# 8 The Evolution of the Credit Counseling Industry in the United States

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The personal insolvency industry has become a big business in the United States. In 2003, over 1.6 million American households filed for personal bankruptcy relief. Over the past decade, over 10 percent of all U.S. households did the same. Consequently, providing assistance to financially troubled consumers has become a growth industry. In addition to formal legal services offered by bankruptcy attorneys, consumers have increasingly sought assistance from credit counseling agencies, most of which are established as nonprofit entities. Beginning in the 1960s as a network of small, locally controlled nonprofit agencies, credit counseling has evolved into an industry in its own right. Although no comprehensive industry statistics exist, a conservative estimate based on available data suggests that between 5 and 6 million consumers sought advice from credit counseling organizations in 2002.[1]

From the outset, credit counseling was conceived as a creditor-sponsored effort to advise financially troubled consumers on alternatives to personal bankruptcy. A network of nonprofit counseling agencies was established to offer in-person, individualized counseling sessions through which consumers received budgeting analysis and advice. A core service of each agency was to negotiate with creditors on behalf of eligible consumer clients to set up voluntary repayment plans, concessions on finance charges and repayment terms, and a halt to collection efforts. When successful, these agency-administered repayment plans provide a valuable service for consumers by helping them to avoid the stigma associated with filing for bankruptcy.

They also help creditors. The oldest network of nonprofit credit counseling agencies, those operating as members of the National Foundation for Credit Counseling (NFCC), returned $2.3 billion to creditors in 2002 through the voluntary repayment plans structured for their

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consumer clients. Industrywide statistics are elusive, but payments to all credit grantors in 2002 through counseling agency repayment plans may have totaled as much as $8 billion. In terms of credit card receivables, up to $22 billion in outstanding balances from major national card issuers were being serviced through credit counseling debt repayment plans in 2002.[2] To put this in perspective, total credit card charge-offs industrywide in 2002 were $35 billion.

The rapid expansion in both credit availability and serious loan delinquencies during the 1990s caused demand for counseling services to soar, and led to the entry of hundreds of new competitors. The number of credit counseling agencies mushroomed from fewer than 250 agencies operating between 700 and 800 offices in 1992 to over 900 agencies operating as many as 2,000 offices by the end of 2003.[3] Unlike the traditional agencies that provided face-to-face counseling, many of the new entrants offered telephone counseling only and could serve clients nationwide from a single call center.

Some of these new entrants adopted deceptive and abusive practices that have tarnished the positive public image of the counseling industry that had been cultivated over the previous thirty years. The Internal Revenue Service (IRS), the Federal Trade Commission (FTC) and the U.S. Senate all launched investigations into the industry practices during 2003. In October 2003, the FTC and the IRS joined with state regulators to issue a joint press release urging consumers to be cautious when considering use of a credit counseling agency, offering tips on how to choose a reputable organization.[4] At least five state attorneys general have filed lawsuits against one of the largest credit counseling agencies in recent years (U.S. Senate 2004, 30–31). Legislation is pending in Congress and in various states that would impose new regulations to curtail abusive practices. In short, despite serving millions of consumers annually, the credit counseling industry has developed a serious reputational problem.

How did a social service-oriented industry comprised mostly of non-profit firms go so far astray? The following sections will describe the evolution of the credit counseling industry in the United States, an industry that began as a market-driven alternative to personal bankruptcy. The industry's birth, subsequent growth, and eventual reputational crisis are readily explainable through simple economic analysis. With the industry now at an evolutionary crossroads, facing stricter regulation and skeptical clients, its future is less clear. The subsequent sections will discuss the central issues facing public policymakers.

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## 8.1 Historical Origins and Growth of Credit Counseling

For as long as there has been a consumer credit industry, there have also been overextended borrowers in need of advice and assistance. During the first half of the twentieth century, financially troubled consumers who had difficulty making payments to multiple creditors would sometimes turn to commercial debt poolers for assistance. A debt pooler was typically a for-profit company that would act as an intermediary between a borrower and his creditors. The primary objective of the debt pooler was to negotiate a repayment arrangement acceptable to most or all of the creditors. The repayment plans would generally entail either a reduction of the outstanding balance and interest charges or a longer payout period, or both. The debtor would make regular payments to the debt pooler, who would then distribute the proceeds to the creditors according to the plan. For this service, the debt pooler typically received a fee from the borrower.

When these plans worked well, debtors were able to utilize the creditor concessions to resolve their debts and avoid bankruptcy. Bankruptcy in the first half of the twentieth century was a relatively rare event and carried considerable social stigma. Negotiation with multiple creditors to arrange and administer repayment plans took considerable effort and expertise, and so represented a valuable service to a struggling debtor. However, when these plans worked badly, unscrupulous poolers took advantage of borrowers and generally gave the entire business an unsavory reputation. In words that ring familiar today, Milstein and Ratner (1981) describe some of the problems: "Preying on a clientele that generally is legally unsophisticated and willing to believe exaggerated claims of ready cures for their overwhelming financial burdens, debt poolers have, for example, charged exorbitant fees and collected these fees before paying amounts owed to creditors. There have been instances in which creditors have simply not received the payments made to the debt pooler, and debtors have been unable to recover their money. Further, debt poolers have often established repayment plans that are clearly not feasible" (980).

Legislative steps to curtail deceptive practices and exploitation of borrowers by debt poolers began as early as 1935 when Minnesota and Wisconsin established licensing requirements for poolers (Milstein and Ratner 1981, 982). The pace of legislation accelerated during the 1950s as states either prohibited for-profit debt pooling or regulated its operation. By 1980, twenty-nine states and the District of Columbia had

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prohibited commercial debt pooling. An additional sixteen states allowed commercial debt pooling but imposed a variety of regulations to curtail abusive practices. These measures included licensing requirements, the posting of a bond or cash deposit by debt pooling companies, established ceilings on fees charged to consumers and maximum time limits for forwarding consumer payments to creditor accounts. At the same time, many of these regulations exempted categories of institutions that provided debt pooling services, presumably because they were structured to operate in the consumer's best interest. Exempted institutions included (1) the debtor's attorney, or other agent working on the debtor's behalf; and (2) organizations or parties whose loyalty to creditor interests was clearly disclosed, such as representatives of one or more creditors (984). Some states specifically exempted nonprofit debt poolers, presumably because they lacked the commercial, for-profit motive that spawned abusive practices.

Perhaps in response to both the rising numbers of delinquent accounts as well as to an increasingly constrained "pooling" industry, in the late 1960s, the credit-granting industry supported a reconstitution of the existing National Foundation for Consumer Credit (NFCC), which was originally established in 1951 to promote borrower education about how to handle credit wisely. In 1967, creditor and community service representatives were added to the NFCC's board of trustees, and the organization's mission was redirected so as to establish and promote credit counseling agencies across the country. Over the next fifteen years, a national network of nonprofit credit counseling agencies evolved under the sponsoring and licensing umbrella of the NFCC. By 1980, NFCC-member agencies operated in over two hundred cities in forty-seven states, generally under the trademarked name Consumer Credit Counseling Service (Milstein and Ratner 1981, 981).

There is little doubt that creditors supported the NFCC's counseling initiative in order to promote an alternative to bankruptcy for debtors.[5] Unlike the earlier commercial debt pooling business, in which debtors bore the cost of hiring intermediaries to negotiate on their behalf, credit counseling evolved as a market-driven alternative to bankruptcy funded mostly by creditors. From the beginning, the centerpiece of the credit counseling industry has been the administration of a Debt Management Plan (DMP). A DMP is a voluntary agreement between a consumer and her creditors that resembles the earlier debt pooling arrangements. In the absence of the CCCS-administered DMP, the typical experience of a financially troubled consumer would be as the re-

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cipient of each creditor's individual collection efforts. In fact, at the first sign of serious trouble, a race would ensue to squeeze the consumer first so as not to be left outside when the consumer's income and assets were exhausted. However, creditors recognized that through mutual forbearance, they could collect more as a group, perhaps much more if by suspending their individual collection efforts they could avoid pushing the consumer into the bankruptcy court. The incentive to participate in a DMP is greatest for unsecured creditors who would typically collect nothing (or almost nothing) in a Chapter 7 bankruptcy liquidation.[6] Mortgage holders and auto lenders worry less about recovery of principle, given the value of the collateral, so are less likely to participate in DMPs. Consequently, the concept of the Debt Management Plan administered by a credit counseling agency originally had the strongest backing from retail creditors, and later by bank credit card issuers as general-purpose credit card debt expanded rapidly through the 1980s.

Of course, consumers also valued an alternative to bankruptcy. Many consumers wished to avoid the social and economic stigma associated with filing for bankruptcy and had sufficient income to repay their debts over a three-to-four-year period. But, a DMP wasn't appropriate for everyone. NFCC-member agencies provided advice and financial/budgeting education to their consumer clients, in addition to setting up a formal DMP. Much of the education regarding budgeting and wise use of credit was an outgrowth of the process of screening borrowers to determine the extent of their credit problems, beginning with an initial, face-to-face interview.

According to NFCC data, during 1992 (the last year in which NFCC-member agencies constituted nearly the entire credit counseling industry in the United States), member agencies conducted individual budget counseling sessions with 549,116 consumers. A large majority of these individuals received advice and assistance without being set up on a DMP. On average, about 30 percent of CCCS clients nationwide were advised after the initial interview that they could handle their debt problems on their own, armed with the information resulting from the budget review and perhaps with some recommended adjustments to spending and incomes. Another 36 percent were referred elsewhere for legal or other assistance (e.g., to handle problems such as substance abuse, child support, and so forth), including legal advice regarding bankruptcy options. Only about 35 percent were placed in debt management plans. Over the past twenty-five years,

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NFCC statistics reveal that these percentages have been remarkably consistent.[7]

In setting up a DMP, the counseling agency negotiates with creditors on behalf of the consumer to lower monthly payments as well as obtain waivers or reductions in finance charges and fees. The objective is to structure a repayment plan out of the client's available monthly income that repays all creditors within three to four years. The average DMP negotiated in 1992 involved nine creditors and $12,548 of debt to be repaid. It called for a monthly payment from the client to the agency of $349, on average, to be distributed to the client's creditors (almost exclusively unsecured). The average scheduled plan length was forty-two months. Repayment plans were strictly voluntary between the consumer and creditors: not all creditors need participate (though the successful negotiation of a plan hinges on convincing as many to participate as possible), and the consumer could back out at any time. Participating creditors agreed to suspend collection efforts, and often reage accounts (i.e., reinstate them as current), so long as plan payments continued. These plans returned nearly $1 billion to creditors nationwide in 1992.

The DMP product was at the heart of the service provided by the agency, and provided the revenue that supported most of the agency's operations. A peculiar funding arrangement evolved in which the creditors that participated in DMPs voluntarily contributed to the CCCS agency a percentage of the debt recovered. This contribution, known in the industry as "fair share," originally was about 15 percent of amount recovered through DMP payments, on average, but has fallen through the years for reasons to be discussed in the following section. The linkage of the fair-share contribution to the dollars recovered through DMPs makes clear that the credit-granting industry viewed their investment in the credit counseling network as supporting an alternative to courthouse remedies for insolvency.[8] However, given the fact that, year after year, the majority of consumers passing through the counseling interviews were not placed on DMPs, the fair-share contribution that derived from payments made by only 30–40 percent of all clients included a sizeable subsidy to support the rest of the agency's operations. A breakdown of NFCC agency revenue in 1992 reveals that 76 percent derived from creditor fair-share contributions. Another 15 percent derived from consumer clients on DMPs (monthly payments that averaged $9.48 plus one-time plan set-up fees that averaged about $14 at the minority of agencies that levied the fee).

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**Table 8.1**
NFCC agency locations, 1982–2003

| Year | Number of agencies | Number of locations | Number of locations per agency |
|---|---|---|---|
| 1982 | 128 | 191 | 1.5 |
| 1983 | 139 | 237 | 1.7 |
| 1984 | 136 | 251 | 1.8 |
| 1985 | 140 | 277 | 2.0 |
| 1986 | 145 | 297 | 2.0 |
| 1987 | 156 | 353 | 2.3 |
| 1988 | 168 | 415 | 2.5 |
| 1989 | 171 | 479 | 2.8 |
| 1990 | 182 | 582 | 3.2 |
| 1991 | 190 | 718 | 3.8 |
| 1992 | 198 | 745 | 3.8 |
| 1993 | 202 | 831 | 4.1 |
| 1994 | 197 | 1,012 | 5.1 |
| 1995 | 200 | 1,197 | 6.0 |
| 1996 | 195 | 1,297 | 6.7 |
| 1997 | 193 | 1,374 | 7.1 |
| 1998 | 190 | 1,414 | 7.4 |
| 1999 | 184 | 1,429 | 7.8 |
| 2000 | 175 | 1,418 | 8.1 |
| 2001 | 155 | 1,295 | 8.4 |
| 2002 | 143 | 1,180 | 8.3 |
| 2003 | 129 | 1,091 | 8.5 |

*Source:* NFCC Annual Member Activity Reports, various years.

Clearly, the DMP product was supporting nearly all of each agency's operation.

## 8.2 New Entrants, Competition, and Erosion of Services

Between 1986 and 1992, personal bankruptcies in the United States more than doubled, with about 900,000 households filing for bankruptcy relief in 1992 alone. If we interpret rising bankruptcies as a sign of rising incidence of households with repayment problems, it is not surprising that NFCC-member counseling agencies experienced enormous growth during the same period. Table 8.1 illustrates the expansion in office locations, with over four hundred locations added to the NFCC network between 1986 and 1992. Dollars returned to creditors through DMPs leaped by 33 percent in 1992 from the previous year.

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DMPs grew even faster than bankruptcies during this period. In 1986, there were 68,000 new DMPs started at NFCC agencies, compared to 121,000 personal bankruptcy petitions filed under Chapter 13 and 324,000 filed under Chapter 7. In 2002, NFCC agencies opened over 202,000 new DMPs, an increase of 197 percent, compared to 254,000 Chapter 13 petitions and 643,000 Chapter 7 petitions the same year. Indeed, the volume of new DMPs began to rival the volume of Chapter 13 petitions filed.

Creditors considered the counseling DMP option an important substitute for both Chapter 13 and Chapter 7 bankruptcies (see chapter 7 for a discussion of the two bankruptcy procedures, and of debtors' choices between them). The large majority of Chapter 7 filers have debts that far exceed their capacity to pay.[9] Chapter 13 is the more relevant comparison point. It is in fact a close cousin to the debt management plan and offers some advantages to borrowers whose income suffices to repay a significant portion of their debts. Court-supervised debt repayment plans are binding on creditors and can be set up to repay less (often far less) than 100 percent of the outstanding debts. All creditors are compelled to participate and required to halt collection activity. Even secured creditors (with the exception of mortgage lenders) are required to accept "cram down" of the balance to be repaid under a plan to an amount equal to the value of the collateral. On the other hand, the use of Chapter 13 carries a price: borrowers must pay attorney fees, and must bear whatever social stigma attaches to the filing of bankruptcy, as well as the economic stigma resulting from the record of bankruptcy attaching to the borrower's credit report for ten years. A voluntary DMP allows the borrower to avoid the stigma (social and economic) associated with bankruptcy, although it may require the repayment of more debt than under a Chapter 13 bankruptcy filing.

Apparently, in the late 1980s and into the early 1990s, many borrowers found this to be an acceptable tradeoff. Figure 8.1 displays the growth of new DMPs at NFCC-member agencies versus Chapter 13 bankruptcy petitions, both against the backdrop of the much larger volume of Chapter 7 petitions.

Yet, even as NFCC agencies were expanding, the volume of calls from troubled consumers was growing faster. Creditors complained of growing backlogs at agencies and waits of one to two weeks before borrowers could get an appointment with a counselor. As bankruptcies resumed a path of rapid growth in 1995–1996, creditors began

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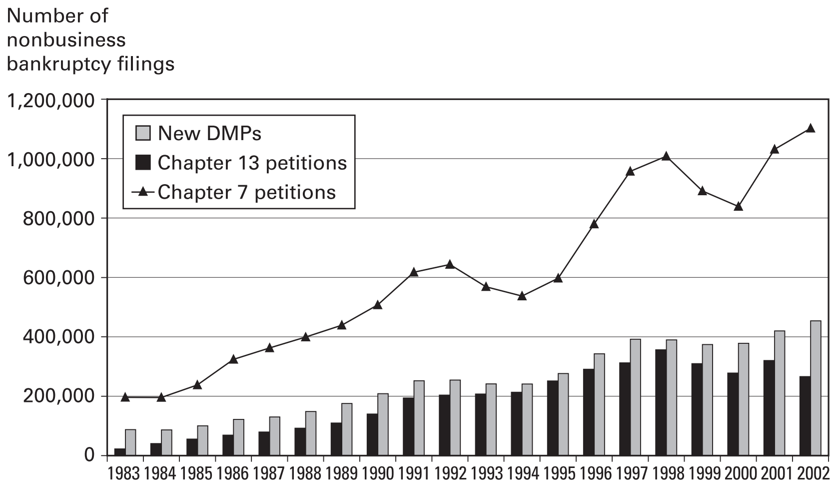


**Figure 8.1**
Nonbusiness bankruptcy filings versus new DMPs at NFCC-member agencies

viewing counseling as triage: Quick assessment of, and response to, repayment problems was deemed necessary to prevent even more debtors from resorting to bankruptcy for relief. As a consequence, creditors were amenable to cooperating with new entrants who could deal quickly and efficiently with the rising tide of enquires from borrowers in trouble. Their willingness to deal with non-NFCC competitors increased further as a result of the Garden State Credit Counseling lawsuit, a key antitrust case filed against the NFCC and several major creditors. The outcome of the lawsuit forced creditors to cooperate with a much broader range of agencies in addition to NFCC members.

NFCC-member agencies retained the exclusive rights to use the CCCS trademark, but no longer had claim to what, in many cities, had amounted to an exclusive geographic territory in which they were the only counseling agency that could effectively negotiate with creditors. Still, the CCCS brand name was well-established and had even greater visibility with creditors than consumers. New competitors hoping to deal with large national creditors on behalf of consumers had to adopt business models that negated the brand name advantage.

Established NFCC agencies had evolved over twenty-five years as quasi-social service agencies, specializing in providing resource-intensive, face-to-face budgeting and financial counseling from brick

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and mortar offices, with little or no competition due to the exclusive territorial licensing arrangement that accompanied the permission to use the CCCS brand. Many NFCC agencies were slow to adopt new technology and unaccustomed to the need for business plans, price competition, or the development of alternative products and revenue streams.[10]

These were the margins that the new entrants exploited. Given the demand by creditors for quick assessment of their delinquent customers' repayment problems, the most successful of the new firms recognized that rapid response and delivery of a core DMP product was the formula for rapid growth in the counseling business. Technology allowed new firms to bypass relatively expensive (and slow) investment in brick and mortar offices in favor of large "call centers" that could support the delivery of telephone counseling. Moreover, telephone counseling coupled with an effective national advertising campaign made a nationwide service possible, and little time was needed to launch a new business. The new entrants could begin competing with virtually every established NFCC agency, regardless of geographic location.

To a new entrant aspiring to rapid growth, there was little point in specializing in providing a service that did not generate revenue. So, competition from the new firms occurred at the one margin of the bundle of counseling services that was actually priced: the DMP. New entrants employed technology to deliver the DMP product faster (shorter queues for consumers), more cheaply (telephone delivery instead of face-to-face interviews at brick and mortar offices), and with greater back-office efficiency (electronic payment processing and accounting). The quicker turnaround, more efficient administration, and national reach appealed to creditors at a time when excess demand for counseling was peaking. Because the new entrants' costs were lower (partly through efficiency, and partly because they offered a more limited service), they could undercut the full-service NFCC agency pricing structure. This triggered downward pressure on prices, namely, on the "fair share" (agency revenue from creditors as a percentage of DMP dollars disbursed to creditors).

Competitors rapidly entered the counseling market. Because most states required credit counseling agencies that administer debt repayment plans to be structured as nonprofit entities, one of the best metrics for tracking the entry of new competitors is the number of applications to the IRS for tax-exempt status under Section 501(c)(3) of

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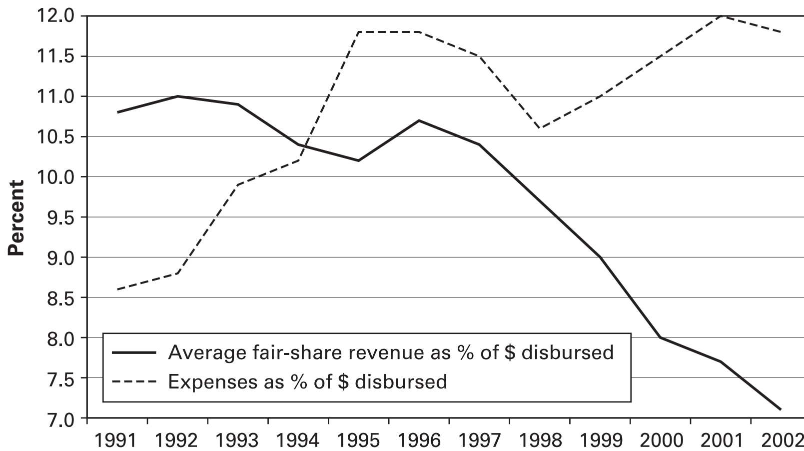


**Figure 8.2**
Trend in NFCC agency fair-share revenue and expenses

the IRS code. According to the IRS, 1,215 credit counseling agencies have applied for tax-exempt status since 1994. Over 800 of those applications were received between 2000 and 2003. As of early 2004, the IRS reported that 872 tax-exempt credit counseling organizations were operating in the United States (United States Senate 2004, 3). Of this number, approximately 126 were NFCC members.

Figures 8.2 and 8.3 illustrate the impact on NFCC agency income statements. Just prior to the wave of new entrants, between 1991 and 1994, NFCC agency revenue exceeded operating expenses, largely because of the increased fair-share revenue that derived from the rapid escalation in dollars disbursed to creditors from existing DMPs. However, as competition from new entrants drove down the "price" that creditors were willing to pay to support DMPs, between 1996 and 2002, the fair-share rate steadily eroded, falling from about 10.6 percent to about 7 percent. At the same time, operating expenses as a percentage of dollars disbursed continued to fluctuate between 10.5 percent and 12 percent. Figure 8.3 illustrates the resulting funding gap collectively experienced by NFCC-member agencies. By 2002, the agencies' primary revenue source, the fair-share payments from creditors in conjunction with DMPs, was generating $110 million less than total agency operating expenses. Fair-share revenue comprised just 58.3 percent of NFCC total revenues, down from nearly 76 percent a decade earlier. Clearly, NFCC agencies were experiencing acute pressure to generate other revenue streams, as well as pressure to cut costs.

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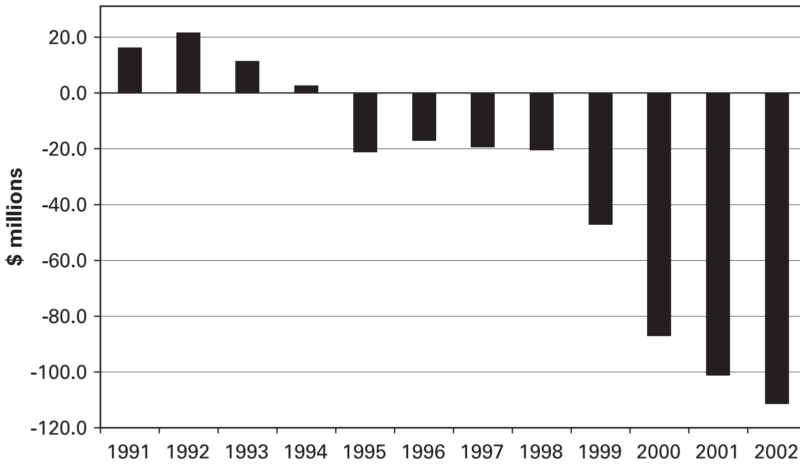


**Figure 8.3**
NFCC agency funding gap (fair-share revenue − expenses)

Increased fees on borrowers made up most of the difference. According to the NFCC, in 2002, client DMP fees rose to 29.6 percent of total NFCC-member agency revenues, up from 23.9 percent just one year earlier. Nearly all agencies (96 percent) charged a monthly fee for DMP clients, averaging $14 per month, and 61.4 percent charged a one-time enrollment fee that averaged $23. As for counseling in the absence of a DMP (i.e., the initial counseling session), 34 percent of agencies were charging a fee that averaged $12.94.

However much the entry of new firms may have boosted the number of consumers on DMPs, it generally did not enhance the delivery of counseling services to non-DMP clients. The reliance on price competition to attract creditor cooperation (and referrals) increased the incentive of new entrants to cut the quality and quantity of nonpriced services (education) and to maximize the number of consumers enrolled in DMPs, regardless of qualifications. Both of these margins were difficult for creditors to monitor.

The new entrants benefited from an information asymmetry. The intake interview allowed the agency to know more about the client than did the creditor. Consequently, creditors could not easily determine if some clients were being placed on DMPs and (given concessions on finance charges and fees) when they could actually handle their debts on their own.[11] And the effectiveness of the counseling session and advice given was very difficult for a creditor to monitor. Consequently, the

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quality of the DMP product, as well as general education and counseling, was subject to erosion because some of the key dimensions of the product were not easily observed by the payor. Over time, poor agency follow-up on the DMP and "cherry picking" (i.e., putting clients on plans who didn't need them) led to distrust on the part of creditors and much closer scrutiny of agency DMP proposals and practices; it also probably contributed to further erosion of the fair share percentage. Quite literally, the new entrants that had effectively become large "debt plan mills," specializing in fifteen-minute counseling sessions over the telephone to set up DMPs, were driving out full-service counseling. The continued erosion of the fair-share rate increased the pressure on the established agencies to cut costs and increasingly emphasize the service that was explicitly priced: the DMP.[12]

Not all of the newcomers followed this strategy, and not all of the new competition was detrimental. The Consumer Federation of America and the National Consumer Law Center, hereafter CFA, noted that newcomer agencies "pioneered more business-like methods of making debt management plans convenient for consumers, including flexible hours, phone and Internet counseling, and electronic payments. These improvements, in turn, have forced the old guard to be more responsive to their clients" (2003, 8). Aggressive advertising on the Internet and through telemarketing and television ads has raised consumer awareness of counseling options, which has been a longstanding objective of the credit-granting industry and the NFCC.

Nevertheless, the CFA report also noted a number of problems associated with the operations of some of the largest of the new entrants. The lack of face-to-face contact inherent in telephone-based counseling raises questions about the education value associated with the "counseling" session. In many cases, the telephone "counseling" appears to be nothing more than a screening interview for DMP eligibility. A CFA survey of non-NFCC agencies found that only five of the forty agencies surveyed offered services unrelated to DMPs. The CFA authors noted that "nearly all of the counselors at non-NFCC agencies we contacted by phone were surprised by inquiries about courses or other consumer education resources. When asked this question, one counselor simply said, 'We consolidate credit cards. That's it'" (2003, 19).

The CFA report also noted that NFCC-member agencies have struggled to continue providing a full range of personal financial education services to their clients. In addition to conducting 1.15 million

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individual counseling sessions in 2002, NFCC-member agencies also conducted 37,368 in-person educational presentations (mostly focused on budgeting) for schools, employers, and religious and community organizations. However, the number of such presentations was down 28 percent from 1999. CFA concluded that "despite these efforts, multi-service agencies are a dying breed" (2003, 19).

Some of the largest newcomers that advertise most aggressively also appear to have engaged in deceptive and misleading practices. Federal Trade Commission testimony before Congress in 2004 stated that "our greatest concern is deception by credit counseling agencies about the nature and costs of the services they offer to consumers" (U.S. Federal Trade Commission 2004, 6). The agency cited the following practices as ones that may violate the FTC Act or other statutes enforced by the FTC:

• *Mispresentations about fees or "voluntary contributions"* Some agencies were charging large fees, often characterized as donations or voluntary contributions that are hidden from consumers. One example would be when an agency retains the consumer's first monthly payment instead of forwarding it to the client's creditors. Such practices may not be adequately disclosed to the consumer up front.

• *Promising results that cannot be delivered* The aggressive advertising employed by some agencies suggests that they will lower consumers' interest rates, monthly payments, or overall debt by an "unrealistic or unattainable amount." Some also falsely promise to eliminate negative (but accurate) information from a consumer's credit report.

• *Abuse of nonprofit status* Some agencies use their nonprofit designation to convince consumers to pay fees disguised as "donations." These agencies "may, for example, claim that consumers' donations will be used simply to defray the [agency's] expenses. Instead the bulk of the money may be passed through to individuals or for-profit entities with which the [agencies] are closely affiliated. Tax-exempt status also may tend to give these fraudulent [agencies] a veneer of respectability by implying that the [agency] is serving a charitable or public purpose. Finally, some consumers may believe that a nonprofit [agency] will charge lower fees than a similar for-profit entity" (6).

• *False advertising regarding credit counseling services* Masquerading as "counseling" agencies that purport to provide advice and education, some of these firms may be enrolling "all clients indiscriminately in DMPs without any actual counseling" (6).

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• *Failure to pay creditors in a timely manner or at all* These charges sound remarkably similar to the regulatory concerns about commercial debt poolers that prompted sharp regulation of that industry nearly fifty years earlier. It seems that after well-intentioned beginnings, the credit counseling industry is in danger of devolving back to the "pooling" industry that fell into disrepute a half century earlier.

## 8.3 What Really Caused the Industry to Devolve?

### 8.3.1 For-Profits versus Nonprofits

Some observers have blamed the for-profit orientation of many of the new entrants for the demise of the educational component of counseling services, and the emergence of the DMP as the sole agency product. Of course, almost all of the major new competitors in the counseling industry were organized as nonprofit firms. A 2004 U.S. Senate investigative report found that many of the new entrants "have developed a completely different business model, using a for-profit model designed so that their nonprofit credit counseling agencies generate massive revenues for a for-profit affiliate for advertising, marketing, executive salaries, and any number of other activities other than credit counseling. The new model looks to the consumer to provide those revenues" (U.S. Senate 2004, 1). The report further notes that "the primary effect of the for-profit model has been to corrupt the original purpose of the credit counseling industry—to provide advice, counseling, and education to indebted consumers free of charge or at a minimal charge, and place consumers on debt management programs only if they are otherwise unable to pay their debts. Some of the new entrants practice the reverse—provide no bona fide education or counseling and place every consumer onto a debt management program at unreasonable or exorbitant charge" (2).

As noted previously, the idea that nonprofit status would insulate a counseling agency from competitive pressures and align agency incentives more closely with the consumer apparently led most states to enact laws that required organizations providing credit counseling services to be nonprofit.

Administration of DMPs by nonprofit credit counseling agencies was validated in 1969 when the IRS affirmed that 501(c)(3) tax-exempt status was properly granted to an "organization that provides information to the public on budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications."

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It also ruled that such an organization may enroll debtors in "budget plans," where the debtor makes fixed payments to the organization and the organization disburses payments to each of the debtor's creditors (U.S. Senate 2004, 3–4). But this ruling, coupled with the requirement by most states that counseling agencies be nonprofit, has had the unintended negative consequence of giving less scrupulous agencies the positive glow of a charitable enterprise, thereby lowering consumer caution and possibly aggravating the damage done by false claims and deceptive advertising. Clearly, a credit counseling agency's "nonprofit" status has lost whatever value it may once have had as a signal of quality and integrity of operation. Equally clear is the fact that nonprofit organizations can compete with each other just as aggressively as for-profit firms.

But, even if the IRS cracks down on the for-profits masquerading as nonprofits, is there any reason to think that the incentives of nonprofits will always align more closely with the consumer than a commercial, for-profit counseling firm? This is especially relevant now that technology allows counseling agencies to compete with each other nationally for clients, without necessarily investing in brick and mortar offices. In other words, is the requirement that a counseling agency be nonprofit necessary or even helpful? As noted earlier, one of the positive effects of new entry into the counseling business was that it forced existing agencies to adopt new technologies for delivering services to consumers and payments to creditors, and be more responsive to both. We know that nonprofit (tax-exempt) credit unions and for-profit banks and savings institutions coexist effectively in providing consumers with a full range of financial services, and consumers trust both. In the context of personal insolvency advice, lawyers who dispense bankruptcy advice are most definitely operating on a for-profit basis. Why is it reasonable to expect them to be unbiased sources of recommendations, but that for-profit counseling firms would not be?

### 8.3.2 Dependence on Creditor Revenues

The reliance of the counseling industry on creditors for the majority of their revenue has been cited by industry critics as compromising the agencies' promise to act in consumers' best interests (Milstein and Ratner 1981; Gardner 2002; CFA 2003). The most frequent criticism is that the typical counseling agency in today's market serves as little more than a collection agency for creditors, does not fully inform the borrower regarding all the available options for handling debts, especially

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those options that involve something other than full payment, and does not adequately disclose to the consumer its financial links to the credit industry. An obsession with enrolling clients on DMPs, at the expense of genuine education and sound advice, has been ascribed to agencies that are dependent on DMP-generated revenue.

It is true that most agencies do not purport to offer comprehensive legal advice on insolvency options, although many will refer debtors for bankruptcy assistance when appropriate. But it does not seem reasonable to expect counseling agencies to offer a full range of legal options, since a well-established market for debtor insolvency attorneys already exists to provide those services. The unique purpose of the creditor-supported counseling agency was and is to offer first-tier budget advice but also to offer a brokered debt repayment plan that coordinates collective sacrifice on the part of creditors in exchange for a borrower's "good faith" effort to repay. Counseling agencies offer a form of personal-finance triage, a way for borrowers who want to pay their debts in full to handle their repayment problems outside the formal bankruptcy system. That is the essence of the product offered. So long as there is sufficient disclosure so that consumers recognize this, the claim that creditor support generates an inferior experience for consumers seems to be a red herring.[13]

In fact, there is plenty of evidence that, when done properly, credit counseling by agencies that do depend on creditors for revenue (which is nearly all of them) can genuinely help consumers. A recent report by the U.S. Senate Committee on Investigations (U.S. Senate 2004) and the already mentioned report published jointly by the Consumer Federation of America and the National Consumer Law Center (CFA 2003) each suggested that NFCC-member agencies are generally providing a broad range of education and counseling services for their clients, in keeping with their original mission, as opposed to indiscriminately enrolling clients on DMPs. In particular, the Senate report commended the NFCC for setting accreditation standards for agency membership, suggesting that "if applied throughout the industry . . . , these professionals standards would go a long way toward addressing the abusive practices identified in this Report" (23–24).

Consequently, it is reasonable to examine the conduct of NFCC-member agencies in evaluating how well credit counseling can work in what has become a very competitive marketplace.

An analysis of NFCC agency experience with clients quickly refutes the suggestion that its member agencies routinely place consumers on

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**Table 8.2**
NFCC DMP closings in 2002

| Reasons cases were closed | % of cases | Months on plan |
|---|---|---|
| Successful completion | 24.5 | 42.6 |
| Self administration | 22.7 | 26.2 |
| Nonpayment | 42.5 | 16.5 |
| Noncompliance | 3.0 | 17.8 |
| Unauthorized new credit | 0.3 | 19.1 |
| Late or partial payment | 2.7 | 16.5 |
| Bankruptcy | 4.8 | 13.4 |
| Unknown | 2.6 | 19.3 |
| N = 304,701 | | |

DMPs when bankruptcy would have been the better option for the consumer, even though the majority of agency revenue derive from DMP payments. Table 8.2 displays data on over 300,000 DMPs closed during 2002.

Nearly one quarter of the closed plans (74,651) were successfully completed, averaging 42.6 months in length. An additional 22 percent (69,167) of plans were closed because the borrowers had recovered sufficiently to handle repayment on their own. Even the plans closed for nonpayment lasted an average of sixteen months. In short, the closed-case breakdown suggests that the large majority of the plans set up for consumers involved an extended period of repayment, even for those plans that ultimately failed. On average, these plans appear to be the result of good-faith assessments by agencies of the likelihood that the repayment option would resolve financial difficulties, and good-faith attempts by consumer clients to see the plans through.

Additional evidence from a study published by Visa USA (1998) indicates that agencies do screen and categorize debtors reasonably accurately according to severity of financial difficulty and likelihood of bankruptcy. The study tracked 129,556 consumer clients of eleven NFCC-member agencies that participated in counseling sessions from January 1996 through July 1998. Counseling was defined as a comprehensive one-on-one money management interview with a trained counselor. Each interview included a detailed discussion of the client's financial situation, the development of a monthly budget, and a written action plan defining steps to be taken. Subsequently, clients were matched to Visa's proprietary Bankruptcy Notification Service data-

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base to determine the frequency of bankruptcy by outcome of the counseling session.

Of the clients who were deemed able to handle their debts on their own (e.g., no need for a DMP and creditor concessions), 5 percent filed for bankruptcy within one year of counseling. For those clients who enrolled in DMPs, 7.4 percent declared bankruptcy within one year of counseling. Among clients who were referred for legal advice (e.g., income insufficient to support a DMP), 32.2 percent declared bankruptcy within one year. Of the clients who were referred for other assistance (e.g., referral to another social service agency to address unstable family issues or addictions such as gambling, alcohol, or drug abuse), 12.6 percent declared bankruptcy within one year. Keeping in mind that agency clients are self-selecting into counseling sessions because they are experiencing credit problems, these statistics on subsequent bankruptcy further refute the charge that, as "glorified collection agencies," the NFCC-member agencies are routinely funneling borrowers into DMPs, regardless of the kind of assistance they really need.

Another recent study documents the value of full-service counseling experience for consumers who do not enroll in DMPs. Staten, Elliehausen, and Lundquist (2002) found that one-on-one credit counseling has a positive impact on borrower behavior over an extended period. The study examined the impact of individual credit counseling sessions for 14,000 consumers during 1997, none of whom were subsequently enrolled in DMPs. Credit bureau data provided objective measures of credit performance for these clients over a three-year period following their initial counseling session, as well as for a large sample of borrowers with similar risk profiles and geographic residences in 1997 who did not receive counseling. Using nine different measures of borrower credit performance, the empirical analysis found that borrowers who received counseling generally improved their credit profile over the subsequent three years, relative to observationally similar borrowers who did not receive counseling. Perhaps not surprisingly, the benefit from counseling was greatest for borrowers with the poorest initial risk profile.

At least two conclusions emerge from this brief review of the operations of one large group of similarly structured counseling agencies. First, creditor support of agency operations does not have to compromise value to consumers. Moreover, if creditors are not permitted to help underwrite agency operations, who will? The same industry critics who advocate that agencies move away from creditor funding

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(or at least deemphasize reliance on fair-share revenue tied to DMP payments) have also condemned many of the new entrants for charging excessive fees to consumers. Given that creditors and consumers are the two primary beneficiaries of successful counseling, who should pay for the service if they do not?

The second conclusion is that the business model followed by virtually all credit counseling agencies today fails to capitalize on some important dimensions of their product by failing to document and price the educational components of their services. For NFCC-member agencies, over two-thirds of the clients who undergo individualized counseling sessions receive training and information of some value but generate little or no revenue. Both creditors and consumers benefit from this service, and presumably both are in a position to pay something for those services. Again, the relevant business issue is not whether creditors should support these agencies at all, but how to diversify agency revenue so as to insulate a broad range of educational services from the impact of price competition on the DMP product.

### 8.3.3 Informational Asymmetry

The prevailing revenue structure on which the industry is based is flawed and primarily responsible for the ongoing erosion in the quality and range of services offered by counseling agencies. To understand the essence of the problem, it is helpful to think about the incentives created under the current revenue structure and its variations. Keep in mind that agencies gain an informational advantage because they deal directly with consumers, see a fuller picture of their overall debt exposure, and have the benefit of the data gathered at the initial counseling interview. Consequently, they can better assess a consumer's financial situation than can creditors.

Agencies that rely more on fair share from creditors and less on initial plan set-up fees from consumers engage in risk sharing with creditors. That is, both the agency and the creditor recover more if the consumer stays on the plan. This arrangement gives the agency increased incentive to work with debtors (follow-up calls and interviews, when warranted) to keep them on a plan, and to enroll them on plans that have a good chance of being successful.[14]

However, it also increases the agency's incentive to sign up lower-risk/less needy consumers for DMPs, to increase the probability that they'll stay on plan (cherry picking). Creditor concern over this development was noted in a previous section.[15] The information asymmetry

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makes it difficult for creditors to know whether consumers who enroll in DMPs actually need the assistance. In other words, are they actually trying to avoid bankruptcy as opposed to trying to save money in interest and fees? Coupled with the explosion in the number of agencies submitting proposals, differing standards used across agencies, and uneven success rates of the resulting plans, the administrative costs to issuers of evaluating DMP proposals have soared, as has distrust. As a result, creditor willingness to continue funding agencies at traditional levels has eroded.

Alternatively, agencies that rely more on up-front fees paid by the consumer have no less incentive to indiscriminately place people on DMPs (to the extent that the up-front fees include one-time setup charges for plans) and have less incentive to follow up with the consumer and shepherd clients through plans. In addition, the higher fees charged to financially stressed consumers probably increase the likelihood that these consumers will default.

However, if techniques such as statistical scoring models could be developed that would give both agency and creditor a similar indication of who is at greater risk of bankruptcy, then the cherry-picking problem could be reduced or eliminated. Moreover, the same models could then be used to calibrate the payment to the agency. That is, payment would include an appropriate base amount for every client (to compensate for the interview/evaluation process and the resulting educational value), but then a graduated payment scale for those that go on DMPs, depending on the initial score. The same model could also be used to determine an appropriate amount of concessions (i.e., reduced finance charges and fees). This approach would preserve the agency's incentive to keep debtors on plans, at the same time reducing the risk of cherry picking and the resulting distrust by creditors.

There is already some indication that the market is moving in this direction. Creditors have begun to utilize performance-based, fair-share rules that take into account an agency's overall plan completion rate when determining the appropriate fair-share percentage (U.S. Senate 2004, 27–29). One very large card issuer (Citigroup) has dropped the fair-share concept altogether in favor of a grants-based approach in which agencies would apply (quarterly) for fixed amounts of funding. Presumably, this could result in some payment to compensate the agency for the educational value of counseling sessions outside of DMP enrollment, and many creditors are reacting to the findings of recent investigative reports by imposing minimum standards on

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agencies as a condition of dealing with them at all. This may be a faster and more effective incentive for policing agency performance than reliance on relatively slow-moving legislative solutions, although the independently derived rules will lack standardization.

With the application of scoring techniques to counseling data, we are likely to see both payment to the agency and concessions to consumers driven by "need," as judged by the totality of information available at the time of the counseling session. By reducing the information asymmetry between creditor and agency, statistical scoring should eventually establish the linkage of higher compensation to better service. To the extent that creditors can discern a measurable value even to non-DMP consumers who receive counseling, revenue streams can be created to sustain the full-service dimension of the traditional counseling agency. So, a competitive market can work after all.

## 8.4 Conclusions

Many of the abusive and deceptive practices identified in recent investigations of the credit counseling industry boil down to poor disclosures and poorly informed consumers. These could occur regardless of whether agencies were supported exclusively by creditor payments or were completely independent of creditor financial support. Consequently, the existence of financial ties between creditors and the counseling industry does not appear to be a fundamental problem. In addition, all of these abuses could occur in both for-profit and nonprofit agencies, so the focus on for-profit rather than nonprofit entities appears misplaced. Consumers have to adjust to the reality of a competitive market for counseling services that requires them to shop across all types of providers, just as they would shop for other financial services. In the absence of large-scale government funding or an outpouring of philanthropic support, neither of which seem likely, the viability of a geographically broad-based credit counseling industry will remain dependent on support from the credit-granting industry.

At its core, it appears that the basic problem plaguing the counseling industry is neither the dependence on creditor funding nor the aggressive competition among agencies. Rather, it is the information asymmetry between creditors and counseling agencies that creates incentive problems, increases distrust, and prevents the explicit valuation of the full range of agency services. Reducing the information asymmetry about the financial condition of clients would enable pricing schemes

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that bring creditor, agency, and consumer interests in closer alignment. Furthermore, to the extent that the value of counseling itself can be documented independent of the DMP recovery function, agencies should be able to collect revenue on every eligible client in order to fund the continued provision of a broad range of educational services for all clients.

## Notes

1. The National Foundation for Credit Counseling (NFCC) is the umbrella organization for the oldest network of nonprofit credit counseling agencies in the United States. The NFCC (2003) reports that 1.3 million households contacted one or more of their 140 agencies (1,040 offices) in 2002. The NFCC estimates that its agencies' share of the counseling market has declined from 90 percent in the early 1990s to between 25 percent and 30 percent by 2002.

2. Furletti 2003 (2) and author's calculations based on top ten receivables as reported in *Card Industry Directory, 2004 edition* (New York: Thomson Financial Media, 2003).

3. NFCC member activity reports; U.S. Senate 2004, 3.

4. See FTC Press Release, "FTC, IRS and State Regulators Urge Care When Seeking Help from Credit Counseling Organizations," October 14, 2003, http://www.ftc.gov/opa/2003/10/ftcirs.htm.

5. Milstein and Ratner (1981, 986) refer to a 1980 NFCC pamphlet that states that CCCS was started in response to the rising number of personal bankruptcies. NFCC listed the reduction in the number of bankruptcies first among the benefits of having a CCCS organization.

6. The vice president of the American Association of Creditor Attorneys said in an interview, "Most of my clients take the position that we'd rather have the debtor go into consumer credit counseling and accept the proposed repayment plan than have the debtor go into Chapter 7" (Daly 1993, 46).

7. According to NFCC annual member activity reports, in 1980, approximately 40 percent of consumers who participated in a counseling "intake" interview were placed on a DMP. By 2002, 30 percent of NFCC interviewees were placed on DMPs.

8. As a case in point, an article published in 1995 in an industry trade publication summarizes the results of a study conducted by one company to see if the fair-share payments and foregone finance charges on behalf of DMP clients were "worth it," relative to handling similarly situated customers through standard collection procedures. The company concluded that it was, indeed, worth it—just in terms of recoveries on DMPs alone. See Spurgin 1995.

9. See Staten 1999 for a summary of the findings of various studies of the capacity to repay debt among Chapter 7 petitioners.

10. Even as recently as 2001, a Consumer Reports study of credit counseling found that NFCC member agencies suffered from "an excess of stodginess" and had been slow to adopt efficient communication and debt repayment methods" (Consumer Reports 2001).

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11. In a workshop on credit counseling sponsored by the Federal Reserve Bank of Philadelphia, the managing director of collections for Juniper Bank remarked that credit card issuers were "particularly alarmed by recent trends in [counseling] agency marketing strategies. In addition to targeting 'credit stressed' consumers, some agencies market their services to any consumer who believes he or she is paying too much in finance charges. This makes it difficult for card issuers to know whether consumers who enroll in DMPs are actually trying to avoid bankruptcy or trying to save money in interest and fees" (Furletti 2003, 3).

12. An analogy to competition from new entrants in the airline industry seems appropriate. In 1980, deregulation brought new entrants and price competition. Between 1985 and 1998, price competition drove down the quality of service. Incumbent airlines shifted toward the "no frills" approach adopted by the startups. This period saw the demise of airline meals, and the installation of additional rows of seats at the expense of leg room.

13. Following an investigation by the Federal Trade Commission, the NFCC agreed in 1997 to require its member agencies to prominently disclose their funding relationship to the credit-granting industry in correspondence with consumer clients, although there is no such requirement on non-NFCC agencies.

14. At least one of the largest new entrants to the counseling business, Cambridge Credit Counseling, has devised a different pricing scheme that also gives consumers extra incentive to continue on their DMPs by promising to rebate a certain proportion of client's fees when they reach certain milestones in the plan.

15. See note 12.

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