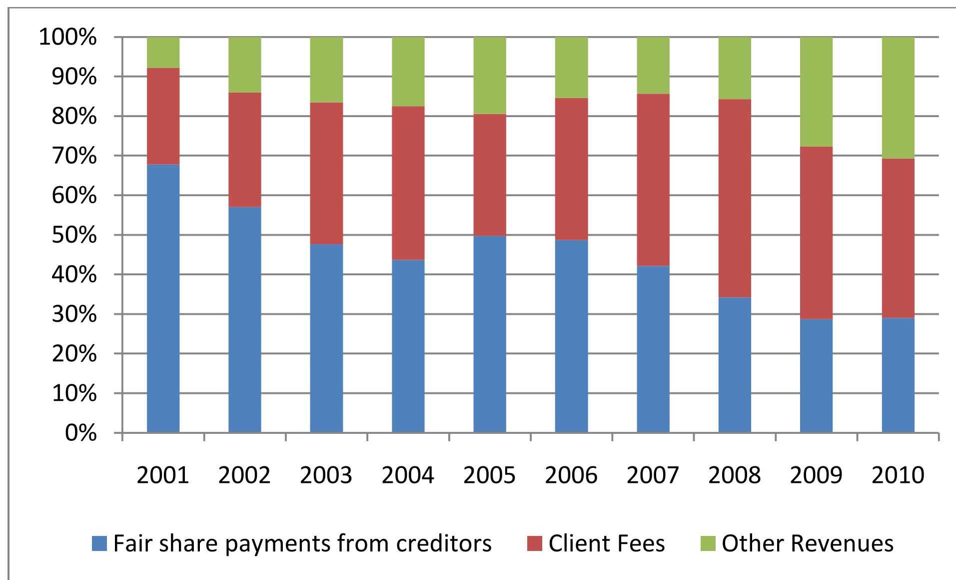
Among the provisions of the CAT, the focus of a nonprofit credit counseling organization's activities must be financial counseling and education. The counseling sessions provided by nonprofit agencies must incorporate a detailed review of a client's budget and finances and a presentation and evaluation of options tailored to a client's particular circumstances. Counselor training and evaluation are also components of the CAT. Nonprofit agencies may advertise their services, but the emphasis must be placed on their counseling and debt management services.

Under CAT, nonprofit agencies must provide service regardless of consumers' ability to pay or ineligibility or unwillingness to enroll in debt management plans. Prohibitions against making loans to or negotiating loans on behalf of clients, engaging in credit activities, or paying or receiving referral fees are also among the additional standards. With respect to fees, they must be "reasonable," which can be determined by state fee caps, and may not be based on a percentage of a client's debt, plan payments, or savings due to enrolling in a DMP, unless permitted under state law.

The law that implemented these changes includes a provision with significant implications for the funding model of nonprofit credit counseling agencies. The law places a cap on the fair share revenue that agencies can receive from creditors. For existing nonprofit organizations, the cap was phased in beginning in 2008 and limits the percentage of total agency revenues provided by creditors in support of DMP services. Fair share may not exceed 80 percent of an agency's total revenue in 2008, 70 percent in 2009, 60 percent in 2010, and 50

percent in 2011 and thereafter. In response, several creditors now provide agencies with grants that are not covered by the cap, unless tied directly to the provision of DMP services.

Chart 6. Distribution of funding sources for NFCC member agencies, 2001-2010[29]



Source: National Foundation for Credit Counseling (NFCC).

Note: The data are for NFCC member agencies and therefore do not span the entire nonprofit credit counseling industry.

As shown in Chart 6, over the last decade, fair share payments have declined as a share of funding at nonprofit counseling agencies. Client fees from pre-bankruptcy filing counseling sessions and pre-discharge financial education courses, as well as federal funding for housing counseling, have gained in importance over time. Thus, in addition to evolving market conditions, the Pension Protection Act of 2006 has increased the need for nonprofit credit counseling agencies to diversify their funding base. Their success in doing so will depend

[29] The Other Revenues category includes federal government grants to fund housing counseling services. Note that funds for the U.S. Department of Housing and Urban Development's Housing Counseling Program grants were zeroed out of the FY 2011 federal budget.

significantly on their ability to demonstrate the value and efficacy of the services they provide. This point is discussed further in Section 6 below.

5.2.2 BAPCPA mandates administered by the Department of Justice

Debt relief organizations are subject to certification by the Executive Office for U.S. Trustees (EOUST) in the Department of Justice to provide pre-filing credit counseling and pre-discharge debtor education mandated under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). As discussed in an earlier section of the paper, these mandates have contributed to the increase in demand experienced by credit counseling agencies and a shift in the distribution of counseling services offered.

5.2.3 UDAP type prosecution by the Federal Trade Commission

The Federal Trade Commission enforces consumer protection through Section 5(a) of the FTC Act, which declares unlawful and broadly proscribes "unfair or deceptive acts or practices in or affecting commerce."[30] In addition, the FTC currently has enforcement authority over most nonbank entities for numerous consumer protection statutes, including the Telemarketing Sales Rule (described below), "that prohibit specifically-defined trade practices" and treat violations as "unfair or deceptive" acts or practices. The FTC enforces these laws through a combination of administrative and judicial processes.[31]

While the UDAP remedy is a valuable and flexible one, there are limitations to its case-by-case approach. This type of enforcement is a reactive remedy. In addition, there is a fairly high evidentiary burden to establishing that a firm's activities are unfair or deceptive. Many cases require a demonstration of a pattern or practice, and this can delay prosecution under this

[30] Such practices are defined as "those that cause or are likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition."

[31] For a summary of these processes, see "A Brief Overview of the Federal Trade Commission's Investigative and Law Enforcement Authority," available on the FTC's website www.ftc.gov/ogc/brfovrvw.shtm. See Posner (2010) for a discussion of the ways in which the FTC's powers and processes are unique for a federal agency.

law. Cases are also expensive to litigate. Relative to the size of this rapidly growing market, the resources available for this type of enforcement are modest, and this limits the number of cases that can be prosecuted each year. Finally, since barriers to entry and exit appear to be relatively low in the debt relief industry, the deterrence effect of using successful prosecutions to prevent bad practices may not be as great as in other industries. For enforcement to keep pace with the recent scalability of activities in the debt relief industry, it may prove necessary to apply more general principles generated from specific cases to lower the cost of prosecution. However, this is difficult without rulemaking authority.

5.2.4 Amendments to the FTC's Telemarketing Sales Rule

Under the Telemarketing Sales Rule, the FTC enjoys rulemaking authority using the Administrative Procedure Act (APA).[32] The Federal Trade Commission promulgated amendments to the Telemarketing Sales Rule (TSR) in July 2010 to create regulations to address alleged deceptive practices in the sale of debt relief services. The amendments to the TSR define "debt relief service" to encompass for-profit credit counseling, debt settlement, and debt negotiation. The FTC does not have jurisdiction over nonprofit credit counseling organizations. The FTC addressed information problems associated with debt settlement in the TSR by requiring better disclosures of the benefits and consequences of the debt settlement option and tackled incentive issues by requiring the back-loading of compensation.

The most notable change to the rule went into effect in October 2010 and affects the timing of the imposition and collection of fees under an advance fee ban. Under the rule, no fees can be collected from a consumer until a settlement company obtains the consumer's consent to a settlement offer and the consumer has made at least one payment on the debt. This amendment attempts to better align the collection of fees with documented provision of service (e.g., proof of

[32] Typically, U.S. federal regulatory agencies can use the APA to create rules to implement and enforce major legislative acts. The FTC is an exception in that, in a number of instances, it must use a relatively more cumbersome process to promulgate rules. For a detailed discussion of the history of FTC rulemaking authority for unfairness, see Beales (2003) and Beales and Muris (1991).

settlement) and is an attempt to improve incentives. Like fair share, this amendment attempts to implement a form of pay-for-performance.

Three additional provisions in the amended rule took effect in September 2010. First, the coverage of the TSR was extended to include inbound telemarketing calls for debt relief service (i.e., calls in response to advertising). Outbound calls are already subject to the rule. Second, the rule also includes new disclosure requirements that are specific to debt relief telemarketing: the cost and other terms of the service; the amount of time necessary to achieve the represented results; the amount of money or percentage of each debt that must be accumulated by the customer to make settlement offers to creditors; the consequences consumers can face if they stop paying their creditors (including legal action by their creditors and damage to their credit report and score); and consumers' rights with respect to dedicated accounts in which funds to pay debts are held. Third, the amendments to the rule prohibit misrepresentations about any material aspect of debt relief service that would affect consumers' decision about choosing a program, such as savings claims, nonprofit status claims, and success rates claims.

5.3 Recent Developments in the Regulatory Arena

5.3.1 The Consumer Financial Protection Bureau

The Dodd-Frank Act consolidates federal rulemaking, examination, and enforcement authority over large bank providers and nonbank providers of consumer credit, debt collection firms, credit counseling agencies, and debt settlement firms under the Consumer Financial Protection Bureau (CFPB).[33] Under the Administrative Procedure Act, the CFPB will have the power to define by rule unfair, deceptive, and "abusive" practices and, in many instances, will have enforcement authority over such practices. Consequently, the CFPB could potentially rely more heavily on rulemaking to deter opportunistic behavior than could the FTC. In addition, the

[33] See Title X of Public Law 111-203.

CFPB is likely to enjoy considerable resources it can devote to supervision and enforcement among nonbank providers of financial services.

Under Dodd-Frank, the CFPB and the FTC will have concurrent enforcement authority over for-profit debt relief service providers and the two agencies are required to coordinate their enforcement efforts. A Memorandum of Understanding establishing this coordination is expected by January 21, 2012. The CFPB will have exclusive authority over nonprofit providers. The FTC will retain its authority to prohibit unfair or deceptive acts or practices under Section 5(a) of the FTC Act. However, the reach of the CFPB will be somewhat broader through the addition of "abusive" to its authority to prohibit unfair, deceptive, or abusive practices. In many ways, then, the CFPB will have more resources and tools at its disposal in the oversight of debt relief service providers.

5.3.2 Proposed legislation

At its annual meeting in July 2011, the National Conference of Commissioners on Uniform State Laws considered amendments to the Uniform Act to eliminate inconsistencies with the recent amendments to the Telemarketing Sales Rule. In particular, the proposed amendments to the Uniform Act address timing of compensation and regulation of trust accounts. To conform to the TSR's advance fee ban, provisions in the Uniform Act to be eliminated include the three-day right of cancellation and the return of all advance fees, and the provision that permits the collection of set-up and monthly fees by a debt settlement firm. Proposed revisions include aligning the timing of compensation to a debt settlement firm with the payment to a creditor of money that settles a debt and the timing of the payment of set-up and monthly plan fees to a credit counseling agency after a consumer begins making plan payments.

6. Research and Evaluation

6.1 Organizational and Methodological Challenges

Going forward, it is extremely likely that the design and supply of loan workout products will depend on the evidence of their efficacy. Creditors will require such evidence to determine under which circumstances to offer repayment alternatives and the terms of those plans. In addition, regulators require proof that loan modification efforts address borrowers' financial problems and not simply delay loan loss recognition. Therefore, the need for careful assessments of credit counseling services could not be greater.

In evaluating existing products and treatments and designing new ones, counseling agencies and policymakers must develop a deeper understanding of how consumers make decisions about incurring and repaying debt and the long-run impact of those choices. Historically, however, consumer credit research has tended to focus on the bankruptcy decision. Relatively few studies examine what happens to financially distressed borrowers who have not filed for bankruptcy and the efficacy of the alternatives available to them.

Despite the importance of evaluating the benefit and cost of the options available to financially distressed consumers, to date, there have been few rigorous studies documenting the value to consumers of credit counseling. In part, that is because there are organizational and methodological challenges to conducting this research. Among the organizational impediments has been the inability to access the necessary data for rigorous analysis. Until recently, there has been little systematic data available to researchers about which consumers seek assistance, what treatments they receive, and the outcome of those treatments. In addition, tracking borrower outcomes is difficult because, typically, researchers know little about those who are not treated. Finally, counseling agencies lack information from creditors on account performance, and without that information, the opportunity for learning through a systematic feedback loop is lost.

An important methodological impediment has been the reluctance to employ the best research designs used for decades in other disciplines, such as medicine. These are randomized controlled experiments.[34] Without such an approach, researchers can't clearly distinguish between the role of treatment and selection in evaluating outcomes. Is it the treatment that counseling agencies provide that influences consumer outcomes or the kind of consumers that agencies attract? The distinction between the effects of counseling from borrower motivation is critical for policy analysis and better product design.

Some counseling agencies have been reluctant to participate in randomized controlled trials due to concerns that the experiments might represent denial of service if the same standard of treatment is not offered to all clients and at the time help is requested. Randomization applied along two margins might address these ethical concerns. First, experiments can be designed to randomize the assignment of clients into two treatment groups: one that receives the standard treatment and another that receives an enhanced version of the standard treatment. In this way, nothing is being denied to consumers, and the value of the incremental treatment can be ascertained. Second, for capacity-constrained counseling organizations, experiments can be designed to randomize service delivery to fairly allocate the scarce counseling resource so that consumers are not turned away. In either case, a successful trial of a new treatment helps to build the case for the resources necessary to implement it more widely.

To conduct a randomized controlled experiment, it is necessary to compare counseled consumers to observationally similar borrowers who do not receive counseling, and creating these sample populations is not easy. Although it is difficult, some research on the effects of credit counseling has been conducted. For example, Elliehausen et al. (2007) found that credit counseling improves credit bureau profiles measured several years after counseling, even for clients who received only financial counseling and did not enroll in a DMP. For clients who are

[34] See the study by Finkelstein et al. (2011) in which the researchers used a randomized controlled design to gauge the effects of expanding access to Medicaid for low-income adults.

advised to enroll in a DMP and who in fact start a DMP, Barron and Staten (2011a,b) provide evidence that these clients have a significantly lower incidence of bankruptcy and experience a significantly greater increase in credit risk scores in the subsequent four years than those who are recommended for a DMP but do not enroll in a plan.

However it is conducted, rigorous assessment of counseling outcomes is vital for making good policy decisions and for the future of the industry. The most robust studies would incorporate data from several sources and would follow consumers for a period of time after they sought counseling and provide a picture of clients' circumstances leading up to counseling. Detailed intake data collected by agencies from consumers when they seek assistance, credit bureau data to describe clients' borrowing and payment behavior, and creditor data on individual account-level performance are the ingredients for an evaluation of outcomes. In addition, a survey administered after counseling has been completed to account for changes in family structure that are not observable in the other data would be useful.[35] Developing a solid understanding of what works and why can inform the modification of product offerings, the appropriate role of government, and the optimal combination of private-public funding of debt relief services.

6.2 Understanding Consumer Financial Decision Making with Respect to Counseling

Research has recognized that, under certain circumstances, at least some consumers exhibit cognitive biases that contribute to poor decision making. Recent research attempts to identify ways that might help consumers overcome these biases.[36] Among the biases in financial decision making exhibited by consumers, the literature shows that consumers sometimes exhibit extreme impatience, especially in the short run. Frederick, Loewenstein, and O'Donoghue (2002)

[35] See Bricker et al. (2011) for a discussion of the nature of the changes experienced by families during the financial crisis and the significant extent to which family structure can change in a period of just three years.

[36] The author gratefully acknowledges the contribution to this section that has resulted from a number of conversations with Professor Jeremy Tobacman of the Wharton School at the University of Pennsylvania.

found that consumers heavily discount the future, which undermines saving plans in favor of instant gratification. Consumers also sometimes exhibit over-optimism, which can contribute to procrastination. Ausubel (1999) provided evidence of over-optimism in consumers' choices of credit cards, borrowing amounts, and duration of borrowing.

To counteract such biases and help consumers improve decision making, recent research has suggested the value of establishing and maintaining commitments to accomplish financial goals. Sometimes, employing simple solutions can often lead to significant results. For instance, enrolling a consumer in automatic ACH payments for the consumer's debt management plan is associated with a higher probability of plan completion.

The latest research is incorporating heuristics and commitment devices into credit counseling products and services and evaluating their effects. For example, Dean Karlan, of Yale University, and Jonathan Zinman, of Dartmouth College, are conducting a randomized field experiment to test the effectiveness of an intervention to support debt-reduction goals as part of counseling sessions. The intervention helps consumers identify whether they should borrow less and helps them make a concrete plan to do so, offers clients options to encourage them to commit to the plan, and sends them reminders to stay on track. Additional research by Zinman suggests that while evidence shows that many consumers struggle with financial decisions, getting and maintaining their attention about financial decisions may be at least as important as informing them through disclosures.[37]

7. Conclusion

A basic question of public policy in credit markets is whether private renegotiation of consumer debt contracts in default is complementary to, or substitutes for, the bankruptcy process. Over a half century of experience with nonprofit credit counseling in the U.S. suggests that these activities are indeed complementary. Each year, more than a million distressed

[37] See, for example, Stango and Zinman (2011).

consumers have the opportunity to at least consider an alternative to filing for bankruptcy, and a significant number do choose an alternative.

But this experience, together with the more recent experience with debt settlement firms, suggests that there are substantial issues that must be addressed in order for these private mechanisms to work properly. Among others, these issues include incomplete information, the incentives of multiple parties, and the ability of distressed consumers to shop effectively. As the last 20 years have demonstrated, these issues pose a significant challenge for consumers, creditors, the many legitimate providers of debt relief services, and regulators at the state and federal levels. These challenges are not insurmountable, but they do require adequate resources to be addressed in a systematic manner.

Debt relief services are an example of credence goods for which consumers have difficulty shopping because there are important unobservable characteristics of the service and service providers. These difficulties, combined with relatively low barriers to entry and exit, likely complicates the problem of disciplining firms and may leave consumers vulnerable to opportunistic intermediaries. In turn, enforcement efforts after the fact may not be as effective as they otherwise would be. While much more analysis is required to reach a definitive conclusion, these characteristics at least tentatively suggest that greater use of rulemaking, combined with more ample resources for enforcement, could be a more effective strategy for disciplining firms.

If private workout arrangements are to work effectively, there is a need to establish appropriate incentives for consumers, creditors, and any intermediaries involved. Financially distressed consumers have limited assets or cash flow with which to pay for coordination and expertise, especially since those are resources that come at the expense of any debt payments the consumer can make. And the willingness of creditors to offer concessions depends on their belief that concessions will make the difference between writing off an account and being repaid. This, in turn, depends on the ability of the creditor, or an intermediary such as a credit counselor or a settlement firm, to effectively screen consumers applying for relief.

A complicating factor is the speed with which these markets can change. Just a few examples of the dynamics in the debt relief industry include the adoption of new technologies that have changed economies of scale, the dramatic change in the mix of services provided and sources of funding due in part to new laws, and at times rapid entry and exit.

Finally, more research is needed to better understand why consumers become financially distressed, to inform the design of products to get them out of trouble and interventions to keep them out of trouble, and to evaluate the efficacy of the competing options available to consumers.

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