The Numbers Don't Lie: The Case For Debt Settlement

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Introduction: The Case for Debt Settlement

While the U.S. economy continues to grow rapidly – GDP has expanded for 15 straight quarters – and 26 of the last 27 – American consumers continue to pile up debt. The Consumer Financial Protection Bureau recently reported that the average consumer's credit-card balance has increased 9% over just the last two years. Applications for new credit-cards have increased a whopping 50% since 2010. The Federal Reserve reports that American consumer borrowing now stands at $3.8 trillion – a number that exceeds the GDP of all but three countries on Earth.

Even in this robust economy, many consumers struggle to stay current on their credit-cards and other loans. Illness, job loss, divorce, natural disasters and other unexpected events can create unforeseen cash flow challenges for consumers that, in some cases, can lead them into seemingly insurmountable debt. In these circumstances, one important option for consumers is a debt settlement program. Debt settlement firms negotiate with creditors on behalf of consumers to reduce the principal the consumer owes and help them to address their debt. This paper shows that debt settlement programs dramatically improve the balance sheets and financial health of the vast majority of consumers who use them.

This analysis is based on a detailed statistical review commissioned by the American Fair Credit Council (AFCC), reflecting 400,000 clients in 2.9 million accounts enrolled in debt settlement programs during the period January 1, 2011 to March 31, 2017. The full report, prepared by Hemming Morse LLP on behalf of the AFCC, can be found at ww.americanfaircreditcouncil.org.

The story the data tells is powerful, overwhelming and crystal clear.

The Numbers Don't Lie

The bottom line: debt settlement produces real results for Americans struggling with unsecured debt:

- Debt settlement on average saves consumers $2.64 for every $1 in fees paid.
- 95% of debt settlement clients receive savings in excess of fees.
- Most consumers see initial account settlements within 4-6 months of program start.
- Debt settlement clients pay no fees until settlements are completed.
- For consumers who qualify, debt settlement offers significant financial and structural advantages over other alternatives.

The Basics

Debt settlement companies negotiate with credit-card companies and other unsecured creditors on behalf of consumers, with the goal of reaching terms for the discharge of outstanding debts at levels substantially below amounts owed. It's worth noting that debt settlement programs only address unsecured loans – not mortgages, auto loans or other types of credit extended with collateral.

Under Federal Trade Commission rules adopted in 2010, consumers can only be assessed fees by a debt settlement company when three criteria are met:

- The debt settlement company must negotiate terms of settlement for a debt;
- The consumer must agree to the terms negotiated on their account(s); and
- The consumer must ratify any settlement offer by making at least one payment to the creditor.

No fees are collected on any accounts until these three conditions are met, making debt settlement the most consumer-centric product in the financial services marketplace.

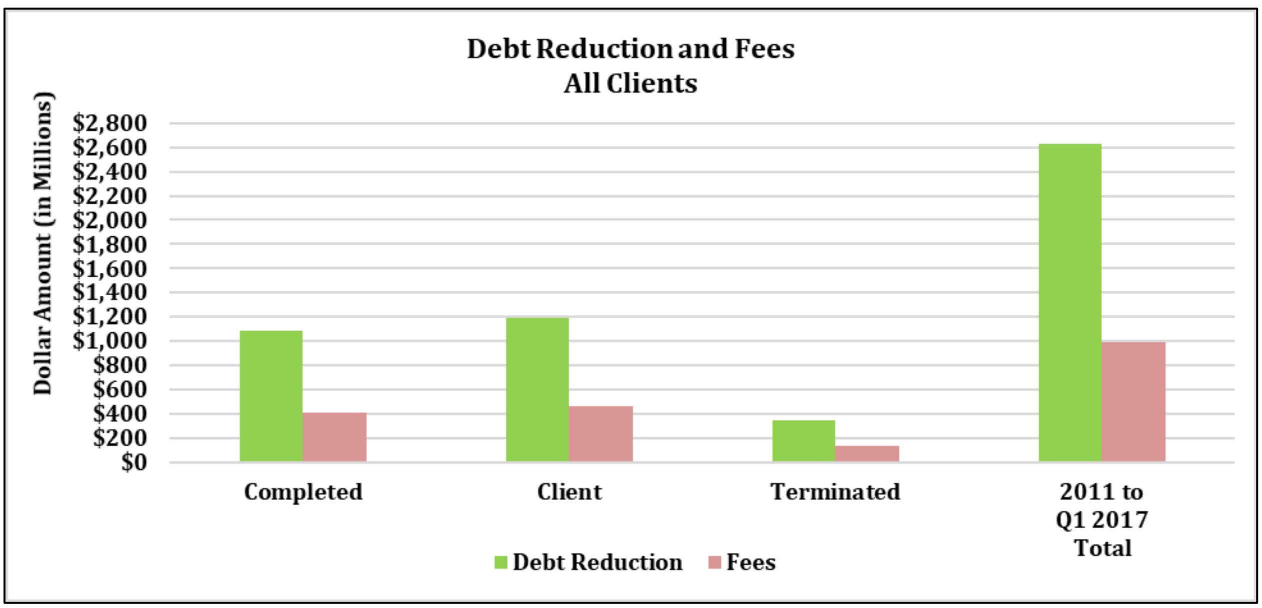
Under the same rules, consumers have the right to:

- Withdraw from debt settlement without penalty at any time, for any reason;
- Reject an offered settlement for any reason – or no reason at all.

It Works

Chart 1 below shows that the 400,000 clients included in the broader analysis have realized an aggregate debt reduction of $2.6 billion, while incurring total fees of $1.0 billion – a net savings of $1.6 billion, or about $4,000 per client.

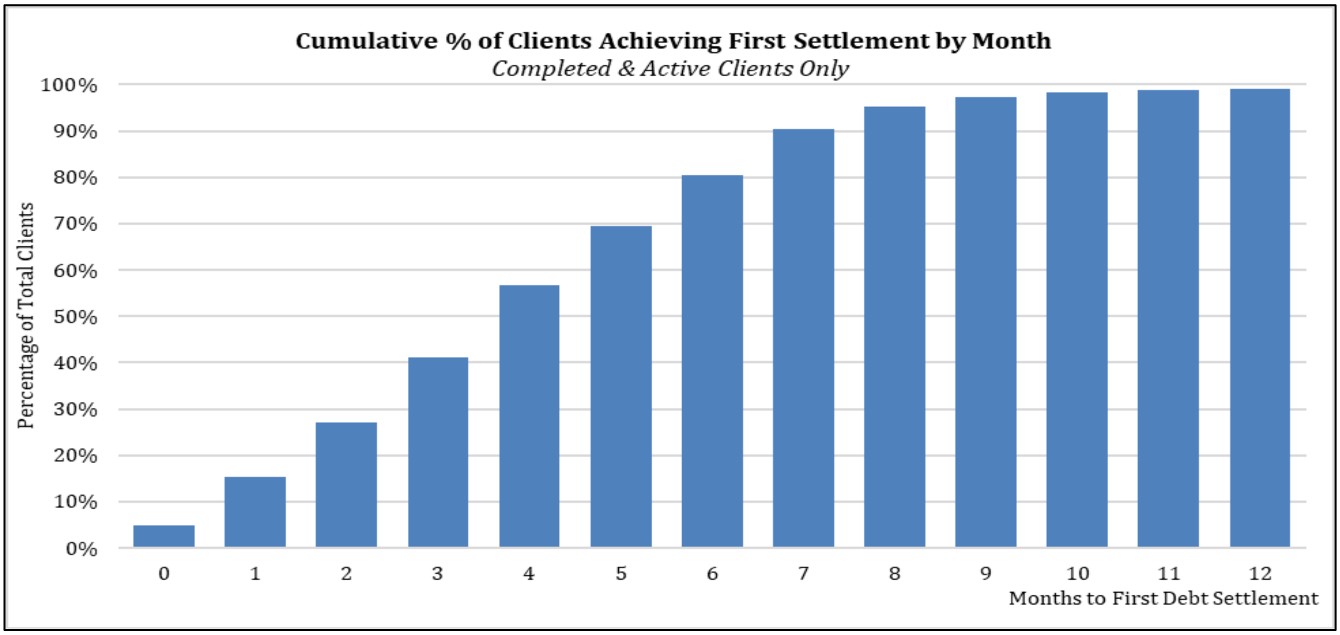
Chart 1



Since almost all settlements result in a reduction of debt that is substantially more than fees charged, clients generally experience savings with each settlement. Chart 2 below shows that more than 95% of clients included in this analysis (including clients who have terminated their participation prior to completing the program) have received savings from their participation in a debt settlement program.

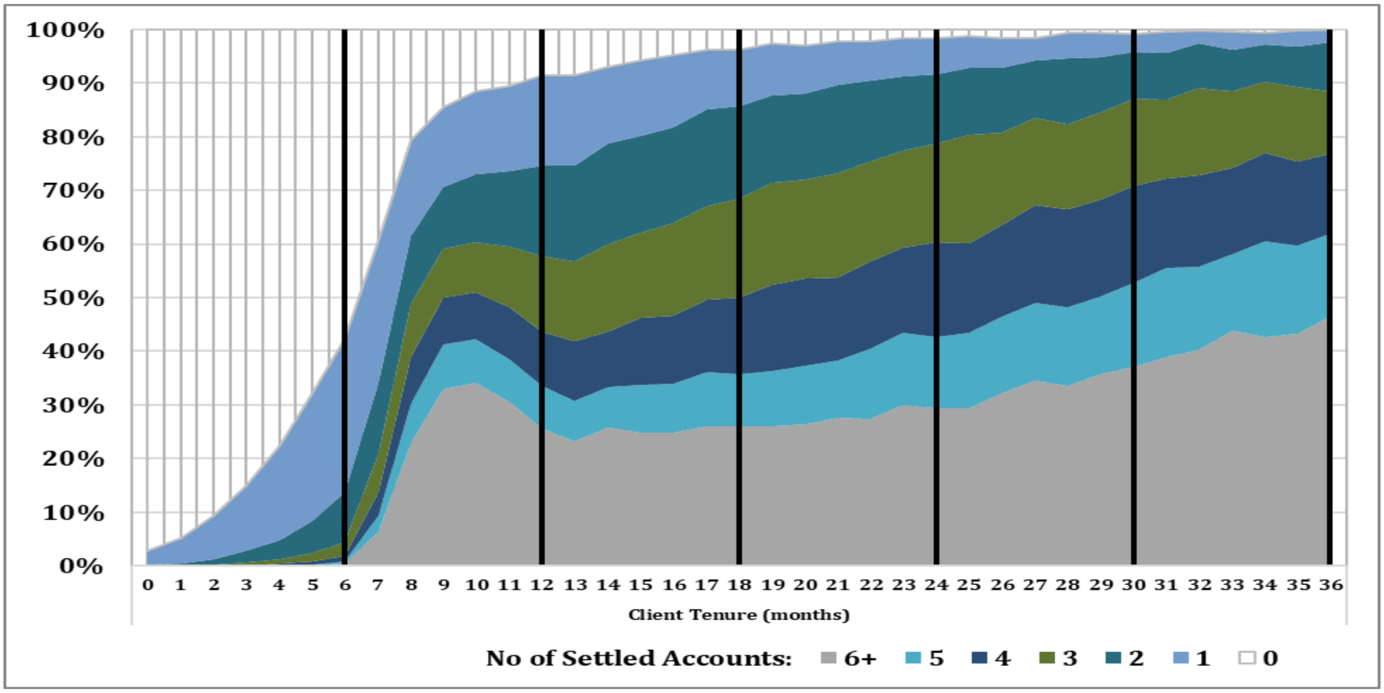
The same chart also shows that the probability of a client reaching a settlement is strongly correlated to the length of time that a client participates in the debt settlement program. This makes sense: clients need to save sufficient funds to allow the debt settlement company to negotiate settlements with creditors. By month four, 50% of clients have reached at least one settlement; by month seven, 90% have done so.

Chart 2



The number of settlements tends to increase over time since most consumers entering debt settlement programs have multiple unsecured creditors. Chart 3 shows the range of settlement outcomes based on client tenure. For clients with 18 months of tenure, 25% settle six or more accounts, 35% settle five or more accounts, 50% settle four or more accounts, and more than 60% settle three or more accounts. Less than 5% of clients with a program duration of 18 months had not settled an account.

Chart 3



Measuring Benefits

One useful way to measure the success of debt reduction programs is debt reduction per dollar of fees. This metric calculates return-on-investment: did the consumer reduce debt in an amount greater than fees paid - and if so, by how much?

The data shows that debt reduced per dollar of fees is consistently in the range of $2.75 to $3.13, for all clients. Or in other words, savings of $1.75 to $2.13 per dollar of fees.

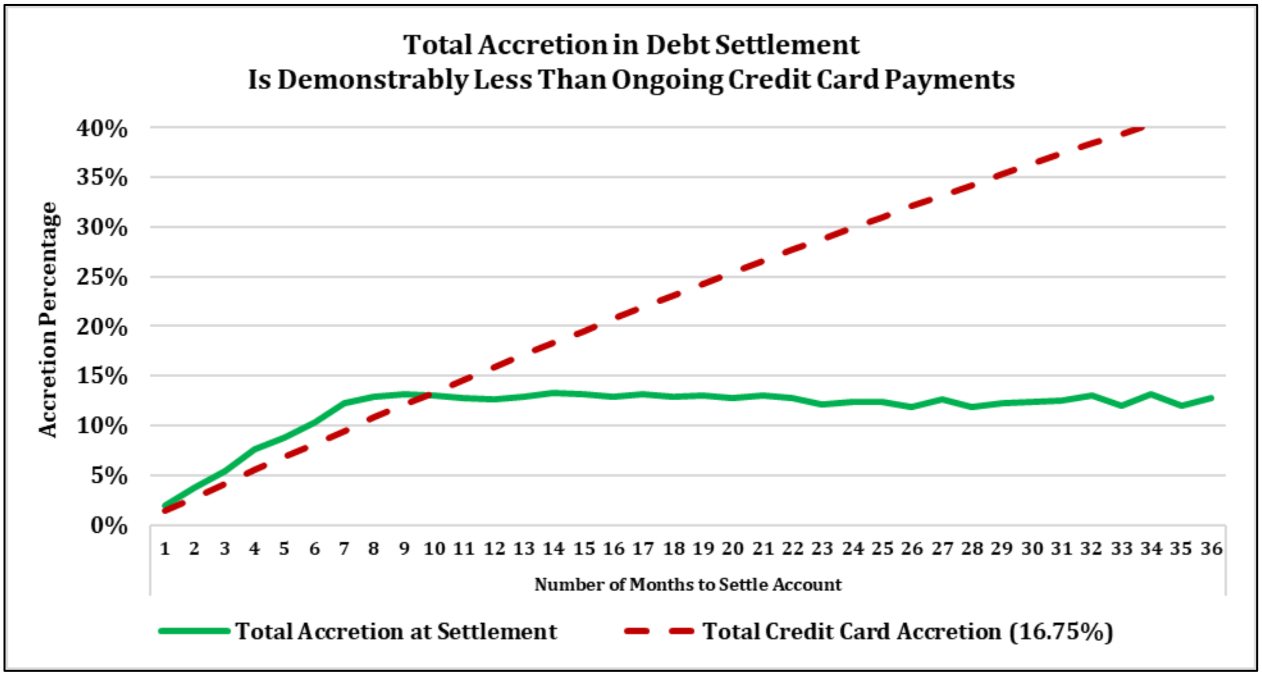
Accretion: What is it and Why it Matters

Consumers who borrow money expect to pay it back with interest. The increase over time in the amount a consumer owes is referred to as accretion. Accretion is a function of the length of time needed to repay the borrowed amount. For example, if a consumer borrows $10,000, the total of all payments needed to resolve the debt will typically be less if the amount is repaid in one year as compared with two years. Accretion is also a function of the borrower's status – the borrower's credit rating and whether the loan is current or delinquent. If a borrower does not make timely payments, accretion is likely to occur at a greater rate, since the lender typically applies a higher interest rate and possibly penalty fees when payments are late and the risk of default increases.

The only way to avoid accretion altogether is to repay debt immediately. This option, however, is not feasible even for many borrowers with healthy balance sheets. To understand how accretion affects consumers enrolled in debt settlement, it is relevant to compare accretion while enrolled in a debt settlement program to the accretion that the consumer would have been experienced otherwise.

Chart 4 reflects data from the more than one million settled accounts addressed in this study. The solid line represents the amount, in percentage terms, that enrolled debt had increased as of the time of the settlement. For example, after six months, the average debt enrolled in a debt settlement program had increased by about 10.4%. The dotted line represents accretion at currently available credit-card interest rates.

Chart 4



In the initial year of a consumer's participation in a debt settlement program, accretion is not significantly different than the accretion that would continue to occur with credit-card-related interest. Over time, however, accretion under debt settlement programs stabilizes.

The data shows that consumers requiring more than nine months to repay a debt save money by enrolling their debt in a debt settlement program rather than continuing to make minimum monthly payments to their creditors. The longer it takes a consumer to repay their debt by making minimum monthly payments, the more significant the savings they would obtain through debt settlement. Those consumers paying just the minimum on credit-card accounts can end up making payments for decades, with interest payments well in excess of the original principal.

About Taxes

The analysis presented in the base report ignores most externalities, including those viewed as positive (improved cash flow attributable to ceasing to pay the full amount currently due) or negative (reduced access to credit). However, because taxability of debt settlement would directly affect economic outcomes, it is worth spending a moment on "relief of indebtedness" income.

It is possible that a consumer will be deemed to have received taxable income as a result of the forgiveness of debt associated with a negotiated debt settlement. However, the IRS allows those who demonstrate insolvency to exclude from taxable income any gains associated with the discharge of indebtedness. Consequently, an analysis of after-tax savings that assumes taxability of income from relief of indebtedness and ignores this option would misstate savings.

Debt Settlement Vs. Alternatives

Debt-burdened consumers have other alternatives: continuing to make minimum payments, filing for bankruptcy, entrance into a debt management plan offered by a credit counselor or debt consolidation loans. Each of these alternatives has different consequences, both plus and minus.

Minimum Credit-Card Payments

The average consumer-enrolled debt was $25,250, most of that credit-card related. Most of these consumers were able to make minimum monthly payments of about $600 at best. If a consumer were able to pay the monthly minimum, the total cost to settle would be approximately $60,000 over 431 months (about 36 years). Stated differently, by making only the required minimum monthly payments, the consumer would have incurred a cost of more than $34,000 above the principal amount owed.

Credit Counseling

Another alternative might be a consumer Credit Counseling Agency (CCA) offering a debt management plan (DMP). A DMP involves concessions on the interest rate charged on outstanding balances, but not a principal reduction. Academic research indicates that a reduction in principal provides a significantly greater benefit to a consumer than does any improved liquidity of payment reductions via interest rate relief.

DMPs are generally not available to those in serious financial hardship; we understand that less than 30% of individuals that contact a CCA qualify for a DMP. It has also been reported that persons who qualify for a DMP actually complete the program at a rate between 20-35%.

Consolidation Loans

Another option is to obtain a debt consolidation loan – but additional credit is rarely, if ever, extended to overextended consumers. Such loans, if available, often carry extremely high interest rates and punitive terms.

Bankruptcy

Some consumers may have the alternative of declaring bankruptcy. Chapter 13 of the United States Bankruptcy Code provides for adjustment of debts of an individual with regular income. Chapter 13 is similar to debt settlement in that it enables consumers to establish a plan to repay part or all of their debts, and similar to credit counseling, in that it requires participants to pay a monthly amount to the bankruptcy court for distribution, after fees, to approved creditors.

Bankruptcy completion rates are not encouraging (generally speaking, Chapter 13 plans fail about 67% of the time), and individuals typically incur substantial upfront costs to enroll in a Chapter 13 bankruptcy plan, including filing fees and attorney costs. Those fees are not refundable if the individual does not ultimately complete the plan.

Conclusion

The data is clear: debt settlement programs can offer struggling consumers a proven path to improved financial health. While not for every borrower, these programs offer borrowers tremendous benefit and an important lifeline towards an improved balance sheet and financial stability.

The numbers don't lie. The programs work. The data shows that 95% of debt settlement clients realize savings in excess of fees - and the average debt-straddled consumer enrolled in a debt settlement program saves $2.64 for every $1 in fees. While there are several viable options available to consumers who are struggling with debt, the data shows that debt settlement is an attractive option for many.