Consumer Federation of America

TESTIMONY OF
TRAVIS B. PLUNKETT
LEGISLATIVE DIRECTOR

ON BEHALF OF
THE CONSUMER FEDERATION OF AMERICA, THE NATIONAL CONSUMER LAW CENTER (ON BEHALF OF ITS LOW-INCOME CLIENTS), AND U.S. PIRG

BEFORE THE
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION OF THE UNITED STATES SENATE

REGARDING
CONSUMER PROTECTION AND THE CREDIT CRISIS

FEBRUARY 26, 2009

Chairman Rockefeller, Ranking Member Hutchison and members of the Committee, my name is Travis Plunkett and I am the legislative director of the Consumer Federation of America (CFA).[1] I am testifying today on behalf of CFA, the National Consumer Law Center,[2] on behalf of its low-income clients, and U.S. PIRG.[3] I commend the committee for investigating the adequacy of consumer protections for families with distressed finances. The number of Americans who cannot afford their consumer or mortgage loans is increasing sharply. Many of these families are desperately seeking debt reduction assistance short of bankruptcy.

Effective assistance that helps some consumers reduce their unsecured debts is available from legitimate, non-profit credit counselors and credit unions. However, some creditors have reduced the value of the "concessions" they will allow agencies to offer to debtors in credit counseling at a time when debt problems are increasing. Meanwhile, scam artists (including some calling themselves credit counselors) are promising to quickly and painlessly reduce the amount of credit card debt that consumers owe through a variety of expensive, harebrained and harmful schemes. Much more needs to be done by state and federal policy makers to stop these abusive debt reduction practices and, in conjunction with creditors, create legitimate, effective debt management alternatives to these harmful "services."

Background: Reckless and Irresponsible Lending Practices Have Caused Household Debt Levels to Skyrocket and Left Consumers Vulnerable to Debt Reduction Scams

For fifteen years, CFA and many others have warned that credit card issuers were irresponsibly pushing cardholders to take on more debt than they could afford, and then using unfair and deceptive tactics to increase debt loads and issuer profits. There is considerable evidence linking the rise in bankruptcy in recent years to the increase in consumer credit outstanding, and, in particular, to credit card debt. For example, research by Professor Ronald Mann of Columbia University has found that an increase in credit card spending in the U.S. and four other countries has resulted in higher credit card debt, which is strongly associated with an

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[1] The **Consumer Federation of America** (CFA) is a nonprofit association of some 300 pro-consumer groups, which was founded in 1968 to advance consumers' interests through research, advocacy and education.

[2] The **National Consumer Law Center**, Inc. (NCLC) is a non-profit corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes and regularly updates a series of sixteen practice treatises and annual supplements on consumer credit laws, including Truth In Lending, Cost of Credit, Consumer Banking and Payments Law, Foreclosures, and Consumer Bankruptcy Law and Practice, as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC attorneys have written and advocated extensively on all aspects of consumer law affecting low income people, conducted training for tens of thousands of legal services and private attorneys on the law and litigation strategies to deal predatory lending and other consumer law problems, and provided extensive oral and written testimony to numerous Congressional committees on these topics. NCLC's attorneys have been closely involved with the enactment of the all federal laws affecting consumer credit since the 1970s, and regularly provide comprehensive comments to the federal agencies on the regulations under these laws.

[3] The **U.S. Public Interest Research Group** (U.S. PIRG) is the national lobbying office for state PIRGs, which are non-profit, non-partisan consumer advocacy groups with half a million citizen members around the country.

increase in bankruptcy filings.[4] To make matters worse, credit card companies have become far more aggressive in implementing questionable fees and interest rate practices in recent years.[5] The upshot of these practices is that penalty interest rates, high and accumulating fees, and interest on fees can push consumers with high debts into the hands of debt reduction scam artists or into bankruptcy.[6] In fact, consumers in debt trouble sometimes owe as much or more in fees and penalty interest charges as in principal.

The growth of revolving debt in this country to $964 billion[7] has obviously not affected all Americans equally. The extraordinary expansion of the credit card industry in the 1990s was fueled by the marketing of credit cards to populations that had not had widespread access to mainstream credit, including lower- and moderate-income households, consumers with seriously blemished credit histories, college students, older Americans and minorities. For example, U.S. PIRG reported last year that the amount of debt held by students who carry credit card debt more than doubles between their freshman year and senior year in college, from $1,301 to $2,623.[8]

In a practice widely known as risk-based pricing, creditors charged riskier consumers more to cover potential losses, usually in the form of higher interest rates. To make the assumption of debt more attractive to these households – and to entice them into carrying debt for longer periods – creditors lowered minimum payment balances from around five percent of principal to just over two percent. As a result, an estimated eighty percent of all households now have at least one card.[9] According to the Federal Reserve Board, about 42 percent of cardholding households pay their credit card bill in full every month,[10] which means that the remaining 50 million or so families that carry debt owe an average of about $17,000.[11]

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[4] Mann, Ronald J., "Credit Cards, Consumer Credit and Bankruptcy," Law and Economics Research Paper No. 44, The University of Texas School of Law, March 2006.

[5] Testimony of Travis B. Plunkett, Legislative Director, on Behalf of the Consumer Federation of America, Center for Responsible Lending, Consumer Action, Consumers Union, National Consumer Law Center (on Behalf of its Low-Income Clients) and U.S. PIRG before the Banking, Housing and Urban Affairs Committee of the United States Senate. regarding Strengthening Credit Card Protections, February 12, 2009, http://www.consumerfed.org/pdfs/TESTIMONY_Travis_Plunkett_Senate_Banking_Feb_12_2009.pdf..

[6] Day, Kathleen and Caroline E. Mayer, "Credit Card Penalties, Fees Bury Debtors," *Washington Post*, March 6, 2005.

[7] According to the Federal Reserve Board, the amount of revolving debt held by Americans at the end of 2008 was $963.5 billion. In the seven year period from the beginning of 2000 through 2007 consumer revolving debt grew by 50 percent from $627.5 billion to $941.4 billion. Federal Reserve, Statistical Release, "Consumer Credit Outstanding," Table G.19. Although this figure is often used as a proxy for credit card debt, most experts believe that outstanding credit card debt is slightly lower. First, approximately 5 percent of consumer revolving credit is not on credit cards. Second, between 4 to 9 percent of the debt does not truly revolve. It is repaid to the credit card issuer before the next billing cycle starts. Taking these two factors into account, outstanding credit card debt at the end of 2008 was between $829 and $877 billion.

[8] Mierzwinski and Lindstrom, "The Campus Credit Card Trap: A Survey of College Students and Credit Card Marketing," March 2008, U.S. PIRG, available at http://www.truthaboutcredit.org, last visited 25 February 2009.

[9] Cardweb.com

[10] Bucks, Brian K., Arthur B. Kennickell and Kevin B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances," Federal Reserve Bulletin, vol. 92, February 2006, pg. 31.

[11] CFA calculation based on estimated credit card (as opposed to revolving) debt of $850 billion. If a conservative estimate of 75 percent of 114.4 million households have credit cards, and only 58 percent of these households carry debt, then the remaining 49.7 million households have an average of $17,103 in debt.

Moderate and lower income households that are more financially vulnerable shoulder a higher level of debt relative to their incomes. In the current economic climate, these households are also under financial pressure from many external factors, such as flat wages, rising unemployment, skyrocketing home foreclosures and increasingly unaffordable health insurance. In other words, the "democratization of credit" has had serious negative consequences for many Americans, putting them one unexpected financial emergency away from bankruptcy.

As the economy has worsened and home foreclosures have increased to record levels, consumers are increasingly having serious difficulty paying their credit card bills. One widely watched measure of financial health, the amount of credit card debt paid off by Americans monthly, is now at one of the lowest levels ever recorded.[12] Credit card charge-offs, the percentage of the value of credit card loans removed from the books (net of recoveries), or "written off," have been persistently high for most of the last thirteen years and are now approaching the highest levels on record. During the decade between the end of 1995 and the start of 2006, credit card charge-offs were not below 4 percent in a single quarter.[13] They increased to more than 4 percent in the fourth quarter of 2006 and broke 4 percent again during the latter half of 2007. Since then, charge-offs have escalated sharply to 5.62 percent in the third quarter of 2008. There is a very good chance that charge-offs will keep rising because the number of delinquent credit card payments – an early sign of payment difficulty – are also approaching historically high levels. Thirty-day credit card delinquencies are now at their highest point in six years, since the last economic recession ended.[14] Moreover, a number of major issuers have reported fourth quarter charge-offs that indicate that borrower defaults and issuer losses will exceed those of the last two recessions.[15] The difficulty that many families are having affording their credit card bills has been exacerbated by the mortgage crisis. As home values have dropped sharply, Americans have been unable to use home equity loans and home refinancing to pay off their credit card debts.[16] Moreover, some families in financial trouble are continuing to use their credit cards to pay for essential purchases and are therefore attempting to stay current on their credit card loans but not their mortgage payments, a shift in behavior from past economic crises that will likely lead to further deterioration of their financial condition.[17]

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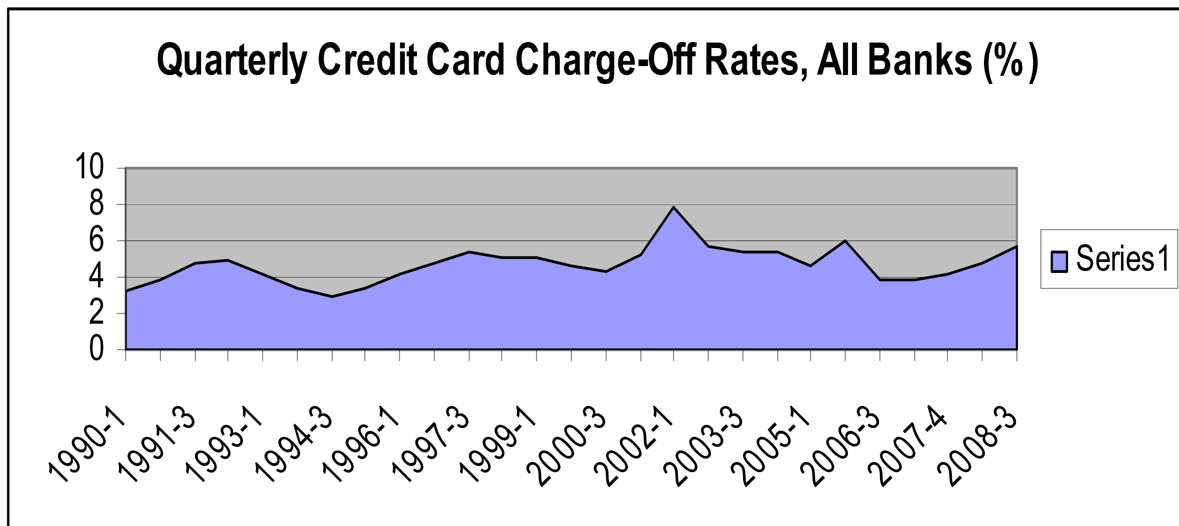
[12] Chu, Kathy, "November Credit-Card Payoff Rate Fell Sharply," *USA Today*, February 8, 2009. The monthly payment rate fell by 2.5 percentage points to 16.1 percent in November 2008, according to CardTrak.com.
[13] Federal Reserve Board, "Charge-Off and Delinquency Rates on Loans and Leases at All Commercial Banks," available at www.federalreserve.gov/release/chargeoff. Most experts attribute lower charge-offs in 2006 to the surge of bankruptcy filings (and corresponding increase in charge-offs) that occurred in the third and fourth quarters of 2005.
[14] 30-day credit card delinquencies during first three quarters of 2008 were between 4.79 and 4.88 percent, the highest levels since 2002. Federal Reserve Board, "Charge-Off and Delinquency Rates on Loans and Leases at 100 Largest Commercial Banks" "U.S. Credit Card Delinquencies at Record Highs – Fitch," *Reuters*, February 4, 2009.
[15] Terris, Harry, "Credit Card Losses Seen Surpassing Levels of Last Two Recessions," *American Banker*, January 28, 2009.
[16] Westrich, Tim and Weller, Christian E., "House of Cards, Consumers Turn to Credit Cards Amid the Mortgage Crisis, Delaying Inevitable Defaults," Center for American Progress, February 2008.
[17] Chu, Kathy, "More Americans Using Credit Cards to Stay Afloat," *USA Today*, February 28, 2008.

Quarterly Credit Card Charge-Off Rates, All Banks (%)[18]



Growing problems with the affordability of unsecured debt has not only led to an increase in the number of consumers who are seeking personal bankruptcy protection. Consumer demand for debt reduction or debt management assistance has increased too, especially in the last two years as the economy has deteriorated.[19] Many non-profit organizations and for-profit businesses have jumped in to "help," including non-profit credit counseling agencies and for-profit debt settlement companies.

Credit Counseling: Abuses Have Declined, but so has Value of the Debt Reduction Offered

The credit counseling industry was created in the mid-1960s by credit card companies, which saw an opportunity to recover overdue debts. Creditors initially provided the bulk of the funding needed to keep the agencies in business.[20] At first, most of the agencies were non-profit. Debt management plans or DMPs were the feature service offered by credit counseling agencies, which also provided financial and budget counseling and community education sessions. With DMPs, a consumer sends the credit counseling agency a lump sum, which the agency then distributes to the consumer's creditors. In return, the consumer is supposed to receive a break in the form of creditor agreements to waive fees and lower interest rates. Consumers also gain the convenience of making only one payment to the agency rather than having to deal with multiple creditors on their own. Through a creditor policy known as "fair share," DMPs provided substantial revenue for the agencies. Creditors returned to the agency a set percentage of the funds that are disbursed to them. Over the years, creditors have reduced the

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[18] Federal Reserve Board, "Charge-Off and Delinquency Rates on Loans and Leases at All Commercial Banks," available at www.federalreserve.gov/releases/chargeoff/chgallsa.htm , accessed April 14, 2008.
[19] "Look Out for That Lifeline, Debt-Settlement Firms are Doing a Booming Business—And Drawing the Attention of Prosecutors and Regulators," *BusinessWeek*, March 6, 2008.
[20] For an excellent history of the credit counseling industry, see David A. Lander, *Recent Developments in Consumer Debt Counseling Agencies: The Need for Reform*, American Bankruptcy Institute Journal, Feb. 2002.

amount of fair share funding they offer or moved away from it entirely by distributing grants that are not explicitly tied to the amount of DMP funding collected. In response, agencies curtailed some free counseling services and raised consumer fees for DMPs.

The National Consumer Law Center, the Consumer Federation of America, and U.S. PIRG were among the first to warn that the nature of credit counseling had also begun to dramatically shift in ways that were very harmful to debtors. In the late 1990s, a new class of agencies emerged that aggressively marketed DMPs and related services, dramatically raised consumer fees, and had extensive relationships with for-profit vendors and consultants. Complaints about deceptive practices, improper advice, excessive fees and abuse of non-profit status sharply increased. [21] Federal and state regulators and policymakers, who had largely ignored the rise of these new agencies, and the problems they had created, began to investigate.[22]

By late 2006, the IRS had investigated 63 agencies that brought in more than half the revenue of the entire credit counseling industry for violating their non-profit status.[23] The Federal Trade Commission had begun taking legal action against AmeriDebt and other phony non-profit agencies for a variety of deceptive practices (see Addendum B). State attorneys general had launched a number of similar investigations and state lawmakers were putting new laws on the books to stop deceptive practices and prevent excessive charges.[24]

In July of 2006, Congress created a new section 501(q) of the Internal Revenue Code that imposed standards on non-profit agencies, including the following:

- Agencies may not refuse to provide credit counseling services due to a consumer's inability to pay or unwillingness to enroll in a DMP.
- Agencies must have reasonable fees.
- Agencies must have a governing body that is not dominated by agency employees or those who benefit financially from agency activities.
- Agencies must not exceed a phased in cap of 50 percent of revenues on creditor fair share contributions by 2011. (The cap for the 2009 tax year is 70 percent.)

About the same time, the Executive Office of the United States Trustees (EOUST) began implementing a requirement of the new bankruptcy law that required those who wish to enter personal bankruptcy to receive credit counseling prior to filing and a debtor education course

[21] Loonin, Deanne; Plunkett, Travis; "Credit Counseling in Crisis: The Impact on Consumers of Funding Cuts, Higher Fees and Aggressive New Market Entrants;" National Consumer Law Center and Consumer Federation of America; April 2003; http://www.consumerfed.org/pdfs/credit_counseling_report.pdf.
[22] "Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling," Report Prepared by the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affars, United States Senate, April 13, 2005, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_reports&docid=f:sr055.pdf. .
[23] http://www.irs.gov/charities/article/0,,id=156827,00.html. The IRS has since reported that it has "revoked, terminated or proposed revocation of over half of the organizations examined, representing 41 percent of revenue in the industry," http://www.irs.gov/charities/article/0,,id=156829,00.html.
[24] Some states used the Uniform Debt Management Services Act proposed in 2005 by the National Conference of Commissioners on Uniform State Laws as a model and others acted independently to adopt standards regarding business practices and fees.

before being discharged.[25] Consumer groups have serious questions about the efficacy and necessity of a credit counseling session for debtors on the verge of bankruptcy, many of whom have suffered a severe reduction in income or a sharp increase in medical expenses not covered by insurance. However, the EOUST has done a good job of setting standards to help ensure that debtors headed to bankruptcy are counseled by legitimate, non-profit agencies that will not harm them or delay their bankruptcy filing.

An initial phase of research directed by the Consumer Federation and American Express has found that credit counseling can be effective in helping consumers to improve their credit worthiness over time.[26] Consumer groups often advise consumers that a DMP could be helpful in reducing some unsecured debts, depending on whether the financial condition of the debtor is stable or deteriorating, and on the interest rate reduction offered by creditors.

However, CFA has also found that some major creditors have actually increased the interest rate they charge in credit counseling, while others have kept these interest rates high for many consumers. For example, when CFA surveyed interest rates in credit counseling in 1999 and 2003,[27] Bank of America was a model for the rest of the industry, charging 0 percent APR for those in a DMP. Now, they have a range of interest rates from 1 percent all the way up to 16 percent. There is not a single major credit card issuer right now that charges less than 5 percent APR for all of its clients in DMPs. (JP Morgan Chase comes the closest, at 6 percent.) Capital One charges a 15.9 percent rate, unless the client enters counseling with a lower rate. Discover charges a range of rates that go as high as 15.9 percent as well.

As more consumers struggle to continue to pay their credit card loans, it is becoming increasingly clear that the DMP is a less viable tool in helping consumers significantly reduce their unsecured debt because creditors have kept interest rates too high. While some credit card issuers appear to have increased the reductions they offer customers in individual "workout" plans, such reductions can only be helpful in stabilizing a consumer's finances if the person does not have multiple credit card debts, as many people in debt trouble do. Credit counseling executives are now openly acknowledging that creditor concessions have not kept pace with growing indebtedness, "… given the high levels of unsecured debt outstanding, bankruptcy will be the only option available to many of these families – unless the credit card industry provides relief through better concessions, so that a greater number of consumers can qualify for Debt Management Plans."[28]

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[25] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 11 U.S.C. §109, 11 U.S.C. §11(c)(2)(E), 11 U.S.C. §111(c)(1). .

[26] Staten, Michael E., Barron John M., "Evaluating the Effectiveness of Credit Counseling," May 31, 2006; http://www.consumerfed.org/pdfs/Credit_Counseling_Report061206.pdf. Consumers who were recommended for a DMP by agencies and chose to start payments had a significantly lower incidence of bankruptcy, as well as improved bankruptcy and delinquency risk scores, over the two years following counseling than did those who were recommended for a DMP and chose not to start.

[27] Consumer Federation of America, "Large Banks Increase Charges To Americans In Credit Counseling, New Practices Will Hurt Consumers On The Brink Of Bankruptcy, July 28, 1999.
National Consumer Law Center, Consumer Federation of America, "First-Ever Study of Credit Counseling Finds High Fees, Bad Advice and Other Abuses by New Breed of 'Non-Profit' Agencies," April 9, 2003; http://www.consumerfed.org/releases2.cfm?filename=040903ccreport.txt,

[28] Keating, Susan C., President and CEO, National Foundation for Credit Counseling, "2008 State of the Credit Counseling and Financial Education Sector Address."

The refusal by credit card issuers to significantly lower interest rates for consumers in credit counseling is perplexing because there are signs that the industry does realize that if it moves aggressively to significantly reduce what consumers owe them, it such assistance would likely benefit card issuers in the long run by keeping consumers from discharging much or all of their credit card debt in bankruptcy. As mentioned above, some issuers appear to be offering greater unilateral concessions to customers who enter workout programs. Moreover, the Financial Services Roundtable has recently collaborated with CFA in an effort to reduce or eliminate regulatory hurdles that currently inhibit issuers from authorizing DMPs that significantly reduce the principal (not just the interest charges) that consumers owe.[29] CFA hopes to work with Congress and the Office of the Comptroller of the Currency (OCC) to quickly create a regulatory path that would allow and encourage issuers to offer reduced principal DMPs. Such a pathway would also need to eliminate or reduce the tax liability that consumers must pay on reduced principal settlements. Reduced principal DMPs could not only help many families in debt trouble stay solvent, but also create a legitimate, pro-consumer alternative to debt settlement scams (see next section.)

Debt Settlement: Business Model is Inherently Harmful to Vulnerable Consumers

Debt settlement involves negotiating with creditors to reduce the principal amount the consumer owes and to pay this reduced amount over a fairly short period, usually in one or two lump sum payments. Unlike most credit counseling agencies, debt settlement and debt negotiation companies are usually for-profit businesses. Settlement services are different from credit counseling (or debt management) mainly because settlement companies do not send regular monthly payments to creditors. Instead, these agencies generally maintain a consumer's funds in separate accounts – or direct consumers to deposit savings in an account that they can observe but do not control – until the company believes it can settle the consumer's debts for less than the full amount owed. Typically, debtors can only afford to pay off their creditors sequentially, saving up enough money (after upfront fees are paid) to make an offer to one creditor, then saving again until there is enough to offer a second settlement, and so on.

Many companies have advised consumers to stop paying debts as a condition of participation in the program. Debtors pay a variety of fees for this service, including enrollment fees, monthly maintenance fees and a settlement fee, which is usually a percentage of the forgiven amount of debt.

The Federal Trade Commission and attorneys general in at least six states have begun legal action against debt settlement firms throughout the country. Addendum A provides significant details about the range of deceptive, fraudulent, and harmful practices that these companies used that the FTC has uncovered, which can be summarized as follows.

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[29] The OCC and other financial regulatory agencies rejected a request made by CFA and the Financial Services Roundtable on October 29, 2008 to permit a pilot project that would allow some credit counseling agencies to offer some consumers reduced principal DMPs over a period of up to 60 months. Current guidance requires that reduced principal "settlements" must generally be paid in full within three to six months. Multi-year, reduced principal payment plans are not allowed unless the issuer charges off the entire loan before offering the settlement.

1. **Settlement firms often mislead consumers about the likelihood of a settlement.** Evidence from debt settlement investigations indicate that a large number of consumers never complete a debt settlement program. One North Carolina assistant attorney general estimates that 80 percent of consumers drop out of debt settlement plans within the first year.[30] A receivers' report on the National Consumers Council, a purported non-profit debt settlement organization that was shut down by the FTC in 2004, found that only 1.4 percent of NCC customers settled with all their creditors. 43 percent of their clients cancelled the program after incurring fees of 64 percent of the amount remitted to NCC.[31]

2. **Unlike credit counseling agencies, settlement firms cannot guarantee to consumers that the creditor will agree to a reduced payment if certain conditions are met.** In fact, some creditors insist that they won't negotiate with settlement firms at all,[32] or that they will initiate a collections action if they learn that a debt settlement company is negotiating on behalf of a consumer.

3. **Settlement firms often mislead consumers about the effect of the settlement process on debt collection and their credit worthiness**. Withholding payment to settle multiple debts is a very long process. Meanwhile, additional fees and interest rates continue to build up, creditors continue to try to collect on unpaid debts, and consumers' credit worthiness continues to deteriorate. Some firms still advise consumers not to pay debts, either implicitly or explicitly. Others firms say they never tell consumers not to pay their debts but only accept clients who have already done so. Moreover, many settlement firms have not followed through with promises that they will stop collection calls. In fact, under the Fair Debt Collection Practices Act, consumers can only request that third party collection efforts stop, not collection attempts by a credit card company on its own behalf.

4. **Settlement firms charge such high fees that consumers often don't end up saving much to make settlement offers, which is why so many drop out of settlement programs.** Debt settlement firms typically require consumers to pay fees of between 14 and 20 percent upfront (and as high as 30 percent) before they receive a settlement. It is often not made clear to consumers that a hefty portion of the payments they make in the first year will go to the firm, not to their reserve fund or creditors. Many firms also charge monthly fees to maintain accounts as well as a "settlement fee" of between 15 and 30 percent of the amount of debt that has been forgiven.

5. **As a result of high fees, consumers targeted by debt settlement companies are generally the least likely to benefit.** Some firms will work only with insolvent consumers who are unemployed or those in a hardship situation. Many have minimum

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[30] "Look Out for That Lifeline, Debt-Settlement Firms are Doing a Booming Business—And Drawing the Attention of Prosecutors and Regulators," *BusinessWeek*, March 6, 2008.
[31] Robb Evans and Associates LLC, "Report of the Temporary Receiver, May 3, 2004 – May 14, 2004, First report to the Court."
[32] "Look Out for That Lifeline, Debt-Settlement Firms are Doing a Booming Business—And Drawing the Attention of Prosecutors and Regulators," *BusinessWeek*, March 6, 2008.

debt requirements of $10,000 to $12,000. Consumers facing serious hardship with very high debts are, of course, the least likely to be able to afford the hefty payments that are charged. Settlement firms also appear to make no distinction, as a good attorney would, between consumers in these hardship situations who are vulnerable to legal judgments to collect and those who are not.

6. **It is unclear what professional services most debt settlement companies offer to assist debtors while they save money to pay for a settlement.** Serious negotiation with creditors cannot commence until a significant settlement amount is saved, which could take years once high fees are paid. A persistent complaint by consumers is that settlement companies do not contact creditors at all in some cases.

The combined impact on consumers of these practices can be devastating. To get a sense of the impact on the many indebted borrowers for whom the debt settlement business model does not work, CFA examined some of the thousands of debt settlement complaints that are on various consumer review web sites. Here are a few summaries of the stories we found (all from the past five months):

- One (anonymous) consumer was convinced by a debt settlement company that it had strong relationships with major creditors and that its services would be a good alternative to bankruptcy. After she signed up with the settlement company, she was instructed to stop making payments to creditors. She later found out that the extent of the settlement company's involvement amounted to sending "power of attorney" letters to the creditors. Without help from the company she hired, she is now facing at least two collections lawsuits alone.

- One woman was persuaded to stop paying her creditors and to start paying the debt settlement company over $800 a month with the promise that her creditors would stop their collections calls and that she could reach a good settlement on her credit card balance. The settlement company took the money, but no settlements ever took place, and creditors never stopped calling. After seven months of no progress with her accounts, she stopped paying the company's fees. Without being able to get a refund of the more than $5,000 she paid in fees, she is now saving money for a bankruptcy lawyer. After a legal firm later acquired her accounts, she discovered that the original settlement company routinely dealt with other customers in the same way.

- After hearing nothing from his debt settlement company for several months, Chris from Maryland attempted to respond personally to a credit card collections letter. The debt settlement company later scolded and threatened him because he contacted the creditor directly. He realized that the company was not keeping up its end of the bargain, and he decided that the $300/month he was paying in fees was not money well spent. He has tried to sever his ties with the settlement company, but they continue to ignore his requests.

- "T" from Arizona regularly saw television advertisements for a particular debt settlement company and thought they appeared legitimate. He called the company and was promised

that his payments would be only $300 a month. The company collected his personal financial information and instructed him to stop paying his creditors. After four months and over $1,500 in fees being automatically drawn from his bank account, the consumer found out that no creditors had been paid. He eventually had to put a "stop payment" order on his bank account to prevent the settlement company from automatically withdrawing what they pleased. The consumer is now stuck with a damaged credit report, excessive fees, and no debt settlements.

- Frank from New York was directly contacted by a debt settlement company after visiting the company website. After a promise that the company would settle his debts, he decided to accept the $250 per month fee. Nearly a year later, with no progress in debt settlements, he stopped hearing from them. After many unanswered calls and emails, he finally received a response from the company that he would get a partial refund. Since then the company has ignored his efforts to receive the refund and his debts remain unsettled.

Creditors obviously must share some responsibility for the growth of the debt settlement industry. For one thing, some credit card issuers are knowingly doing business with these firms. For another, there clearly is consumer demand for a legitimate debt reduction approach that offers more relief than traditional credit counseling but is not as far reaching as bankruptcy. As stated above, creditors have not lowered interest rates in credit counseling. On a positive note, as mentioned above, creditors have now taken steps to get permission from federal regulators to offer reduced principal, multi-year payment plans. The 2005 bankruptcy act attempted to provide an incentive to creditors to offer "60/60" plans (60 percent of what the borrower owes paid off over 60 months.)[33]

Ultimately, it appears clear that the business model for debt settlement is structurally flawed. The essential promise made by debt settlement firms to the public, that they can settle most debts for significantly less than what is owed, is often fraudulent. There is a general consensus that credit counseling, if done well, can provide significant benefits for some financially distressed consumers. No such consensus exists for debt settlement. Debt settlement firms should have to prove that, in the face of significant evidence to the contrary, their business model can and does actually help more than a few financially distressed consumers.

Recommendations

Congress, the Federal Trade Commission, and the States:

Debt settlement is regulated primarily at the state level. Seven states have banned debt settlement.[34] Four more have adopted limited restrictions on the practice proposed by the

[33] 11 U.S.C. §502(k)
[34] "Look Out for That Lifeline, Debt-Settlement Firms are Doing a Booming Business—And Drawing the Attention of Prosecutors and Regulators," *BusinessWeek*, March 6, 2008.

National Conference of Commissioners on Uniform State Laws.[35] A number of other states have restrictions on debt management or adjustment that do not explicitly pertain to the practice of for-profit debt settlement, but cover it. States can also deploy laws regarding credit repair, the unauthorized practice of law, and unfair and deceptive practices (UDAP) against selected debt settlement practices.[36]

Regarding laws at the federal level, some debt settlement firms appear to have violated the federal Credit Repair Organizations Act by claiming that they will improve consumers' credit. The Federal Trade Commission has used the FTC Act well to pursue settlement firms that have used unfair and deceptive practices.

We recommend that state and federal policymakers, regulators and enforcement offices consider taking the following steps:

1. The Federal Trade Commission and state attorneys general should continue to enforce UDAP laws. We also urge the FTC to immediately use its subpoena power to examine the records of the largest debt settlement firms in the country to determine if these firms are or are not making fraudulent claims about their ability to deliver large settlements for most of their customers.

2. UDAP prosecutions can be time-consuming and costly, so it is essential that state lawmakers in particular begin to more aggressively enforce debt management and other laws that regulate the practice of debt settlement, including tight limits on what firms are allowed to charge.

3. Congress should consider the enactment of a federal law setting a strong minimum standard based on the best state laws directed specifically at debt settlement, which states could exceed if local conditions warrant such a move. This would bring the power and reach of the federal government in enforcing tough standards throughout the country. At the very least such minimum standards should:

    - Prohibit debt settlement firms from collecting any fees from consumers until debts are settled, except for a small enrollment fee.
    - Prohibit firms from misrepresenting the settlement process' impact on the credit worthiness of consumers.
    - Place a cap on back end settlement fees, based on the settlement services actually rendered rather than the amount of debt that was forgiven.
    - Require that any debt serviced by a settlement firm must be settled within 12 months.

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[35] Uniform Law Commissioners, "A Few Facts about the Uniform Debt-Management Services Act of 2005, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-udmsa.asp. The National Consumer Law Center and Consumer Federation of America opposed including provisions regulating debt settlement firms in the same law that regulated debt management and credit counseling because the businesses are so different. The highly questionable debt settlement business model necessitates a different and more stringent regulatory framework that does not legitimize the debt settlement.

[36] Loonin, Deanne, National Consumer Law Center, "An Investigation of Debt Settlement Companies: An Unsettling Business for Consumers," March 2005.

4. In order to help facilitate the creation of a legitimate alternative to third-party debt settlement, banking regulatory agencies should take steps to allow creditors to offer multi-year, reduced principal payment plans, consistent with sound accounting principals. If regulators cannot agree on a solution that achieves this goal quickly, Congress should step in to offer one.

5. As it has done in the mortgage lending context, Congress should consider waiving or reducing the tax liability that consumers must pay for the forgiven amount of any debt settlement (above $600).

Creditors

Credit card issuers should act to immediately lower interest rates charged to consumers in credit counseling and should continue to consider methods that might be acceptable to regulators to allow consumers to pay back a reduced amount of principal over a three to five year period of time.

ADDENDUM A: RECENT FTC DEBT SETTLEMENT CASES

1. Edge Solutions, Inc. and Money Cares, Inc. aka The Debt Settlement Company and The Debt Elimination Center; Pay Help, Inc.; Miriam and Robert Lovinger
Press release on August 5, 2008 at: www.ftc.gov/opa/2008/08/edge.shtm
Complaint filed on October 3, 2007
Complaint alleged that the defendants:

- Promised that they could reduce consumers' debts so they would only pay 55 cents for each dollar of debt.
- Told consumers that their payments would cover both negotiated debts and fees.
- Told consumers to stop making payments to and have no further contact with their creditors, and that this would place them in a "hardship condition," making negotiations possible.
- Promised that debts would be begin to be paid to creditors within several weeks and would ultimately be paid in a shorter time, and for a reduced amount, than if consumers continued to pay.
- Required consumers to set up direct debit from their bank accounts to a bank account controlled by the company, from which their fees and debts would be paid.
- Promised one-on-one financial counseling, which in most cases was never provided.
- Buried in the agreement the fact that consumers must pay 45 percent of total fee upfront before any payments would begin to creditors and that this might take several months.
- Failed to negotiate with and pay creditors as promised.
- Caused consumers to incur late fees, finance charges, overdraft charges, and negative information on their credit reports, and to face various types of legal action by creditors, leaving them in worse financial condition than before.

Status: Settlement

2. Debt-Set, William Riggs, Leo Mangan, Resolve Credit Counseling, Inc., and Michelle Tucker
Press release on February 14, 2008 at: www.ftc.gov/opa/2008/02/debtreduct.shtm
Complaint filed on March 27, 2007
Complaint alleged that the defendants:

- Falsely promised that they could significantly reduce consumers' credit card interest rates to between 0 and 9 percent or reduce the amount of their unsecured debt to 50 percent or 60 percent.
- Encouraged consumers who called in response to ads to enroll in a "debt consolidation program" if their unsecured consumer debt was up to one month overdue, or in a "debt settlement program" if they were overdue by a longer period.
- Misrepresented that they would not charge consumers any upfront fees before obtaining the promised debt relief and buried inadequate fee information in the agreement, when in fact they generally charged 8 percent of the total debt before they would contact the creditors.

- Sent consumers documents to sign that were described as “not contracts” but “just information” but in fact were agreements that, among other things, authorized the companies to make withdrawals from consumers’ bank accounts.
- Misrepresented that participation in their program would stop creditors from calling or suing consumers to collect debts.
- Failed to negotiate with and pay creditors as promised.
- Caused consumers to incur late fees, finance charges, overdraft charges, and negative information on their credit reports, and to face various types of legal action by creditors, leaving them in worse financial condition than before.

Status: Settlement

3. Homeland Financial Services, National Support Services LLC, United Debt Recovery LLC, Freedom First Financial LLC, and USA Debt Co, LLC, Financial Liberty Services, and their principals, Dennis Connelly, Richard Wade Torkelson, and Joanne Garneau (doing business as Prosper Financial Solutions)
Press release on September 21, 2006 at: www.ftc.gov/opa/2006/09/nationwide.shtm
Complaint filed on September 21, 2006
Complaint alleged that the defendants:

- Falsely claimed that, for a non-refundable fee of up to 15 percent of a consumer’s unsecured debt, they could reduce all of their unsecured debts, including credit card balances and medical bills, by as much as 40 percent to 60 percent.
- Falsely represented that they would contact consumers’ creditors immediately.
- Charged a nonrefundable fee of 12-15 percent of the total debt.
- To the extent that they initiated negotiations with creditors, these settlements typically began only after a consumer paid 30 percent to 40 percent of the fee. This could take up to three months after a consumer followed the advice of the settlement firm and stopped making payments to creditors.
- Rarely negotiated settlements with all of a consumer’s creditors, and even when they have successfully negotiated an account, in many cases, the settlement amount is significantly more than 60 percent of what consumers owe.
- Caused most consumers, who typically left the program within six months of enrolling without completing it, to incur larger debt as a result of penalties, fees, interest, and other charges.
- Failed to adequately disclose the likelihood that consumers would be sued if they took the defendants’ advice and stopped making payments to creditors.
- Falsely advised consumers that negative information that appeared on their credit report as a result of participating in the defendants’ program would be removed upon completion of the program.

Status: Settlement for some of the defendants, injunctions still in place on others.

4. Innovative Systems Technology, Inc., dba Briggs & Baker; Debt Resolution Specialists, Inc., Todd A. Baker; and Jack Briggs, aka John Briggs
Press release on July 19, 2005 at: http://www.ftc.gov/opa/2005/07/briggsbaker.shtm

Complaint filed February 13, 2004
Complaint alleged that:

- Innovative Systems Technology, Inc., which did business as Briggs & Baker and Debt Resolution Specialists, Inc., falsely told consumers they could negotiate with their creditors and reduce their debt.
- Consumers were told to end all contact with their creditors and to stop making payments on their accounts.
- However, Innovative Systems Technology, Inc., never did negotiate with the consumers' creditors and consumers often ended up deeper in debt and incurred further damage to their credit ratings.

Status: Settlement. Both companies are now currently in Chapter 7 bankruptcy and barred from selling any debt negotiation services in the future.

5. National Consumer Council, London Financial Group; National Consumer Debt Council, LLC; Solidium, LLC; J.P. Landis, LLC; Financial Rescue Services, Inc.; Signature Equities, LLC; M&L Springfield Trust; PC Hailey Trust; Via Lido Trust; and United Consumers Law Group
Press release on March 30, 2005 at: www.ftc.gov/opa/2005/03/creditcouncel.shtm
Complaint filed April 23, 2004
Complaint alleged that:

- National Consumer Council, a purported nonprofit organization, solicited customers through an aggressive telemarketing and direct mail advertising campaign that falsely promised free debt counseling.
- In fact, NCC's role in the scheme was simply to generate leads for the other defendants who then charged consumers thousands of dollars in fees to enroll in their debt negotiation programs.
- The defendants deceptively claimed these programs were an effective way to stop creditors' collection efforts and eliminate debts.
- The defendants failed to disclose important information to consumers before they enrolled, including the fact that very few people were able to reduce their debts through the debt negotiation programs; consumers would suffer late fees, penalties, and other charges; and that participation in the program might hurt their credit rating.
- Very few consumers were helped; a court-appointed receiver determined only 1.4 percent of the consumers who enrolled in the defendants' debt negotiation programs – 638 out of 44,844 consumers – actually completed them. 43 percent of NCC's clients cancelled the program after incurring fees of 64 percent of the total amount remitted to NFCC.

Status: Settlement

6. Jubilee Financial Services, Jabez Financial Group, Gustavsen Learning Centers, Inc., and Debt Relief Counselors of America, P.C. et al
Press release on January 26, 2005 at: www.ftc.opa/2005/01/jubilee.shtm
Complaint filed August 19, 2002

Complaint alleged that defendants:

- Lured consumers with false promises that consumers who enrolled in their debt negotiation program would be able to pay their debts at a reduced amount of 40 to 60 percent and that consumers would stop receiving collection calls from creditors.
- Told consumers to stop making payments to creditors so that they would be in a "hardship condition" that would make it easier to negotiate.
- Misled consumers about the effects of the Jubilee program on their credit report and failed to tell consumers that, as a result of using the defendants' services, negative information would appear on consumers' credit reports and stay there for seven years.
- Falsely told consumers that money sent to the Jubilee companies would be held in a trust account to be used by defendants to pay off consumers' debts at a reduced rate, when instead the companies withdrew the funds to pay operating expenses.
- Failed to negotiate with and pay creditors as promised.
- Caused consumers to incur late fees, finance charges, overdraft charges, and negative information on their credit reports, and to face various types of legal action by creditors, leaving them in worse financial condition than before.

Status: Permanent injunctions against defendants

7. Better Budget Financial Services (BBFS) and its principals, John Colon, Jr. and Julie Fabrizio-Colon
Press release on November 15, 2004 at: www.ftc.gov/opa/2004/11/bbfs.shtm
Complaint filed November 15, 2004
Complaint alleged that the defendants:

- Falsely claimed that they could negotiate with consumers' creditors to reduce their debt by as much as 50 to 70 percent.
- Promised to negotiate with consumers' creditors for a non-refundable retainer fee, monthly administrative fees of $29.95 to $39.95, and 25 percent of any savings realized by a debt settlement, resulting in consumers paying hundreds or even thousands of dollars in fees.
- Told consumers to stop paying their creditors directly, claiming that consumers' failure to pay their creditors will demonstrate a "hardship condition" that will enable BBFS to negotiate on their behalf and instructed them to set a bank account into which to deposit a specific amount each month to cover the fees and negotiated debt amounts.
- Claimed that they would settle each creditor's account once the consumer saves half the amount owed on each debt.
- Told consumers to sign power of attorney forms, claiming that the forms would enable BBFS to contact creditors on the consumers' behalf and instruct debt collectors to stop calling consumers directly.
- Instructed consumers not to talk to any creditors who contacted them directly.
- Told consumers that negative information may appear on their credit reports while they worked with BBFS, but that the information was temporary and that BBFS would direct consumers to a company to get assistance repairing their credit.

- Failed to negotiate with consumers' creditors or to contact debt collectors as promised, even after consumers called to let them know that they had sufficient funds set aside to pay a settlement.
- Caused consumers to incur late fees, finance charges, overdraft charges, and negative information on their credit reports, and to face various types of legal action by creditors or to file for bankruptcy, leaving them in worse financial condition than before.

Status: Settlement

ADDENDUM B: RECENT FTC CREDIT COUNSELING AND OTHER DEBT MANAGEMENT CASES

1. AmeriDebt, Inc., DebtWorks, Inc., Andris Pukke, and Pamela Pukke, also known as Pamela Shuster
Press release on September 10, 2008 at: http://www.ftc.gov/opa/2008/09/ameridebt.shtm
Complaint filed on November 19, 2003

Complaint alleged that:

- AmeriDebt falsely claimed they were a non-profit corporation operating for charitable purposes.
- Despite its claims to the contrary, AmeriDebt did not teach clients how to handle debt. Instead, they sold them into "debt management plans" (DMPs) which had monthly fees.
- AmeriDebt falsely claimed that there were no up-front fees. When they collected these fees, they held onto them and did not disburse them to creditors.

Status: Settlement. It was one of the biggest debt management/credit counseling deception cases brought by the FTC ever, ultimately $12.7 million was returned to more than 280,000 customers.

2. Select Personnel Management, Inc., an Ontario, Canada, corporation d/b/a Select Management Solutions, and James Stewart, individually and as an officer or director of Select Personnel Management, Inc., d/b/a Select Management Solutions
Press release on August 19, 2008 at: http://www.ftc.gov/opa/2008/08/smsomax.shtm
Complaint filed on: February 2, 2007

Complaint alleged that:

- The Canadian telemarketer, Select Personnel Management, Inc., falsely told U.S. consumers that they could reduce their credit card interest rates and that they were affiliated with the consumers' credit card companies, violating Section 5 of the FTC Act and the FTC's Telemarketing Sales Rule (TSR).
- The telemarketer promised consumers to effect credit card rates between 4.75 percent and 9 percent, thus saving consumers at least $2,500, and that if consumers did not save that amount their money would be refunded.
- Consumers paid $675 (plus $20 for shipping) for promotional materials that eventually resulted in three-way telephone calls with the telemarketer, consumers and their credit card companies where the companies were asked to lower their interest rates. The requests were usually denied and that was often the extent of the services provided.
- Consumers who did not receive the promised savings, did not receive a refund despite claims to the contrary.

Status: Ongoing, complaint recently amended.

3. Randall L. Leshin, Randall L. Leshin, P.A. also d/b/a Express Consolidation, Express Consolidation, Inc., Consumer Credit Consolidation, Inc., and Maureen A. Gaviola

Press release on May 8, 2008 at: http://www.ftc.gov/opa/2008/05/express.shtm
Complaint filed on: January 8, 2007

Complaint alleged that:

- Express Consolidation, Inc. illegally tele-marketed millions of consumers under the guise of a non-profit that only charged a monthly administrative fee.
- Instead, Express Consolidation, Inc. charged a fee equal to the monthly payment in addition to a monthly administrative fee.
- Despite their claims, Express Consolidation, Inc.'s services did not reduce the consumer's total debt and did not provide any services to improve the customer's credit history, record, or rating.

Status: Settlement. The settlement included a $40 million judgment, based on the money the defendants received through the scam. However, the payment was drastically reduced because of the defendants' inability to pay.

4. Debt Solutions, Inc., a Florida corporation, also doing business as DSI Financial, Inc., and Accelerated Financial, Inc.; DSI Financial, Inc., a Florida corporation, also doing business as Accelerated Financial, Inc.; DSI Direct, Inc., a Florida corporation; Pacific Consolidation Services, Inc., a Washington corporation, also doing business as DSI Financial, Inc., and Accelerated Financial, Inc.; Kenneth Schwartz, individually and as an officer of Debt Solutions, Inc., DSI Financial, Inc., and DSI Direct, Inc.; Jennifer Ruth Whalen, aka Jennifer Ruth Krizan, individually and as an officer of Pacific Consolidation Services, Inc., and DSI Direct, Inc.; David Schwartz, individually and as a manager of Pacific Consolidation Services, Inc.; and GREG MOSES, individually and as a manager of Pacific Consolidation Services and DSI Direct, Inc.
Press release on May 23, 2007 at: http://www.ftc.gov/os/caselist/0523002/0523002.shtm
Complaint filed on: March 21, 2006

Complaint alleged that:

- Debt Solutions Inc. charged consumers hundreds of dollars for a "debt elimination program" that, despite its claims to the contrary, did not greatly reduce interest rates and result in thousands of dollars in savings.
- Through unsolicited phone calls and online marketing, the defendants falsely told consumers upon enrolling in the program they would be assigned a financial consultant who would help them to greatly lower their interest rates.
- Instead, most consumers who did enroll did not receive lower interest rates and those that did only saw reductions of around one percentage point.
- Very few consumers received the promised refund.
- Consumers were not told that the promised savings would take decades to achieve and that the majority of savings would result from increasingly paying more every month, not reduced interest rates.

Status: Settlement

5. Credit Foundation Of America, a California Corporation; TTT Marketing Services, Inc., a California Corporation; Credit Defenders Of America, Inc., a California Corporation; Credit Shelter Of America, Inc., a California Corporation; Sure Guard Credit Corporation, Inc., a California Corporation; ANTHONY P. CARA, individually and as a director or officer of Credit Foundation of America and TTT Marketing Services, Inc., WALTER F. VILLAUME, individually and as a director or officer of TTT Marketing Services, Inc. and Sure Guard Credit Corporation, Inc.; TODD A. RODRIGUEZ, individually and as a director or officer of TTT Marketing Services, Inc., and Sure Guard Credit Corporation, Inc.; ROBERT BROWN, individually and as a director or officer of Credit Defenders of America, Inc.; and BRYAN TAYLOR, individually and as a director or officer of Credit Shelter of America, Inc.
Press release on June 15, 2006 at: http://www.ftc.gov/opa/2006/06/cfa.shtm
Complaint filed on June 15, 2006

Complaint alleged that:

- The Credit Foundation of America, Inc. sold debt management services by falsely claiming that consumers were pre-approved for a service to consolidate their credit card debts to single monthly payment at a much lower interest rate (sometimes as low as zero percent).
- Consumers' individual circumstances were not taken into consideration when they were being recruited to enroll. Many enrollees lost the large enrollment fees they paid.
- Credit Foundation of America, Inc. claimed it was exempt from the do-not-call requirements of the FTC's Telemarketing Sales Rule (TSR) because of its tax-exempt status with the IRS. However, it primarily generated profits for for-profit companies.

Status: Settlement. Credit Foundation of America, Inc. ultimately agreed to pay $926,754 in consumer redress and civil penalties.

6. Integrated Credit Solutions, Inc.; Flagship Capital Services Corp.; Lighthouse Credit Foundation, Inc.; Mary H. Melcer; and J. Steven McWhorter, Defendants, and Jeffrey E. Poorman; and Daniel M. Melgar, Sr.,
Press release on: May 3, 2006 at: http://www.ftc.gov/opa/2006/05/lighthouse.shtm
Complaint filed on May 3, 2006

Complaint alleged that:

- Lighthouse Credit Foundation Inc. falsely advertised itself as a non-profit enterprise that could assist consumers with debt management plans.
- The Foundation misled consumers when they told them they could dramatically lower their interest rates, they would provide financial counseling, and that their monthly administrative fee was tax-deductible.

Status: Settlement. The Lighthouse Credit Foundation Inc. and its co-defendants were ultimately ordered to pay more than $2.4 million in consumer redress.