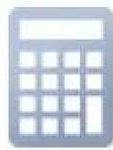
Universal Default:

How to Deal With Credit Challenges



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About the Author

Boun Vilailath, founder of Global Debt Systems, is a debt settlement expert who advocates for fair and ethical client-representation in consumer debt management plans. His firm improves the process of resolving delinquent consumer debt through training and outreach efforts designed to create a more mutually beneficial result for lenders, consumers, and debt settlement providers.

Boun's previous experience includes co-founding a debt settlement firm in response to the need of consumers in the growing debt dilemma. However, he left the firm after realizing that most clients eventually fail to complete their settlement program and are left in worse financial straits for the effort. Following his thorough analysis of the industry, Boun determined that the inferior training available to debt settlement companies and the dubious compensation plans paid to their employees were the cause. Boun is trying to fix a broken system and create one that treats consumers fairly by teaching debt settlement providers how to deliver results for their clients.

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Table of Contents

Introduction 4

Part 1: Consumer Credit In America

Chapter 1 The Concept of Credit 6
Chapter 2 The Credit Agreement 7
Chapter 3 Types of Consumer Loans 8

Part 2: The Credit Card Industry

Chapter 4 The Financial Product 10
Chapter 5 How Credit Card Issuers Earn Profits 11
Chapter 6 Credit Card Regulations 12

Part 3: The Rules of Credit Reporting

Chapter 7 Credit Reporting Agencies 14
Chapter 8 The Credit Report 15
Chapter 9 The Scoring Models 17

Part 4: Debt Relief Solutions

Chapter 10 Debt Relief Solutions 18
Chapter 11 Debt Relief Comparison 21
Chapter 12 Debt Collection Process 24

Chapter 13 **Final Thought** 27

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Introduction

A recent consumer report conducted by Harris Interactive for the National Foundation for Credit Counseling indicates that many Americans are not making sound financial decisions. They are not well informed about financial issues, do not keep adequate financial records or monitor spending, and are not saving enough money to finance their retirements.

The fate of consumers was sealed by a 1978 Supreme Court usury law decision that allowed credit card issuers to apply the law of the state in which there business was domiciled to out-of-state customers. The Marquette decision ushered in deregulation of usury ceilings on consumer interest rates and fundamentally altered the market for credit card loans in a way that significantly expanded the availability of credit and increased the average risk profile of borrowers.

The decision led credit card companies, Citi Group in particular, to set up their credit card lending operations in South Dakota after that state eliminated its cap on interest rates to attract new business at a time when its economy was faltering. At that time, the interest rates that banks in New York could charge were capped at the usury ceiling of 12 percent. After the Marquette decision and subsequent move to South Dakota, Citi Group could charge consumers across the nation the 25 percent rate that was legal in that state.

A current crisis arose when predatory lenders, typically targeting the subprime market, made home loans to people who could not afford them. Most of these loans were re-packaged and sold through Wall Street brokerages before they could default creating huge short-term profits. In 2005, after extensive pressure from the credit industry, the federal government changed bankruptcy laws to make it harder for consumers to discharge debts. Congress also passed the Talent Amendment, which capped interest on loans made to active military personnel and their families at 36 percent, after learning that high-cost payday lenders had been targeting the military.

Eventually, the subprime loans began to default. Foreclosure rates increased dramatically causing the mortgage-backed securities on Wall Street, many of which were sold to foreign investors, to go bad and leading to a worldwide economic downturn. Some of the largest and most recognized commercial and investment banks went under. Others were saved only by an injection of capital by the US government through “bailouts" paid for by American taxpayers – the ultimate victims in the fiasco.

This book is not about budgeting and will not recommend that you give up your daily cup of coffee. Comparatively, it’s about providing insight into real solutions

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that work, while saving you the disappointment and thousands of dollars in debt relief and credit repair service fees.

The commercials seen on T.V. promising you relief or that you're protected by a government program is false and misleading. The government does not protect consumers from creditors while enrolled into debt settlement or credit repair program.

You may be wondering about credit counseling? The credit counseling industry has a very small program success ratio. The truth is credit counseling is not what it is made out to be. If majority of debtors are failing to pay a relatively small portion of their debts under a Chapter 13 bankruptcy program, how in the world can they manage to repay 100% of their debts under a credit counseling service? And, did you know that most credit counseling agencies receive half of their funding from banks? Who are they really looking out for?

Together, we will set out to find answers that can truly benefit your situation. I want to educate you on the process of credit and collections. Let's explore your options!

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CHAPTER 1: THE CONCEPT OF CREDIT

America is a consumer economy, and the creation of credit markets over the last century made that possible. The extension of credit by banks, credit unions, and retailers has enabled consumers to fund larger and more frequent purchases, which meant manufacturers and homebuilders could sell more products. That created more jobs, and more credit-worthy employees, and the cycle repeated.

Without credit access, previous generations had to accumulate the entire sale price of any purchase. Just as it takes a homeowner today many years to pay off the mortgage, without credit, it would take many years for a prospective homeowner to save up the money to purchase a home outright. Obviously, most consumers are not able to save large sums of money. With credit, however, you could “buy now and pay later.” Credit has been largely responsible for the growth of the real estate, automotive, and consumer products industries.

Creditors consider a potential borrower’s debt payment history by examining a credit report published by a credit bureau. Credit bureaus track billions of credit transactions to create a measurement of each borrower’s ability to pay and that probability, which is called a credit score. Technology gives lenders instant access to consumer credit scores, which they rely upon to extend credit – especially unsecured credit. You must establish and maintain a good credit score to have access to the credit markets.

Americans have done exactly that for many decades now, borrowing billions and becoming a consumer-driven economy in the process.

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CHAPTER 2: THE CREDIT AGREEMENT

A credit transaction occurs when one party, the creditor or lender, agrees to advance funds to another party, the borrower, in return for an agreement to repay the funds, with interest, at a later time or according to a credit contract and payment schedule. The debt can be secured by underlying collateral, such as an automobile or land, or unsecured, as is most consumer credit card debt.

In most consumer credit transactions, there are three parties: the borrower, the lender, and the credit bureau.

The Borrower**:** You initiate the transaction with a request for credit when making a purchase, rather than using your own money. Your motivation for using credit could be:

- A lack of available funds today
- To establish or build a good credit score to enable future, larger purchases
- The enticement of attractive financing option (zero-down, low introductory rate, etc.)

The Lender**:** The bank funds your purchase based on your agreement to repay the loan in the future or according to scheduled payments. They earn a profit from the interest and fees charged for the loan. Consumer lenders are typically large banking institutions, even if the credit card is branded with a retailer's name. The banks are better at managing and collecting consumer loans, and outsourcing this function allows the retailer to focus on sales.

The Credit Bureau**:** Through reporting agreements from almost every consumer lender, credit bureaus accumulate a credit history for each borrower. From analysis of that history, the bureau calculates a credit score that retailers use when determining whether to extend credit, and if so, the credit terms and limit. Lenders pay a fee for fast, reliable, access to the credit bureau's accurate information.

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CHAPTER 3: TYPES OF CONSUMER LOANS

Secured Loan: when you provide collateral of sufficient value to guarantee payment of the debt, the loan is "secured." This type of loan will use a written agreement to identify the specific asset or property that secures the debt. Should you default on the debt, the creditor typically has contractual rights to seize the collateral without filing suit or obtaining a judgment.

Typically, borrowers with low credit scores or those seeking a large credit limit, perhaps, to purchase an expensive item, will be asked to provide collateral to secure the loan by lenders.

Examples of common loans that are secured include:

- Mortgages and home equity lines of credit.
- Loans for cars, trucks, boats, motorcycles, RVs, and tractors.
- Store purchases with a security agreement.
- Personal loans from finance companies with agreements.

Unsecured Loan: You promise to repay the loan, but pledge no collateral. Because the lender assumes more risk, unsecured loans typically comes at a higher interest rate and/or fees. If you default on an unsecured debt, the creditor cannot seize your property or possessions to satisfy the debt without a court order. To force payment, the creditor must pursue a civil action and obtain a judgment against you.

Common unsecured debts that consumers incur are:

- Credit card purchases or cash advances
- Utility bills
- Student loans
- Loans from friends or relatives
- Medical and dental bills
- Fees for professional services

INSTALLMENT AND REVOLVING CREDIT

The legal obligations of the parties to a credit transaction are defined in the credit agreement. In general, those agreements are one of two types: an installment or a revolving credit agreement.

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Installment credit: these agreements typically define a one-time transaction, for a specific loan amount and interest rate that you repay in scheduled payments for a set term. Payments are amortized so that the borrower pays equal payments over the life of the loan. As payments decrease the balance owed, you cannot secure additional funds through that same credit agreement, for instance, up to the original loan value. Most secure debt, such as a home mortgage or auto loan, are transacted through an installment credit agreement.

Revolving credit: the term of a revolving credit agreement is not fixed; you are only required to make a minimum payment each payment period. The borrower can also execute multiple transactions through a single agreement, as long as the total outstanding debt under the agreement does not exceed the available credit limit authorized by the lender. Credit cards are the most popular example of revolving credit agreements.

Credit cards are sold as a convenience to you – they eliminate the need to carry cash and provide you a simple tool for tracking expenses. However, installment loans usually have lower interest rates and more favorable terms. While obtaining a credit card is a great first step to establishing credit, you need to also establish a pattern of discipline when using revolving credit because of its more onerous terms.

Under revolving credit agreements, more of your monthly payment is applied towards interest and fees charged than to repaying the principal balance. Instead of a fixed term with equal payments that reduce the debt to zero over that term, revolving credit requires only a minimum payment each month that includes a finance charge that is based on the ending month's balance and annual percentage rate.

For example, a typical car purchaser might finance an installment debt of $25,000 carrying a 10% interest rate. The loan could be repaid in 4 years at a cost of about $6,000 in interest. Compare that to a revolving debt of just $5,000, but carrying a 20% interest rate. If you only paid the minimum payment, that balance would take about 24 years to repay at a cost of more than $24,000 in interest.

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CHAPTER 4: THE FINANCIAL PRODUCT

The most available type of credit is the revolving credit card. Credit cards have evolved from merely a convenient form of payment into a very profitable financial product for the issuers. Today, banks borrow money from their depositors by paying about 2 percent interest, and in turn, loan the money to credit card customers at about 20 percent interest. That interest is also collected on a monthly basis, which serves to increase their profits (see below). Additional credit card revenue includes balance transfer fees, cash advance fees, and transaction fees charged.

Comparing recent statistics on consumer debt from leading industry analysts reveals that Americans owe a lot of money. Their numbers vary slightly, but together display the same trends. The most recent data from CardWeb.com, a service that tracks credit card trends, show that the average debt per American household with at least one credit card was $8,940. At the end of 2008, a similar service, The Nilson Report, a leader in payment systems research, estimated that those households have credit card debt of $10,679.

In the late 1980s, banking consultant and founder of First Deposit Corporation (later Providian Financial Services) Andrew Kahr convinced many credit card companies to lower their minimum payment from 5 percent of the balance to 2 percent. This allowed the debt to ‘revolve’ longer and caused credit balances to increase. In Andrew’s words, “Having a lower minimum payment allows you to offer higher credit lines.” The strategy preyed on gullible consumers who accept high balances as long as they can make the minimum payment.

The credit card issuers profit when you don’t pay off the balance at the end of each month. In 2005, it is estimated that approximately 60 percent of cardholders, roughly 90 million Americans, did not pay their balance in full, while 45 percent of cardholders, or about 35 million people, made only the required monthly minimum payment.

As recently as 2006, the credit card industry earned record profits from revenues that included $91 billion from interest charged to card holders and another $55.2 billion from annual fees, cash advances fee, and penalties. Estimates of the industry’s net pre-tax profits for the year were $36.8 billion.

However, after many years of rising profits, credit card companies are experiencing record losses in 2009. As reported by Innovest Strategic Value Advisors, the industry absorbed a $41 billion dollar charge off in 2008, and this year the loss is expected to reach $96 billion.

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Chapter 5: How Credit Card Issuers Earn Profits

Credit cards are the most profitable commodity sold in America. How is this possible? The answer is because the credit card debt is revolving.

How long will it take to pay back a $5,000 credit card debt when making monthly minimum payments?

The answer is not good. Because most credit card debt is held in "revolving accounts," it would take 24 years to pay off a $5,000 debt by making the credit card company's minimal payment. The total cost: about $30,000.

Revolving credit accounts are an ingenious way for creditors to exponentially increase their return on the consumer loan. Under these plans, the monthly minimum payment includes a finance charge calculated by multiplying the outstanding balance by one-twelfth of the annual interest rate.

For example, if that $5,000 debt carries an annual percentage rate of 20 percent (not unusual in this economy for debtors in trouble), you might assume that the annual interest charge is $1,000 ($5,000 x 20 percent). However, the credit card company bills monthly, not annually, and therefore, a finance charge is assessed each month. The effect is not unlike the difference between the interest earned on a Certificate of Deposit that pays "simple" (annual) interest and one that pays compounded interest.

So instead, take the annual interest fee of $1000 and divide it by the 12 monthly payments to reveal an $83.33 monthly fee. You can reach the same result by multiplying the outstanding balance by 1/12th of the annual rate.

However, the minimum payment includes more than interest – but not much more. Most credit cards require that at least 2 percent of the outstanding balance to be paid each month. In our example, that would equal $100. The creditor then subtracts the interest from that minimum payment and reduces the principal owed by the remainder. So for our debtor, each month his debt would be reduced by only $16.77 by making that minimum payment.

Yet, the next month, that minimum payment is reduced as well. If it stayed at $100, each month, our debtor would have more of that payment apply to the principal owed and his repayment would accelerate over time – just as a home mortgage or car loan works. However, the reduced minimum payment means that you actually pay less principal each month. This extends the loan's term and increases the creditor's profits.

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CHAPTER 6: CREDIT CARD ACT OF 2009

The universal default policy of the credit card companies has outraged consumer advocates and the federal government intervened on their behalf with the passing of the Credit Card Accountability, Responsibility, and Disclosure (CARD Act). The Act establishes fair and transparent credit practices regarding open-end consumer credit plans, and for other purposes. The act does not apply to business or corporate credit cards.

Major provisions in the new legislation:

- Requires issuers to mail statements to you 21 days before the due date of any payments. Due dates will be on the same day each month. Payment must be received by 5:00 pm.

- Provide 45 days' written notice of any increases in the interest rate or other significant changes to the terms of a credit card account. Issuers must inform you of your right to keep the current terms by closing the card credit card account.

- Disclose the period of time and total interest it will take to pay off the card balance if only minimum monthly payments are made. Payment amount in excess of the minimum required must be applied first to the credit card balance with the highest rate of interest.

- If the interest rate increases because the minimum payment is not received within 60 days after the due date, the rate must go back to the original lower rate if you make on time minimum payments for 6 months.
- No over-the-limit fees may be charged unless you give permission for the account to be set up to allow transactions that will exceed the credit limit.

- Prohibits arbitrary interest rate increases on existing balances (universal default ban) and interest charges on debt paid on time (double cycle billing ban).

- Requires issuers extending credit to young consumers under the age of 21 to obtain an application that contains: the signature of a parent, guardian, or other individual 21 years or older who will take responsibility for the debt; or proof that the applicant has an independent means of repaying any credit extended.

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- Protects recipients of gift cards by requiring all gift cards to have at least a five-year life span, and eliminates the practice of declining values and hidden fees for those cards not used within a reasonable period of time.

The provisions aren't effective immediately. Instead, the new credit card rules will take effect in a time schedule. The first series of changes took effect on August 20, 2009. The bulk of the legislation's key provisions will take effect in February 2010. The remaining provisions are scheduled to take effect in August 22, 2010.

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CHAPTER 7: CREDIT REPORTING AGENCIES

Most U.S. consumer credit information is collected by three major credit bureaus: Experian, Equifax, and TransUnion. A fourth, Innovis, is now recognized as a reliable credit reference source for selected businesses. Though the companies compete, they have formed a trade organization, the Consumer Data Industry Association (CDIA), to establish reporting standards and to lobby lawmakers on the industry's behalf. Experian, Equifax and TransUnion each maintains 200 million or more credit files, which are used by independent credit reporting agencies across the United States.

A credit bureau is a for-profit company that collects consumer information from multiple sources for analysis and resell to commercial and government lenders. Their customers include institutions that issue credit or lease property – primarily banks, mortgage lenders, credit unions, credit card companies, department stores, property owners, and the government. Their analysis allows lenders to assess credit worthiness and risk of default.

MAJOR CREDIT BUREAUS	
Equifax P.O. Box 740241 Atlanta, GA 30374	Toll Free: 800.525.6285 www.equifax.com
Experian National Consumers Assistance Ctr P.O. Box 2104 Allen, TX 75013-2104	Toll Free: 888.397.3742 www.exprian.com
TransUnion Consumer Disclosure Ctr P.O. Box 2000 Chester, PA 19022	Toll Free: 800.916.8800 www.transunion.com
Innovis Data Solutions, Inc 250 E. Town St. Columbus, Ohio 43215	Toll Free: 800.540.2505 www.innovis.com

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CHAPTER 8: THE CREDIT REPORT

Credit bureaus sell lenders the data collected on consumer borrowing in the form of individual credit reports that provide a snapshot of a borrower's recent credit activity. The credit bureau also applies complex data models to the person's information to predict behavior, character, and commitment to repaying debts, which it translates into a "credit score." Lenders evaluate the credit reports, or simply the credit score, of loan applicants to calculate the risk of non-payment before approving an extension of credit.

Lenders are also, as a group, the source of that credit report data through their reporting of credit extended and payments received on a monthly basis. As we learned earlier, there are three major consumer credit bureaus. Most frequent lenders report to at least one of those bureaus. Major credit companies may report to all three. Similarly, those lenders may buy reports from only one bureau or all three. Also, since credit bureaus do not share reported data and each calculates credit scores differently, you will have multiple credit scores, depending on the credit bureau that provided the report.

Old data can be removed from a credit report. Federal law requires that most negative credit events, such as late payments, collection actions, and foreclosures, be removed from the report after seven years. Lenders can report losses from a borrower's bankruptcy settlement for ten years. Even credit inquires from consumers, which the bureaus consider signs of potential risk, have to be deleted after two years.

On the other hand, positive information, including loan repayment and payment history, can be used in the report indefinitely, and many consumers will make that request.

THE COMPONENTS OF A CREDIT REPORT

Although each credit bureau uses slightly different terminology, the information contained in their reports is essentially the same and include these general categories:

- Personal profile – information about you, including your name, previous name(s), social security number(s), current and former address, current employer, and previous employers.
- Current credit accounts – the report includes all credit and loan accounts, also known as "trade lines," opened by you. Information provided includes

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the type of loan, when it was opened, the current balance, payment history, and the current status, i.e., whether it is still active, paid in full, defaulted, or closed.

- Credit inquires – when you authorize lenders' review of your credit report when processing a loan request, referred to in the industry as a "hard inquiry," it is documented in the credit report and, if there are a high number of inquiries, it can affect the credit score. A "soft inquiry" is one that was not authorized by you, and it does not affect the credit score. Soft inquiries are typically from credit card companies that are marketing pre-approved card offers.
- Public records & collections – the results of collection efforts by creditors are reported, including collection accounts, bankruptcies, tax liens, foreclosures, wage garnishments, lawsuits, and judgments awarded.
- Credit Score – the credit scores calculated by credit bureaus are included in the credit reports, but the bureaus are not required to provide that proprietary information in the free annual reports available to consumers under federal law. For a fee, you can get the credit score or subscribe to a credit score monitoring service.

There is also specific personal information that the credit report cannot contain, including:

- Race, ethnicity, or national origin
- Political affiliation
- Religious beliefs or preference
- Checking or savings account information (although specialty bureaus can report accounts that were closed in default with money owed)
- Hard inquires older than two (2) years
- Debt accounts subject to seven (7) year limit
- Bankruptcy filings older than ten (10) years
- Medical condition or a debt account incurred from a hospital bill

Legally restricted personal information can mistakenly appear in a credit report. A typical scenario is the indirect disclosure of a healthcare debt when the account is sold by the hospital to a collection agency. A medical bill should not appear in a credit report, unless referred to a collection agency after a default. While the account is noted as "collection" in the report, the creditor's name (Dr. Smith's Cancer Treatment, Williams Diabetes Center, etc.) leads to an assumption about the consumer's medical condition.

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CHAPTER 9: THE SCORING MODELS

A credit score is based on statistical analysis of credit report information, and predicts payment behavior, calculates financial capacity, and assesses the value of available collateral. The overall result is a number that represents credit worthiness.

Your income is not recorded in a credit report, therefore, not a factor in the credit score calculation. However, income can feel like it's a part of the credit score, especially when required to disclose it when applying for a loan. Sometimes, income can be a bigger determinant of the outcome than the credit score. For instance, a person with a low credit score may be able to get a loan if they can prove a high income. Conversely, a person with a high credit score and low income may be turned down because the new debt payment decreases the capacity to pay.

Behavior is a more important measure - you can have a high credit score and low income, or high income and a very low credit score. The only way to improve your credit score is by improving your credit history.

A credit score is primarily based on credit report information, typically from one of the three major credit bureaus: Experian, TransUnion, and Equifax.

There are more than one hundred different credit-scoring models being marketed to lenders by credit bureaus. The most accepted credit-scoring method is FICO, named from an acronym for Fair Isaac Corporation, the developers of the system. It is a risk-based system used by many mortgage lenders to assess the possibility that the borrower could default on financial obligations. A second method, the VantageScore, is designed to better accommodate consumers with thin credit history files, a group that the FICO algorithm will score very low. The VantageScore methodology should provide higher credit ratings for:

- Young adults just starting their careers
- Recently divorced or widowed individuals with little or no credit in their own name
- Newly arrived immigrants
- Consumers who have previously filed for bankruptcy protection
- Consumers who have avoided the traditional banking system by choice

The FICO score ranges form 300 to 850, and VantageScore rates consumers from 501 to 990. In both systems, a higher score is preferred. Simply based on the range comparison, the consumer's VantageScore will always be higher than the FICO score.

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CHAPTER 10: DEBT RELIEF SOLUTIONS

For consumers straddled with debt and seeking an alternative to bankruptcy, the debt management industry offers two programs. In the first approach, consumers are assisted by a Consumer Credit Counseling Service (CCCS) – generally, non-profit organizations that receive funding from the credit card industry and from fees charged to clients. Under a CCCS program, you repay the entire principal balance owed and the creditor agrees to accept a lower interest rate and suspend the assessment of late fee penalties. Consumers may also contract the services of debt settlement companies – privately owned businesses that derive profit from fees charged to clients or do it themselves. The goal of a Debt Settlement Program (DSP) is to completely eliminate debt by negotiating a reduced lump-sum payment for you.

Consumer Credit Counseling Services

The concept of credit counseling services that promote financial literacy and help consumers originated with the creation of the National Foundation for Credit Counseling (NFCC) in 1951. Although funded by credit grantors, the foundation did not participate in the collection of debts. Local credit counseling offices emerged in the 1960s, often acting as franchises for national chains. In the US today, there are well over 1,000 active credit counseling organizations.

Under most CCCS programs, counselors work with you to close current credit accounts and consolidate the monthly payments due into one manageable monthly payment. In return, the creditors agree to lower, or even eliminate, the interest rate. As a result, more of the payment is applied to the principal balance and total debt is paid off sooner, even though the new monthly payment will usually be reduced by about 10-20%. If you follow the typical CCCS plan, the outstanding debts will be paid off in 3-6 years, rather than the 20+ years required by the original, high-interest, credit terms.

If a credit account has not been charged off by the lender, a credit counseling program may be able to "re-age" or "cure" the account to bring delinquencies current. To qualify, you must make several scheduled payments to demonstrate your commitment to the program. Curing an account will not erase the record of delinquent payments from the credit report. As with all derogatory credit information, only time will lower the effect of negative marks on a credit score. This process merely signals a fresh start, and an opportunity to begin re-building a positive credit history.

Debt Settlement Program

The concept of debt settlement is not new. A “bird in the hand,” has always been

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worth “two in the bush” to lenders. The settlement process recognizes the time and expense creditors incur to collect past due accounts, and that their risk of never collecting the account increases as the delinquency ages. Consumers can negotiate with creditors to accept a reduced pay-off by offering a lump-sum payment of the entire balance.

The debt settlement industry became established in the US following bank deregulation of the late 1980s that loosened consumer lending practices. The industry has exploded in recent years as over-extended consumers were caught up in the slowing economy and Congress passed new bankruptcy regulations (see below).

By enrolling in a DSP, you execute a Limited Power of Attorney agreement authorizing the debt settlement company to negotiate with creditors in your behalf. Most firms will advise you to forego debt payments while negotiations are underway and, instead, save that money towards payment of the lump sum and the debt settlement firm’s fees.

Bankruptcy Protection

Consumers filing for bankruptcy protection peaked in 2005, in anticipation of tougher regulations enacted under the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). Those regulations made it more difficult for consumers to discharge all debts and, instead, forced more people into debt payment programs.

The legislation introduced a ‘means test’ by which the courts could determine whether you qualify for a Chapter 7 debt discharge and liquidation of assets or the Chapter 13 debt restructuring program that requires you to repay some or all of the debts to unsecured lenders. The court mandates repayment rates and the term based on your ability to pay. Those who earn below the median income level receive a 3-year payment schedules and those above pay for 5 years according to IRS guidelines.

Consumer Bankruptcy Filings

Year	1st Q	2nd Q	3rd Q	4th Q	Total
2005	393,086	458,597	532,526	654,633	2,039,214
2006	112,685	150,975	165,862	177,599	617,660
2007	187,361	203,744	211,742	218,428	822,590
2008	236,982	266,767	280,787	288,436	1,074,225
2009	330,477*	381,073*	388,485*	n/a	Est. 1.4m

Source: American Bankruptcy Institute
*Data includes U.S. Territories

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After the sharp drop from 2005's record highs, totals have risen steadily. By the end of 2008, filings again exceeded one million per year. Because consumers have less control over repayment terms under the new regulations, those terms can be challenging for many people living paycheck to paycheck. As many as two-thirds of borrowers are unable to complete the terms of a Chapter 13 bankruptcy program and have to exit it. However, most are able to discharge their debts by converting to a Chapter 7 liquidation bankruptcy.

In 2009, the total filings reached 1.4 million, soaring 32% from the previous year – making it the highest since the passing of the BAPCPA. The most recent data available (November 2009) show that Chapter 7 filings were up 42% compared with the same period a year earlier. Chapter 13 filings rose by 12% and made up less than a third of 2009 filings as of November. There has also been an increase in bankruptcy filings among borrowers with above average incomes.

The surge can be attributed to foreclosure and unemployment. For those reasons, most borrowers now qualified for Chapter 7 bankruptcy and could walk away from their debts without entering into a repayment program under Chapter 13. The new bankruptcy legislation was intended to prevent consumers from discharging debts in such ways; however, due to the current economic conditions, they have been able to walk without having to pay back nothing.

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CHAPTER 11: DEBT RELIEF COMPARISON

In this section, we compare program results from debtors choosing relief through credit counseling, debt settlement, and bankruptcy. Current data for these debt-relief related services is very limited. Surprisingly, many trade associations are less than forthcoming with their completion data. An article by Steve Rhodes entitled, "The Truth About Failure Rates and Completion Rates of Credit Counseling, Debt Settlement, and Bankruptcy," has been insightful for this topic. The article can be found at getoutofdebt.org.

CCCS Data

In its September 2006 report, "The Life and Debt Cycle," the National Consumer Law Center stated:

"Because of inconsistent and reduced concessions, it appears that only consumers with considerable disposable income left over each month are able to get out of debt through Debt Management Programs (DMPs). It is difficult to find conclusive data on the effectiveness of DMPs – most agencies do not release information on their retention rates – however, a 1999 NFCC (National Foundation for Credit Counseling) memo cited by Consumer Reports found that just 21% of their (the foundation's) clients completed DMPs, while about the same percentage left to self-administer debt payments.

For 2001, the NFCC reported completion rates of about 26% and 20% of clients left for self-administration of debt. A significant factor in the high failure rate in DMPs is undoubtedly the limited concessions creditors offer to consumers. If consumers cannot significantly lower the amount that they owe and/or the interest rate charged, they are not likely to complete a three to five-year DMP."

David Jones, the president of Association of Independent Consumer Credit Counseling Agencies said, "The agencies affiliated with the AICCCA used to be able to help 20-25% of the people who came to them to avoid bankruptcy. Now we find they can only help about 7-8% of those people."

Debt Settlement Data

An updated report on the debt settlement industry from TASC to the FTC released December 2007, profiled member companies in its research to determine the effectiveness and completion rate of debt settlement programs. Most of the companies defined "completion" as the status of having all debts settled. One company claimed completion if only 80% of the debt was settled,

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and another company used a 50% number. The TASC report concluded that industry completion rates range from 35%-65%, with the average between 45% and 50%.

A more recent report, released in August 2009 by Dr. Richard A. Briesch of the SMU Cox School of Business and entitled "Economic Factors and the Debt Management Industry," analyzed a very large debt settlement firm and randomly selected 4,500 clients. The intent was to understand whether consumer behavior or firm performance produced different results between groups with various levels of debt.

Dr. Briesch's study found that program duration was similar among all groups and the weighted average cancellation rate was 60%. The number of debt accounts increased as total debt increased, and cancellation percentages are highest in the group with the most debt, although not appreciably. Fourteen percent of clients canceled their program to attempt to settle debts on their own. Thirteen percent were forced out of the program by litigation instigated by creditors that forced them into bankruptcy. Nine percent had buyers' remorse and canceled within 30 days of the initial program payment. The biggest reason for cancellation, cited by 56.5% of the study participants, was "other," without further explanation.

Bankruptcy

Although statistical data for the disposition of Chapter 13 (restructure) bankruptcy cases is very limited, industry experts estimate that between 27-33% of cases are completed to resolution by the debtor. Chapter 13 bankruptcies appear to have a high failure rate, like other DMPs; however, many are converted to Chapter 7 (liquidation) filings and the debts are fully discharged through that process. Based on the experts' analysis of attorney surveys, it is estimated that nearly 90% of debtors filing bankruptcy petitions are able to repay or discharge all qualifying debts through that process. Certain debts (student loans, alimony, fines and restitution) are near impossible to discharge.

Comparison

From a financial perspective, the discounted lump sum payment offered by debt settlement is definitely a more effective solution for consumers than credit counseling or a Chapter 13 bankruptcy, both of which have the goal of repaying the entire debt. If the consumer's priority is to repay the debt in full, Chapter 13 can be a better option than CCCS because creditors have to operate according to defined rules. None of the solutions can salvage one's credit score; however,

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because bankruptcy remains on the credit report for up to 10 years, debt settlement can allow consumers to begin repairing their credit sooner.

For other debtors, a Chapter 7 bankruptcy may be the best solution. Also, because bankruptcy is a legal solution, enforceable by the courts and executed according to legal guidelines, some consumers will want its power to halt a creditor's collection efforts or stop a pending lawsuit. No other debt management solution can make that claim, although some may try.

In some cases, bankruptcy can be more trouble than its worth. Many lenders will automatically disqualify a credit application for that reason. Other obstacles a bankruptcy filer could face include difficulty in obtaining housing, insurance, or employment.

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CHAPTER 12: DEBT COLLECTION PROCESS

The collection industry is becoming a routine business with prescribed steps designed to clear out debts. They purchase or are contracted to collect debts for the original creditor for pennies on the dollar. Delinquent accounts incur bogus fees which inflate the balance, so accepting a reduced lump-sum payment is clearly favorable as oppose to pursuing the full amount for an indefinite period. Debts that are not collected in a reasonable time are repackaged and sold to another collector for an even lesser amount.

Debt buyers purchased delinquent debts with a face value of approximately $110 billion in 2005, which is about double the amount purchased in 2000. Depending on the age and history of the debt, a buyer typically pays between 3 and 16 percent of the debt's face value. Accounts that come directly from the original creditor have the highest value. Prices decrease as the number of collection agencies that have previously attempted to collect the debt increases.

Buyer	Debt Worth	Paid:	Cents on $
Asset Acceptance	$4.2 billion	$102.3 million	2.4
Encore Capital Group	$5.9 billion	$195.6 million	3.3
Portfolio Recovery Associates	$5.3 billion	$149.6 million	2.8

Source: 2005 SEC Filing

As a result of the 2008 economic downturn, prices for the best accounts have fallen from the high in 2007 of 14 cents on the dollar to a price 4-7 cents today. However, the large increase in the number of delinquent accounts has resulted in sizable growth for industry overall.

Communicating With Debt Collectors

Locating a debtor can take many months. After finally reaching you via phone, it's time for the collector to get into action. However, before they can begin the collection attempt, they must start off with the "Mini-Miranda" warning; informing you that the call is an attempt to collect a debt and the conversation is being recorded.

Take a step back. What goes on from here can be used against you. The facts of the debt account should determine how you react to the collector. Is the debt entering into collections for the first time? How long has this debt been delinquent since the last payment? Are you about to be sued?

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If the account has been recently charged off and entering into collection, the process may be new to you. If your intention is to pay off the debt, kindly inform them of your plans and hang up the phone immediately. During this period, money is tight and paying the collector may be next to impossible. There's no need to discuss your intentions any further. If you plan to file bankruptcy, let the collector know and forward your attorney's contact information.

Recognize that the collector's job is to keep you on the phone. The longer you're on the phone, the more personal financial information you divulge. Don't carry a conversation with them. They are professionals, and by the end of the call, some debtors will authorize a post dated electronic withdrawal to pay the debt in a schedule. This inadvertent mistake can cause electronic checks to bounce and it will put you further in the hole by reneging on a contract and incur return check fees.

If you're in a position to pay the debt, why not negotiate a little? All debt collectors will accept a reduced amount for an immediate lump sum payment. Chances are your credit rating has already suffered. Having an account reported as "settled" is similar to a "paid-in-full" status following a charged off citation. A settlement payment still releases you from all legal remedies associated with unpaid debts and the chances of being approved for another loan is comparable to as the debt being paid in full, which in this economy, is slim to none.

Debt Validation

Even if you had the money to settle with a collector, how do you know if they are legally entitled to collect the debt for the original creditor? You have the right to ask the collector to validate the debt. Debt validation requires the collector to present proof that they are indeed contracted by the debt holder, provide accurate accounting on the debt, refrain from reporting the collection account to credit bureaus, and stop all communications until the debt has been verified. In order to successfully request validation, you must submit a validation letter within 30 days of receiving the collector's initial letter that informs you about the debt.

Statue of Limitations

If the debt has been delinquent for a very long time, it is common for consumers to hear from collectors before the debt expires. After the statue of limitations expires, collectors cannot use the courts to force a payment. At this stage, the collectors become aggressive in demanding a payment. If you cannot afford a payment, they may resort to filing a lawsuit before the debt expires.

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Debts that go beyond the legal time limit are considered time-barred. Collectors can only request you to pay and cannot use the court system to get a payment. However, collectors can still sue after the statue of limitations has expired. When this happens, they argue that you either waived the statue of limitations, extending the statues, or re-aged the account. In some states, the debtor must prove that the statues expired and defend any creditor claims about waiving, extending, or re-aging the debt.

If your accounts are near expiration, tell the collectors, “I don’t know what you’re talking about and stop contacting me about this debt.” Kindly send them a cease and desist letter requesting that they stop contacting you about this debt. Seek the advice of a qualified consumer attorney if their attempts don’t end.

STUDENT LOAN COLLECTION POWERS

Defaulting on a student loan should be avoided at all costs, if possible. Most student loans, whether issued by a bank or the state, are guaranteed by the federal government. The government will reimburse the original lender and use its extensive collections power to recover the debt. The government is allowed to garnish your wages and intercept tax refunds without a court ordered judgment until the debt is paid in full. There is no statute of limitations on the collection of student loans, and the government will pursue you as long as it takes to recover the loan.

After the student borrower graduates, leaves school, or drops below half-time enrollment, they have approximately 6-9 months before the repayment schedule begins. If you’re unable to make a scheduled payment, there are many options available. The type of loan and length of time since default will determine which of the following options are available.

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FINAL THOUGHT

For millions of Americans mired in debt by the current recession, settling those debts by negotiating with creditors is a legitimate solution and a preferable alternative to bankruptcy. Although debt settlement has always been an available option, the recent changes to federal bankruptcy laws, which have made it more difficult to wipe out debts, have increased the interest in debt settlement. Predictably, many new companies are emerging to assist consumers through the settlement process.

Unfortunately, many of the consumer debt counselors employed by the new firms are insufficiently trained in the nuances of debt settlement, with the result that consumers are poorly represented. In many cases, the debtor is either led to accept a less favorable settlement than should have been negotiated, or worse, they are misled to believe that settlement is a viable option for their situation when it's not.

The root of the problem is that this fast-growing industry is under-regulated, unlike their counterparts, the debt collection firms, which are heavily regulated. Most debt settlement companies operate without established policies and procedures to ensure the services offered are appropriate and professionally delivered. The reality is that many debt settlement programs regularly fail to provide the services promised to the consumer.

The mistake made by most consumers is that they enroll into a debt settlement program and then drop the program in an effort to do it themselves after already paying the firm a substantial amount in fees. It's also fair to say that because the program is projected to conclude in up to 36 months; financial circumstances may change and force the program to end. Today's uncertain economy makes that more of a possibility.

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