Freedom Debt Relief White Paper

Debt Relief: Panacea or Problem?

Uncovering the truth: the real differences, pros, cons of options for consumers in serious debt

Introduction

Over the past five years, American consumers have faced a consistently darkening future. For many individuals and families, the recent economic recession has taken their households from a shaky financial position to dire straits.

With mounting debt in America, consumers' problems will continue. Consider:

- Consumer revolving debt (debt that requires ongoing payments, such as credit card debt) increased by a total of 7 percent between 2005 and 2009, according to the Federal Reserve Bank. The amount of added debt was more than $157 billion, or an increase of $524 deeper in debt for every man, woman and child in the United States. Total revolving debt equates to nearly $8,200 for every man, woman and child.[1]

- In April and May 2010, foreclosure numbers reached record highs for two consecutive months. May foreclosures rose 44 percent over the previous year, with about 1 in 400 households receiving a foreclosure notice. Banks have seized more than 3 million homes since 2005, and another 5 million delinquent mortgages are headed toward foreclosure.[2]

- Bankruptcy numbers are not as high as they were before the new bankruptcy law was passed in October 2005, but continue to climb. The number of consumer bankruptcy filings in the United States – 1.4 million – increased 32 percent in 2009 over calendar year 2008. The 1,074,225 consumer filings during the 2008 calendar year represented a 31 percent increase over the 822,590 recorded during the same period in 2007. Consumer filings are up 11 percent through the first nine months of 2010 vs. the same period a year ago.[3]

- During the early 2000s, the U.S. unemployment rate hovered at or below 6 percent. When the "Great Recession" began in late 2008, however, the unemployment rate shot upward to around 10 percent, and that trend has not yet fallen back to normal.[4] Families and individuals will feel the repercussions of the tight labor market for years to come. Those who have fallen into debt during these tough times may look ahead to several more years of trying to dig out of debt, and find themselves falling further and further behind.

Making informed debt-relief choices

As more consumers have been unable to pay their bills, debt relief companies have proliferated, claiming they can help with debt problems. At times, some of these companies have not been upfront with consumers about their connections and funding sources. This was seen most clearly in the 2006 Internal Revenue Service crackdown on consumer credit counseling agencies. Many of these companies were claiming to operate as nonprofit organizations, but in reality were receiving large "fair share" payments from credit card banks, generating significant income and providing excessive compensation to executives. As a result of its investigation, the IRS revoked the not-for-profit status of every one of the 41 credit counseling companies on which it completed an audit. Those 41 organizations represented 40 percent of the credit counseling industry's revenue.

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[1] Federal Reserve Consumer Credit release, June 7, 2010. http://www.federalreserve.gov/releases/g19/Current/
[2] http://www.businessweek.com/news/2010-06-10/u-s-home-foreclosures-climb-44-to-record-in-may-update1-.html
[3] http://www.abiworld.org/Content/NavigationMenu/NewsRoom/BankruptcyStatistics/Bankruptcy_Filings_1.htm
[4] Bureau of Labor Statistics Current Population Survey, released June 15, 2010.
http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?data_tool=latest_numbers&series_id=LNS14000000

Today, regulators and legislators have growing concern about the debt settlement industry because of rumored predatory companies taking advantage of struggling consumers. Those concerns are resulting in proposed national and state legislation, as well as new rules from the Federal Trade Commission. (See Appendix for details on these actions.)

Amidst this confusion, it is crucial for consumers to understand their options to resolve debt problems, and how their choices can impact their futures. This white paper addresses the options that are available to consumers in serious debt, giving consumers the information they need to make an informed choice about their futures.

Discussion of alternatives: definitions, differences, pros and cons

When it comes to taking care of debt problems, consumers have several options. Not every route is right for every person or every family. Before making a decision about how to take care of debt trouble, it is very important that consumers take the time to understand their options.

This section reviews the debt options that are available to consumers and reviews the pros and cons of each. It also gives an outline of what situations are best suited to each debt-reduction method.

1) **Paying down debt** systematically, also known as **independent debt reduction,** is the best resource for consumers who can make it work. Handling debt reduction independently is the best way to protect one's credit score while getting out of debt. The keys are to stop using credit completely and to always pay secured debt, such as a mortgage or vehicle loan, first. Borrowers then should pay as much as possible on the debt that has the highest interest rate, while staying current with other debts by making minimum payments. When the first debt is repaid, consumers can use the same strategy on the next-highest-rate debt.

    a) **Pros:** Protects the credit score; does not accrue additional fees beyond interest on the existing account balances.

    b) **Cons:** Requires discipline to make payments on time and the ability to avoid using additional credit; demands that consumers be able to make at least minimum payments on existing debt, and ideally more than minimum payments.

    c) Who it is best for: People who have simply gotten into too much debt, but who are able to make minimum payments.

2) **Negotiating with creditors directly.** Those who cannot make even minimum payments on bills can try calling creditors and asking for temporary hardship status. Some creditors may work out payment plans. While creditors are under no obligation to negotiate, it is often in their interest to do so, since it makes payoff more likely.

    a) **Pros:** Protects the credit score; may create "breathing room" for people in debt; may make it feasible to pay off debts without outside help or additional fees.

    b) **Cons:** Does not always provide results; alerts creditors to hardship status; requires clear, full documentation of any agreement.

    c) **Who it is best for:** People who have acquired too much debt due to a short-term situation, and who are recovering from the situation but need some additional time to repay debts.

3) **Debt consolidation** simply combines multiple debts into one larger loan. Debt consolidation services usually ask consumers to make one monthly payment, which the consolidator then uses to pay creditors. Consumers pay back 100 percent of the debt, plus interest.

   a) **Pros:** Can lower interest rate; can simplify bill paying, because it results in just one payment.

   b) **Cons:** The loan is usually secured by the borrower's property, such as a home or car, which makes this option only available to those who have those assets; using a home or car as collateral puts those items at risk if the borrower cannot pay; fees can be high, and some services are disreputable; those working with a debt consolidator may sacrifice the freedom to open and use additional credit lines.

   c) **Who it is best for:** Debt consolidation might work for people who are able to pay their bills, but find it difficult to juggle multiple bills and payments. It is most advantageous when the debt consolidation offer includes a lower interest rate than most of the rates the consumer already is paying.

4) **Debt management companies**, also known as **consumer credit counseling agencies**, maintain pre-arranged agreements with credit card companies to lower interest rates on a consumer's existing debt to a creditor-issued "concession rate." Often, credit counseling agencies enroll consumers in a *debt management plan (DMP).* The agencies collect a monthly fee from consumers, as well as revenue from the credit card companies called "fair share" payments. Terms of payment are typically limited to five years.

   a) **Pros:** Debt management plans reduce monthly payments and may reduce interest rates, and do not necessarily have a negative impact on credit scores; reputable programs can help teach consumers better budgeting and financial management skills; consumers generally avoid harassment or collection calls, as bills are being paid. Monthly fees typically are $10-$15 per line of debt.

   b) **Cons:** Since debt management plans do not reduce the total principal amounts owed, payments can be significant in order to pay off the entire principal balance within the five-year time period, and are usually only slightly lower than regular minimum payments; consumers who are unsure whether they can keep up with the payments should proceed cautiously; in many cases, consumers attempt a debt management plan or DMP, but eventually wind up filing bankruptcy because the payments really are more than they can afford to pay; enrolling in a DMP can make it difficult to obtain higher credit lines, such as a home or auto loan; the low monthly fees add up over the course of the five-year program, often amounting to $6,000 or more; since part of a credit counselor's revenue comes from the creditor based on the amount repaid, there is a conflict of interest between the provider and the customer.

   c) **Who it is best for:** A DMP can help consumers who simply need a lower interest rate and who can stick with the program for about five years. DMPs are best suited for individuals who are facing a less-severe financial hardship than a typical debt settlement customer (see No. 5).

5) A **debt settlement** firm works on consumers' behalf to lower principal balances due on existing debts. Final agreements often obtain savings of 50 percent of the total debt. The firm does not make monthly payments to creditors, but rather negotiates directly with the consumer's creditors while the consumer accumulates funds for the settlement through a monthly program payment. Debt settlement firms charge consumers a fee for their services, typically a percentage of the debt enrolled or a percentage of the debt reduced.

   Designed for those in very serious debt hardship, debt settlement offers an alternative to debt management (credit counseling), debt consolidation and bankruptcy. Debt settlement programs help qualified clients who stay with the program fully resolve their debts, typically in two to four years. Debt settlement sometimes is called "debt resolution" or "debt negotiation."

   a) **Pros:** Along with the potential of reducing total principal owed by 50 percent or more, debt settlement programs provide one monthly payment. This program payment is used to accumulate funds for the

settlements, and is typically significantly less than minimum payments and the monthly payment into a DMP; consumers who stay with a debt settlement program typically can resolve all debt within two to four years, vs. five years for credit counseling; with rules enacted by the Federal Trade Commission in 2010, debt settlement companies can only charge fees associated with debts that they actually settle.

Programs typically provide better repayment terms than a Chapter 13 bankruptcy filing and do not leave a permanent bankruptcy judgment on one's record; no conflict of interest exists with creditors, because the debt settlement provider receives no payments from credit card companies.

b) **Cons:** Debt settlement can leave a significant mark on a credit report; because consumers do not make payments to creditors while they are accumulating settlement funds, creditors or collectors are likely to pressure consumers during the settlement period (consumers should expect help with managing creditor calls from a debt settlement company with which they work); fees and interest will accumulate during the settlement period, and should be taken into account when calculating savings; creditors can take legal action against consumers for unpaid accounts during the settlement period.

c) **Who it is best for:** Debt settlement is best suited for individuals who are struggling with very serious debt, who cannot make required minimum payments, and who would otherwise be considering bankruptcy or credit counseling.

6) **Bankruptcy** is generally considered a last resort, as it destroys a credit rating for many years. Since the 2005 bankruptcy reform, bankruptcy is more difficult to obtain, and more expensive. The 2005 reform sharply curtailed filings for Chapter 7 bankruptcy, the type of bankruptcy that eliminates most consumer debt. Chapter 13 bankruptcy filings, which require consumers to repay debt on repayment plans, are available to those whom their state determines, through its means test, have enough income to pay back at least some of their debt. Consumers considering a bankruptcy filing should speak to a bankruptcy attorney licensed in their state.

a) **Pros:** Can eliminate most consumer debt, although under the bankruptcy law passed in 2005, Chapter 7 filings are more difficult and more expensive to obtain.

b) **Cons:** Destroys a credit rating for seven to 10 years; monthly payment amounts in a Chapter 13 filing are generally comparable to or less favorable than those found with debt settlement program payments; additional upfront legal fees are required to file bankruptcy; bankruptcy filings are part of the public record, meaning they are accessible to anyone who wishes to seek out the information; non-exempt assets may be liquidated as part of a bankruptcy.

c) **Who it is best for:** People who are completely unable to repay their debt and who either do not have a home or do not wish to keep their home when they resolve their debt situation.

How to choose a debt relief provider

When it comes to getting debt help, how can individuals and families choose a solid partner that will help them, rather than harm them? For those who are looking for a trustworthy organization to help win the battle against debt, the following considerations will help choose a reputable firm.

In conducting their research consumers can review the websites of debt help companies, check their reputations online, ask friends or family for their opinions or insights, and speak to the companies themselves to find out what they do and whether they would be a good fit.

Consumers must beware of companies that make specific promises before they review an individual's situation, or that pressure consumers to sign up immediately or send money before an agreement is created. A trustworthy company will be honest and communicative with prospective clients.

1. **Compensation:** Does the company get any form of consideration or compensation from the creditors themselves? Some companies – particularly credit counseling companies – receive funding in the form of what are called "fair share" payments from creditors. The payments are incentives to get consumers into debt management plans (DMPs), and could lead to a conflict of interest between creditors' and consumers' interests. Does the company charge fees before a debt is resolved? The Federal Trade Commission issued new rules in 2010 that prohibit companies from charging any fee before a debt is resolved.

2. **Individualization:** Does the company provide actual consultations and provide advice and education to consumers free of charge? Or is the company simply directing every consumer into a debt management plan or a debt settlement plan? DMPs and debt settlement are not right for everyone. Some disreputable companies drive consumers directly into a DMP without a thorough review of finances. In addition, if the consumer cannot keep up with the program's payment plan, he or she still might wind up in bankruptcy.

3. **Free education:** Does the company provide educational material, including budgeting and financial advice, free of charge? Many firms consider educational material an additional fee source, not a benefit to their clients.

4. **Background:** What is the background of the company's management team? Look for good, relevant education and experience – not a team that jumps from opportunity to opportunity to make its fortunes.

5. **History:** How long has the company been in business? How many customers has it served? Determine if the company and its own employees are those who will actually provide service through the life of the program, or if they contract out to others once they have enrolled a client.

6. **Success:** What are the company's dropout and success rates? Request these statistics. The Association for Settlement Companies, the major debt settlement trade association, reports that credit counseling companies historically have had a success rate of 21-26 percent, meaning that three-quarters of those who enter the programs are unable to complete them.[5] The National Foundation for Credit Counseling has reported that dropout rates are at least 45 percent; the foundation has no statistics on what portion of the remaining 55 percent complete the program and what portion call the organization to say they plan to resume payments on their own.[6]

   The national rate of completion for confirmed Chapter 13 bankruptcy plans is only 33 percent, while debt settlement completion rates have been reported at 35-45 percent. A survey by The Association of Settlement companies reveals that even for those consumers who terminated programs before all debt was resolved, at least one of their debts was resolved in nearly 35 percent of the cases. Reviewing these rates is important, as it provides an indication of how the company is able to structure resolutions and payment plans for its clients.

7. **BBB:** In the recent past, the Better Business Bureau did not have a system for separating good companies from bad. Instead, they rated all debt settlement companies with a D or an F due to concerns about the industry, and an inability to perform the analysis required to determine which companies were providing value to consumers. Fortunately, that is all changing in response to the Federal Trade Commission's new regulations for the industry (see Appendix A). As of late 2010, the BBB was in the process of revising its process and criteria for evaluation of debt relief companies. In the interim, the BBB is assigning "NR" (not rated) status to select companies that have pledged to abide by the requirements of the rule, including the advance-fee ban. After an accreditation process verifying their compliance, those companies will be eligible for a letter grade according to the BBB's standard grading methodology. The BBB has maintained that debt settlement can be a viable option for people as a last resort before filing bankruptcy.[7]

[5] http://www.tascsite.org/index.cfm?event=IndustryNewsDetail&IndustryNewsID=54[5]
[6] http://articles.moneycentral.msn.com/Banking/YourCreditRating/why-credit-counseling-often-fails.aspx
[7] http://www.bbb.org/us/article/complaints-to-bbb-against-debt-settlement-companies-on-the-rise-19186

8. **Fees**: Make sure to understand exactly what the fees are and how the debt relief provider will assess the fees. Credit counseling fees may sound minimal, for instance, but it is important to look at the whole picture. Monthly fees can be $10-$15 per line of debt, but over the course of five years – the typical length of time for a debt management program – fees can easily mount to $6,000 and more. In addition, credit counseling only reduces interest rate, not principal amount of debt owed. Original debt of $20,000 easily can end up costing a consumer $42,000 over five years in credit counseling, vs. less than $15,000 in debt settlement.
9. **Additional services:** How will the company help with creditor calls? Will they provide assistance if a payment issue goes to court? Many debt relief companies will drop clients if a creditor sends a summons. Find a company that will work with you through the entire period, and all circumstances, of your debt resolution.

Above all, consumers must trust their instincts when evaluating debt relief plans. If a "gut feeling" says something isn't right with a company, move on. Numerous organizations can help consumers resolve financial issues – with integrity and skill.

Appendix A
Summarizing key issues with regulatory and legislative matters

As of this writing, efforts to more tightly regulate the debt settlement industry continue to develop. Amidst claims that the actions of some debt settlement companies have harmed clients, both regulatory and legislative bodies are actively looking to curb deceptive practices.

The intent to protect consumers from unprincipled companies is on target. However, the moves proposed both by regulatory and legislative action could end up hurting, rather than helping, consumers in serious debt hardship. The proposals could result in making it difficult or impossible to provide sound debt settlement services – and thereby take debt settlement away as a legitimate option for consumers.

While debt settlement is not for everyone, and only for those in very serious debt who meet specific criteria, debt settlement **is** a critical form of debt relief needed in the current economic times. Following is a brief summary of legislative and regulatory action.

Legislation
In Congress, Charles E. Schumer, D-N.Y., and Claire McCaskill, D-Mo., introduced legislation in April 2010 that could result in debt settlement companies being unable to operate viable businesses.

- Debt settlement companies would be prohibited from collecting fees before final settlements are reached with creditors, and fees are capped at 10 percent of the debt reduction. For example, a debt settlement company that works for three years to reduce $10,000 in debt to $5,000 would earn $500 for its efforts. Fee restriction would result in the end of debt settlement services in the United States.

- Consumers would gain the right to cancel a debt settlement contract and receive a full refund, with enforcement through state attorneys general and the Federal Trade Commission (FTC).

- The FTC would gain authority to regulate the industry's advertising and marketing practices.

Regulation
In July 2010, the FTC promulgated rules that significantly change the way debt relief services are marketed and provide.

- The FTC rule requires standard marketing disclosures and prohibits debt relief providers from misrepresenting their services.

- The rule prohibits debt relief providers from charging any fees before a successful resolution of a debt. Fees charged must be proportionate to the debt that is resolved.

- Rule leaves a loophole for nonprofit organizations, face-to-face transactions and, potentially, attorneys, and allows companies operating in one of these methods to avoid compliance.

- Creates potential conflicts with existing state legislation.

State Regulation
Now that the FTC has come out with federal rules for the debt relief industry, it is important that state regulation which conflicts with the federal rule be amended to allow debt settlement to remain a viable option for consumers. Most existing state laws set fee caps and mechanisms that incorporate a monthly fee structure, which makes it difficult or impossible to operate in conjunction with the FTC's requirement for success fee pricing.

Furthermore, state regulations could be used to close loopholes in the FTC rule for nonprofit organizations, attorneys and face-to-face transactions.

As Andrew Housser, CEO of Freedom Financial Network, points out, “It is critical that any regulations do not have the unintended consequences of driving the good companies – those that are dedicated to providing quality services to consumers – from the market.” Once that occurs, the regulations, in effect, remove a viable option for consumers in debt.

Appendix B
Options for Consumers with $20,000 in Credit Card Debt

	Credit Counseling	Debt Settlement	Chapter 13 Bankruptcy	Chapter 7 Bankruptcy
Monthly PMT (% of debt)	2.0 - 3.0%	1.5 - 2.0%	Varies	$0
Monthly PMT ($)	$400 - $600	$300 - $400	Varies	$0
Annual Fees	12.0 - 14.0%	N/A - success fee only[1]	$2,000 filing	$1,500 filing
Typical Program Length	5 years	2-4 years	5 years	6 months
Typical Total Cost	$30,000[2]	$14,000[3]	$14,000[4]	$1,500
Completion Rate	21 - 26%[5]	35-45%	30 – 35%[6]	N/A
Key Concerns:				
	Certain creditors may not agree to concession rate.	Payments are not made to creditors until sufficient savings balances have accrued; credit rating is impaired.	Severe credit rating impact.	Severe credit rating impact.
	IRS audit of industry has resulted in revocation of nonprofit status from many companies.	Collection calls and potential legal action on delinquent accounts.		Bankruptcy reform in 2005 requires means test – harder to qualify.
	Minimal impact on credit score, viewed by credit issuers negatively.			

[1] Based on 15% - 18% total fee, and a typical program length of 3 years.
[2] Assumes credit card rates are reduced to 11.9%, and adds debt management program fee of $50 per month. Payment is fixed at $500 or 2.5% of starting debt.
[3] Assumes average settlements of 50% and total fee of 20% of debt (on a success fee basis).
[4] Assumes 60% of debt paid back, plus $2,000 filing fee.
[5] *Credit Counseling in Crisis: The Impact on Consumers of Funding Cuts, Higher Fees and Aggressive New Market Entrants*, Consumer Federation of America and National Consumer Law Center, April 2003.
[6] "Bankruptcy by the Numbers: Measuring Performance in Chapter 13" by Gordon Bermant and Ed Flynn, Executive Office for the U.S. Trustees.

About Freedom Debt Relief (www.freedomdebtrelief.com)

Freedom Debt Relief provides consumer debt settlement services. Working for the consumer to negotiate with creditors and lower principal balances due, the company has served more than 100,000 clients since 2002. The company is an accredited member of The Association of Settlement Companies and a platinum member of the International Association of Professional Debt Arbitrators. FDR holds the Goldline Research Preferred Provider certification for excellence among debt settlement companies.

Freedom Debt Relief is a wholly owned subsidiary of Freedom Financial Network, LLC (FFN). Based in San Mateo, Calif., FFN also operates an office in Tempe, Ariz. The company, with more than 600 employees, was voted one of the best places to work in both the San Francisco Bay and Phoenix areas in 2008, 2009 and 2010.