



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

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EXECUTIVE SUMMARY

Debt settlement companies purport to offer debt-burdened consumers a way to become debt-free while paying substantially less than what they owe, particularly on their credit cards. But debt settlement can be risky; for many consumers, it is not the solution it is marketed to be. All too often, far from becoming debt-free, debt settlement clients are in fact left in a worse financial position than where they started.

This study analyzes recent data published by the debt settlement trade association to determine whether debt settlement services are on balance beneficial to consumers. The data point to two key findings:

- (1) **Consumers must settle at least two-thirds of their debts to improve their financial position through debt settlement.** Using conservative assumptions, on average, consumers must settle at least two-thirds (four of six) of their debts to be in a better financial position than they were at the time of enrollment in the debt settlement program. Consumers who incur tax liability or other costs, are unable to complete all installment payments on their settlements, or are sued by one or more of their creditors may not benefit even if they settle nearly all of their debts.
- (2) **It is difficult (if not impossible) for consumers to predict their likelihood of completion ahead of time.** Consumers are unable to fully evaluate the risk factors that affect the number of debts that can be settled (if any). Thus, an individual considering a debt settlement program cannot accurately gauge whether debt settlement services will leave her debt-free, result in some benefit while still leaving some debts unsettled, or leave her worse off than she was at the time she began the debt settlement program.

In the past, investigations of the debt settlement industry revealed dismal settlement rates, with many consumers having few, if any, of their debts settled. Recent federal rule changes restricting debt settlement companies from charging up-front fees before settling any debts have helped to curb some of the worst industry abuses. However, debt settlement programs can take three years or longer to complete and only three years have passed since this rule change took effect. Debt settlement companies have not yet publicly released completion rates, or even partial completion rates, of consumers enrolled over this period. Therefore, it is unknown whether the ban on charging advance fees will result in significantly better completion rates for consumers than under the previous regime. Regardless, even if a larger proportion of consumers end up experiencing a positive outcome as a result of the advance fee ban than before the ban, individual consumers are unlikely to be able to assess their chances for success prior to entering into a debt settlement agreement, making the model itself problematic.

States that have not authorized or that strongly restrict debt settlement should keep in place the protections they have.

Other options may be more suitable for many consumers overwhelmed by debt, such as engaging directly with their creditors, getting help from a nonprofit credit counseling agency in setting up a debt management plan, or filing for bankruptcy.

States that have not authorized or that strongly restrict debt settlement should keep in place the protections they have, at least until the data demonstrate a dramatic improvement on the consumer outcomes of recent years. States that have authorized debt settlement should: (1) require screening before enrollment to comprehensively assess the consumer's likelihood of success; (2) include a "not worse off" provision that provides consumers with some form of refund or concession if they end up worse off after enrollment; (3) establish meaningful limitations on fees and allow fees to only be assessed as settlements are completed; (4) require detailed data reporting; and (5) ensure broad coverage of the law over all debt settlement providers. State attorneys general and regulators should continue to ensure compliance with all applicable laws and regulations.

At the federal level, the Consumer Financial Protection Bureau (CFPB) should apply rules and restrictions uniformly to all debt settlement providers and transactions, and supervise larger debt settlement providers to assess compliance. Like states, the CFPB should also require screening before enrollment, establish a "not worse off" provision, allow fees to be assessed only as settlements are completed, and require detailed data reporting. Finally, where violations of existing law are present, the CFPB and Federal Trade Commission (FTC) should continue to undertake enforcement actions.

What is Debt Settlement?

Debt settlement companies promise debt relief to families in financial distress with claims that they can settle debts for less than the amounts owed.

To enroll in a debt settlement program, consumers must stop paying their debts and are encouraged to cease contact with creditors. Consumers often grant a power of attorney to the debt settlement company to communicate with creditors on their behalf.

Companies typically calculate the fees consumers pay based on a percentage of their debt at the time of enrollment, not on any savings achieved through settlements.

Clients typically need to remain in the program for three to four years to settle all or most of their debts.

BACKGROUND

Although consumer debt levels have declined in recent years, many American households remain highly indebted. With nearly \$850 billion in total credit card debt outstanding, the average household carrying a credit card balance owes \$15,159 across all of their credit cards.¹ One-in-five credit card users who carries a balance pays only the minimum each month, thereby accruing significant interest and prolonging the amount of time they will remain indebted.²

As a result of carrying these debt loads and having little—if any—household savings, many households are vulnerable to shocks such as divorce, layoffs, or unexpected medical expenses, resulting in a risk of default on outstanding loans.³ When households experience an untenable financial situation that leaves them unable to pay their debts, they might decide to file for bankruptcy or negotiate a plan to pay down debts, either working directly with creditors or having a credit counseling agency do so on their behalf.

For-profit debt settlement companies claim to offer an alternative mechanism for reducing unsecured consumer debt, most frequently debt from credit cards. “Be debt free in 36 months!!” and “We can reduce your debt load by up to 50 percent!!” are common claims in the industry.⁴

Debt settlement companies offer to negotiate reductions in debt balances with a consumer’s creditors in exchange for a fee. To do so, however, debt settlement companies require consumers to first default on their debts.⁵ Consumers also must grant the debt settlement company, typically through a power of attorney, the authority to negotiate on their behalf and are generally counseled by the debt settlement company to cease contact with their creditors. As a result, consumers enrolling in debt settlement typically put themselves at risk of lawsuits from their creditors; see their debt loads increase because of higher interest rates, late fees and default charges; and damage their credit before any debts are settled.

This gamble may pay off for consumers if the debt settlement company is successful in settling the consumer’s debts at a discount that exceeds the costs incurred. However, far from becoming “debt free,” many debt settlement clients end up in worse financial straits. Recognizing this problem, a 2010 Federal Trade Commission (FTC) rulemaking restricted the charging of fees in advance of negotiating settlements.⁶ This advance fee ban has improved industry practices, and new industry data demonstrate somewhat better outcomes for consumers.⁷ However, even with this progress, the inherent dangers of debt settlement make it a risky proposition and often an inferior choice to other options available.

Far from becoming “debt free,” many debt settlement clients end up in worse financial straits.

After providing a brief description of how debt settlement works as well as the current regulatory environment, we offer evidence that debt settlement only results in an improved financial position for consumers who are successful in settling at least two-thirds (four of six) debts, and that consumers cannot accurately predict at the outset whether their financial position will improve or worsen through the debt settlement process. We then provide examples of potentially more suitable options, and close with policy recommendations for legislators and regulators at the state and federal level.

OVERVIEW OF DEBT SETTLEMENT AND REGULATORY ENVIRONMENT

The debt settlement business model

Debt settlement companies market themselves as providing a way to “get out of debt,” become “debt free,” or reduce debt.⁸ Many companies market their services as a favorable alternative to making minimum monthly payments on credit cards.⁹ They present debt settlement as a faster and less-costly option.¹⁰

In order to enroll in a debt settlement program, consumers must stop paying their debts¹¹ and are encouraged to cease contact with creditors. Consumers often must grant a power of attorney to the debt settlement company to communicate with creditors on their behalf, which prevents a creditor from negotiating directly with the consumer.

There are at least two reasons under the debt settlement model that consumers must stop paying their debts and thus default. First, rather than making debt payments, consumers are required by most debt settlement programs to fund a dedicated account held by a third-party that eventually can be used to pay settled debts and the associated fees to the debt settlement company. Second, debt settlement companies note that creditors will not reduce the principal balances of customers whose debts are current, even if the customer is only making minimum payments.

Although some consumers enter debt settlement having already defaulted on one or more debts, they must default on all debts they plan to enroll in order to enter a debt settlement program. A recent analysis prepared on behalf of a debt settlement industry trade association, the American Fair Credit Council (AFCC), points to “the value to a Client of improved cash flow when the Client chooses to stop making minimum monthly credit card payments and substitutes a substantially reduced periodic deposit requirement” as a benefit of debt settlement.¹²

Although consumers may experience the short-term benefit of more disposable income when they stop paying their debts, they also may experience longer-term negative financial impacts. Once a debt becomes delinquent under the debt contract, creditors can and generally do impose higher default interest rates, late fees, and instigate collection efforts. Creditors can file lawsuits for payment, which could result in wage garnishment. In addition, defaults can hurt borrowers’ credit reports and scores for about seven years.¹³ The impact will vary depending on the consumer’s credit score before the delinquency or defaults, but the score may fall 60-100 points.¹⁴ A lawsuit or unpaid judgment will remain on a consumer’s credit report for seven years or until the statute of limitations runs out, whichever is longer.¹⁵

The AFCC report analyzed data from large national debt settlement companies within its membership, finding that the typical client enrolls six debts in the debt settlement program and that the first settlement is typically negotiated four months after enrollment.¹⁶ Settlement agreements are often structured so that the consumer pays her creditor over a series of installments, although a lump sum settlement payment may also be an option. CRL has reviewed settlement agreements that extend from a few months to over a year.¹⁷ While making payments on current settlement agreements, consumers also continue to fund a dedicated account for potential future settlement agreements on other debts.

Once the consumer enters a settlement agreement with her creditor and makes a first payment on a particular debt under the settlement, the debt settlement company is able to collect the full fee associated with that particular debt. This is the case even when the agreement calls for the consumer to make installment payments over an extended period of time to the creditor. Often, debt settlement companies calculate their fee as a percentage of the debt at the time of enrollment, rather than as a percentage of the savings achieved as a result of the settlement. For example, if fees are set at 20% of the enrolled debt, the fee remains the same regardless of the amount by which the debt is reduced.¹⁸

Debt settlement clients typically need to remain in the program for three to four years in order to settle most or all of their debts.¹⁹ However, as discussed in more detail later, there is considerable evidence that, historically, only a minority of consumers have completed their debt settlement programs. There are a variety of reasons why a consumer may not have all her debts settled. First, certain creditors are simply unwilling to deal with debt settlement companies. Second, some creditors may expedite collection efforts and pursue lawsuits against consumers who default on their debts and enroll in debt settlement, causing some consumers to drop out of the program.

Third, because many clients are financially fragile, a financial shock such as a job loss or unanticipated expense may make it impossible to keep current on the monthly payments to their dedicated savings account or to make installment payments under a settlement agreement, thereby decreasing the likelihood of completion. Finally, some consumers may choose to terminate their debt settlement program and settle debts on their own.

Consumers who continue to have unsettled debts may see their debt loads increase further after enrolling in debt settlement as a result of late fees, default interest rates, and possible litigation expenses. When this happens, filing for bankruptcy might be the only way to avoid further damage.

There is considerable evidence that, historically, only a minority of consumers have completed their debt settlement programs.

Regulatory overview

Debt settlement firms are regulated at both the state and federal level. Some states ban for-profit debt settlement entirely,²⁰ or limit the fees to 10% to 15% of the actual savings that debt settlement companies can charge.²¹ State attorneys general also have successfully sued debt settlement companies under state laws prohibiting fraudulent or deceptive acts and practices.²²

In 2008 and 2009, the FTC hosted public meetings on the debt settlement industry, and the Government Accountability Office (GAO) issued a report outlining its concerns about the industry in 2010. This culminated in the promulgation of new FTC rules in July 2010, which became effective in October 2010.²³ Among the most significant provisions is an “advance fee” ban, which only allows firms to collect fees when a settlement agreement has been reached and at least one payment related to the settlement has been made by the consumer to the creditor. Prior to the rule, many firms charged substantial up-front fees, which delayed the accumulation of funds for settlements, leading to high dropout rates, large financial losses for consumers, and extremely low rates of completion.

The Consumer Financial Protection Bureau (CFPB) also has jurisdiction over all debt settlement firms for rule writing and larger firms for supervision, and their affiliated service providers.²⁴

Evasions of federal and state debt settlement regulations

Although this brief focuses on debt settlement programs that are compliant with the FTC's advance fee ban, some debt settlement firms have chosen to not comply with this regulation. Because the FTC's jurisdiction is limited by the scope of the Telemarketing Sales Rule, the rules do not apply to all players or all situations. For example, debt settlement programs that provide for certain face-to-face transactions are excluded, as are any programs in which all activity is conducted online.²⁵

Some companies have attempted to evade the FTC's rule as well as state laws that often exempt attorneys from their debt settlement regulations by associating with attorneys, even though these attorneys do not actually perform much, if any, debt settlement work.²⁶ The business practices of Legal Helpers Debt Resolution and Morgan Drexen provide examples of this approach. Legal Helpers Debt Resolution is a company that includes attorneys, but which contracts out the debt settlement work to third-party non-lawyers, to the extent any work is performed. Morgan Drexen is a company of non-lawyers that contracts with attorneys who charge up-front fees in return for minimal work on debt settlement cases, while Morgan Drexen's own non-lawyer employees actually provide the bulk of the work and consumer communication.

State attorneys general and the CFPB have brought increased scrutiny to these business models.²⁷

FINDINGS

Although the FTC's advance fee ban appears to have reduced the potential financial harm to consumers enrolled in debt settlement programs, it remains unclear whether a substantial share of consumers will be better off after pursuing debt settlement than they were when they enrolled. Also, consumers cannot accurately judge the likelihood of completion at the time of enrollment. Other alternatives—pursuing hardship programs or otherwise negotiating directly with credit card companies, setting up a debt management plan through a non-profit credit counseling agency, or even filing for Chapter 7 bankruptcy—carry fewer risks and may ultimately be preferable for consumers with unmanageable debt.

The AFCC report, released in February 2013, examined outcomes at several AFCC-member debt settlement firms that comply with the FTC's advance fee ban.²⁸ The report concludes that debt settlement—especially after the advance fee ban—is always beneficial for consumers regardless of how much debt is settled, since clients pay fees only if and when settlement agreements are reached. Data in the report also provide evidence that consumers are better off with the advance fee ban in place than they were without it, as some clients in the past paid hefty fees without any debts being settled. These data also suggest that companies complying with the ban have implemented changes in the business model that result in settlements occurring more rapidly under the new rule.

However, although the report goes into detail about the proportion of total debts in the data set for which settlement agreements have been reached, and the terms and costs of those settlements, it does not examine outcomes at the consumer level to determine what share of consumers settle all, some, or none of their debts. Further, the report does not consider the impact to the consumer of debts that remain unsettled, including the growth of balances on those debts and the potential for lawsuits, or other consequences such as state and federal tax liability.

To fill these information gaps, CRL has constructed a model that more fully evaluates consumer outcomes 36 months after enrollment in a debt settlement program using publicly available data from the AFCC report.

Finding 1: Consumers must settle at least two-thirds of their debts to improve their financial position through debt settlement.

With our model, we seek to evaluate what share of debts must be settled in order for a consumer to realize a positive change in financial position relative to when she enrolled in debt settlement. We focus our analysis on consumers who enrolled in debt settlement after the advance fee ban took effect on October 27, 2010.

The report notes that 56,000 consumers in the AFCC data set enrolled a total of \$1.7 billion in debt in debt settlement programs after the advance fee ban.²⁹ This equates to an average total enrolled debt of \$30,357 per consumer. Additionally, each consumer enrolled six debts on average.³⁰ For simplicity, we assume each of the six debts is of equal size, roughly \$5,060.

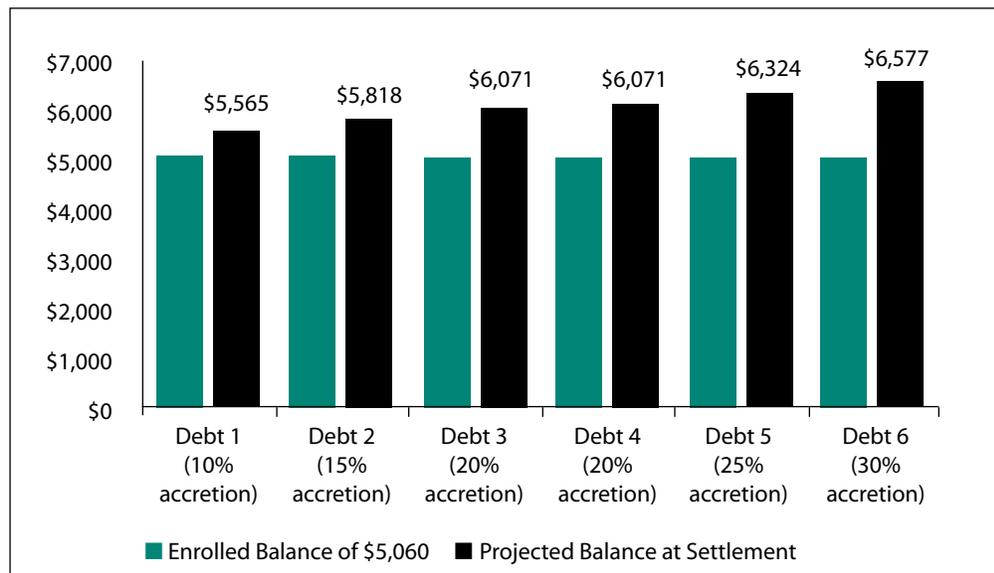
Table 1: An average consumer’s debt at enrollment in a debt settlement plan

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

Each of these debts experience “accretion,” or growth, 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 AFCC report notes a consumer’s total enrolled balance will grow by 20% before all debts are settled.³¹ However, because settlement agreements are reached sequentially, one debt may settle relatively soon after enrollment and thus incur less total accretion than another debt that remains in default longer (or never settles). According to AFCC, the first debt settles just a little after four 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.³²

We therefore construct a model, shown in Chart 1 below, which estimates the amount by which each of the 6 debts enrolled would grow before settlement. This ranges from 10% growth in debt balance for the first debt to 30% growth for the final debt. While the growth of each individual debt varies by the time it takes to settle, the consumer’s total debt grows by 20% overall from \$30,357 to \$36,429, consistent with the finding in the AFCC report.

Chart 1: Projected accretion of each account from time of enrollment until settlement (assuming all accounts settled 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.

If a settlement agreement is reached on a given debt, the AFCC report finds that this settlement typically reduces the outstanding balance on that debt (which includes accretion from the time of enrollment to settlement) by 48%.³³ In exchange for reaching a settlement, the consumer owes a fee, which varies by debt settlement company. Because fees often range from 20-25% of the debt balance at the time of enrollment, we use the midpoint: 22.5%.³⁴

Table 2 below provides an illustration of these calculations on the settlement of the first account, which generally happens after four months in a debt settlement program:

Table 2: Illustration of first debt settled

Balance at enrollment	\$5,060
Growth (“accretion”) 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 up exactly due to rounding

With these findings from the AFCC report and resulting assumptions outlined above, we can now measure what share of debts must be settled for a consumer to experience a positive financial change relative to her position at enrollment in a debt settlement program. As noted above, our model shows what share of debts must settle for a **typical** debt settlement client—that is, a consumer who (according to AFCC’s data) enrolls with the average level of debt and experiences the average rate of accretion.

As Table 3 summarizes below, a consumer must settle at least two-thirds (four of six) debts to have a positive change in financial position after 36 months. A consumer that can do this will still be in default on two of six debts—risking lawsuits from creditors—but will experience a positive change in financial position of over \$1,350 (relative to the amount of debt when she enrolled).

Table 3: Change in financial position 36 months after enrollment

	Unable to settle any debts	Settle 1 debt (unable to settle 5 of 6 debts)	Settle 2 debts (unable to settle 4 of 6 debts)	Settle 3 debts (unable to settle 3 of 6 debts)	Settle 4 debts (unable to settle 2 of 6 debts)	Settle 5 debts (unable to settle 1 of 6 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	N/A	\$2,671	\$5,464	\$8,379	\$11,293	\$14,329	\$17,486
(C) Total debt settlement fees due	N/A	\$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	N/A
(E) Accretion on unsettled debt, over 36 months	\$9,107	\$7,589	\$6,071	\$4,554	\$3,036	\$1,518	N/A
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
# debts that remain in default	6	5	4	3	2	1	0

For more information on the calculations in this table, see the Appendix.

For example, a consumer who settles 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. These funds would be paid from the consumer's dedicated account, in 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 over 36 months by \$4,554. Ultimately, this consumer would end up with \$31,526 in total obligations to creditors and debt settlement companies, 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.

The analysis in Table 3 above assumes that the client did not file for bankruptcy or negotiate settlements directly with creditors herself during these 36 months. Thus, any unsettled debts continued to grow over time.

It is worth noting that our model was designed in a way that may understate the harm and overstate the benefits associated with participation in a debt settlement program. This is because we chose to resolve all ambiguities in favor of debt settlement. These assumptions are detailed below:

Conservative assumptions of our analysis that may understate harm and overstate benefits of debt settlement:

1. All debts enrolled are equal in size.
2. Consumer is able to fully pay all settlement installment plans as agreed.
3. There is no cost of maintaining dedicated third party account.
4. There is no tax liability for cancelled debt.
5. Creditors do not bring any lawsuits on defaulted debts enrolled in debt settlement.
6. There are no financial impacts for unsettled debts beyond the 36-month period analyzed.

1. **All debts are of equal size.** We assumed that the consumer's debts are all 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. In general, the larger the debts left unsettled, the greater the accretion that will accrue. Accordingly, our assumption likely understates the accretion that accrues on unsettled debts.³⁵
2. **All settlement installment plans paid as agreed.** For the purposes of our analysis, we assume all settlements are successfully repaid as stipulated in the agreement. However, increasingly, settlement agreements are structured to be repaid in installments over time. In a survey of creditors dealing with term settlements, approximately 40% of respondents reported that 20% or less of term settlements fail; however, another 29% of respondents reported a breakage rate of 40% or higher.³⁶ A broken settlement agreement will result in the debt returning to a default status.
3. **No costs for dedicated account.** We also did not include the costs of maintaining the dedicated account, which is typically required for participation in a debt settlement program. The third-party companies that manage these accounts charge debt settlement clients monthly, annual and/or transaction-based fees to process regular debits from their bank account to the dedicated account and disbursements from the dedicated account to creditors for settlement payments. Typical fees include a \$9 set up fee plus \$10 per month in continuing fees—\$369 in total fees for a client who spends 36 months in a debt settlement program.³⁷

4. **No tax liability.** Our model further assumes that the client does not incur any income tax liability in connection with the settled debts. 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.³⁸ State tax laws are generally 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, meaning that they fill out the correct tax form and can demonstrate that their debts exceed the value of their assets. However, a quick glance at online reviews of debt settlement companies reveals testimonials from customers who say they incurred tax liability on their settled debts.³⁹ Moreover, qualifying for such an exemption may require hiring and paying for a tax advisor, if the consumer is even aware of the exemption. Thus, at least some debt settlement clients do face the additional costs of the tax liability and tax advisor fees.
5. **No creditor lawsuits.** Additionally, debt settlement clients are sometimes sued by their creditors while participating in a debt settlement program. The difficulty in estimating the proportion of clients that is likely to be sued, and the variability of the costs involved,⁴⁰ led us to exclude these costs from our calculation.
6. **No additional impacts after 36 months.** Finally, Table 3 shows the change in financial position at 36 months from enrollment, although any unsettled debts may continue to grow past this point until the consumer reaches an agreement with her creditors, files for bankruptcy, or dies. Therefore, our model may further understate the extent of a client's negative change in financial position if debts are left unsettled past the three year time period.

Taking some of these additional factors into account would result in consumers needing to settle nearly all debts to experience a positive change in financial position relative to the time of enrollment, as shown in Table 4. Although Table 3 shows that consumers must settle four of six debts for a positive change in financial position (leaving two debts unsettled), this threshold increases to five of six debts for those consumers who incur tax liability and dedicated account fees.

A consumer who settles four of six debts over 36 months would have had total debt reduction of \$8,945. Conservatively assuming a combined federal and state income tax rate of 15%, this consumer, if not “insolvent” as defined by tax law, would owe taxes of \$1,342 on the debt reduction. If we also include the \$369 in dedicated account fees, this consumer would experience a negative change in financial position of \$355 instead of the positive change of \$1,356 reported in Table 3.

While Table 4 shows a positive change in financial position after settling five of six debts, this outcome could also be wiped away if that last outstanding debt results in a lawsuit.

Table 4: Impacts of additional factors such as tax liability and dedicated account fees

	Settle 1 of 6 debts (unable to settle 5 debts)	Settle 2 of 6 debts (unable to settle 4 debts)	Settle 3 of 6 debts (unable to settle 3 debts)	Settle 4 of 6 debts (unable to settle 2 debts)	Settle 5 of 6 debts (unable to settle 1 debt)	Settle all debts
(A) Change in financial position 36 months after enrollment (from Table 3)	(\$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

For more information on the calculations in this table, see the Appendix.

A substantial share of debt settlement clients are unlikely to settle two-thirds of their enrolled debts

If the six assumptions most favorable to the debt settlement companies apply, a positive change in financial position does not occur unless at least two-thirds of debts are settled. It is therefore important to know whether debt settlement clients are likely to achieve these results.

Prior to the FTC’s advance fee ban, AFCC estimated—based upon a survey of its members—that approximately two-thirds of clients failed to have 70% or more of their debt settled.⁴¹ Investigations revealed even lower completion rates. The GAO concluded that debt settlement companies are overly optimistic in reporting their success rates, noting “[t]he 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.”⁴² Data obtained through litigation by states’ attorneys general similarly found completion rates in the low single-digits before the advance fee ban took effect.⁴³

Notwithstanding the industry’s poor performance record for the period up to October 2010, the AFCC report posits that the data will demonstrate much better completion rates for those clients who enrolled in debt settlement after the advance fee ban went into effect. No data is yet publicly available from which to evaluate this claim. Neither the AFCC report nor any subsequent industry statements have disclosed completion rates (or even partial completion rates) for clients enrolled after the advance fee ban took effect. Nothing in the report or subsequent disclosures reveals, for example, the proportion of clients who have had at least two-thirds of their debts settled.

AFCC's report does indicate a higher percentage of settlements in the first two years after the advance fee ban took effect than occurred over the same period of time prior to this reform. For example, approximately 35-40% of debts enrolled in 2011 had been settled by the end of 2012, and an additional 20-25% remained active, which might result in additional settlements in the future.⁴⁴ However, it is unclear 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.

Only the consumers remaining in the program have a chance of completing the program or settling enough of their debt to have a positive change in their financial position. However, the AFCC and a state regulator have observed that a significant share of consumers continue to terminate their debt settlement programs early in their tenure even after the advance fee ban, suggesting that—at least for this segment of consumers—few if any settlements were reached. AFCC data show that about one-quarter of debts enrolled after the advance fee ban took effect have been terminated.⁴⁵ The Colorado regulator reports that over a third of consumers (37%) enrolled in 2011 ended up terminating by the end of that year.⁴⁶

Finding 2: It is difficult (if not impossible) for consumers to predict their likelihood of completion ahead of time.

Another important question is whether consumers can readily assess at the outset whether they are likely to succeed in a debt settlement program. As outlined below, several uncertainties affect a consumer's likelihood for success, and these uncertainties are not transparent to the consumer at the time of enrollment. This is not an issue that can be resolved by adding disclosures; rather, it is in the very nature of debt settlement that consumers cannot know ahead of time whether they will be better or worse off as a result of the debt settlement process.

Inability of debt settlement companies to negotiated with creditors. First, certain creditors are unwilling to work with debt settlement companies. A 2012 survey of credit card issuers, debt buyers, and debt collectors, for example, found that only half of respondents will engage with debt settlement firms.⁴⁷ The responses vary by creditor type, with 63% of credit card company respondents reporting that they will work with debt settlement companies, compared with 40% of collection agencies and 59% of debt buyers.⁴⁸ Given that a significant portion of creditors are not willing to negotiate with debt settlement companies, consumers may have no chance of settling all of their debts regardless of a debt settlement company's efforts.

Potential for lawsuits on defaulted debts. Second, when a consumer defaults on her debt and cuts off communications with a creditor, the creditor may respond with escalated collection efforts, including lawsuits that can carry added expense and, often, garnishment of wages. AFCC has noted that one of the primary reasons that clients terminate their debt settlement programs before accounts can be successfully settled is because of creditor lawsuits.

The possibility that some or all of the consumer's creditors will not deal with debt settlement firms and that the creditor may sue the borrower are both troubling, as the consumer has no way to assess these risks when making a decision to enroll in debt settlement rather than pursue other options. Even a disclosure of the likelihood of successful negotiation with a consumer's creditors by the debt settlement company may be ineffective. For example, a consumer's creditor may be willing to work with a debt settlement company at the start of the process, but the creditor could soon thereafter

change its policies or sell the debt to a debt buyer that refuses to negotiate and instead immediately initiates a lawsuit. Thus, unlike the alternative options we outline in the next section, at least two critical factors affecting whether the consumer will experience a benefit or loss are completely outside of the control of the consumer and even the debt settlement company.

Inability of consumer to continue to make contributions to dedicated account or installment payments on settlements. In addition, the consumer must ensure that she is able to fulfill her settlement agreements with creditors (increasingly installment agreements paid over time) and also continue regular contributions to her account for debts not yet settled for years into the future, since completion of a debt settlement program may take three years or more. If the consumer faces another financial shock, such as loss of income, she may be unable to complete payments on any existing debt settlement agreements where installment payments are still due or to continue contributions into her debt settlement account for future debt settlement. Breaking a settlement agreement carries the risk of landing the consumer back into default with her creditor, potentially facing re-imposed late fees and other penalties.

ALTERNATIVE OPTIONS ARE AVAILABLE TO CONSUMERS WITH UNMANAGEABLE DEBT

A consumer overwhelmed by excessive debt has several potential options other than debt settlement. In this section, we describe these alternatives and discuss the benefits and drawbacks of each.

1. **Repay debts slowly over time.** For consumers who can afford to do so, making at least the minimum monthly payments on their credit cards is one option—although perhaps an ultimately slow and costly one. The minimum payments will cover monthly interest charges plus a small part of the outstanding principal balance. Accordingly, the debt will decrease over time until it is eliminated. If the consumer can supplement the minimum payments from time to time with additional principal payments, she can speed the rate at which the debt is eliminated and reduce the overall cost of repayment.

A consumer overwhelmed by excessive debt has several potential options other than debt settlement.

Although it may take years for her to become debt-free, remaining current means she will avoid all of the negative consequences of default. These consequences include a lower credit score; high late fees and other charges; the imposition of default interest rates; and the possibility of lawsuits, wage garnishment, and other debt collection efforts.

2. **Negotiate directly with creditors for hardship repayment or other assistance before or after default.** Many credit card companies offer hardship programs to customers in severe financial distress. Features may include a waiver of late fees and other penalty charges, reduced interest rates, and payment plans.⁴⁹ The creditor will not pursue collections efforts or lawsuits against customers in the hardship program. Accordingly, the consumer can minimize or prevent a growth in debt.

Unlike reductions in principal balances, the waiver of late fees and other penalty charges and reductions in interest rates are not taxable under either federal or state laws. In addition, participation in at least some creditors' hardship programs will not adversely impact a consumer's credit.

In conversations with creditors, CRL has learned that some will offer these hardship programs even if a consumer is not yet delinquent on her debt, so long as the consumer can appropriately document her financial hardship. However, the creditor would likely close the consumer's account (something that would obviously also happen with debt settlement).

In addition, whether the debt collection is in the hands of a credit card company, debt buyer, or collections agency, if the consumer has defaulted on a debt, these parties may be willing to offer a concession such as an interest rate or principal reduction.⁵⁰ For example, a debt buyer who has purchased a consumer's debt at a heavily discounted rate may be able to offer a substantial savings and still profit from the settlement. Staying in contact with creditors may also reduce the risk of a lawsuit.

3. **Non-profit credit counseling/debt management plan.** Debt management plans, which are offered by non-profit credit counseling agencies, generally require consumers to repay unsecured debts in full with modified terms such as significantly reduced interest rates and the elimination of late and other penalty fees, all of which significantly limit the accretion of debt. Debt management plans are available to consumers who have sufficient income to pay down their debt under these terms within three to five years. These plans do not require participants to default on their debts as a condition of enrollment. Upon completion, the consumer's accounts are reported as "closed-paid in full" to credit bureaus, which can provide an immediate improvement in credit score. However, if a consumer is unable to complete a debt management plan, the credit card companies generally treat the debts as in default.

Debt management plan completion rates are generally not reported and—when data are available—vary widely by source from about one-quarter to one-half of plan participants.⁵¹ Those who terminate their plans before completion face the consequences of default. However, unlike debt settlement programs, debt management plans are agreed to by the creditors up-front. As a result, while complying with the plan, the consumer will not face lawsuits or collections activities over the enrolled debts.

Consumers entering a debt management plan typically pay a modest up-front fee, as well as a monthly fee while making payments.⁵² Because debt management plans typically do not entail reductions in outstanding balances, there is no tax liability for the concessions made by creditors in connection with such plans.

4. **Consumer bankruptcy.** The legally sanctioned way for consumers and businesses to obtain relief from unmanageable debts is through the bankruptcy courts. Bankruptcy provides relief from almost all of the consumer's debts—not just the unsecured debts eligible for a debt settlement program. A key advantage of bankruptcy is that once the consumer files, all collection activities are halted, and no new late fees or default interest rates can be imposed. When consumers complete the bankruptcy process, their debts are extinguished, whether paid in full, in part, or not at all. Consumers whose debts are discharged in bankruptcy incur no tax liability for the reduction in their debts.

Bankruptcy generally offers two options for consumers: a Chapter 7 liquidation or a Chapter 13 repayment plan. In Chapter 7, a qualified consumer's⁵³ "non-exempt" assets are sold and the proceeds used to repay creditors. Chapter 7 bankruptcy typically takes three to four months to complete. About 90% of Chapter 7 cases are "no asset" cases in which the consumer does not lose property because her assets are sufficiently protected by the state or federal asset exemptions.⁵⁴

Consumers who do not qualify for Chapter 7 or who wish to keep non-exempt assets can file under Chapter 13. In Chapter 13, the consumer pays all disposable income beyond court-approved living expenses into a court-supervised fund to repay debts over a three to five year period.

Nearly all consumers (approximately 97%) who file Chapter 7 bankruptcy complete the process.⁵⁵ Taking into account both the consumers who complete Chapter 13 bankruptcy (approximately one-third of filers) and the initial Chapter 13 filers who convert to Chapter 7, approximately 50% of Chapter 13 filers succeed in achieving a discharge of their unsecured debts.⁵⁶

The total cost of a Chapter 7 no-asset bankruptcy averages about \$1,309, including attorney's fees, filing fees, and other associated costs.⁵⁷ In Chapter 13 cases, typical attorney fees are higher, at around \$3,700.⁵⁸

A bankruptcy leaves a negative mark on the consumer's credit report for seven to ten years from the date of filing,⁵⁹ which is somewhat similar to the duration of debt settlement's impact on credit scores. Although consumers associate bankruptcy with stigma, it still may be the most cost-effective, direct, and successful way to deal with significant debt, and provides much greater certainty than debt settlement.⁶⁰

POLICY RECOMMENDATIONS

Only three years have passed since the advance fee ban took effect, and debt settlement companies have not yet publicly disclosed the completion rates, or partial completion rates, of consumers enrolled over this period. The data released to date do not reveal whether debt settlement companies that comply with the advance fee ban are settling a sufficient percentage of debts to allow a substantial share of enrolled consumers to realize a positive change in financial position. In addition, even if many consumers do experience a positive outcome, it is difficult or impossible for consumers to predict whether they will be successful. Legislators and regulators at the state and federal level can help to mitigate the risks currently created by debt settlement by implementing the following recommendations:

States

- States that have not authorized for-profit debt settlement or that strongly restrict debt settlement activities should keep in place the protections they currently have. Because it is unclear whether the advance fee ban alone will result in substantially better outcomes for consumers—and given that a consumer’s success remains highly unpredictable—states that currently do not authorize debt settlement should retain those limits. Existing bans provide state officials with sufficient authority and basis to pursue debt settlement companies that may operate in violation of the ban. Legalizing debt settlement in these states will increase the likelihood of consumers being ensnared in programs that can leave them worse off.
- States that currently authorize debt settlement should implement the following reforms:
 - Require screening before enrolling consumers. As discussed in this paper, there is a substantial risk that consumers may not complete debt settlement programs due to factors both in and beyond their control. As a result, states should require debt settlement providers to conduct a personalized evaluation of a prospective client that concludes that the debt settlement program is likely to provide a net benefit and is affordable, given the prospective client’s current income, expenses, assets, and liabilities. The written analysis should also review whether the creditors are likely to settle, and whether the consumer’s particular circumstances, such as whether her income is protected from garnishment or lawsuits (as is the case with Social Security income) make debt settlement an unsuitable option.
 - Include a “not worse off” provision. To encourage debt settlement companies to not enroll people who have a significant chance of ending up worse off, states should enact provisions that provide consumers with some form of refund or concession if they end up worse off after enrolling in a debt settlement program.
 - Establish meaningful limitations on fees. Debt settlement fees should be calculated based on the amount of savings achieved comparing the settlement amount with the amount of the debt at enrollment. The fee limit should be set at a rate that ensures that the majority of clients will achieve a substantial reduction in debt load (taking fees into account) compared with the debt balance at enrollment. For example, states such as Connecticut, Illinois and Maine limit fees to 10-15% of savings to achieve this result.

Fees should be owed only after the settlement is negotiated and fully paid and released or, in the case of installment settlements, payable in *pro-rata* shares that correspond to the size of

the installment payments. This reform would better align the interests of consumers with the interests of debt settlement companies, leading to programs that consumers have a greater chance of completing.

- **Require detailed data reporting.** States should require debt settlement companies to report on the outcomes achieved for their clients, indicating at a minimum 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 is the subject of a creditor lawsuit.
- **Ensure broad coverage of the law.** States should ensure that their debt settlement laws include all debt settlement providers, including attorneys and others whose activities are not covered by the FTC rule.
- **Enforce existing laws pertaining to debt settlement.** State attorneys general and regulators should continue efforts to ensure compliance with existing laws and regulations, whether the state allows debt settlement in some form or does not authorize the practice.

Consumer Financial Protection Bureau (CFPB)

- **Apply rules and restrictions to all debt settlement transactions.** Because some companies seek to evade the FTC rule banning advance fees by arguing that they do not fall within its scope, the CFPB should extend this protection—and all additional rules—to all debt settlement providers and transactions.
- **Supervise larger debt settlement providers.** The CFPB should ensure compliance by undertaking a rulemaking to supervise larger debt settlement providers.
- **As recommended for states, CFPB should also require screening before enrollment, establish a “not worse off” provision, allow debt settlement fees to be assessed only as settlements are completed, and require detailed data reporting.**

Consumer Financial Protection Bureau (CFPB) and Federal Trade Commission (FTC)

- **Ensure compliance with existing regulations and guard against unfair, deceptive, or abusive acts and practices.** The CFPB and FTC should continue to monitor the practices of debt settlement firms and, where violations exist, undertake enforcement actions.

ENDNOTES

1 Total outstanding revolving consumer credit as of October 2013, seasonally adjusted, Federal Reserve Board. Estimates of average credit card debt among indebted households. Tim Chen, *American Household Credit Card Debt Statistics: 2013*, NERDWALLET.COM, <http://www.nerdwallet.com/blog/credit-card-data/average-credit-card-debt-household/> (last visited Oct. 27, 2013).

2 David Morrison, *Study Quantifies How Credit Card Repayment Affects Risk*, Credit Union Times, Aug. 20, 2013.

3 For example, a June 2013 Bankrate.com survey finding that three-quarters of Americans do not have enough savings to cover six months of expenses. *June 2013 Financial Security Index charts*, BANKRATE.COM, <http://www.bankrate.com/finance/consumer-index/financial-security-charts-0613.aspx> (last visited Oct. 1, 2013).

4 Examples include the following: *Achieve Financial Freedom in 12-36 Months!* PRESTIGEFINANCIALSOLUTIONS.COM, <http://www.prestigefinancialsolutions.com/debt-options.php> (Last visited Oct. 1, 2013); *Be Debt Free in 12-48 Months*, LEVELTHIRTYTHREE.COM, <http://www.levelthirtythree.com/> (Last visited Oct. 18, 2013); “DMB Financial’s typical client has seen over 50% of their unsecured debt negotiated away and is debt free in as little as 36 months. For many, DMB’s debt settlement services are a viable alternative to bankruptcy, credit counseling, and credit card and debt consolidation.” *Be debt free in as little as 36 months*, DMBFINANCIAL.COM, <http://www.dmbfinancial.com/> (Last visited Oct. 1, 2013); *Within 24 to 48 months expect to settle your debts through a payment plan you can afford and live with*, NATIONALDEBTRELIEF.COM, <http://www.nationaldebtrelief.com/> (Last visited Oct. 1, 2013); “Q. When will I have my debts paid off? A. The average debt settlement program lasts 2-4 years and the speed at which your program is finished depends entirely on how much money you apply to your program.” *When will I have my debts paid off?*, ACCREDITEDDEBTRELIEF.COM, <http://www.accredited-debtrelief.com/faq/> (Last visited Oct. 1, 2013); “You can resolve Your Debt In As Little As 24-48 Months! On average, our debt settlement program takes most clients 2 to 4 years to complete. However, ProActive Debt’s programs allow you control the pace with the amount of money you apply to them. The faster you build up the amount in your settlement fund, the more quickly your debts will clear.” *Resolve Your Debt in as little as 24-48 Months*, PROACTIVEDEBT.COM, <http://www.proactive-debt.com/#> (Last visited Oct. 1, 2013); “One phone call and you’re on your way to a credit card DEBT-FREE life! It’s easy! And you pay NO fees until we receive an acceptable settlement offer from your creditor *You’re on Your way to a DEBT FREE life!*” VANTAGEACCEPTANCE.COM, <http://www.vantageacceptance.com/> (Last visited Oct. 18, 2013); *Reduce Your Total Unsecured Debt*, GOFULLCIRCLENOW.COM, <http://www.gofullcirclenow.com/debt-settlement.php> (Last visited Oct. 1, 2013).

5 Debt-settlement companies typically require consumers to stop paying their creditors and thus default on their debts. The Government Accountability Office (GAO) investigated abuses in the debt settlement industry using mystery shoppers who called debt settlement companies posing clients. The GAO reported, “Representatives of nearly all the companies we called—17 out of 20—advised us to stop paying our creditors.” U.S. Government Accountability Office, GAO-10-593T, *Debt Settlement: Fraudulent, Abusive, and Deceptive Practices Pose Risks to Consumers*, (Apr. 22, 2010), <http://www.gao.gov/new.items/d10593t.pdf>. Some debt settlement companies disclose this openly on their websites. See, e.g., Stephen Craig, *How Does Debt Settlement Work?* TRIDENT DEBT SOLUTIONS.COM (Aug. 8, 2011), <http://tridentdebt.com/how-does-debt-settlement-work/> (“Rather than paying your creditors directly, you make payments to your attorney, who puts the funds in a trust account until enough has been accumulated to pay off the reduced settlement amounts that your creditors have agreed to accept.”); *Debt Settlement FAQ*, PERSELSANDASSOCIATES.COM, <http://www.perselsandassociates.com/faq.html> (last visited Oct. 1, 2013) (“Your monthly payment will be deposited into a lawyer’s trust account instead of being sent to your creditors. When this happens, your accounts will become delinquent. As funds in your trust account grow, the firm’s negotiators will begin to contact your creditors to attempt to work out a settlement.”); *Frequently Asked Debt Settlement Questions*, DEBTMERICA.COM, <http://debtamerica.com/debt-settlement-faq#what-is-debt-settlement> (Last visited Oct. 1, 2013) (“If you are current on your payments, it is very difficult, if not impossible to settle your debt. Creditors typically want to see that you are in a hardship situation before they are willing to negotiate. Therefore, you will have to voluntarily stop paying your unsecured debts; allowing them go into delinquency before settlement.”); *General Debt Settlement Questions and Answers*, SOLIDROCKDEBTS.COM, <http://www.solidrockdebts.com/faq/> (Last visited Oct. 1, 2013).

6 Telemarketing Sales Rule, 16 CFR Part 310, available at <http://www.ftc.gov/os/2010/07/R411001finalrule.pdf>.

7 Greg Regan, *Options For Consumers In Crisis: An Economic Analysis Of The Debt Settlement Industry*, Hemming Morse LLP (Feb. 28, 2013), http://americanfaircreditcouncil.org/listing/options_for_consumers_in_crisis.pdf [hereinafter *AFCC report*].

8 Examples include the following AFCC members: Prestige Financial Solutions: “Achieve financial freedom in 12-36 months!,” available at <http://www.prestigefinancialsolutions.com/debt-options.php>; Level Thirty Three Financial: “Be Debt Free in 12-48 Months,” available at <http://www.levelthirtythree.com/>; DMB Financial: “DMB Financial’s typical client has seen over 50% of their unsecured debt negotiated away and is debt free in as little as 36 months.* For many, DMB’s debt

settlement services are a viable alternative to bankruptcy, credit counseling, and credit card and debt consolidation,” available at <http://www.dmbfinancial.com/>; National Debt Relief: “Within 24 to 48 months of working with us, you can expect to settle your debts through a payment plan that you can afford and live with,” available at <http://www.nationaldebt-relief.com/>; Accredited Debt Relief: “Q. When will I have my debts paid off? A. The average debt settlement program lasts 2-4 years and the speed at which your program is finished depends entirely on how much money you apply to your program,” available at <http://www.accrediteddebtrelief.com/faq/>; Proactive Debt Relief: “Resolve Your Debt In As Little As 24-48 Months! On average, our debt settlement program takes most clients 2 to 4 years to complete. However, ProActive Debt’s programs allow you control the pace with the amount of money you apply to them. The faster you build up the amount in your settlement fund, the more quickly your debts will clear,” available at <http://www.proactivedebt.com/>; Vantage Acceptance, Inc.: “One phone call and you’re on your way to a credit card DEBT-FREE life! It’s easy! And you pay NO fees until we receive an acceptable settlement offer from your creditors!” available at <http://www.vantageacceptance.com/>; Full Circle Debt Relief: “Reduce Your Total Unsecured Debt,” available at <http://www.gofullcirclenow.com/debt-settlement.php>.

9 Debt settlement companies settle primarily credit card debts, but will also accept medical and private student loan debts. They do not accept or settle secured debt (such as car loans or mortgage loans), insured or federally-guaranteed student loans, utility bills, tax obligations or payday loans.

10 Examples from the websites of AFCC member firms include the following: “By simply paying the minimum payments each and every month, as much as 85% of your payments are going to interest and it may take you 25 years or more to pay off your debt in full!” *Settle Your Debt and Gain Peace of Mind*, PACIFICDEBTMANAGEMENT.COM, <http://www.pacificdebtmanagement.com/debt-solutions/> (Last visited Oct. 1, 2013); “It’s true: making your minimum payments keeps you looking ‘decent’ on paper. You avoid late fees and you aren’t reported to the credit bureaus as ‘delinquent,’ nor do you have to worry about your credit score being lowered. So what’s the catch? Interest. You pay a very, very heavy price for making only your minimum payments. Minimum payments are how credit card companies make serious money from you. When you make only the minimum payment, a significant portion of your payment goes towards your interest or finance charges. If you are struggling to make ends meet and only paying the minimum on your accounts, it may feel like your balances never come down. Fees and interest accumulate quickly and you’ll be paying way more than you originally owed. Not to mention, it could literally take you decades to pay off. If your debts are being reduced at a very slow pace, it may be time to seek another alternative.” *Minimum Payments, Is it Worth the Wait*, FREEDOMDEBTRELIEF.COM, <http://www.freedomdebtrelief.com/min-payment-option> (Last visited Oct. 1, 2013). US Financial Options: “Debt Settlement programs empower clients to overcome their debt burden in a timeframe that is much shorter than if a client were to continue paying off their creditors at minimum payment amounts. With only a fraction of minimum monthly payments going towards principal, a debtor is faced with the unrelenting future of paying off their debts for perhaps decades to come. However, through Debt Settlement, a client has the ability to repay their debts at a discount in a much shorter timeframe.” *Avoid Having to Claim Bankruptcy*, U.S.FINANCIALOPTIONS.COM, <http://usfinancialoptions.com/program-benefits/> (Last visited Oct. 1, 2013); “Paying the minimum payment on variable interest rate credit cards is a tough battle. To just maintain the balance without going deeper into debt, one must typically pay more than the minimum required payment. If you only make your minimum payments, it can take upwards of 25-35 years and thousands of dollars in interest to pay off the entire balance. This is obviously the most expensive option that takes the longest amount of time to complete.” *Where are My Options to Get Out of Debt?*, CLEARONEADVANTAGE.COM, <http://clearoneadvantage.com/debt-relief-details/> (Last visited Oct. 1, 2013). “Are you tired of spending your hard earned money on endless debt that never seems to go away? Do you find yourself needing to charge monthly necessities, such as gasoline, groceries and utilities on your credit cards? If you are one of millions struggling to make only the minimum payment on your credit cards and have no additional cash flow at the end of the month, or if you answered ‘yes’ to one or more of the above, then we can provide a customized resolution for you.” *Change Your Financial Future Today*, AMERICADR.COM, <http://www.americadr.com/> (Last visited Oct. 1, 2013); Yellow Brick Financial: “Yellow Brick’s Debt Reduction Program is appropriate for consumers who are in over their heads with credit card debt and feel like they are spinning their wheels making minimum payments.” *Affordable Financial Solutions*, YELLOWBRICKFINANCIAL.COM, <http://www.yellowbrickfinancial.com/Debt-Settlement-FAQ.aspx> (Last visited Oct. 1, 2013); “Many people struggle to make their minimum monthly payments and this option could take over 30 years to pay back the debt you owe, costs thousands of dollars in interest alone, and could require you to potentially pay back over three-times what you now owe on these balances. This may be the least timely, most costly, and most economically disadvantageous way to get out of your unsecured debt,” *Debt Relief Programs and Options*, DEBTMERICA.COM, <http://www.debtmerica.com/your-debt-options> (Last visited Oct. 1, 2013).

11 See *supra* note 5.

12 AFCC report, *supra* note 7 at 6.

13 See, e.g., an answer from the CFPB on how long negative information remains on credit reports, available at <http://www.consumerfinance.gov/askcfpb/323/how-long-does-negative-information-remain-on-my-credit-report.html>.

14 See, e.g., *Credit Missteps—How Their Effect on FICO Scores Vary*, FICO.COM, <http://www.myfico.com/crediteducation/>

questions/credit_problem_comparison.aspx (Last visited Nov. 8, 2013) which shows that a 30-day delinquency can cause a consumer with a FICO score of 780 to fall to 670-690, and a consumer with a FICO score of 680 to fall to 600-620. Likewise, a reported settlement of a debt has varying impacts to a consumer's credit score given their previous standing.

15 See *supra* note 13.

16 AFCC report, *supra* note 7, at 8 and 15.

17 See, for example, a settlement letter posted on a debt settlement company's website at <http://clearoneadvantage.com/testimonials/debt-settlement-letters.php>.

18 If fees are calculated as a share of the debt at time of enrollment rather than a percentage of savings, consumers could be charged a fee that is more than the savings realized, for example when the enrolled debt grows over time and is then reduced by only a nominal amount.

19 AFCC report, *supra* note 7, at 10.

20 These include Arkansas, Hawaii, Louisiana, New Jersey, and Wyoming.

21 For example, Illinois and Maine cap fees at 15% of savings from debt settlement; in Connecticut the cap is 10% of savings.

22 For example, the Attorney General of New York has successfully sued debt settlement companies under New York's consumer protection statutes. See, e.g., *People v. Credit Solutions of America, Inc.*, No. 401225/09, 2012 NY Slip Op 31170(U) (N.Y. Sup. Apr. 12, 2012), at <http://www.murthalawfirm.com/wp-content/uploads/2012/05/csa.pdf> (Decision and Order granting Plaintiff's Motion for Summary Judgment). Several other states brought similar claims against the same defendant. Complaint at 7, ¶ 21, *Florida v. Credit Solutions of America, Inc.*, No. 8:2009cv02331 (Fla. Cir. Ct.) (noting that as of the date of the filing of the Florida complaint, Credit Services of America had been sued by the Attorneys General of Texas, New York, Missouri, and Illinois). The Attorney General of Vermont has likewise sued debt settlement companies for violations of the state Consumer Fraud Act's prohibitions on unfair and deceptive consumer acts and practices, see, e.g., Assurance of Discontinuance, *In re Debt Settlement America, Inc* (Jan. 27, 2010) (No. 56-1-10-WNCV), at <http://www.atg.state.vt.us/assets/files/Debt%20Settlement%20America%20AOD%20-%202010-1-27.pdf>.

23 See proceedings from the FTC meetings at <http://www.ftc.gov/bcp/workshops/debtsettlement/index.shtm> and <http://www.ftc.gov/bcp/rulemaking/tsr-debtrelief/>. See also U.S. Government Accountability Office, GAO-10-593T, *Debt Settlement: Fraudulent, Abusive, and Deceptive Practices Pose Risks to Consumers* (Apr. 22, 2010), <http://www.gao.gov/new.items/d10593t.pdf>.

24 Before the CFPB can supervise debt settlement companies, it first must determine by rule which firms are considered to be "larger participants" of that market. To date, this rulemaking has not taken place.

25 For a more detailed discussion of potential loopholes, see Michael Mallow & Michael Thurman, *In Search of Exceptions to the FTC's Amended Telemarketing Sales Rule- Don't Put Your Neck in a Loophole!* LOEB.COM, (August 2010), <http://www.loeb.com/exceptionsoftcsamendedtelemarketingsalesrule/>. See also Steve Rhode, "Credit Counseling Group Makes Presentation to the FTC about Cracking Down on Bad Actor Debt Settlement," GETOUTOFDEBT.ORG, (Dec. 22, 2010), <http://getoutofdebt.org/24571/credit-counseling-group-makes-presentation-to-ftc-about-cracking-down-on-bad-actor-debt-settlement-companies>.

26 The FTC has made clear that attorneys are not exempted from the Rule as a matter of course. See, e.g., the Telemarketing Sales Rule at 48468 ("Based on the record in this proceeding, the Commission has concluded that an exemption from the amended rule for attorneys engaged in the telemarketing of debt relief services is not warranted").

27 See, e.g., *People v. Legal Helpers Debt Resolution, LLC* (Ill. Cir. Ct. 7th Jud. Cir., filed Mar. 2, 2011); *West Virginia v. Morgan Drexen, Inc.* (Civ. Action No. 11-C-829, filed May 20, 2011) and *Consumer Financial Protection Bureau v. Morgan Drexen, Inc.* (U.S. District Court Central District of California, filed August 20, 2013). For more details on the attorney model of debt settlement generally, see Caryn Becker and Ellen Harnick, *Debt Settlement Firms Adopt "Attorney Model" to Evade State & Federal Rules*, Center for Responsible Lending (Nov. 5, 2013), <http://www.responsiblelending.org/other-consumer-loans/debt-settlement/research-analysis/The-Rise-of-the-Attorney-Advance-Fee-Debt-Settlement-Model-FINAL-11-7-13.pdf>

28 AFCC report, *supra* note 7.

29 AFCC report, *supra* note 7, at 7.

30 AFCC report, *supra* note 7, at 8.

31 AFCC report, *supra* note 7, at 19.

32 AFCC report, *supra* note 7, at 10 and 15.

33 AFCC report, *supra* note 7, at 19.

34 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% of the enrolled debt balances that are settled,” <http://debtmerica.com/debt-settlement-faq#what-are-your-fees> (last visited Nov. 13, 2013). In addition, the General Counsel for Century Negotiations, a large debt settlement company and AFCC member, noted a 25% fee was an appropriate fee. Gary Haber, *Bill’s Cap on Debt-Settlement Fees Still Considered High*, Baltimore Business Journal, Apr. 1, 2011, http://www.maryland-consumers.org/LinkClick.aspx?fileticket=jU_Pf4b1WVI%3D&tabid=61

35 For example, a \$1,000 debt that has 10% of accretion by the time of settlement would have an accretion cost of \$100. In contrast, a \$10,000 debt with that same 10% accretion rate would have an accretion cost of \$1,000.

36 *InsideARM Debt Settlement Survey: How Creditors and Collectors Utilize the Debt Settlement Industry to Increase Collections*, INSIDEARM.COM, (Jan. 2013), <http://www.insidearm.com/freemiums/debt-settlement-survey-round-ii-how-creditors-and-collectors-increase-collections/>

37 These are the approximate fees based on a fee schedule from Global Client Solutions, Inc., a large national account management company used by debt settlement companies and their clients. According to a decision by the Washington Supreme Court, as of 2009, the company’s charged a \$9.00 account set up fee, a monthly service fee of \$9.85, and fees for certain transactions, such as a \$15 wire transfer charge, *See Carlsen v. Global Client Solutions*, 171 Wash.2d 486, 492 (2011).

38 Information about the tax treatment of canceled debt, IRS.GOV, <http://www.irs.gov/publications/p4681/ch01.html> (last visited Oct. 1, 2013).

39 Reviews of debt settlement companies, for example, “sonya [sic] of Youngstown OH” wrote, “I joined this program in 2009 to try and resolve our debt—we went in with \$12,000 in debt and came out with \$27,000 in debt. Two accounts were settled (which we had to pay IRS fees on as income and we were actually having our wages garnished for a few of these creditors.)” *Freedom Debt Relief Consumer Reviews and Complaints*, Comment to Debt Settlement Companies, CONSUMERAFFAIRS.COM, http://www.consumeraffairs.com/debt_counsel/freedom_debt_relief.html (last visited on Sept. 26, 2013). See also Herb Weisbaum, *Surprise! Forgiven Debt May Be Taxable Income*, “any creditor or debt collector who agrees to reduce the balance you owe by \$600 or more is required to report that to the IRS. They file a form 1099-C and send you a copy. People tend to miss this because they didn’t see any cash from the debt settlement. This puts you at risk of being audited or hit with penalties and interest” (internal quotation omitted), TODAY.COM, (Mar. 15, 2013), <http://www.today.com/money/surprise-forgiven-debt-may-be-taxable-income-1C8884337>. See also Connie Prater, *1099-C surprise: IRS tax follows canceled debt*, “According to the IRS, the number of 1099-C debt cancellation forms filed by creditors and debt collectors more than tripled between 2003 and 2010,” CREDITCARDS.COM (Jan. 10, 2013), <http://www.creditcards.com/credit-card-news/forgiven-debt-1099C-income-tax-3513.php>

40 Such costs could include attorney’s fees, court costs, out-of-pocket expenses, and lost income.

41 Letter from The Association of Settlement Companies (TASC) to the Federal Trade Commission, 10 (Oct. 26, 2009), <http://www.ftc.gov/os/comments/tsrdebtrelief/543670-00202.pdf>

42 U.S. Government Accountability Office, GAO-10-593T, *Debt Settlement: Fraudulent, Abusive, and Deceptive Practices Pose Risks to Consumers* (Apr. 22, 2010), <http://www.gao.gov/new.items/d10593t.pdf>

43 The Association of the Bar of the City of New York, *Profiteering From Financial Distress: An Examination of the Debt Settlement Industry*, NYCBAR.ORG, 62-63 (May 2012), <http://www2.nycbar.org/pdf/report/uploads/DebtSettlementWhitePaperCivilCtConsumerAffairsReportFINAL5.11.12.pdf>

44 For example, about 40% of debts enrolled from 2006-2008 were settled. The remaining debts are largely no longer active, and thus this settlement rate is not expected to increase further for debts in these vintages. Debts enrolled in 2011 (after the advance fee ban took effect) have settlement rates of between 35%-40%, with an additional 20%-25% remaining active that could potentially settle in the future. AFCC report, *supra* note 7, at 9-10.

45 See Table 4.3, AFCC report, *supra* note 7 at 8.

46 Information for all licensed providers that submit reports to the Attorney General’s office in that year. *Colorado 2011 Annual Report of Debt Mgmt. Services*, COLORADOATTORNEYGENERAL.GOV, <http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/Annual%20Report%20-%202011.pdf>

47 *Inside ARM Debt Settlement Survey: How Creditors and Collectors Utilize the Debt Settlement Industry to Increase Collections*, INSIDEARM.COM, (Jan. 2013), <http://www.insidearm.com/freemiums/debt-settlement-survey-round-ii-how-creditors-and-collectors-increase-collections/>

48 The same survey a year prior found that very few credit card companies would work with debt settlement companies, but higher rates of collection agencies would engage. This volatility across years may reflect a different set of respondents and small samples of certain creditor types rather than signaling specific trends. See *InsideARM Debt Settlement Survey: How Creditors and Collectors Utilize the Debt Settlement Industry to Increase Collections*, INSIDEARM.COM, (Oct. 2011), <http://www.insidearm.com/freemiums/debt-settlement-industry-collections/>

49 Examples of some characteristics of credit card hardship plans are outlined at http://www.needhelp-payingbills.com/html/credit_card_hardship_programs.html#List and <http://www.creditcards.com/credit-card-news/credit-card-hardship-program-debt-problems-1273.php>

50 If a consumer directly negotiates a principal reduction with her creditor of at least \$600, she may be subject to tax liability, just as she might be if a debt settlement firm does so on her behalf.

51 See, e.g., the reporting of some near and full completion rates of debt management plans here: <http://getoutofdebt.org/7233/the-truth-about-the-failure-rates-and-completion-rates-of-credit-counseling-debt-settlement-and-bankruptcy>

52 Fees associated with debt management plans are often limited by state law.

53 To qualify for Chapter 7 bankruptcy, the consumer must demonstrate either that her income is at or below the median income in her state or that her disposable income—that is, her actual income less necessary living expenses—is below certain thresholds.

54 See “Bankruptcy FAQ” from the National Association of Bankruptcy Trustees, available at National Association of Bankruptcy Trustees, *Bankruptcy FAQ*, NABT.COM, <http://www.nabt.com/faq.cfm> (Last visited Oct. 1, 2013).

55 Angela Littwin, “The Affordability Paradox: How Consumer Bankruptcy’s Greatest Weakness May Account for its Surprising Success,” 52 *Wm. & Mary L. Rev.* 1933, 1973 (2011) analyzes data from the 2007 Consumer Bankruptcy Project which found that Chapter 7 filings reached successful completion in 97.5% of cases.

56 Of the two-thirds of Chapter 13 filers who do not discharge their debts, 27% convert to a Chapter 7 filing. Thus, 33% of Chapter 13 filers receive a discharge directly and an additional 18% (27% of 66%) receive a discharge after their conversion to Chapter 7. Katherine Porter, *The Pretend Solution: An Empirical Study of Bankruptcy Outcomes*, 90 *Tex. L. Rev.* 112 (2011).

57 Lois Lupica, Am. Bankr.Inst., *The Consumer Bankruptcy Fee Study: Final Report*, ABIWORLD.ORG (December 2011), http://www.abiworld.org/Fee_Study/CFSFinalReport_Final_Dec7.pdf. The mean total cost for a Chapter 7 bankruptcy with assets was \$1,414.

58 See, e.g., U.S. Bankruptcy Court for the Middle District of North Carolina, In the Matter of Chapter 13 Cases, Order Regarding Attorneys’ Fees (Jan. 3, 2013) (raising to \$3,700 the presumptive base attorneys’ fee for Chapter 13 cases filed on or after January 1, 2013), available at http://www.ncmb.uscourts.gov/sites/default/files/general-ordes/Order%20Regarding%20Attorney%27s%20fees_0.pdf.

59 See, e.g., Maxine Sweet, *Ask Experian: Bankruptcy*. EXPERIAN.COM, <http://www.experian.com/credit-advice/topic-bankruptcy.html> (Last visited Oct. 1, 2013).

60 For example, given AFCC’s estimate that most debt settlement clients are legally insolvent, it is likely that a significant proportion qualify for Chapter 7. Nevertheless, debt settlement companies’ informational materials emphasize the difficulty of filing for Chapter 7 and focus on the challenges associated with Chapter 13. See, e.g., Debtmerica Relief: “As of October 2005, congressional legislation made filing for bankruptcy more difficult and burdensome. A Chapter 13 bankruptcy could result in higher monthly payments and may last longer than an alternative debt resolution program,” *Debt Relief Programs and Options*, DEBTMERICA.COM, <http://www.debtmerica.com/your-debt-options> (Last visited Oct. 1, 2013); Prestige Financial Solutions: “Under the old rules, people who filed under Chapter 13 had to devote all of their disposable income—what they had left after paying their actual living expenses—to their repayment plan. The new law adds a wrinkle to this equation: Although Chapter 13 filers still have to hand over all of their disposable income, they have to calculate their disposable income using allowed expense amounts dictated by the IRS—not their actual expenses—if their income is higher than the median in their state (see “Restricted Eligibility for Chapter 7,” above). These expenses are often lower than actual costs. What’s worse, these allowed expense amounts must be subtracted not from the filer’s actual earnings each month, but from the filer’s average income during the six months before filing. This means that debtors may be required to pay a much larger

amount of "disposable income" into their plan than they actually have to spare every month—which, in turn, means that many more Chapter 13 plans will fail.... Under the old rules, most filers could choose the type of bankruptcy that seemed best for them—and most chose Chapter 7 over Chapter 13. The new law will prohibit some filers with higher incomes from using Chapter 7," *New Bankruptcy Law*, PRESTIGEFINANCIALSOLUTIONS.COM, <http://www.prestigefinancialsolutions.com/bankruptcy.php> (Last visited Oct. 1, 2013); US Financial Options: "Get out of debt on better terms than bankruptcy—If a person opts to use the bankruptcy route, they will be under the rule of a bankruptcy court and will be given specific payment amounts and date that they must adhere to. Thus, a person who files is unable to get out of debt in a manner that they can dictate. Debt Settlement incorporates a more client-friendly alternative and is an involved process where the client is included in the decisions and has the final authorization to agree or decline a settlement offer," *Avoid Having to Claim Bankruptcy*, U.S.FINANCIALOPTIONS.COM, <http://usfinancialoptions.com/program-benefits/> (Last visited Oct. 1, 2013); see also, advice given on Bills.com website (owned by Freedom Financial Network, which also performs debt settlement), whose article, "Tips and Advice to Manage Credit Card Debt Effectively" states: "Bankruptcy should be your last choice for getting out of debt because it will damage your credit for 7-10 years and, depending on which type of bankruptcy you file for, you could be forced to give up some of your assets or assigned a long-term payment plan. There have also been legal changes put in place by congress that makes it more challenging to qualify for a Chapter 7 Bankruptcy, forcing many people to file for a Chapter 13 Bankruptcy which is really a repayment plan," *Credit Card Debt Help and Advice to Reduce Debt Fast*, BILLS.COM, <http://www.bills.com/credit-card-debt/> (Last visited Oct. 1, 2013).

APPENDIX

Data used for calculating change in consumer financial position

Note: all figures rounded to nearest dollar

Table A: Consumer's debts at enrollment

Total debt enrolled post advance fee ban (AFCC report)	\$1,700,000,000
Average number of debts enrolled per consumer (AFCC report)	6
Total consumers enrolled post 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

Table B: Overall accretion (AFCC study) and estimated accretion on each of 6 accounts

Debt #	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

Table C: Settlement amounts due to creditor and fee owed to debt settler, per debt settled

Debt #	Debt balance at enrollment	Debt balance at settlement (from Table B)	Amount due to creditor (AFCC report states that debt settles at 48% of current debt balance)	Cumulative amount owed to creditor(s)	Fee owed to debt settler (assumes fee of 22.5% of debt balance at enrollment)	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

Table D: Tax liability assessed on principal reduction

Debt #	Debt reduction (difference between debt balance at enrollment and amount due to creditor—see Table C above)	Cumulative debt reduction	Cumulative tax liability at 15% 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

Table 3: Change in Financial Position 36 Months After Enrollment

The data for this table is 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 table C above.

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

Row D, Original balance of total unsettled debt remaining: The total debt that has not been settled, not taking into account any accretion, or growth in balance, from the time of enrollment. This 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 3 of 6 debts has a balance of \$15,179, which is $\$5,060 \times 3$ (all numbers rounded).

Row E, Accretion on unsettled debt, over 36 months: The accretion on unsettled debts from the time of enrollment until 36 months later. As shown in table B above, each debt that remains unsettled at month 36 experiences an accretion rate of 30%, resulting in a debt of \$5,060 at the time of enrollment increasing to \$6,577—a total 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 3 of 6 debts has accretion of \$4,554 on those debts, which is $\$1,518 \times 3$.

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.

Table 4: Impacts of Additional Factors Such as Tax Liability and Dedicated Account Fees

Row A, Change in financial position 36 months after enrollment: This is from Table 3.

Row B, Cumulative debt reduction: See calculation in table D above. Note that principal reduction calculation may be conservative, since 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 table D above.

Row D, Dedicated account fees if enrolled 36 months: This assumes only a \$9 set-up fee and a \$10 monthly maintenance fee are assessed ($9 + (10 \times 36) = \$369$).

Row 4, Revised change in financial position, taking these costs into account: Subtracts Rows C and D from Row A.

About the Center for Responsible Lending

The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

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