A Roll of the Dice: Debt Settlement Still a Risky Strategy for Debt-Burdened Households

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Abstract

Consumers with unmanageable debt loads face challenging options for dealing with their obligations, including filing for bankruptcy. Debt-settlement companies purport to offer indebted consumers an alternative way to become debt free while paying substantially less than what they owe. Though this sounds like an attractive option, consumers are likely to underestimate the risk that they will be unable to settle enough debt to benefit. Using data reported by the industry's trade association, I find that debt settlement is likely to leave consumers financially worse off, despite improved consumer protections enacted by the Federal Trade Commission (FTC) in 2010. The model specifically shows that consumers must settle at least two-thirds of their debts to benefit from enrolling in a debt-settlement program. Recent data from state regulators suggest that—similar to the outcomes before the 2010 FTC rule—debt settlers routinely fail to settle enough debts for this positive outcome to occur.

Introduction

Although aggregate consumer debt levels have declined in recent years, many American households remain highly indebted. The total outstanding credit card debt for all U.S. households exceed $700 billion, and the average American household carrying a credit card balance owes about $15,800 (Chen, 2015; Federal Reserve Bank of New York, 2015). One in five credit card users who carry a balance pay only the minimum each month, thereby accruing significant interest and prolonging the amount of time they will remain indebted (Morrison, 2013).

If this debt load becomes unmanageable, a consumer has a few options other than continuing to make minimum monthly payments until the debt is eventually retired. Some options provide a process by which the consumer and her creditors enter into an agreement regarding how the debt

will be handled. For example, the consumer could file for bankruptcy, resulting in either a liquidation of the debt or the establishment of a repayment plan. A consumer alternatively could reach individual agreements with each creditor on her own or, through a credit counseling agency, could set up a debt-management plan to which all creditors agree. These agreements usually require the consumer to repay the full outstanding balance but may waive the interest and fees.

Debt settlement is an alternative approach to dealing with debt, especially credit card debt. This option is marketed through television and radio ads, with the promise of being able to pay less than the balance currently owed, which may make it seem like a more attractive and affordable option. When consumers enroll in a debt-settlement program, they stop making payments on their debts (if not already in default) and instead may be directed to save funds into a dedicated account (GAO, 2010). Consumers also must grant the debt-settlement company, typically through a power of attorney, the authority to negotiate on their behalf and cease any contact with their creditors.

After the dedicated account has an adequate balance, the debt-settlement firm attempts to negotiate settlements with the consumer's creditors for less than the amount owed. Settlement agreements can be structured to be paid from the dedicated account in a single, lump-sum payment or, more frequently, as a "term settlement" with a series of payments made over time from the dedicated account. Term settlements can range in length from just a few months to more than a year.[1] The debt-settlement company earns its fee after the consumer agrees to the settlement agreement negotiated with the creditor and after at least one payment is made to the creditor, regardless of whether it is the sole settlement payment or the first in a series. To settle most or all of their debts, consumers typically need to remain enrolled in a debt-settlement program for 3 to 4 years (Regan, 2013).

Debt-settlement advertisements claim that typically consumers see "over 50% of their debt written off…" and are "…debt free in as little as 36 months" (DMB Financial, 2013). Debt-settlement companies promote themselves as being faster and less expensive than slowly paying off credit card debt through minimum payments and as providing a less drastic strategy than filing for bankruptcy (Freedom Debt Relief, 2013a, 2013b; US Financial Options, 2013). Debt settlement, however, comes with significant risks not present in the other options previously outlined that involve an upfront agreement between a consumer and her creditors. Two key differences between debt settlement and other approaches is that (1) consumers using debt settlement stop payments to their creditors and thus default on their debt and (2) consumers face the risk that the creditor will refuse to negotiate with the debt-settlement company and instead pursue collection activity or even a lawsuit against them after they stop payment.

In this article, I summarize existing findings from state and federal regulators and discuss research on the significant uncertainties and risks consumers undertake when enrolling in a debt-settlement program. Using an evaluation of consumer outcomes that was developed for the industry's trade association, I then estimate the share of debt a consumer needs to settle to benefit from a debt-settlement program relative to their financial position at the time of enrollment. I close with policy options that may lower risks to consumers.

[1] See, for example, settlement letters posted on a debt-settlement company's website at http://clearoneadvantage.com/testimonials/debt-settlement-letters.php that show term settlements of varying lengths.

Regulatory and Literature Review

Debt-settlement firms are regulated at both state and federal levels. Some states ban debt settlement entirely, and others limit the allowable fees that can be charged to such an extent that companies opt not to do business in those states. At the federal level, the Federal Trade Commission (FTC) and the Consumer Financial Protection Bureau (CFPB) are the primary regulators that oversee the industry.

Modern-day debt settlement experienced strong growth in the early 2000s, when several states authorized the practice based on a model bill, the Uniform Debt Management Services Act, promoted by the debt-settlement industry (Association of the Bar of the City of New York, 2012). At the time, the two debt-settlement trade associations—the United States Organizations for Bankruptcy Alternatives (USOBA) and The Association of Settlement Companies (TASC)—represented approximately 200 and 265 companies, respectively (Association of the Bar of the City of New York, 2012).

With that growth came increasing concerns regarding industry practices, leading to investigations and hearings by state attorneys general and federal agencies. One of the more troubling of these industry practices was charging high fees at the time of enrollment and continuing monthly charges before debts were settled. Companies historically would charge an upfront fee of around 15 percent of the amount of debt enrolled (Regan, 2013). Thus, many consumers paid thousands of dollars to the companies before those companies made any attempts to settle their debts.

Multiple state attorneys general and regulators successfully sued debt-settlement companies for fraudulent and deceptive acts and practices. State attorneys general and their regulators took at least 127 enforcement actions against debt-settlement firms by 2010.[2] In 2008 and 2009, the FTC hosted public meetings on the debt-settlement industry, and, in 2010, the Government Accountability Office (GAO) issued a report outlining its concerns about the industry. These actions culminated in 2010 with the FTC's promulgation of new regulations that required changes regarding when fees can be charged and added other reforms. Now, debt-settlement firms may collect a fee only when they reach a settlement agreement with a consumer's creditor and the consumer agrees to the settlement and makes a payment.

The FTC's 2010 reforms dramatically changed the scope and size of the industry. Many companies changed their business models to charge fees only when debts settled. Other companies went out of business, presumably because they were unable to profitably operate under the new rules. In addition, some firms argued that they were not subject to the advance fee ban and continued to charge fees upon enrollment. USOBA's membership dropped to 30 firms, and eventually the trade association folded (Ody, 2011). TASC rebranded itself as the American Fair Credit Council (AFCC) and asked that members be in compliance with the FTC's ban on advance fees. Membership in AFCC now consists of just 33 debt-settlement companies (AFCC, 2013).

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[2] Federal Trade Commission. 2010. Amendments to the Telemarketing Sales Rule. Federal Register 75 (153), 48458–48523. http://www.ftc.gov/sites/default/files/documents/federal_register_notices/telemarketing-sales-rule-final-rule-amendments/100810tsr.pdf.

Certain debt-settlement companies continue to charge advance fees despite the FTC rule, arguing that they are using an "attorney model" of debt settlement, in which a loosely affiliated attorney is part of the debt-settlement program (though non-attorneys continue to conduct the actual debt-settlement work) (Becker and Harnick, 2013). Although attorneys are not exempt from the FTC rule per se, some companies employ attorneys or paralegals to hold face-to-face meetings with consumers. Because the FTC's rule does not cover such in-person communication, the companies claim that their conduct is exempt from the rule (Becker and Harnick, 2013). This type of debt settlement is increasingly under attack by federal regulators, however, with the CFPB placing particular focus on firms that use the attorney model to continue to charge advance fees (CFPB, 2015, 2014, 1013a, 2013b, 2013c, 2012). Because of this scrutiny and the success of recent enforcement actions, it is likely that the dominant model of debt settlement in the future will be one that complies with the 2010 FTC rules barring advance fees.

Relatively little research or data about the debt-settlement industry are available to evaluate consumer outcomes, particularly after the advance fee ban took effect. During the time the FTC was considering regulatory changes, a debt-settlement trade association survey showed that about 42 percent of consumers who enrolled at member firms had none of their debts settled and nearly two-thirds failed to have most of their debts (70 percent or more) settled.[3] Independent investigations of the industry before the 2010 changes took effect also found low settlement rates. A GAO investigation concluded that debt-settlement companies overstate their success rates, noting, "The success rates we heard [from debt-settlement companies] are significantly higher than is suggested by the evidence obtained by federal and state agencies. When these agencies have obtained documentation on debt settlement success rates, the figures have often been in the single digits" (GAO, 2010: 10). Data obtained through litigation by states' attorneys general similarly showed completion rates in the low single digits before the advance fee ban took effect (Association of the Bar of the City of New York, 2012).

One might expect to see settlement rates increase after the advance fee ban took effect, because debt-settlement companies are now unable to collect a fee until an agreement is reached. An analysis of industry data by a forensic accountant for AFCC shows a higher percentage of debts settled in the first 2 years after the ban took effect than in the years before the reform (Regan, 2013). According to the report, approximately 35 to 40 percent of debts enrolled in 2011 had settled by the end of 2012 and an additional 20 to 25 percent remained active (Regan, 2013). It is unclear, however, how these settlements are distributed among consumers (because each consumer typically enrolls multiple debts) and what percentage of a given consumer's debts will eventually settle.

Annual reports published by the Colorado Office of the Attorney General call into question whether consumer-level outcomes have improved since the advance fee ban came into effect. The data in these reports enable us to compare preliminary outcomes 24 to 36 months after enrollment for two groups of consumers: (1) those who enrolled in 2009, the last full year in which debt-settlement companies operated without the advance fee ban and (2) those who enrolled in 2011, the first full year in which the advance fee ban was in effect. Exhibit 1, showing how these consumers fared by the end of 2011 and 2013, respectively, offers no indication of an improvement in outcomes for consumers. In both cases, more than 60 percent of consumers terminated their participation in

[3] In its Final Rule, in a discussion of outcomes for consumers who drop out of debt-settlement programs, the FTC notes that the TASC survey found that 65.2 percent of dropouts had no debts settled, the equivalent of more than 42 percent of all debt-settlements clients.

Exhibit 1

Distribution of Colorado Consumer Debt Settlement Outcomes 24 to 36 Months After Enrollment

Percent of Consumers Who…	After Advance Fee Ban (outcomes at year-end 2013 for consumers who enrolled in 2011)	Before Advance Fee Ban (outcomes at year-end 2011 for consumers who enrolled in 2009)
Settled all debts	7%	11%
Remain active in program	28%	27%
Terminated participation in program	64%	62%

Note: Numbers may not add to 100 percent because of rounding.
Sources: Colorado Attorney General (2014, 2012)

debt settlement, and less than 10 percent had managed to complete their program by settling all their debt (Colorado Attorney General, 2014, 2012). As a best-case scenario, if all the remaining active consumers were to complete their debt-settlement programs in the future, it would still result in less than one-half of all who enrolled in a debt-settlement program settling all their debt.

Perhaps two reasons for low settlement rates and a large share of consumers terminating their participation in these programs are (1) the refusal of creditors to negotiate with debt settlers and (2) creditors suing consumers after they default and cease communication. A 2012 survey of credit card issuers, debt buyers, and debt collectors found that only one-half of respondents would engage with debt-settlement firms (InsideARM, 2013). The responses vary by creditor type, with 63 percent of credit card company respondents reporting that they will work with debt-settlement companies compared with 40 percent of collection agencies and 59 percent of debt buyers (InsideARM, 2013). A study by the Association of the Bar of the City of New York (2012) found that one-third of consumers who enrolled with a particular debt-settlement company faced lawsuits from their creditors; in some cases, consumers were not even aware of the legal action until their wages were garnished. Among more recent cases, the Maryland debt-settlement regulator reported that, among those consumers who enrolled in a debt-settlement program after the advance fee ban took effect in October 2010, one-fourth had a lawsuit filed against them by at least one creditor by the end of 2011 (Maryland Office of the Commissioner of Financial Regulation, 2014).

An analysis by a researcher at the Federal Reserve Bank of Philadelphia notes that, despite the low completion rates and risks of debt settlement, consumers may still find such programs attractive because of a tendency to be over-optimistic about future outcomes, to seek a strategy that offers instant gratification due to impatience to improve their financial situation, and to have a inclination to discount problems that may result in the future (Wilshusen, 2011). She notes that debt-settlement advertisements are persuasive to vulnerable consumers who have no way to properly evaluate claims that these companies make (Wilshusen, 2011). Only after significant time has passed after enrolling in a program will these consumers have a sense of whether their experience will turn out to be a positive one. The author of a recent law review article is similarly critical of the industry, noting that consumers may endure negative impacts to their credit scores, lawsuits, and poor settlement outcomes and still end up filing for bankruptcy (Nelson, 2014). The author believes that these programs will not be safe for consumers unless debt-settlement firm principals are held criminally liable for bad practices and regulators engage in intensive monitoring (Nelson, 2014).

Methodology and Findings

Although the risk of a creditor lawsuit or inability of a debt-settlement company to settle some of its debts is difficult for a consumer to predict at the outset, the share of overall debt that must be settled for a consumer to financially benefit from enrolling in a debt-settlement program, relative to her financial position just before enrollment, can be estimated. To calculate this estimate, I draw on data from an account-level analysis of outcomes conducted for AFCC (Regan, 2013). This analysis shows that consumers enroll six debts on average, totaling slightly more than $30,000. The report also notes that these debts will experience an average "accretion" (or an increase in outstanding balance) of 20 percent from the time they are enrolled until they are settled due to interest charges and other fees that accrue on defaulted debts.[4] Because some debts settle relatively quickly and others may remain in default for several years, however, the actual accretion rate per account varies, with those debts settled more quickly having less overall accretion than others.[5] We also know from the report that debts are settled for an average of 48 percent of the balance owed at the time the agreement is reached and from industry statements that a typical firm may charge 20 to 25 percent of the amount of the debt enrolled as a settlement fee.

The model is constructed by applying the applicable accretion rate to each debt until the time at which we would expect a settlement to occur. I then weigh the costs (the increase in outstanding balance, total debt owed to the creditor per the settlement agreement, and the fee assessed by the debt-settlement company) against the savings the consumer achieves through the settlement (the reduction in debt owed) to determine the net benefit or cost experienced by a given consumer who is able to settle one, two, three, four, five, or all six of the debts enrolled. Because the debt-settlement industry notes that programs are typically completed within 3 to 4 years, I model findings at 36 months of enrollment.

The findings are presented in two ways: one that is quite conservative and the other that is more inclusive of common costs consumers in a debt-settlement program may pay. The conservative estimate of how many debts must be settled for a benefit does not take into account the costs associated with maintaining a dedicated account into which the consumer makes deposits and through which the creditor is paid in accordance with the settlement agreement. These fees may vary, depending on the account provider, and, in some cases, the account may not be required. This conservative estimate also does not take into account any tax liability. Under federal tax law, when a creditor cancels some or all of a debt owed, the amount of the debt reduction is generally counted as taxable income if the debt's outstanding principal balance is reduced by at least $600 (Internal Revenue Service, 2013; Prater, 2013). State tax laws, in general, are similar. The debt-settlement industry claims that most clients do not face this liability because they can successfully qualify for a tax exemption available to people who are insolvent at the time the debt is reduced.

[4] If a debt remains unsettled after the 36-month period used in our model, it will have also grown by 20 percent and remain outstanding.

[5] Note that accretion does not accrue at a uniform rate throughout the 36-month period because of the timing of interest charges, late fees, and other penalties that are assessed on delinquent and defaulted credit card debt. For example, a higher interest rate and late fees may be charged until a creditor charges off a debt and either begins collection attempts or sells the debt to a debt buyer. At that point, no further interest charges would apply.

The second, more inclusive estimate of how many debts must be settled for a consumer to benefit incorporates typical fees associated with a dedicated account. Such fees include a $9 setup fee plus $10 per month in continuing fees—$369 in total fees for a client who spends 36 months in a debt-settlement program.[6] It also includes tax liability at a combined state and federal 15-percent rate on all debt that is cancelled through settlements. A quick glance at online reviews of debt-settlement companies reveals testimonials from customers who say they incurred tax liability on their settled debts (Prater, 2013; Weisbaum, 2013). Even if a consumer qualifies for an exemption from tax liability, she must be aware of that fact and be able to complete the proper tax forms to avoid that cost.

Assumptions

This model includes three key assumptions that likely cause the resulting findings to be conservative.

First, all debts that a consumer enrolls in a debt-settlement program are assumed to be equal in size. In practice, debt-settlement companies may settle a somewhat smaller debt first to enable the consumer to experience a faster initial settlement agreement, leaving the larger debts to be settled later. The larger the debts left unsettled, the greater the accretion that will accrue. Therefore, this assumption likely understates the accretion that accrues on unsettled debts.

Second, all settlements are assumed to be successfully repaid as stipulated in the agreement. Settlement agreements increasingly are structured for repayment in installments over time (called "term settlements"). In a survey of creditors dealing with term settlements, approximately 40 percent of respondents reported that 20 percent or less of term settlements fail; however, another 29 percent of respondents reported a failure rate of 40 percent or higher (InsideARM, 2013). A broken settlement agreement will result in the returning of the debt to a default status, with the consumer still owing the debt settler a fee.

Third, the potential that one or more creditors may sue a consumer while she is participating in a debt-settlement program is not taken into account. The difficulty in predicting which creditors would likely sue and the variability of the costs involved[7] led me to exclude these costs from the calculation.

Finally, the analysis shows the change in financial position only at 36 months from enrollment, although it is possible that unsettled debts may continue to grow past this point until the consumer reaches an agreement with her creditors, files for bankruptcy, or dies. Therefore, the model may further understate the extent of a client's negative change in financial position if debts are left unsettled past the 3-year period.

Findings

As exhibit 2 shows, the AFCC report notes that the 56,000 consumers in the data set enrolled a total of $1.7 billion in debt after the advance fee ban took effect (Regan, 2013). This overall total

[6] *Carlsen* v. *Global Client Solutions, LLC, et al.* 2011. Washington State Supreme Court, No. 84855-6. http://caselaw.findlaw.com/wa-supreme-court/1567511.html.

[7] Such costs could include attorneys' fees, court costs, out-of-pocket expenses, and lost income.

Exhibit 2

An Average Consumer's Debt at Enrollment in a Debt-Settlement Plan

Total debt enrolled after the advance fee ban	$1,700,000,000
Average number of debts enrolled per consumer	6
Total number of consumers enrolled after the advance fee ban	56,000
Average total debt enrolled per consumer ($1.7 billion/56,000)	$30,357
Average size of each debt enrolled per consumer ($30,357/6)	$5,060

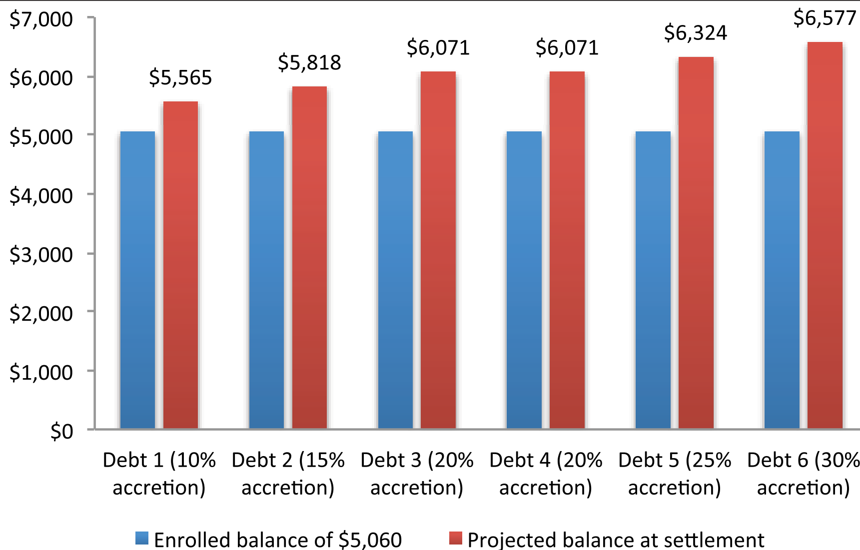
equates to an average total enrolled debt of $30,357 per consumer. In addition, each consumer enrolled six debts on average (Regan, 2013). Therefore, the average size of each debt a consumer enrolls is approximately $5,060.

Each of these debts experiences accretion, as interest, late fees, and other penalties accrue over time while the consumer waits for the debt-settlement company to reach settlement agreements with her creditors. The report notes a consumer's total enrolled balance will grow by 20 percent before all debts are settled (Regan, 2013). Because settlement agreements are reached sequentially, however, one debt may settle relatively soon after enrollment and thus incur less total accretion than another debt that remains in default for a longer time (or never settles). According to AFCC, the first debt settles just a little after 4 months from enrolling in the program, and—assuming all creditors are willing to settle—a debt-settlement program should complete within 36 to 48 months (Regan, 2013).

We therefore construct a model, shown in exhibit 3, which estimates the amount by which each of the six debts enrolled would grow before settlement. The amount ranges from 10-percent growth

Exhibit 3

Projected Accretion of Each Account From Time of Enrollment Until Settlement (assuming all accounts settle within 36 months)



Note: This chart assumes all debts are eventually settled; however, if any unsettled debts remain outstanding, they will grow from $5,060 to $6,577 at the 36-month mark.

in debt balance for the first debt to 30-percent growth for the final debt. Although the growth of each individual debt varies by the time it takes to settle, the consumer's total debt grows by 20 percent overall from $30,357 to $36,429, consistent with the finding in the AFCC report.

The AFCC report found that, if an agreement is reached on a given debt, this settlement typically reduces the outstanding balance on that debt (which includes accretion from the time of enrollment to settlement) by 48 percent (Regan, 2013). In exchange for reaching a settlement, the consumer owes a fee, which varies by company. Because fees often range from 20 to 25 percent of the debt balance at the time of enrollment, we use the midpoint: 22.5 percent.[8]

Exhibit 4 provides an illustration of these calculations on the settlement of the first account, which generally happens after 4 months in a debt-settlement program.

With these calculations based on data from the AFCC report and the assumptions outlined in the previous section, the share of debts that must be settled for a consumer to experience a positive financial change relative to her position at enrollment in a debt-settlement program can be measured. As noted previously, the model shows what share of debts must settle for a *typical* debt-settlement client; that is, a consumer who enrolls with the average level of debt and experiences the average rate of accretion.

A consumer must settle at least two-thirds (four of six) of her debts to have a positive change in financial position after 36 months of participating in a debt-settlement program, as exhibit 5 illustrates. A consumer who can do this will still be in default on two of six debts—risking lawsuits and continued collection activity from creditors—but will experience a positive change in financial position of more than $1,350 (relative to the amount of debt when she enrolled).

For example, a consumer who settles one-half (three of six) of her debts within a 36-month timeframe would owe her three creditors a total of $8,379 and the debt-settlement company a total of $3,415 for negotiating those settlements. Those funds would be paid from the consumer's dedicated account to which she regularly deposits funds over time. She would have three remaining unsettled debts, which originally totaled $15,179 when she began her debt-settlement program but grew during the 36 months by $4,554. This consumer ultimately would end up with $31,526

Exhibit 4

Illustration of First Debt Settled

Balance at enrollment	$5,060
Accretion (growth) in balance by 10%	$505
Balance at settlement ($5,060 + $505)	$5,565
Debt owed to creditor per settlement agreement (48% of $5,565 outstanding balance)	$2,671
Fee owed to debt-settlement company (22.5% of $5,060 balance at enrollment)	$1,138

Note: Numbers do not add exactly because of rounding.

[8] Many debt-settlement companies do not disclose the fee charged on their website. One exception to this is Debtmerica, which notes "[t]he total fees for our programs range from 20 to 24 percent of the enrolled debt balances that are settled" (Debtmerica, n.d.). In addition, the General Counsel for Century Negotiations, a large debt-settlement company and AFCC member, noted a 25 percent fee was an appropriate fee (Haber, 2011).

Exhibit 5

Change in Financial Position 36 Months After Enrollment (conservative estimate)

	Unable To Settle Any Debts	Settle One of Six Debts	Settle Two of Six Debts	Settle Three of Six Debts	Settle Four of Six Debts	Settle Five of Six Debts	Settle All Debts
(A) Total debt enrolled	$30,357	$30,357	$30,357	$30,357	$30,357	$30,357	$30,357
Costs associated with settled debt(s)							
(B) Total due to creditor on settled debts	NA	$2,671	$5,464	$8,379	$11,293	$14,329	$17,486
(C) Total debt-settlement fees due	NA	$1,138	$2,277	$3,415	$4,554	$5,692	$6,830
Costs associated with unsettled debt(s) and outstanding balance							
(D) Original balance of total unsettled debt remaining	$30,357	$25,298	$20,238	$15,179	$10,119	$5,060	NA
(E) Accretion on unsettled debt during 36 months	$9,107	$7,589	$6,071	$4,554	$3,036	$1,518	NA
Total costs and financial position 36 months after enrollment							
(F) Total debt balance plus costs (B+C+D+E)	$39,464	$36,697	$34,051	$31,526	$29,001	$26,598	$24,316
Change in financial position 36 months after enrollment (A-F)	**– $9,107**	**– $6,340**	**– $3,693**	**– $1,169**	**$1,356**	**$3,759**	**$6,041**
Number of debts that remain in default	**6**	**5**	**4**	**3**	**2**	**1**	**0**

NA = Not applicable.
Note: For more information on the calculations in this table, see appendix A.

in total obligations to creditors and her debt-settlement company, an increase from her original $30,357 debt at the beginning of the debt-settlement program of $1,169. Had she instead been able to settle four of six debts, she would achieve a positive change in financial position of $1,356 at the 36-month mark.

As noted previously, the finding that a consumer would need to settle two-thirds of her debt to benefit is our conservative estimate. If, instead, factors such as the cost of the dedicated account and tax liability are taken into consideration, the threshold for a positive financial benefit increases to settling at least five of six debts.

As exhibit 6 shows, this more inclusive estimate would mean, for example, that a consumer who settles four of six debts during 36 months would have had total debt reduction of $8,945. Assuming a combined federal and state income tax rate of 15 percent, this consumer, if not "insolvent" as

Exhibit 6

Change in Financial Position 36 Months After Enrollment (inclusive estimate)

	Settle One of Six Debts	Settle Two of Six Debts	Settle Three of Six Debts	Settle Four of Six Debts	Settle Five of Six Debts	Settle All Debts
(A) Change in financial position 36 months after enrollment (from exhibit 5)	– $6,340	– $3,693	– $1,169	$1,356	$3,759	$6,041
(B) Cumulative debt reduction	$2,388	$4,655	$6,800	$8,945	$10,969	$12,871
(C) Potential tax liability (assuming 15% rate)	$358	$698	$1,020	$1,342	$1,645	$1,931
(D) Dedicated account fees if enrolled for 36 months	$369	$369	$369	$369	$369	$369
Revised change in financial position, taking these costs into account (A-C-D)	**– $7,067**	**– $4,761**	**– $2,558**	**– $355**	**$1,745**	**$3,741**

Note: For more information on the calculations in this table, see appendix A.

defined by tax law, would owe taxes of $1,342 on the debt reduction. If $369 in dedicated account fees are also included, this consumer would experience a negative change in financial position of $355 instead of the positive change of $1,356 reported in exhibit 5.

Conclusion and Policy Implications

Consumers overwhelmed by their credit card and other forms of unsecured consumer debt face tough decisions when determining whether to continue paying on those debts as agreed. If they are unable to do so, options such as negotiating directly with a creditor, entering into a debt-management plan, or filing for bankruptcy can at least provide consumers with the certainty that, as long as they complete the program, their creditors will not pursue collection activities or initiate lawsuits. By comparison, debt settlement is a risky gamble in which consumers cut off communication with their creditors, stop making payments, and hope that negotiations conducted on their behalf are successful in settling most or all of their debts. Data from state and federal regulators and from independent studies of consumer outcomes, although limited, show that consumers incur significant risk of a creditor lawsuit and that many consumers' debts are left unsettled.

Because vulnerable consumers will naturally be attracted to an option that promises to reduce the amount of debt that they owe, regulations providing for more transparency regarding outcomes and accountability of debt-settlement firms for the impact of those outcomes are needed. Specifically, the following measures may help lessen risks to consumers.

- **Provide relief for consumers who do not benefit from debt-settlement services.** To discourage debt-settlement companies from enrolling people who have a significant chance of failing to settle much, if any, of their debts, consumers could be provided with some form of refund or concession if they end up worse off after they enroll in a debt-settlement program. Such a provision could require debt-settlement firms to provide refunds to clients who ultimately have to file for bankruptcy to cover some or all of their associated expenses. Debt-settlement firms could similarly be required to refund all fees paid if the client's total expenses (settlements owed to creditors, fees owed to debt-settlement firm, balance on any unsettled debt, etc.) exceed the original principal balance. This requirement would result in debt settlers having an incentive to enroll only consumers for whom debt settlement will likely be successful.
- **Establish meaningful limitation on fees.** Debt-settlement fees should be calculated based on the amount of savings achieved rather than on the size of the debt enrolled. Fees should be calculated by taking the difference between the amount of the debt at enrollment and the settlement amount. Setting the fee in this manner better aligns the debt-settlement firm's incentives with the interest of the consumer, because they would be paid more if they negotiate a larger debt reduction. It also ensures that a fee could not be larger than the debt reduction achieved, which may occur when fees are set as a percentage of the balance at enrollment.
- **Require detailed data reporting.** Debt-settlement companies should be required to report on the outcomes achieved for their clients, at a minimum, indicating for each consumer the number and amount of enrolled debts and for each such debt the date and amount of settlement (if any); the structure of each settlement (and whether term settlements are completed); the fees charged; and whether any of these debts are the subject of a creditor lawsuit. This data reporting is most helpful if it tracks enrollees' progress in a debt-settlement program over the course of several years, allowing for outcomes to be assessed over time for groups of consumers who enroll in a given year. Providing data reporting in this manner would not only enable consumers to better assess whether debt settlement is worth the risk but also would provide a tool for regulators to determine whether particular companies are delivering on promised results.
- **Ensure broad coverage of the law.** To establish a level playing field and to ensure that consumers can be confident that they are receiving the same level of protection regardless of the company they choose, any applicable laws or regulations should include all debt-settlement providers, including attorneys and others whose activities are not covered by the FTC rule.

Appendix A

This appendix provides more detail on how the change in consumer financial position is modeled in this article. (Note: All figures are rounded to the nearest dollar.)

Exhibit A-1

Consumer's Debts at Enrollment

Total debt enrolled after advance fee ban (AFCC report)	$1,700,000,000
Average number of debts enrolled per consumer (AFCC report)	6
Total consumers enrolled after advance fee ban (AFCC report)	56,000
Average total debt enrolled per consumer	$30,357
Average size of each debt enrolled per consumer	$5,060

AFCC = American Fair Credit Council.

Exhibit A-2

Overall Accretion (AFCC Study) and Estimated Accretion on Each of Six Accounts

Debt Number	Debt Balance at Enrollment ($)	Estimated Accretion (%)	Debt Balance With Accretion ($)
1	5,060	10	5,565
2	5,060	15	5,818
3	5,060	20	6,071
4	5,060	20	6,071
5	5,060	25	6,324
6 (or any debt unsettled after 36 months)	5,060	30	6,577
Total	**30,357**	**20**	**36,429**

AFCC = American Fair Credit Council.

Exhibit A-3

Settlement Amounts Due to Creditor and Fee Owed to Debt Settler per Debt Settled

Debt Number	Debt Balance at Enrollment ($)	Debt Balance at Settlement[a] ($)	Amount Due to Creditor[b] ($)	Cumulative Amount Owed to Creditor(s) ($)	Fee Owed to Debt Settler[c] ($)	Cumulative Fees Owed to Debt Settler ($)
1	5,060	5,565	2,671	2,671	1,138	1,138
2	5,060	5,818	2,793	5,464	1,138	2,277
3	5,060	6,071	2,914	8.379	1,138	3,415
4	5,060	6,071	2,914	11,293	1,138	4,554
5	5,060	6,324	3,036	14,329	1,138	5,692
6	5,060	6,577	3,157	17,486	1,138	6,830

[a] *From exhibit A-2.*
[b] *American Fair Credit Council report states that debt settles at 48 percent of current debt balance.*
[c] *Assumes fee of 22.5 percent of debt balance at enrollment.*

Exhibit A-4

Tax Liability Assessed on Principal Reduction

Debt Number	Debt Reduction[a] ($)	Cumulative Debt Reduction ($)	Cumulative Tax Liability at 15-Percent Rate ($)
1	2,388	2,388	358
2	2,267	4,655	698
3	2,145	6,800	1,020
4	2,145	8,945	1,342
5	2,024	10,969	1,645
6	1,902	12,871	1,931

[a] *Difference between debt balance at enrollment and amount due to creditor; see exhibit A-3.*

Calculations for Exhibit 5: Change in Financial Position 36 Months After Enrollment (conservative estimate)

The findings for exhibit 5 are calculated as follows—

Row A, Total debt enrolled: The starting balance at enrollment in the debt-settlement program, $30,357.

Row B, Total due to creditor on unsettled debts: The cumulative amount of settlements owed to creditors, given the number of debts settled. See exhibit A-3.

Row C, Total debt-settlement fees due: The cumulative fee owed to the debt settler as a result of settlement agreements reached. See exhibit A-3.

Row D, Original balance of total unsettled debt remaining: The total debt that has not been settled, not taking into account any accretion (growth in balance) from the time of enrollment. This row is calculated by multiplying the number of unsettled debts by $5,060 (the amount of each unsettled debt at the time of enrollment). For example, a consumer who is unable to settle three of six debts has a balance of $15,179, which is $5,060 x 3 (all numbers rounded).

Row E, Accretion on unsettled debt during 36 months: The accretion on unsettled debts from the time of enrollment until 36 months later. As shown in exhibit A-2, each debt that remains unsettled at month 36 experiences an accretion rate of 30 percent, resulting in a debt of $5,060 at the time of enrollment, increasing to $6,577—a total increase of $1,518. Thus, total accretion is calculated by multiplying the number of unsettled debts by $1,518. For example, a consumer who is unable to settle three of six debts has accretion of $4,554 on those debts, which is $1,518 x 3.

Row F, Total debt balance plus costs: The sum of rows B, C, D, and E.

Change in financial position 36 months after enrollment: The difference between the initial $30,357 debt balance at enrollment (row A) and row F.

Calculations for Exhibit 6: Change in Financial Position 36 Months After Enrollment (inclusive estimate)

The findings for exhibit 6 are calculated as follows—

Row A, Change in financial position 36 months after enrollment: This is from exhibit 5.

Row B, Cumulative debt reduction: See calculation in exhibit A-4. Note that principal reduction calculation may be conservative, because it is calculated by taking the difference between the debt balance at enrollment (rather than the debt balance at the time of settlement) and the amount due to creditor.

Row C, Potential tax liability: See calculation in exhibit A-4.

Row D, Dedicated account fees if enrolled for 36 months: This assumes only a $9 setup fee and a $10 monthly maintenance fee are assessed (9 + (10 x 36) = $369).

Revised change in financial position, taking these costs into account: Subtract rows C and D from row A.

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