Debt Resolution Options

Market & Policy Context Executive Summary

OCTOBER 2022

About FinRegLab

FinRegLab is a nonprofit, nonpartisan innovation center that tests new technologies and data to inform public policy and drive the financial sector toward a responsible and inclusive financial marketplace. With our research insights, we facilitate discourse across the financial ecosystem to inform public policy and market practices.

About the National Foundation for Credit Counseling

Dedicated to educating Americans about how to reduce personal or household debt responsibly, the National Foundation for Credit Counseling (NFCC) is a trusted, nationwide resource for education and support in building financial management skills. Through its network of nonprofit agencies and certified counselors, the NFCC offers impactful approaches to debt reduction and improved credit standing, whether consumers are struggling with credit card debt, decisions about housing, or student loans. For more information about the NFCC or to be connected to a certified counselor, please call 800-388-2227 or visit www.nfcc.org.

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This report is part of a broader research project to evaluate data, technology, and other innovations' potential to help consumers recover more quickly from personal and economic crises such as COVID-19. The independent empirical research described in the report is being conducted in collaboration with Professor Stephanie Moulton of The Ohio State University and Marsha Courchane and Adam Gailey of Charles River Associates, using data from member agencies of the National Foundation for Credit Counseling and other sources. This report lays a foundation for future subsequent empirical and policy analyses.

Many of the insights in this report were derived from interviews with stakeholders in the financial services, technology, and civil society sectors. FinRegLab would like to thank stakeholders who participated in interviews and discussions, including members of our project Advisory Board and Counseling Agencies Council. We would also like to thank individuals who provided valuable feedback on this report. They include:

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EXECUTIVE SUMMARY

Even prior to the COVID-19 pandemic, one in three U.S. adults were estimated to have experienced at least one severe loan delinquency over their lifetimes, and one in eight to have filed for bankruptcy.[1] The downstream effects of financial distress can continue for years, in part because credit reports are used to help determine eligibility for employment, rental housing, and insurance, in addition to future loans. Households' ability to rebound from past periods of distress affects not only their own future financial health, but the nation's longstanding racial wealth gaps and recovery from broader economic downturns.

Yet while mortgage and student loan workouts have been a major research and policy focus in the past decade, options for families struggling with credit card and other general unsecured credit have not received much public attention. Current debt resolution structures are often fragmented and prone to break where consumers experience a second financial hardship due to layoffs, medical emergencies, or divorce. Lenders' repayment options and practices vary, and different types of intermediaries offer consumers very different debt-resolution strategies. The complex ecosystem can be overwhelming for consumers to navigate, particularly when they are also struggling to resolve underlying shocks.

As rising inflation and interest rates increase pressure on household budgets, the need for effective, efficient resolution options for unsecured credit is becoming more urgent. Stakeholders are debating the potential for new workout plan structures and data and technology innovations to facilitate better outcomes at scale. FinRegLab is working with researchers from The Ohio State University and Charles River Associates to empirically evaluate potential innovations using data from pilot programs organized by the National Foundation for Credit Counseling and other sources. The results could be important not only to nonprofit counseling agencies, but to a broad range of other market participants, advocates, and policymakers.

This report lays the project's foundation by surveying the market landscape, available research, and policy issues and challenges as stakeholders work to develop a more effective suite of tools for helping consumers recover from personal and broader economic crises such as COVID-19. Key findings include:

1 Loan delinquencies and other evidence of past financial distress can have significant downstream effects on households' economic activities. Vulnerability to shocks appears to be increasing, and households of color are particularly likely to experience financial hardships.

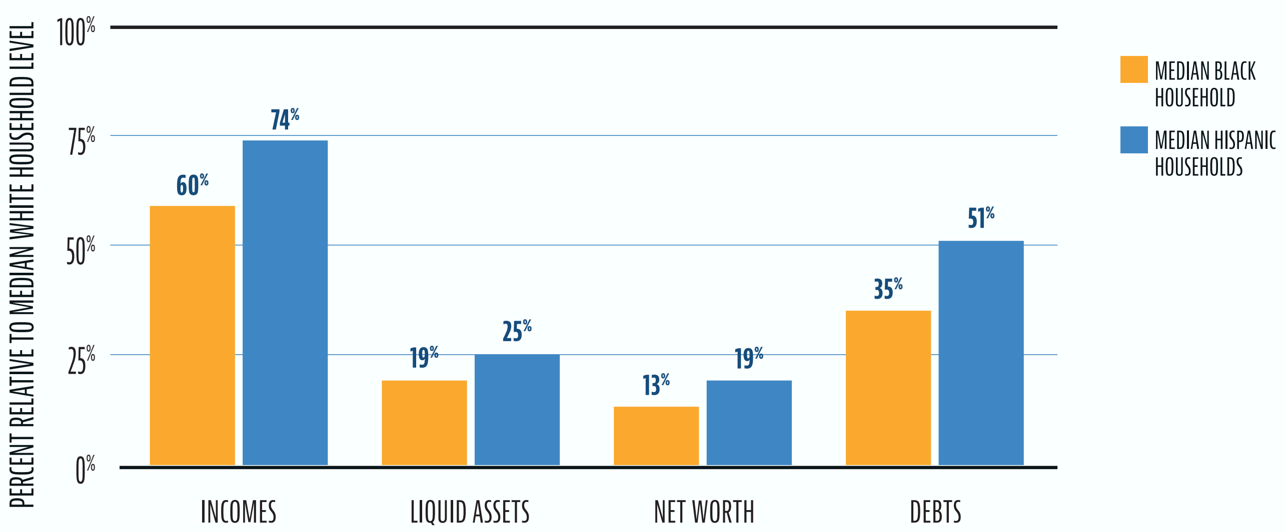
In part because loan delinquencies and other negative credit history remain on consumers' credit reports for seven to ten years, past periods of financial distress can affect households' stability and wealth-building activities long after they have rebalanced their budgets. Negative credit history affects both loan approvals and pricing, making it harder for households to invest in reliable transportation, homeownership, and small business formation. Credit reports are also used by many prospective employers and landlords and by some types of insurers. Research also shows linkages between financial distress and physical and mental health, cognitive performance, marital relationships, and work productivity, which can prolong financial hardships or trigger additional ones.

U.S. households' vulnerability to financial shocks appears to be increasing. For example, income volatility has increased substantially over the past several decades, with up to a third of adults reporting occasional to frequent variations in monthly income on the eve of the pandemic.[2] About 16 percent of consumers surveyed by the Federal Reserve in 2021 reported experiencing hardships in the past year in connection with natural disasters.[3] Medical events also continue to be a major driver of financial distress despite health care reform.[4]

At the same time, lower savings rates and higher debt levels also make it harder for households to weather financial hardships when they occur. Even a decade after the 2008 financial crisis, surveys found that only about half of consumers had specifically set aside emergency savings or "rainy day" funds. Nearly 40 percent of respondents reported that they could not cover more than one month of expenses in the event of a loss of their primary income, even if they exhausted their savings, sold assets, turned to friends and family, and borrowed money.[5] While savings rates improved in response to stimulus programs during the pandemic, those balances are now eroding in the face of inflation and higher interest rates.

The likelihood of experiencing periods of financial distress is especially high for households of color, given that historical discrimination in lending, employment, education, housing, and other sectors have helped to create substantial disparities in median incomes, liquid assets, and other financial metrics. On the eve of the pandemic, median Black and Hispanic households had less than 75 percent of the income and 25 percent of the liquid assets of median White households.[6] Racial disparities in delinquencies, collections items, and bankruptcies contribute to substantial disparities in credit scores and make it more difficult to close longstanding racial wealth gaps through homeownership and small business formation.[7]

DISPARITIES IN INCOMES, ASSETS, AND DEBT LEVELS AS OF 2019 BETWEEN MEDIAN BLACK, HISPANIC, AND WHITE HOUSEHOLDS



Sources: Semega et al. (2021); Bhutta et al. (2020); Federal Reserve Board, Survey of Consumer Finances 1989-2019 Interactive Chartbook, Debt by Race or Ethnicity.

2 Current options for resolving unsecured loans are fragmented and complicated for consumers to evaluate. Structures that spread payments out over longer time periods can be more affordable yet may increase the risk that consumers experience a second financial hardship before they can resolve their debts.

Borrowers who are struggling to repay credit card or other unsecured loans have historically had five primary alternatives to seek relief: (1) applying for a debt consolidation loan from a new lender; (2) asking for assistance from their current lenders; (3) working with a nonprofit credit counseling agency to set up a multi-lender debt management plan; (4) enrolling with a for-profit debt settlement company that will seek less-than-full-balance (LTFB) settlements from their lenders; or (5) filing for bankruptcy to resolve nearly all of their debts.

However, not all of these options are available to all consumers, and each has potential tradeoffs as to the timing and amount of direct costs, effects on credit reports and scores, and other considerations. For example:

- **Debt consolidation loans** can help some consumers lower their monthly payments and simplify their finances by replacing multiple previous higher-cost loans. But consolidation loans become more expensive and difficult to obtain as consumers' finances deteriorate, and research suggests that the loans can worsen distress levels if they increase long-term debt burdens or consumers incur more debt after consolidation.
- **Lenders' workout options** vary significantly as to whether and what level of concessions are available to borrowers facing financial hardships. Banks typically provide multiple options, but their programs are usually structured in very particular ways in light of regulatory guidance on impaired debts. For example, if delinquent credit card borrowers cannot afford to repay all loan principal within 60 months or to complete a settlement for less than the full balance owed in three months, banks frequently do not offer other settlement options until the loan has been "charged off" for accounting purposes at 180 days delinquency. In the meantime, borrowers' financial situations may worsen and they may begin looking for other debt resolution options.
- **Debt management plans** (DMPs), which are generally administered by nonprofit credit counseling agencies, are structured to repay full balances to multiple lenders over no more than 60 months. Research suggests DMP participants improve their debt loads and increase their credit scores more quickly than consumers with similar credit profiles who do not receive credit counseling or participate in the plans. However, interviews and studies suggest that roughly 50 percent of counseled consumers cannot meet eligibility requirements and that roughly 50 percent of eligible consumers choose not to enroll. The length and cost of payments and the fact that DMP participants are generally required to close their accounts and avoid taking on more debt may make the plans less appealing to consumers.
- **Debt settlement companies** (DSCs) are for-profit intermediaries that seek less-than-full-balance settlements from individual lenders on behalf of consumers who meet their income and other eligibility requirements. Data from large DSCs indicate that about 60 percent of their customers settle the majority of their debts within 36 months; although the settlements average about 50 cents on the dollar, the companies generally charge fees that equal 15 to 25 percent of settled debts. In addition, consumers often incur additional arrearages and credit score damage early in the process, and about 25 percent of DSC customers do not settle any accounts. Lenders vary as to whether they are willing to work directly with debt settlement companies, and may file collections lawsuits if customer communications are cut off after they enroll with DSCs.

OVERVIEW OF DEBT RESOLUTION OPTIONS

OPTION	DESCRIPTION	ELIGIBILITY AND ENROLLMENT	IMPACT ON CREDIT SCORES AND ACCESS	OTHER BENEFITS, COSTS, AND RISKS
DEBT CONSOLIDATION LOAN	A loan or credit line used to pay off multiple existing debts. May be unsecured or secured by home equity in some cases.	Criteria vary by lender. Pricing and availability worsen as consumers' credit scores and financial situations deteriorate.	New loan may have a brief negative effect on scores. May also be treated as negative if consumers run up credit card balances again.	Offers a single lower monthly payment but effect on overall cost of credit depends on rates and fees.
BILATERAL LENDER WORKOUTS AND SETTLEMENTS	Long-term options may include full principal repayment plans that waive some interest and fees as well as LTFB settlements.	Criteria vary by lender. Prior to charge off, banks generally offer only to consumers who can pay all principal in 60 months or a settlement in 3 months.	Depends on type and reporting codes used; codes for LTFB settlements are treated as negative by some scoring models. Original accounts are often suspended or closed.	Borrower must work with each lender individually. LTFB settlements may have tax consequences.
DEBT MANAGEMENT PLAN	Multi-lender full principal repayment plans that waive some interest and fees. Usually administered by nonprofits.	Sufficient residual income to pay full principal in 60 months. About 50% of counseled consumers do not qualify.	Codes are not treated as negative, but closing of original accounts may cause initial decline. Opening new accounts is discouraged.	Consumer fees may be $1,000 to $2,000 depending on state and agency. Not all lenders participate in DMPs.
DEBT SETTLEMENT COMPANY	For-profit DSCs seek LTFB settlements from individual lenders. Process and payments may take up to 4 years.	Criteria vary by DSC. Large DSCs typically require at least $10,000 to $15,000 in debt and steady income.	Credit score declines are often substantial when consumers stop lender payments. Codes for LTFB settlements are treated as negative by some scoring models.	Balances often grow initially. Fees are often 15-25% of settled debt. LTFB settlements may have tax consequences. Lenders' willingness to work with DSCs varies and some may file suit if communications are cut off.
CHAPTER 7 BANKRUPTCY	"Liquidation plan" administered by trustee. Requires significant assets to be surrendered but discharges most debts in 6 months.	Means-tested based on state median family income. Accounts for about 60-70% of bankruptcy filings.	Treated as negative and stays on credit report for 10 years. New loans often carry lower limits and higher prices.	Costs average $1,800 and are typically paid upfront.
CHAPTER 13 BANKRUPTCY	"Wage earner's plan" administered by trustee. No asset surrender but must pay for 3-5 years to obtain discharge. Discharges more types of debt than Chapter 7.	Sufficient residual income for payments, plus debt below certain statutory thresholds.	Treated as negative and stays on credit report for 7 years. Approval is needed to open new credit during repayment plan.	Costs average $3,300, but may be paid over time. Up to two thirds of filers do not actually obtain discharge of debts.

» **Bankruptcy options** can give consumers substantial relief across multiple types of debt, but have significant effects on the price and availability of credit and other financial health metrics going forward. Consumers who meet the income limitations for Chapter 7 filings are typically discharged from their debts within six months, although they are required to surrender any substantial assets as part of the process. Consumers who file under Chapter 13 are required to pay their disposable income toward their debts for three to five years to obtain discharge, but may be able to retain their homes and cars. Research indicates that as many of two-thirds of Chapter 13 filers do not actually obtain discharge, however, and may be subject to additional interest and penalties when they drop out of the programs. Studies have also found that disproportionate numbers of Black consumers file for Chapter 13 and that Black filers experience worse outcomes than other groups under both Chapter 7 and Chapter 13.

Across these varied options, data and research are limited and methodological issues complicate comparisons between consumers who choose particular alternatives and those who leave past debts unresolved. However, academic studies and interviews underscore a substantial tension between lengthening various workout options to make payments more affordable and increasing the likelihood that consumers experience a second financial shock before they can finish recovery. Absent standardized protocols for dealing with additional hardships, consumers tend to drop out of their initial programs and may be left even worse off than before.

3 Consumers often rely on intermediaries to help them navigate this complex system, but frictions between market actors can complicate resolution processes. The activities of for-profit debt settlement companies are particularly controversial.

The fact that most households have multiple credit cards and other sources of unsecured credit substantially complicates workout structures and processes for borrowers and lenders alike. In contrast to mortgage loans, which may constitute a third or more of households' monthly expenses, it may be difficult for any single unsecured lender acting alone to enable consumers to stabilize their broader finances. This creates a collective action problem where lenders could potentially achieve better results if they cooperate, yet also have strong incentives to maximize individual recoveries relative to their peers. It also increases burdens on distressed borrowers, who often must seek to resolve multiple debts while also dealing with job searches, medical emergencies, or other underlying hardships.

Intermediaries can thus potentially benefit both consumers and lenders, and it is not surprising that many consumers turn to them. But in practice, coordination challenges and competitive dynamics can further complicate resolution processes. For example, while most lenders will participate in debt management plans administered by nonprofit agencies, they differ as to whether and when they refer consumers for counseling and how much they contribute toward administrative expenses. Some lenders will not join individual DMPs unless all of a consumer's other lenders participate due to concerns that their concessions would otherwise subsidize competitors' recoveries.

Lenders diverge even more widely in their interactions with debt settlement companies, with some seeking to be first in line for settlement negotiations and others refusing to work directly with them and in some cases filing collections suits against some consumers who enroll with DSCs. A recent survey of large credit card issuers suggests that roughly 50 percent of less-than-full-balance settlements may now occur through such companies,[8] which marks an important milestone given debates about industry practices. While proponents argue that DSCs fill gaps in debt resolution options, critics argue they can substantially exacerbate consumers' financial distress depending on the size of their fees, credit score impacts, and particular business practices.

The complex dynamics between market actors make it more challenging to implement the kinds of workout reforms for unsecured credit that have been adopted for mortgages and student loans in recent years. Based on lessons learned since the 2008 financial crisis, mortgage servicers have adopted standardized waterfalls of concessions and streamlined processes to encourage borrowers to enroll in workout plans before they build up substantial arrearages. As the source of more than 90 percent of student loans, the federal government has also directed implementation of broad-based pandemic forbearances, income-based repayment plans, and debt forgiveness initiatives. In the unsecured context, however, competitive considerations and communications challenges among diverse actors further complicate the provision of early, comprehensive relief for borrowers facing significant hardships.

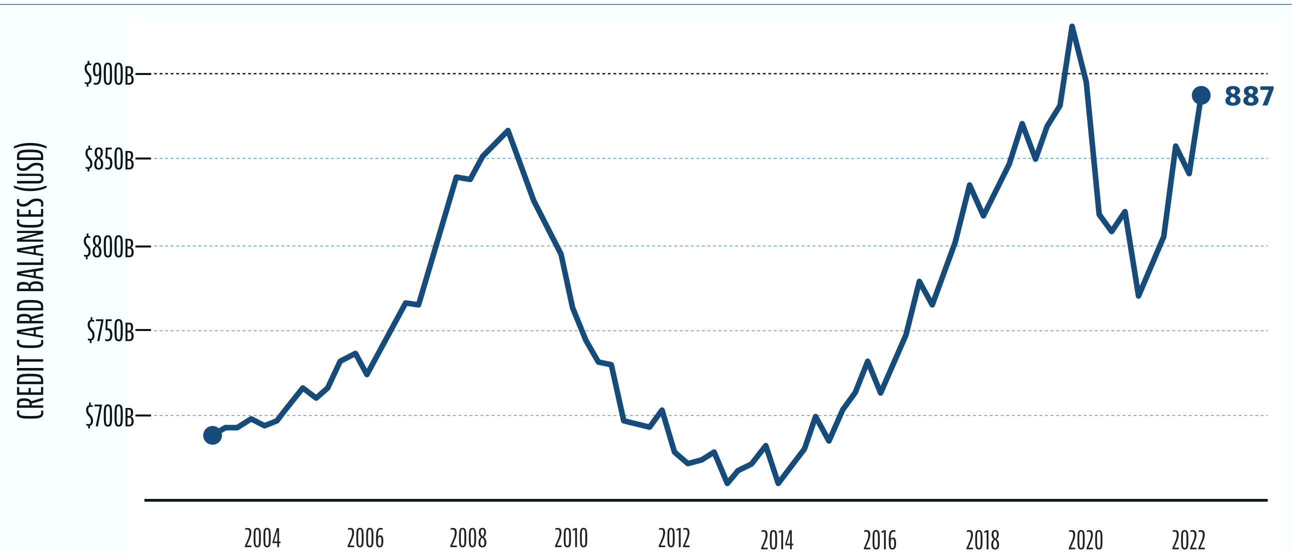
4 Innovations in workout plan structures and data and technology applications have the potential to improve outcomes at scale, but many stakeholders are reluctant to make substantial changes and investments in the absence of additional research.

As rising inflation and interest rates are pushing credit card balances to near-record levels and average rates to 30-year highs,[9] many debt resolution providers are bracing for a potential increase in demand. At the same time, many stakeholders hope that there may also be opportunities to validate new approaches and to build greater momentum around market and policy initiatives in light of continuing economic stressors, increased awareness of racial equity issues, and a deeper appreciation of the importance of increasing the resiliency of both financial systems and households. Rather than assuming that conditions and practices revert to 2019 patterns, they question whether there are ways to build on the experiences of the pandemic to strengthen households' financial stability and to improve options for those consumers who experience future shocks.

Interviews with stakeholders reveal widespread interest in the potential for new repayment plans and data and technology innovations to improve outcomes at scale. Proponents point to the way that digital platforms, new data sources, and predictive algorithms are being used in loan originations, and argue that these same tools could be used to provide more tailored workout options to better meet the needs of distressed borrowers. Some stakeholders see such innovations as part of a broader effort to center the system more closely on consumer outcomes by structuring processes and resolution options to promote long-term household financial stability and customer relationships.

Some improvements in data and technology have already occurred, although adoption has been uneven. For example, many lenders have substantially improved their customer-facing platforms over the past decade and can use them to communicate with distressed borrowers. Several fintech startups have entered the space, in some cases by providing services directly to consumers and in others by providing more sophisticated platforms to lenders and intermediaries. However, lenders often do not prioritize technology investments to improve back-office systems that can play a vital role in administering workout plans, and nonprofit counseling agencies face resource constraints compared to for-profit actors.

AMERICANS ARE RELYING MORE ON THEIR CREDIT CARDS



Source: New York Fed Consumer Credit Panel/Equifax, Abha Bhattarai/The Washington Post

Using automated feeds of bank account data could potentially facilitate faster and more sophisticated analyses, but broader market practices and regulatory protections for such data transfers are still evolving. Accessing such information may also be more challenging than in the context of loan originations. Although an increasing number of consumers are willing to share bank account information with lenders at origination when it may help them get better terms, trust between borrowers and lenders may have eroded in situations where loans are severely delinquent. Nonprofit credit counseling agencies collect detailed information from consumers to provide budget advice, but emphasize that processes must be carefully structured to build consumer trust.

Finally, developing new workout structures can also take significant time and effort, for instance by requiring market actors to reprogram existing systems, make changes to their accounting and credit reporting processes, and coordinate with regulators particularly where existing standards do not provide flexibility. New workout structures can also present potential tradeoffs for both lenders and consumers if they affect the timing and amount of losses recorded by lenders or impact consumers' credit scores (and thus future cost of credit) in different ways. In the absence of publicly available research and assurances from regulators about adopting new approaches, many stakeholders are reluctant to make substantial investments in changing repayment plans and processes.

* * *

The forthcoming research project will inform many of these issues by evaluating potential innovations in workout structures and data and technology applications. The empirical analyses will focus primarily on data from counseling agency pilots that have been facilitated by the National Foundation for Credit Counseling over the past several years. Initial topics include:

» **The tradeoffs between length of repayment plans and the amount of recovery,** including pilots of alternative workout structures for consumers who do not qualify for or want to participate in traditional 60-month debt management plans.

» **Short-term programs to help consumers who experience income and expense shocks,** including pandemic relief initiatives and a pilot to help DMP participants who experience a second hardship restabilize their finances without dropping out of the plans.

» **The outcomes of multi-lender debt resolution plans as compared to workouts with individual lenders,** particularly for consumers who have many unsecured accounts.

» **The use of digital platforms to facilitate consumer intake and communications,** including questions about user experience and automated access to bank account data.

» **Use of cash-flow data and more sophisticated predictive algorithms** to help assess what workout options may be most likely to succeed for particular borrowers.

In addition to the empirical research, other reports will explore the potential evolution of related policy, regulation, and market practices based on stakeholder engagement and policy and legal analyses. The goal is to take a broad-based look at potential innovations to support more rapid and inclusive recoveries from personal and broader economic crises such as COVID-19.

* * *

Section 2 of the full report, Debt Resolution Options: Market & Policy Context, provides a primer on the challenges faced by borrowers who are struggling to repay unsecured credit, describing the triggers, cycles, and consequences of financial distress as well as current options for debt resolution and research about those options' scale and outcomes. Section 3 and Section 4 describe how evolution in markets and regulations have shaped this ecosystem, with the first focusing on the two decades leading up to the COVID-19 pandemic and the latter on how the past two years have affected both consumers and debt resolution providers. Section 5 discusses policy issues and challenges as stakeholders seek to improve debt resolution options going forward, and Section 6 concludes with a description of the broader research project.

Appendix A provides an overview of credit counseling, secured credit cards and credit builder loans, and credit repair organizations, which consumers may rely on for generalized advice and assistance in rebuilding their credit after past financial distress. Appendix B and Appendix C summarize debates about front-end policy initiatives that could potentially reduce the number of households struggling with unsecured credit and about modification of credit reporting practices that could potentially reduce the downstream effects of past financial shocks.

Endnotes

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