Whither Consumer Credit Counseling?

BY ROBERT M. HUNT

For more than 50 years, nonprofit credit counseling organizations have been helping consumers manage debt. Despite this long track record, credit counseling is not without controversy. In recent years, concerns about conflicts of interest and the emergence of a new type of credit counseling agency have triggered significant legislative and regulatory activity. In this article, Bob Hunt outlines the history and development of credit counseling in the United States, highlights the concerns raised about consumer protection, and describes industry, regulatory, and legislative responses.

The availability and use of consumer credit in the U.S. has grown dramatically over the last 50 years.[1] While this is undoubtedly beneficial, one consequence is that, at any time, there are a million or more consumers having difficulties in managing their unsecured debts. For a half century, nonprofit credit counseling organizations have offered financial education and budget counseling sessions for free or at nominal cost to borrowers. They also negotiate comprehensive repayment plans (debt management plans) with a borrower's unsecured creditors. These repayment plans provide an alternative to bankruptcy that is valuable to many consumers.

But credit counseling is not without controversy. The older counseling organizations rely primarily on creditors for their revenues, and this may create the appearance of a conflict of interest. More recently, many new debt counseling organizations have appeared on the scene. This new breed relies less on creditors for revenues because they charge borrowers significantly more for their services. If these higher fees are drawn from a borrower's limited reserves, he or she may have additional difficulty completing the repayment plan. In addition, creditors worry that at least some of these new organizations are not screening their clients—proposing concessions for borrowers who could have paid their debts on the original terms. This has affected how creditors work with counselors. These concerns and others have triggered significant legislative and regulatory activity in recent years.

The credit counseling industry is an important one, but its activities and effects are not widely understood. Still the available research does give us some insight into the effects of consumer credit counseling and debt management plans on borrower behavior and the implications for the industry and regulation.

Any conclusions, unfortunately, must be tentative. There are few formal studies of the contribution of credit counseling organizations, and they must wrestle with a difficult methodological problem: Do borrowers who seek credit counseling perform better because of the counseling (a treatment effect) or because they are somehow different from borrowers who don't seek counseling (a selection effect)?

BACKGROUND

Credit counseling organizations typically provide four types of services to consumers: (1) they offer consumer financial education; (2) they offer budget counseling to individual households; (3) they negotiate *debt management plans* with creditors on behalf of borrowers; and (4) when appropriate,

[1] This article was inspired by two workshops organized by the Philadelphia Fed's Payment Cards Center in 2001 and 2003. These workshops are summarized in the article by Anne Stanley and the one by Mark Furletti. I thank Patti Hasson for many helpful discussions. Chris Ody and Paul Weiss helped me compile the data for this article.

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they refer consumers to other support organizations or recommend that they seek advice about a bankruptcy filing.

A debt management plan is a schedule for repaying all of the borrower's *unsecured* debts over three to five years.[2] Ideally, the credit counselor is able to include all of the borrower's unsecured creditors in the plan. While the principal is repaid in full, creditors typically reduce interest rates and other charges. Creditors are sometimes willing to *re-age* accounts in a debt management plan. In other words, assuming plan payments are made, the creditor considers the account as current and reports it this way to credit bureaus. This improves the borrower's payment history and credit rating.

An essential feature of the benefit credit counselors offer is the ability to coordinate the concessions made by a borrower's creditors. Of course, borrowers can negotiate with individual creditors, but they must overcome each creditor's concern that any concession it makes benefits the borrower's other creditors at its expense. Winton Williams coined a phrase for this phenomenon—the *creditor's dilemma*.[3] All creditors would likely benefit if they all agreed to refrain from legal action and allow the borrower more time to repay. But if all creditors agree to this approach, any individual creditor might do better by insisting on being repaid from the proceeds of the concessions offered by other creditors. If creditors distrust each other, they will refuse to make concessions and possibly race to secure claims on the borrower's cash flow (by garnishing wages) or assets (by placing liens on the borrower's property). If this happens, the borrower is more likely to file for bankruptcy, and all the unsecured creditors are likely to recover very little.

Credit counselors can often avoid this outcome. Through repeated interactions with creditors, they have established a reputation for securing the agreement of most or all of a borrower's creditors and establishing repayment plans that put each creditor on more or less the same footing in terms of the borrower's resources. This reduces the risk of a run against the borrower, which, in turn, increases the chances the creditors will be repaid.

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Note that participation in debt management plans is entirely voluntary. Borrowers need not seek a credit counselor, and they may abandon a repayment plan if they so choose. Similarly, creditors cannot be forced to agree to a debt management plan, and they are free to resort to collections activity or other legal activity at any time. Clearly, what makes these plans work, when they do work, is a good deal of trust that is fostered by the credit counselor.

Origins of the Nonprofit Credit Counseling Industry. The traditional nonprofit credit counseling organizations emerged in the 1950s and 1960s, partially in response to the rapid growth in unsecured consumer debt during that time. Many were organized by or with the support of creditors. During this same period, many states enacted legislation to regulate or simply ban the operation of the existing for-profit debt counselors (sometimes called debt poolers or proraters) on consumer protection grounds. Most states deliberately exempted nonprofit counseling organizations from these laws in the hope that they would continue to develop.[4]

A national trade organization, what is now called the National Foundation for Credit Counseling (NFCC), became active in 1951. At its peak, NFCC membership included about 200 organizations with about 1,500 offices around the country.[5] Today, NFCC member organizations counsel 1.5 million borrowers each year. They administer nearly 600,000 debt management plans, which pay unsecured creditors at least $2.5 billion a year. To put these numbers into perspective, very roughly speaking, each year NFCC member agencies counsel about 1 percent of American bankcard holders, and there is one debt management plan for every two personal bankruptcy filings.

These nonprofit credit counselors rely primarily on contributions from creditors for their revenues. Under a norm called *fair share*, creditors would return to the credit counselor about 12 percent of debt payments it helped to facilitate. These contributions accounted for two-thirds or more

[2] An unsecured debt is one in which the borrower does not pledge collateral (e.g., a house or car) that may be taken by the creditor in the event the borrower defaults on the loan. Credit card debts are almost always unsecured.

[3] See Williams's book, *Games Creditors Play*.

[4] See the book by Perry Hall; section V of the *Northwestern University Law Review* Consumer Credit Symposium; the article by Abbey Sniderman-Milstein and Bruce Ratner; and the article by Margery Kabot Schiller. For a recent review of state regulations, see the report by the California Department of Corporations and the report by Deanne Loonin and Heather Packard.

[5] Not all credit counseling organizations are NFCC members. Others are members of the Association of Independent Consumer Credit Counseling Agencies (AICCCA).

of the revenues of traditional credit counselors, but the share has fallen in recent years.[6] In the past, fair share receipts exceeded the cost of administering debt management plans, which afforded resources for the agencies' consumer education and budget counseling programs.

Some argue that a dependence on creditors for revenues creates at least a potential conflict of interest. For example, does a credit counselor that relies on fair share payments have an adequate incentive to suggest that a consumer seek legal advice about bankruptcy?[7] About 6 percent of borrowers who contact an NFCC member agency are referred to legal assistance, while 30 to 35 percent are enrolled in a debt management plan.[8] While these numbers suggest that counseling agencies might steer some borrowers away from bankruptcy, we need to know a good deal more about borrowers' circumstances and preferences to conclude that this pattern is inappropriate from the standpoint of borrowers or society.

OPTIONS AVAILABLE TO DISTRESSED BORROWERS

Why do borrowers enter into debt management plans? Why are unsecured creditors willing to accept these plans? The answer is that participating in the plans is better than the alternatives for some borrowers and their creditors (see *Pros and Cons of Options Available to Borrowers*). Depending on the resources available, borrowers can choose between repaying on the original terms, not paying but not filing for bankruptcy either (informal bankruptcy), and formal bankruptcy. Creditors can be either more or less aggressive in their collection efforts, or they may take legal action, such as obtaining an order to garnish wages.

One factor that influences borrowers' choice is the effect on their future access to credit. Obviously, timely repayment on the original terms preserves the borrower's credit history and is most likely to ensure future access to credit on good terms. Under the informal or formal bankruptcy options, borrowers will have difficulty obtaining new credit on affordable terms for a long time. A bankruptcy flag remains on a borrower's credit report for 10 years.

> Most borrowers can choose between two forms of bankruptcy: Chapter 7 (liquidation) or Chapter 13 (a wage-earner plan).

Another factor that influences borrowers' choice is the size of the payments they make and how creditors respond. Payments are typically largest if the debt is paid on the original terms. Alternatively, the consumer can simply stop making payments (informal bankruptcy). But this option affords borrowers few protections from debt collectors. They can't prevent repossession of their car or foreclosure on their house. They can't prevent creditors from placing liens against the real property they own. They have few ways of avoiding garnishment of their wages. Still, many distressed borrowers choose not to repay and not to file for bankruptcy.[9]

Two Forms of Bankruptcy for Consumers. Most borrowers can choose between two forms of bankruptcy: Chapter 7 (liquidation) or Chapter 13 (a wage-earner plan).[10] Both chapters impose a stay on collections and legal actions by creditors. In the case of Chapter 13, this may allow the borrower to catch up on mortgage payments and avoid foreclosure.

Under Chapter 7, the borrower's assets (except for certain exempt property) are used to pay some portion of the debts owed to unsecured creditors.[11] The remaining unsecured debt is discharged, so the consumer's future income is unencumbered. In practice, borrowers filing under this chapter rarely have assets to surrender, so unsecured creditors receive little or nothing. The claims of secured creditors are unaffected, so they can eventually foreclose on those assets if they choose. It is not uncommon for borrowers to *reaffirm* their secured debts in order to retain the collateral (such as the car or the house).

Alternatively, the borrower can file under Chapter 13 of the bankruptcy code. Under this chapter, the borrower can keep his or her assets but must propose a repayment plan financed by a significant share of his or her future income over the next several years. The plan must offer

[6] Until recently, this source of funding was not always disclosed to borrowers. In 1997, the NFCC reached an agreement with the Federal Trade Commission (FTC) to make such disclosures a matter of policy.

[7] This question applies equally to credit counselors that rely primarily on fees charged to consumers.

[8] Another third of borrowers receive financial education or household budget counseling.

[9] See the paper by Lawrence Ausubel and Amanda Dawsey and the article by Michele White.

[10] Good summaries of consumer bankruptcy law are found in the article by Wenli Li and the one by Loretta Mester. Significant changes to U.S. bankruptcy law were enacted in 2005 (see page 17).

[11] Exempt property is typically determined by state law. It may include some portion of equity in the borrower's home, automobiles, household goods and clothing, and tools used for one's trade.

Pros & Cons of Options Available to Borrowers

Option	Borrowers	Unsecured Creditors
Repayment on original terms	**Preserves access to credit on better terms** Assumes sufficient cash flow to pay principal & interest	**Principal repaid in full** **Earns interest & fee income**
Informal bankruptcy	**Preserves cash flow for other expenses** Little or no access to new credit Little protection from legal action by creditors	Lose most or all principal Collections & legal action are costly
Chapter 7 bankruptcy filing*	**Unsecured debts typically discharged** **Future income unencumbered by debt payments** **Prevents collections & legal action by creditors** Borrower must undergo credit counseling prior to filing and obtain financial education prior to the discharge Nonexempt property sold to pay debts Filing and attorney fees Bankruptcy flag on credit report for 10 years Cannot file again for Chapter 7 bankruptcy for 8 years	Stay against collections & legal action Lose most or all principal
Chapter 13 bankruptcy filing	**Borrower retains his or her property** **Repayment plan based on future income (3-5 years)** **Unsecured debts are not repaid in full** **Prevents collections & legal action by creditors** Part of future income devoted to debt payments Filing, attorney, and trustee fees Bankruptcy flag on credit report for 10 years Cannot obtain a Chapter 13 discharge within 2 years of a previous Chapter 13 discharge, or within 4 years of a discharge under another chapter	Stay against collections & legal action Planned payments typically cover a small portion of original principal Many repayment plans fail
Debt management plan	**Creditors voluntarily abstain from collections & legal action** **Lower interest & fees** **Improved credit history should ensure access to new credit sooner than bankruptcy** Diverts cash flow from payments on secure debts Must pay entire principal Plan fees (see text)	**If successful, principal repaid in full** **Part of repayment (fair share) goes to counselor** Lower interest & fee income Many repayment plans fail

*Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, access to a Chapter 7 discharge is subject to a means test. For details, see the January-March 2005 issue of the Federal Reserve Bank of Philadelphia's *Banking Legislation and Policy* (www.philadelphiafed.org/econ/blp/index.html).

unsecured creditors at least as much as they would obtain under a Chapter 7 filing, but, as noted above, this is typically not very much. Creditors cannot reject the terms of a plan if the borrower has pledged his or her entire *disposable* income over the next three to five years for debt payments. Disposable income here means income after taxes, basic living expenses, and tuition. Upon completion of the plan, the remaining unsecured debts are discharged. In practice, unsecured creditors typically receive a fraction of the outstanding principal (see below). General unsecured creditors received about $815 million from Chapter 13 plans during the 2001 fiscal year.[12]

Debt Management Plans Are Not the Same as Chapter 13. While debt management plans are similar in many ways to a Chapter 13 bankruptcy filing, there are several important differences.[13] Borrowers who participate in a debt management plan should be able to improve their credit history more quickly than if they default or file for bankruptcy. This should mean they are able to gain access to new credit more rapidly.[14] Unlike most Chapter 13 plans, debt management plans expect the borrower to repay the entire principal owed. A number of protections afforded in bankruptcy are absent in a debt management plan. For example, participation in a debt management plan does not protect the borrower from legal action by his or her creditors. Nor are creditors compelled to accept a proposed debt management plan.

Debt management plans also do not address secured credit. If consumers have important assets, financed by secured loans, which they are also having trouble paying, a bankruptcy filing may be the better option. In this situation, a borrower who enters a debt management plan might increase the risk of losing the house because he or she has pledged income to pay unsecured debts that would probably be discharged in bankruptcy. In short, while debt management plans are useful for many distressed borrowers, they are not suitable for all borrowers in trouble, and they are not simply a substitute for a Chapter 13 filing.

> Do borrowers who seek out credit counseling perform better because of the counseling or because they are somehow different from borrowers who don't seek counseling?

Why Do Creditors Agree to Participate in Debt Management Plans? From the creditor's standpoint, the net benefit of agreeing to a debt management plan depends on what they think the borrower will do in the absence of the plan. If the creditor thinks a borrower will otherwise stop paying altogether or enter bankruptcy, the creditor might recover more if it agrees to a debt management plan than if it refuses. But if the creditor thinks a borrower would otherwise continue to pay, agreeing to a debt management plan would likely reduce the payments the creditor will receive. After all, longer repayment terms, lower interest charges and fees, plus fair share payments come at the expense of the creditor.

What's more, creditors' expectations depend significantly on what they expect a borrower's other creditors will do. As explained earlier, if it is likely that another creditor will push a borrower into bankruptcy, every creditor has less incentive to offer concessions or to refrain from collections activity.

WHAT DO CREDIT COUNSELORS ACCOMPLISH?

Once again, it's important to recognize the very difficult problem of selection: Do borrowers who seek out credit counseling perform better because of the counseling or because they are somehow different from borrowers who don't seek counseling? It is at least possible that any measured differences between these groups is due to a selection effect (perhaps only highly motivated borrowers seek out counseling) rather than a treatment effect (the counseling itself helps borrowers to manage their debts).

Debt Management Plans. According to data from NFCC members, a typical debt management plan included $16,000 in unsecured debts, roughly 40 percent of the annual income of the participating borrowers.[15] Despite this remarkable degree of leverage, about one-quarter of plan participants remain in the plans until all their debts are paid off. In many other cases, borrowers pay down some of their debts and exit the plans to manage the remainder on their own. Still, approximately one-half of debt management plans fail after about six months. In some instances, borrowers have pledged more cash flow than they can afford. In others, one or more creditors refuse to accept the terms

[12] See the article by Ed Flynn, Gordon Burke, and Karen Bakewell.

[13] See the 1999 and 2004 articles by David Lander.

[14] There is no direct test for this, but the Visa study (discussed later) is suggestive.

[15] These borrowers had an average total indebtedness of $51,000 including mortgages, medical debt, and tax liens.

of a plan and take actions (such as garnishment) that push the borrower into bankruptcy.

Anecdotal evidence suggests the completion rate of debt management plans is a bit higher than for Chapter 13 plans (which is only about 33 percent). But the criterion for success is different under debt management plans, where the entire principal is expected to be repaid. Even in successful Chapter 13 plans, unsecured creditors receive only about 35 percent of the original principal.[16] Chapter 13 plans are also costly to administer. The average attorney's and trustee's fees for a Chapter 13 case in 2003 were $1,500, or about 14 percent of the amount repaid.[17]

A 1999 study conducted by Visa provides some insights into the success or failure of debt management plans. Borrowers who dropped out were more likely to be unemployed or to lose their jobs. Similarly, borrowers with lower income were less likely to complete their plans. Almost a third of borrowers who dropped out of a debt management plan had filed for bankruptcy. Compared to a separate survey of borrowers who filed for bankruptcy, participants in debt management plans appear to enjoy better access to unsecured and secured credit. Those successfully completing a debt management plan were more likely to hold a credit card than those who could not. Borrowers who successfully completed a debt management plan were more likely to buy a house than those who did not complete the plan.

Visa asked borrowers why they sought credit counseling. Respondents were three times as likely to mention a desire to get out of debt, or concerns about being overextended, than to cite creditors' collection tactics or the desire to avoid a bankruptcy filing.[18] This may suggest that borrowers who enter into debt management plans are different from other distressed borrowers. To rule out such a possibility, researchers typically devise studies that randomly assign participants into *treatment* and *control* groups and then examine differences in outcomes between these groups.[19]

Is there any evidence that creditors do better with accounts in debt management plans than with accounts held by borrowers with similar observable characteristics?

Is there any evidence that creditors do better with accounts in debt management plans than with accounts held by borrowers with similar observable characteristics? Creditors obviously believe they do, or they would not be willing to participate in the plans. Ralph Spurgeon describes the results of comparison between two sets of cardholders at a large store chain: One group enrolled in debt management plans, and the other group did not.[20] The chain lost money on both groups of accounts, but it lost 32 percent less on the accounts in debt management plans. Taking into account fair share payments to the credit counseling organizations, the chain's net losses were 17 percent lower.

Consumer Financial Education. There is some evidence of significant effects for the counseling programs offered by NFCC member organizations. In one study, only 7 percent of consumers counseled filed for bankruptcy, compared with 25 percent in a comparable control group. In another study, economists Gregory Elliehausen, Christopher Lundquist, and Michael Staten examined the effect of budget counseling (not debt management plans) on borrower credit quality, as measured by data contained in credit bureau files for about 6,000 borrowers just before and three years after the counseling session (that is, in 1997 and in 2000). Improvements among this group were compared to changes in the creditworthiness of a comparable control group—comparable in the sense that individuals with similar credit scores were drawn from the same geographic areas as those who were counseled.[21]

The authors report significant improvements in a wide variety of measures of creditworthiness among borrowers who sought credit counseling. Relative to the control group, counseled borrowers increased their credit scores and decreased their total indebtedness and the number of accounts with balances. They also experienced a significant decline in the number of delinquent accounts.

[16] The statistics on debt management plans are from the articles by David Lander and statistics provided by the NFCC. The statistics on Chapter 13 plans are from the report by the Congressional Budget Office and the articles by Jean Braucher; Scott Norberg; and William Whitford.

[17] See the 2005 article by Gordon Bermant. These amounts do not include filing fees.

[18] But when asked, "What was the last straw?" borrowers cited collection tactics four times as often as any other factor.

[19] There is now at least one study of this sort for debt management plans underway. See the article by Ladwig.

[20] The samples were selected to exhibit comparable distributions of credit scores.

[21] Borrowers who received counseling were identified from the files of five NFCC member counseling organizations.

The effects were the largest among borrowers with the lowest credit scores around the time they sought out credit counseling.

There remains the concern that the borrowers who sought out credit counseling are somehow different from other borrowers. In their analysis, Elliehausen, Lundquist, and Staten try to control for this by first attempting to predict, using data contained in credit bureau files, which borrowers would seek out counseling. That makes this study superior to most other studies, but we still cannot be entirely sure the authors' technique has fully controlled for selection bias.

A REVOLUTION IN THE CREDIT COUNSELING INDUSTRY?

Around 1990, there were about 200 nonprofit credit counseling organizations in the U.S. It took 30 years to reach that number. But this process of gradual increase changed dramatically in the 1990s. After 1994, at least 1,200 new organizations began counseling borrowers; three-quarters of these became active after 1999.[22] This *new breed* has been very successful, taking market share away from NFCC member organizations. Several of the new organizations are the largest in the field, managing roughly $7 billion in outstanding debts.[23]

The new breed is different from the previous generation of counseling agencies. For example, they are more automated, and they invest much more heavily in advertising. They also focus almost exclusively on debt management plans. They offer little budget counseling or financial education. They rely more on borrowers, and less on creditors, for their revenues. They do this by charging borrowers significantly higher fees than the traditional counseling agencies. It can cost a borrower $1,000 or more in fees to complete a debt management plan with some of the new counseling organizations.[24]

Some members of the new breed have been accused of engaging in egregious trade practices, similar to those attributed to the for-profit debt counseling organizations of the 1950s and 1960s.[25] Some organizations apply the first month of debt payments to plan fees rather than payments to creditors, but they don't disclose this information to borrowers. As a result, these borrowers fall further behind with their creditors. Other counseling organizations charge borrowers large upfront fees. Some deduct significant fees ($50 or more) from borrowers' monthly debt payments. Some counselors don't include all unsecured creditors in the plan, increasing the risk of legal action against the borrower and ensuring the failure of the plan. The completion rate on plans administered by some of the largest of the new counseling organizations is rather low—only 2 percent in one instance.[26]

Why the Influx of New Counseling Organizations? Several factors explain the influx of new organizations into the counseling industry. For one, demand for these services has increased significantly. Consider the case of general purpose credit cards issued by banks. In the 11 years between 1992 and 2003, the number of bankcard holders increased by nearly 33 million. Among this group, the share that was seriously delinquent rose gradually until 1999 and then rose rapidly as the U.S. entered into recession. The combination of these two trends has contributed to a tripling of the number of delinquent cardholders (Figure 1).[27] This also corresponds with a period of rapid increase in bankruptcy filings and in active debt management plans relative to the population (Figure 2). The recent decline in the use of debt management plans may be due in part to rising house prices (and low interest rates), which have helped many consumers to pay down their unsecured debts using home equity loans.[28]

A second factor is that barriers to entry into the credit counseling business have fallen, at least temporarily. There are a number of reasons for this. For one, nonprofit credit counseling organizations are lightly regulated at the state and local level, and there is no federal regulation that directly addresses this industry.[29] Another is that

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[22] Not all of these survive—there are currently about 870 active nonprofit credit counseling organizations.

[23] This number is calculated from the 2005 report by the U.S. Senate Subcommittee on Investigations (hereafter Senate Report).

[24] By way of contrast, the average set-up fee among NFCC organizations is $25, and the average monthly maintenance fee is $15.

[25] While it is difficult to measure the frequency of such practices, a number of examples can be found in the Senate Report, the testimony of Howard Beales of the FTC, and the report by Deanne Loonin and Travis Plunkett.

[26] See the March 30, 2005, FTC press release.

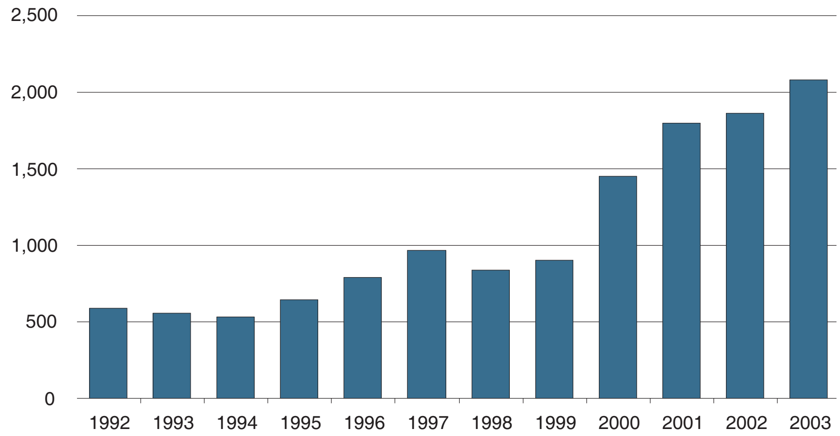
[27] A similar pattern is observed when comparing the 1992 and 2001 editions of the Survey of Consumer Finances (SCF). According to the SCF, the number of families with bankcards increased by 19 million. The share of families 60 or more days late on a debt payment increased from 6 to 7 percent. Taking into account the increase in households over this period, it appears that about 1.9 million more families were having trouble paying their debts in 2001 than in 1992.

[28] Another factor was the declining market share of NFCC members—the figure includes only debt management plans administered by those organizations.

[29] The Federal Trade Commission can sue counseling organizations that engage in unfair or deceptive trade practices, but its jurisdiction does not include nonprofit organizations. That means the FTC must also convince a court that these institutions are "organized to carry on business for its own profit or that of its members."

FIGURE 1

Delinquent Bank Cardholders (thousands)

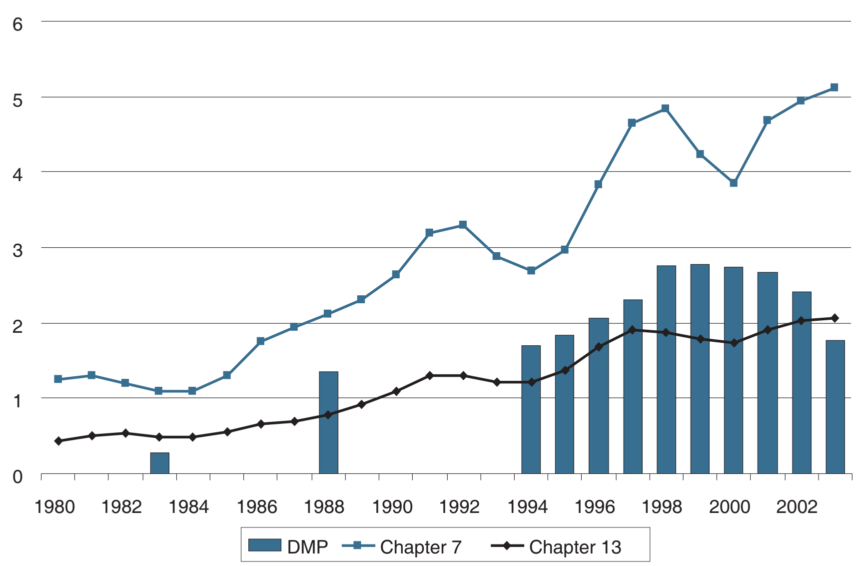


Sources: Author's calculations based on data from the *Statistical Abstract of the United States, The Nilson Report,* and TransUnion's Trendata.

Note: Delinquency refers to cardholders who are 90 or more days late on their payments.

FIGURE 2

Bankruptcy & Debt Management Plans per Thousand of Population 16 and Older



Sources: Author's calculations using data from NFCC and the Administrative Office of the U.S. Courts.

Note: Data on debt management plans refer only to NFCC member organizations

advances in technology (call centers, the Internet, data processing, and electronic payments) reduced the upfront cost of setting up debt management plans and the ongoing cost of administering them. But these technologies also require significant investment, and that is one reason newer counseling organizations seek the business of borrowers around the country rather than in a particular local market, as was common with the older counseling organizations.

Another reason barriers to entry were at least initially low is the amount of trust established between credit counselors and creditors over the previous 30 years. Creditors expected counselors to properly screen borrowers and were willing to provide generous fair share payments. At least initially, creditors treated the new organizations much as they did the older ones.[30] The success of the existing institutions also invited entry. If fair share payments could be used to subsidize education and budget counseling, profits could be earned by organizations willing to focus on just debt management plans, assuming they are successful in attracting borrowers.

The Relationship with Creditors. Credit counselors no longer enjoy the same relationship with creditors. One reason is that the out-of-pocket costs for debt management plans have become quite large. The share of large credit card portfolios that consist of accounts in debt management plans is now about 2 to 3 percent. About a quarter of the collections budget of

[30] This may be due in part to antitrust concerns. In 1994, several independent credit counseling organizations sued Discover Card and NFCC, alleging an illegal restraint of trade, because Discover would make fair share payments only to NFCC members. The suit was eventually settled.

major credit card lenders is spent on fair share payments.[31]

While it has always been difficult to quantify the benefit to creditors of participating in debt management plans, creditors suspect the benefits to them may have fallen. With the entry of the new breed, creditors are convinced that at least some consumers that would otherwise pay their unsecured debts are simply seeking more advantageous terms.

At the same time, creditors began to reduce their fair share payments from the 12 to 15 percent typical of 20 years ago to half this amount, or even lower, today. Among NFCC members, fair share payments currently average about 6 percent of payments made to creditors. Revenue compression has contributed to consolidation among NFCC members and the near failure of others.[32] In contrast, the new breed is less affected because they rely more on fees paid by the borrowers and are more willing to raise those fees.

In addition, creditors have reduced the concessions (such as lower interest rates) they offer to borrowers enrolled in debt management plans, making them more difficult to complete.[33] This has a significant effect on borrowers, since balances take longer to pay off when the interest rates are higher. As a result, borrowers pay down less debt over the typical three- to five-year length of a debt management plan. In addition, borrowers are more likely to become discouraged and drop out of the plan altogether.

COUNSELORS, CREDITORS, AND REGULATORS RESPOND

More recently, there are signs that established credit counselors and creditors are responding to the influx of counseling organizations. For example, the NFCC has established new standards for its member organizations, including accreditation of counselors, licensing and bonding requirements, annual audits of accounts, educational and counseling requirements, and disclosure of financing sources and fees. In addition, the NFCC prohibits the payment of bonuses to credit counselors, charging consumers fees in advance of providing services, and "prescreening" consumers to be solicited for debt management plans.

Large creditors are concentrating their fair share payments on a smaller number of counseling organizations—ones that can demonstrate their effectiveness.

Credit counselors are seeking alternative funding sources for their financial education and budget counseling efforts. They are also participating in studies to demonstrate the efficacy of these programs. NFCC members are also making significant investments in IT to improve their productivity.

Creditor Action. Lenders are changing their relationship with counseling organizations. For example, they now play a more active role in determining which consumers should be eligible for debt management plans. Some creditors make fair share payments only to counseling organizations that meet specific standards, for example, by limiting fees charged to borrowers.

Creditors are adopting back-loaded fair share payments and other pay-for-performance formulas. For example, when a borrower starts a debt management plan, the creditor may return only 2 percent to the counseling organization. If the borrower remains current on the plan for a year, the creditor may return an additional 7 percent of plan payments to the counseling organization. Other lenders are replacing fair share contributions altogether with charitable contributions made to nonprofit counseling organizations that apply for support.[34] In short, large creditors are concentrating their fair share payments on a smaller number of counseling organizations—ones that can demonstrate their effectiveness. These changes are relatively new, so creditors and credit counselors continue to hone the measures of effectiveness used to determine fair share payments.

Legislation. The most significant changes affecting the credit counseling industry are those contained in the recently enacted bankruptcy law.[35] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 limits access to Chapter 7 for some high-income borrowers, leaving them to consider either a workout under Chapter 13 or a debt management plan negotiated by a credit counseling organization. The act also lengthens from six to eight the number of years before a borrower can obtain another Chapter 7 discharge.

In addition, borrowers are now required to obtain credit counseling from an approved nonprofit organization before filing for bankruptcy. To obtain a

[31] See the article by Linda Punch and the Senate Report.

[32] See the report by Deanne Loonin and Travis Plunkett and the article by Jane Adler.

[33] See the 1999 press release by the Consumer Federation of America. It also documents the decline in fair share contribution ratios among a number of large banks.

[34] For examples, see the Senate Report and the articles by David Breitkopf and Burney Simpson.

[35] Public Law No. 109-8. For a summary, see the January-March 2005 issue of the Federal Reserve Bank of Philadelphia's *Banking Legislation and Policy.*

discharge of their debts in bankruptcy, borrowers must first complete a course in personal financial management. The NFCC estimated its members would provide 780,000 pre-filing counseling sessions and 535,000 pre-discharge education sessions in the first year after the law took effect (October 17, 2005). This will require an increase of more than 1,000 counselors.[36]

The law specifies minimum standards to be used by U.S. trustees or the courts to determine whether a nonprofit credit counseling organization is approved for the purposes of the mandatory counseling requirement. Assuming these standards are sufficiently rigorous, such a certification process could make it easier for consumers to identify reputable credit counselors. The law also requires the Executive Office for U.S. trustees to develop standards for the required consumer financial education programs and to evaluate the effectiveness of those efforts.[37]

This law includes a provision designed to encourage unsecured creditors to accept debt management plans proposed by credit counselors. If such a plan would repay 60 percent of the original principal (under current practice these plans return 100 percent of the principal), and the creditor refuses to participate, a borrower filing for bankruptcy can petition the court to reduce the outstanding debt by up to 20 percent. The likely effect of this provision is unclear. If a borrower is able to file under Chapter 7, most or all of his or her unsecured debts will be discharged anyway. Most Chapter 13 repayment plans offer unsecured creditors some portion of the original principal, but it is typically small and even less is usually repaid. A 20 percent reduction in such amounts may be insufficient to influence the decisions of unsecured creditors.

There are a number of other legislative proposals at the federal level. A 2003 bill, the Debt Counseling, Debt Consolidation, and Debt Settlement Practices Act (H.R. 3331), would make explicit that credit counseling organizations, irrespective of their nonprofit status, can be sued for unfair and deceptive trade practices. There are also proposals to revise the 1996 Credit Repair Organizations Act with credit counselors in mind. That law currently does not apply to nonprofit organizations. A recent federal court case, however, makes clear that the act will apply to tax-exempt charities that are, in fact, operated as for-profit organizations.[38]

The National Consumer Law Center, together with the Consumer Federation of America, has proposed a model state law to regulate credit counselors. The National Conference of Commissioners on Uniform State Laws is also working on a draft Uniform Consumer Debt Counseling Act that would, among other things, regulate fees charged to consumers for debt management plans and require that counselors spend at least as much on education as they do on advertising.

Regulatory Action. Since 2003, the Internal Revenue Service has initiated investigations into the nonprofit status of 59 credit counseling organizations, which collectively account for approximately 50 percent of the industry's revenues. It has since revoked the tax-exempt status of six organizations and denied applications for nonprofit status to 20 others.[39] Also in 2003, the FTC sued a number of the newer counseling organizations for engaging in unfair and deceptive trade practices and operating as for-profit enterprises. In 2005, the FTC concluded a number of settlements, effectively shutting some of these organizations down. Others have announced changes in their organization and business practices.[40]

CONCLUSION

In the U.S., credit counseling organizations are playing an increasingly important role in the functioning of the market for unsecured consumer credit. Credit counselors make it possible for some borrowers to repay their unsecured debts. This, in turn, offers borrowers the chance to re-establish access to credit more rapidly than if they file for bankruptcy.

Credit counselors are also important providers of consumer financial education and budget counseling, which, until recently, was indirectly subsidized through fair share payments made by creditors. If these programs are indeed effective, but creditors are now less willing to fund them, perhaps the public should. In other words, these activities may represent an important public good. A lender may well benefit when its customers become more sophisticated about credit, but the lender does not enjoy all the benefits. Some of the benefits are enjoyed by the customer and his or

[36] See the September 2005 press release from the NFCC.

[37] A list of approved counseling organizations can be found at www.usdoj.gov/ust/bapcpa/ccde/index.htm. There is also a list of organizations approved to provide instruction in personal financial management.

[38] See *Zimmerman v. Cambridge Credit Corp et al.*, 1st Circuit, No. 04-2039 (2005). A key test, according to the decision, is whether the organization is generating income for itself or others.

[39] See the article by Caroline Mayer.

[40] See the testimony of IRS Commissioner Everson, the March 2005 press releases from the FTC, and the Senate Report.

her other creditors. Thus, lenders may have an inadequate incentive to fund such efforts. While customers may benefit from receiving budget counseling and financial education, they are presumably unable to afford it at their time of greatest need.

There is evidence that credit counseling organizations are effective in helping some consumers regain access to credit and better manage their finances. But it is difficult to interpret these results. Are they due to selection or treatment effects? Relatively little formal research has been done, and there remains a lot more to do.

In recent years, changes in technology and in the market for consumer credit have induced major changes in what had been a quiet life for nonprofit credit counseling organizations. There has been a dramatic increase in the number of counseling organizations and in the observable costs of debt management plans among unsecured creditors. Creditors are not so sure they are benefiting from the increased use of debt management plans.

Creditors and traditional counseling organizations are beginning to respond to these new conditions, but it is too early to tell how effective these changes will be. There is also growing interest, both at the state and federal levels, in additional regulation of credit counselors. The idea is to make it easier for consumers to make an informed choice among credit counselors.

But distressed borrowers must also decide between their different options. Is it better to file for bankruptcy than to participate in a debt management plan? If so, is it better to file under Chapter 7 or Chapter 13? How well do borrowers understand these options? What organizations are in the best position, and have the right incentives, to educate consumers about these options? More generally, how can we quantify the effect of credit counselors' activities on consumers' access to unsecured credit and the price they pay for it? These are just a few of many important questions that require further study.

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