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Credit Counseling in Crisis:

The Impact on Consumers of Funding Cuts, Higher Fees and Aggressive New Market Entrants

A Report by

Consumer Federation of America and **National Consumer Law Center**

April 2003

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The National Consumer Law Center and
Consumer Federation of America
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Consumer Federation of America is a non-profit association of 300 groups that was founded in 1968 to advance consumer interests through advocacy and education. CFA regularly monitors developments in the credit counseling industry. A CFA representative has served on the advisory board of the National Foundation for Credit Counseling for several years.

National Consumer Law Center is a non-profit organization specializing in consumer issues on behalf of low-income consumers. NCLC works with thousands of legal services, government and private attorneys, as well as community groups and organizations that represent low-income and elderly individuals on consumer issues.

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Credit Counseling in Crisis: The Impact on Consumers of Funding Cuts, Higher Fees and Aggressive New Market Entrants

The National Consumer Law Center and Consumer Federation of America

April 2003

Findings And Executive Summary

- In the last decade, the credit counseling industry has undergone an alarming transformation. Consumer demand for credit counseling has grown, funding to agencies has been sharply reduced, and an aggressive new class of credit counseling agencies has emerged. As this new generation of credit counseling agencies has gained market share, complaints about deceptive practices, improper advice, excessive fees and abuse of non-profit status have grown.

- Traditional credit counseling agencies offered a range of services, including financial and budget counseling and community education, as well as debt consolidation plans, known as debt management plans, or DMPs. Newer agencies, in contrast, often push consumers into DMPs even if they will not benefit.

- New creditor policies, lax oversight of non-profit corporations by the states and the Internal Revenue Service, and consumer demand for contact with agencies via the telephone and Internet have contributed to the rise of agencies that aggressively sell DMP services.

- Credit card banks and issuers have significantly cut back funding for agencies in the last decade. As available revenue has declined, most agencies have curtailed the range of services they offer and have increased the fees they charge to consumers. Creditors have recently made some efforts to stop the trend toward low-quality credit counseling "mills." However, in doing so, they have significantly increased the administrative burdens on and costs to agencies.

- Creditors have also reduced the concessions they offer to those who enter a DMP, such as lower interest rates. Low creditor concessions cause more consumers to drop off DMPs and to declare bankruptcy. According to a survey by VISA USA, one-third of those who failed to complete a DMP would have stayed on if creditors had further lowered interest rates or waived fees. Almost half of those who dropped off a DMP had or were going to file for bankruptcy.

Key problems highlighted in this report include:

- **Deceptive and Misleading Practices**. Consumer complaints and government investigations have focused on agencies that do not pay consumers' DMP payments on time, that deceptively claim that fees are voluntary, and that do not adequately disclose fees to potential clients.

- **Excessive Costs**. As creditors have reduced funding, some reasonable fee increases are to be expected. However, in an industry that rarely charged for counseling and other services a decade ago, one major counseling trade association, the National Foundation for Credit Counseling (NFCC) now reports that about eighty-eight percent of its agencies charge monthly DMP fees. A survey of non-NFCC agencies found that almost ninety-three percent said they charged some type of fee for debt management plans. Some agencies charge as much as a full month's consolidated payment simply to establish an account. Monthly DMP fees and costs for non-DMP services are also growing.

- **Abuse of Non-Profit Status.** "Non-profit" credit counseling agencies are increasingly performing like profit-making enterprises. Nearly every agency in the industry has non-profit, tax-exempt status. Nevertheless, many of these agencies function as virtual for-profit businesses, aggressively advertising and selling DMPs and a range of related services. Some agencies appear to be in clear violation of Internal Revenue Service (I.R.S.) rules governing eligibility for tax-exempt status. Credit counseling organizations should not qualify under I.R.S. rules if they are organized or operated to benefit individuals associated with the corporation or if they are not operated exclusively to accomplish charitable or educational purposes.

- Not all new credit counseling agencies exhibit these problems. Some are above-board and have pioneered consumer-friendly practices, such as flexible hours, electronic payments and easy access by phone and by Internet.

- Credit counseling mandates proposed in federal bankruptcy legislation and already in some state laws, could well increase the number of consumers who are served by disreputable credit counselors.

- There is virtually no federal regulation of the industry and generally ineffective state regulation. The Internal Revenue Service and state charity regulators have done little to weed out for-profits in disguise.

Recommendations

1. The Internal Revenue Service should aggressively enforce existing standards for non-profit credit counseling organizations. The I.R.S. should also use its power to impose "intermediate sanctions" on agencies that pay unreasonable or excessive compensation to individuals associated with the agencies.

2. Congress and the states should enact laws that would directly address abuses by credit counseling agencies. Among other provisions, the law should:

   - Prohibit false or misleading advertising and referral fees.
   - Require credit counseling agencies to better inform consumers about fees, the sources of agency funding, the unsuitability of DMPs for many consumers, and other options that consumers should consider, such as bankruptcy.
   - Prohibit agencies from receiving a fee for service from consumers until all creditors have approved a DMP.
   - Give consumers three days to cancel an agreement with a credit counseling agency without obligation.
   - Cap fees charged by agencies at $50 for enrollment or set-up. Allow only reasonable monthly charges.
   - Require agencies to prominently disclose all financial arrangements with lenders or financial service providers.
   - Provide consumers with the right to enforce the law in court.

3. Credit counseling trade associations should set strong, public "best practice standards" and provide for vigorous, independent enforcement of these standards. They should also require that all of their members disclose the "retention" rates of consumers who enter debt consolidation programs. Trade associations and individual agencies should work to diversify agency funding and decrease agency reliance on creditor funding. This will improve the financial stability of these agencies and decrease the potential conflicts-of-interest that currently exist.

4. Creditors should increase financial support to credit counseling agencies, especially to improve credit counseling options for consumers who are unlikely to benefit from DMPs. Creditors should also reverse the trend toward reducing the concessions they offer to consumers who enter DMPs, and immediately stop funding and doing business with agencies that charge high fees, function as virtual for-profit organizations and employ deceptive or misleading marketing practices.

CREDIT COUNSELNG IN CRISIS: THE IMPACT ON CONSUMERS OF FUNDING CUTS, HIGHER FEES AND AGRESSSIVE NEW MARKET ENTRANTS

A Report by The National Consumer Law Center and Consumer Federation of America

1. INTRODUCTION

Credit card debt in the United States is rapidly approaching $700 billion.[1] This staggering debt burden disproportionately affects lower and moderate income Americans, including elders, students, unemployed and disabled consumers, new immigrants and others living on the economic edge.

Those with incomes below the poverty level more than doubled their credit card debt during the early and mid-1990's--the sharpest increase of any income group. Moderate-income consumers also increased their credit card debt during this period.[2] By the end of the decade, the wealthiest Americans were using credit cards less frequently, while the poorest were increasing their use.[3] These trends, combined with increases in other types of debt, contributed to extremely heavy levels of overall debt for many lower and moderate-income families. [4]

[1] Revolving debt, most of which is credit card debt, was $723.7 billion in October 2002. Federal Reserve Bulletin, Table 1.55, February 2003.
[2] Average credit card debt held by lower income Americans earning less than $10,000 increased from $500 to $1,100 between 1992 and 1998. Average credit card debt held by moderate-income households earning $10,000 to $25,000 increased from $900 to $1,000 in the same period. "Family Finances in the United States: Recent Evidence from the Survey of Consumer Finances", Federal Reserve Bulletin, p. 18 at Table 11 (Jan 1997) and "Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances", Federal Reserve Bulletin, p. 21 at Table 11 (Jan. 2000).
[3] Between 1998 and 2001, the number of lower-income households using credit cards increased from 24.5 percent to 30.3 percent. Moderate-income household usage increased from 40.9 percent to 44.5 percent. Meanwhile, usage by Americans in the three highest income groups decreased from 57.4 percent to 52.6 percent, from 53.1 percent to 50.3 percent, and from 42.1 percent to 33.1 percent. Federal Reserve Board, "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances", p. 22, 23 at Tables 11a and 11b. Federal Reserve Bulletin, January 2003.
[4] By 2001, just over one-quarter of lower income families were spending more than 40% of their income on debt repayment, compared to 16% of moderate income households and 12% of middle income families. Id. at Table 14.

Nearly nine million people in financial trouble have some contact with a consumer credit counseling agency each year.[5] These consumers are turning to an industry that promotes itself as saviors of people in debt. But what really happens when a consumer goes to a credit counselor for help? The growing numbers of complaints about the industry suggest that consumers who seek credit counseling will not necessarily find a helping hand out of debt, but may instead find themselves even deeper in financial trouble.[6]

Despite growing problems, the credit counseling agencies have done such an effective job of portraying themselves as "good guys" that state and federal policymakers are increasingly considering and requiring credit counseling as a condition of filing for bankruptcy or taking out a high rate loan. For example, the bankruptcy reform bill that has been pending in Congress for years would require consumers to receive credit counseling "briefings" before filing for bankruptcy and to complete credit counseling "courses" before receiving a discharge.[7] Given the growing numbers of consumers filing bankruptcy each year (over 1.5 million in 2002)[8], it seems clear that this would lead to rapid growth in the number of people turning to credit counseling agencies for help.

This report takes an in-depth look at the credit counseling industry. It examines both the pro- and anti-consumer players in the industry, finding that the honest, reputable agencies are losing out to companies that are in the "non-profit" credit counseling business to make quick money. Instead of offering a range of diagnostic and counseling services, these companies sell debt consolidation as a solution for nearly every person with debt problems. This report focuses first on key problems in the industry and then offers a series of policy recommendations.

[5] Christopher H. Schmitt with Heather Timmons and John Cady, *A Debt Trap for the Unwary,* Business Week, Oct. 29, 2001. In a 2002 Fact Sheet, the National Foundation for Credit Counseling (NFCC), stated that 1.5 million households contacted NFCC members in 2001 and that 1 million of those households received counseling. The "Fact Sheet and Industry Background" is available on-line at www.nfcc.org.
[6] The Better Business Bureau reported in 2002 that complaints about credit counseling agencies nationwide had increased to 1,480, up from 261 in 1998.
[7] Section 106, H.R. 975. See §5 of this report.
[8] Administrative Office of the U.S. Courts, cited on the web site of the American Bankruptcy Institute, www.abiworld.org.

2. CREATED IN THE CREDITOR'S IMAGE: THE GENESIS OF THE CREDIT COUNSELING INDUSTRY

The credit counseling industry developed in the mid-1960's through the efforts of credit card companies that saw a creative opportunity to recover overdue debts. Creditors created the industry and provided the bulk of the funding needed to keep the agencies in business.[9] At first, most of the agencies were non-profit and called themselves the Consumer Credit Counseling Service (CCCS) of the regions they served. The CCCS agencies were affiliated with the National Foundation for Consumer Credit (NFCC),[10] a national trade organization that controls the name "Consumer Credit Counseling Services" (CCCS) and prescribes various standards for member organizations.

From the outset, debt management plans or DMPs (also known as debt consolidation) were the feature service offered by credit counseling agencies. Through these plans, a consumer sends the credit counseling agency a lump sum, which the agency then distributes to the consumer's creditors. In return, the consumer is supposed to get a break in the form of creditor agreements to waive fees and in some cases lower interest rates. Consumers also gain the convenience of making only one payment to the agency rather than having to deal with multiple creditors on their own.[11]

Through a creditor policy known as Fair Share, DMPs provide substantial revenue for the agencies. Under this policy, creditors voluntarily return to the agency a set percentage of the funds that are disbursed to them. This dependence on creditor funding was rarely discussed as the industry evolved, and until the mid-1990's, rarely disclosed to consumers.[12]

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[9] For an excellent history of the credit counseling industry, see David A. Lander, *Recent Developments in Consumer Debt Counseling Agencies: The Need for Reform*, American Bankruptcy Institute Journal, Feb. 2002.
[10] In December 2000, NFCC changed its name to the National Foundation for Credit Counseling, currently located at 801 Roeder Rd., Suite 900, Silver Spring, MD 20910, www.nfcc.org.
[11] Although not the topic of this report, many agencies now offer debt negotiation or settlement services in addition to or instead of debt management plans. Negotiation and settlement differ from DMPs mainly because the agencies do not send regular monthly payments to creditors. In fact, they encourage consumers to pay fees to the negotiation firm and not pay their creditors. These agencies generally maintain debtor funds in separate accounts, holding these funds until the agency believes it can settle the entire debt. There are growing concerns about abuses in settlement and negotiation practices.
[12] As a result of a settlement with the Federal Trade Commission (FTC) in 1996, NFCC now includes in its best practices standards that member agencies must disclose this possible conflict. The conflict remains, but at least consumers going to

Because DMPs are the primary, or even sole, source of revenue for most agencies, there is a built-in bias toward enrolling consumers in these plans. However, particularly early on in the development of the industry, most agencies offered services other than DMPs as well. Agencies often used excess revenues from DMPs to fund these other services, including counseling for consumers who were not enrolled in DMPs and consumer education seminars and courses. Although not the topic of this report, many also began to offer counseling specifically for homeowners in distress and first-time homebuyers.

The "social services" model developed by these agencies, which featured face-to-face counseling in neighborhood offices, was by no means perfect. Although counselors were generally caring and well-trained, consumers sometimes had to wait days or weeks for assistance and were required to attend counseling, and in some cases make payments, at remote and often run-down offices. A *Consumer Reports* article on credit counseling found that NFCC affiliates suffered from "an excess of stodginess" and have been slow to adopt efficient communication and debt repayment methods.[13]

The growth in consumer debt and related defaults during the late 1980's and early 1990's brought tremendous changes to the credit counseling field. The industry became increasingly competitive, with many of the newcomers advertising aggressively on the Internet and through telemarketing and television ads. Ten years ago, there were about 200 credit counseling organizations in the country, with 90% affiliated with NFCC.[14] By 2002, there were more than 1,000 credit and debt management organizations in the country. Most of these organizations are independent agencies. About 150 are members of the NFCC, comprising about 1300 counseling offices.[15]

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some credit counseling agencies are now told about it. See Stephen Gardner, *Consumer Credit Counseling Services: The Need for Reform and Some Proposals for Change*, Advancing the Consumer Interest Vol. 13 Fall 2001/Winter 2002.
[13] *Pushed Off the Financial Cliff*, Consumer Reports, July 2001.
[14] Jennifer Barrett, *Debt Consolidation: Beware Big Fees and Big Promises,* Newsweek on-line, January 3, 2002.
[15] National Foundation for Credit Counseling, "Fact Sheet and Industry Background" (2002), available on-line at www.nfcc.org.

The "newcomers" include many agencies that are literally new to the field as well as older agencies that have begun to adopt the businesses strategies of the newer players. Some of them belong to other trade associations, including the American Association of Debt Management Associations, the American Federation of Independent Credit Counseling Associations and the Association of Independent Consumer Credit Counseling Agencies (AICCCA).

These agencies have 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. Some of these newer agencies are responsible, effective and sensitive to their client's needs. However, as the newer agencies have gained market share, a number of serious problems have surfaced as well.

Common problems associated with many of the new players in the industry include:

- **Lack of face-to-face contact with consumers.** Most of the agencies provide assistance mainly or even exclusively by phone or Internet. While not practical in all situations, face-to-face counseling sessions are often a more thorough way to assess a consumer's financial situation and offer personalized budget advice.
- **Nothing but DMPs.** The trend is away from providing a range of services such as consumer education and counseling for non-DMP clients and towards offering DMP-related services only. Some agencies do provide videotaped educational information or self-directed credit counseling "courses" on the Internet, generally for a fee.
- **Aggressive and sometimes deceptive marketing tactics.** The newer agencies are generally much more aggressive, particularly with Internet and telemarketing advertising.[16] Some claim

[16] Many of the newer agencies have very large advertising budgets. For example, according to a 2000 tax report, Cambridge Credit Counseling spent over $3 million in advertising expenses. Many other agencies reported advertising expenses well

that there is no charge for their services even when this is not true. Others are under investigation for offering “voluntary fees” that are not truly voluntary.[17] A number of these agencies offer bonuses to existing customers who refer new clients to the agency. Others appear to pay telemarketers based on an incentive system.

- **Picking and Choosing Creditors.** Many agencies are now only willing to place some of a consumer’s unsecured debt into a DMP, leaving consumers to manage on their own with their other creditors.[18]
- **Higher Costs for Services.** Newer credit counseling agencies have led the way in charging consumers more--in some cases much more--for credit counseling. Some agencies charge as much as a full month’s consolidated payment simply to establish an account.
- **Close connections to for-profit businesses.** Some agencies have found ways to make more money by setting up close ties to for-profit businesses, including lenders and payment processing centers. These connections allow non-profit credit counseling organizations to direct excess revenue to affiliates. In some cases, the directors of these non-profit and for-profit ventures are related. It is unclear to what extent these practices are limited to a few operators or more widespread throughout the industry.[19]

above $1 million. Tax report information used throughout this report was obtained from the web site of Philanthropic Research, Inc., www.guidestar.com.

[17] For example, a February 2003 lawsuit filed by the Illinois Attorney General’s office against AmeriDebt alleges that the company’s “voluntary contributions” are in fact mandatory fees. See “The High Cost of Lowering Debt: Madigan Takes on AmeriDebt, Says Company Hides Fees, Fails to Send Consumers’ Payments”, Press Release, February 5, 2003.

[18] NFCC and AICCCA instruct their member agencies to deal with all of a consumer’s unsecured creditors in a DMP.

[19] Media reports have focused on the for-profit affiliates of three of the largest credit counseling agencies, AmeriDebt, Genus Credit Management Corporation, and Cambridge Credit Counseling. See Caroline E. Mayer, *Easing the Credit Crunch?*, Washington Post, November 4, 2001 at H01. The article cites problems with all three of these companies, focusing first on AmeriDebt’s connections with DebtWorks, a for-profit company that processes client accounts for nine credit counseling firms. AmeriDebt’s 2000 tax report shows over $13 million paid to DebtWorks. A February 2003 lawsuit filed by the Illinois Attorney General’s office against AmeriDebt alleges that the company represents itself as a non-profit although a for-profit company does the debt management work. See “The High Cost of Lowering Debt: Madigan Takes on AmeriDebt, Says Company Hides Fees, Fails to Send Consumers’ Payments”, Press Release, February 5, 2003. The Washington Post article also focused on Bernard Dancel, the founder of Genus Credit Management. Mr. Dancel started a for-profit company, Amerix, to handle the processing of Genus’ accounts. He later left Genus, but according to the Washington Post article, the company still relies on Amerix for processing operations. Genus reported paying nearly $80 million to Amerix in 2000.

3. KEY PROBLEMS WITH THE INDUSTRY: THE PATH TO DMP MILLS

3.1 Creditors Are Changing the Rules

3.1.1 Declining Revenues From Creditors: Trends in the Fair Share Contribution

Traditionally, creditors paid a Fair Share contribution to agencies of fifteen percent of the funds that agencies collected from their customers. In the late 1990's, creditors unilaterally began cutting their contributions to all agencies to ten percent or less. In 1999, when the Consumer Federation of America surveyed Fair Share contributions, the average contribution by major credit card issuers was nine percent.[20] By 2002, NFCC was reporting an average Fair Share return from creditors of about eight percent.[21] In 2002, one creditor, Household Credit Services, decreased its contribution to three percent for DMPs set up by phone. Several other creditors are not paying any Fair Share contributions to some agencies.

Current Fair Share contribution rates for major credit card issuers are as follows:[22]

Creditor	Contribution[23]
Citibank:	8%
Bank One Corp/ First USA	0 to 6.8 %
MBNA America	0 to 10%
Chase Manhattan	6 to 10 %
Bank of America:	0 to 9%
Providian Financial Corp.	8%

Genus also reported receiving a number of loans from Amerix beginning in December 1998. These loans ranged from about $192,000 to $1.6 million. Finally, the Washington Post article focused on Cambridge Credit Counseling, another non-profit company that does substantial business with a for-profit company owned, or formerly owed, by a company officer. Also see Massachusetts Senate Committee on Post Audit and Oversight, *Losing Credibility: Troubling Trends in the Consumer Credit Counseling Industry in* Massachusetts, July 2002.

[20] "Large Banks Increase Charges to Americans in Credit Counseling," Consumer Federation of America, July 28, 1999.

[21] NFCC, "Industry Overview", (2002).

[22] As reported by several credit counseling agencies and confirmed by the Consumer Federation of America, February, 2002.

[23] Fair Share contribution information was provided by several credit counseling agencies and cross-checked. Virtually all creditors pay lower contributions than are listed below if agencies do not transmit the funds they collect electronically.

Capital One Financial Corp	9%
Fleet Boston Financial Corp	6 to 9%
Household Credit	3 to 10%
Wells Fargo Bank	10%
Discover	7%
Sears	4 to 10%[24]
American Express	8%

These cuts in Fair Share appear to be disproportionately affecting agencies that offer a range of counseling services. These agencies have traditionally used excess revenues from Fair Share to help fund other programs such as basic counseling for consumers not enrolled in DMPs and consumer forums. Many of these "full-service" agencies have responded by eliminating services that are not funded directly by the Fair Share. Others are trying to keep these services, but are charging consumers.[25] Others simply cannot find a way to generate sufficient revenues to replace Fair Share and are either closing their doors, merging with other agencies, or operating at a deficit.

Our survey of forty Internal Revenue Service (IRS) 990 tax reports by NFCC and non-NFCC agencies found that many NFCC agencies, in particular, were facing tremendous financial troubles.[26] Fifty percent of the ten NFCC agencies examined reported deficits on their tax returns. Thirty percent reported very low margins of revenues over expenses, from $2,000 to $9,000. The remaining agencies

[24] The higher the payment volume forwarded by the agency to Sears, the lower the percentage paid to the agency.
[25] See §3.2 of this report.
[26] The thirty tax reports from non-NFCC agencies examined in this survey were randomly selected from those included in the fees and services survey discussed later in this report. Only agencies with recent tax reports on the Philanthropic Research, Inc. web site (www.guidestar.com) were used. The ten NFCC agencies were selected to reflect a range of agency sizes and geographic distributions.

reported fairly healthy returns. Although some of the newcomers were also struggling financially, many others reported tremendous profits.[27]

3.1.2 Additional Creditor Restrictions

Instead of contributing a flat amount to all agencies, several major creditors now link the amount of their contribution to the fulfillment of multiple requirements by agencies. These criteria, often called "pay for performance programs," vary from creditor to creditor. MBNA, for example, was one of the first creditors to start sharply decreasing its Fair Share contributions, to six percent in 1999. MBNA now bases the amount of its contribution on the number of DMPs proposed by a particular agency that it accepts or rejects. The higher the rejection rate, the lower the Fair Share contribution. Over the last two years, MBNA has decreased the number of allowable rejections if agencies want to maintain their existing contribution. In addition, MBNA will not offer a contribution at all unless agencies meet a number of other requirements related to their non-profit and accreditation status, the amount of fees that are charged to consumers, and their financial practices.[28] Bank of America grades agencies "on the curve," offering the highest contribution to the minority of agencies that do the best job of meeting "pay for performance" requirements.[29]

In conjunction with lowering the Fair Share contributions and making them more conditional, creditors have begun imposing restrictive criteria that agencies must meet before creditors will accept proposed DMPs. The standards tend to vary by creditor. Many creditors, such as MBNA, Sears and

[27] See §3.2 of this report.
[28] MBNA will not offer a contribution at all unless the agency is nonprofit, is accredited, has fees that do not exceed $100 to begin a DMP and $50 monthly, submits payments and client DMP plans electronically and has a "decline rate" (rejection rate for DMP plans submitted by the agency to MBNA) of less than 15 percent. [Letter to agency managers, January 4, 2002.] The letter, with any private or confidential information redacted, is on file with CFA and available upon request.
[29] Bank of America develops a "scoring matrix" based on: the range of "service channels" offered to customers (in-person, phone or internet contact); accreditation by the Council on Accreditation or BSI's ISO 9000 series; amount of customer fees (lower is better); size of monthly payment (larger is better); customer delinquency levels once a DMP is set up; the level of customer indebtedness and the duration of the plan. The top ranked agencies providing DMPs to 20 percent of Bank of America's credit counseling customers will then receive the highest possible Fair Share contribution of 9 percent. The lowest rated agencies serving ten percent of Bank of America's customers will receive nothing. [Letter to agencies, November 8, 2002.] The letter, with any private or confidential information redacted, is on file with CFA and available upon request.

Fleet, do not inform agencies about the specific criteria for accepting consumers into a DMP. This makes it difficult for an individual agency to develop a consistent policy. The result, according to many, is that creditors are rejecting greater numbers of DMPs and placing additional burdens on credit counseling agencies to provide background information on consumers.[30]

Some of the new creditor-imposed conditions and requirements related to agency accreditation, the provision of the Fair Share contribution, and the acceptance of DMP plans could help limit some of the abuses that are documented in this report. This is most likely to occur if these requirements are focused on increasing the affordability and range of options that are available to consumers and the quality of credit counseling. For example, conditioning creditor contributions on agencies' willingness to charge reasonable fees could lead some agencies to lower their fees, benefiting both consumers and creditors. However, until very recently, creditors have focused only on their bottom line costs by making deep, across-the-board funding cuts. These policies have increased administrative overhead and reduced options at counseling agencies. In addition, creditor requirements have tended to reward the agencies that provide a high number of DMPs at low cost. This has helped to fuel the growth in high-cost, low-quality "mills" that are focused only on getting as many people as possible into DMPs. [31]

3.2 Increasing Costs to Consumers

In an industry where charging consumers was virtually unheard of even a decade ago, the majority of agencies now charge fees for service. By 2001, about 88% of NFCC agencies were charging monthly DMP fees, a little more than half charged enrollment fees, and almost 25% were charging for counseling. The percentage charging enrollment fees, in particular, increased dramatically, from 38.3%

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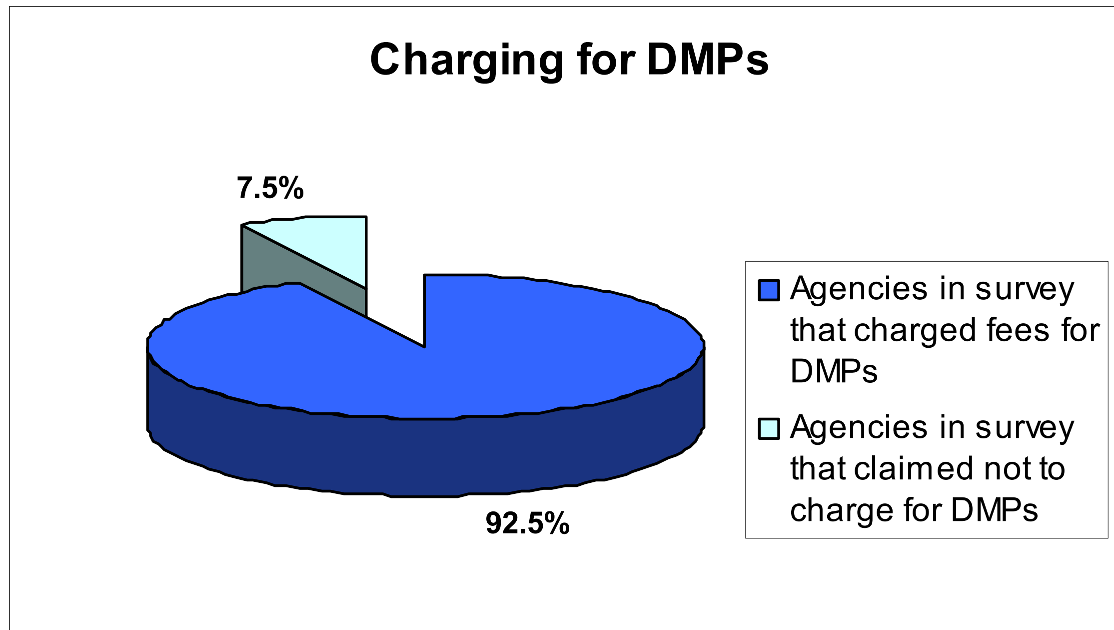
[30] See e.g., Consumer Reports, *Pushed Off the Financial Cliff*, July 2001.

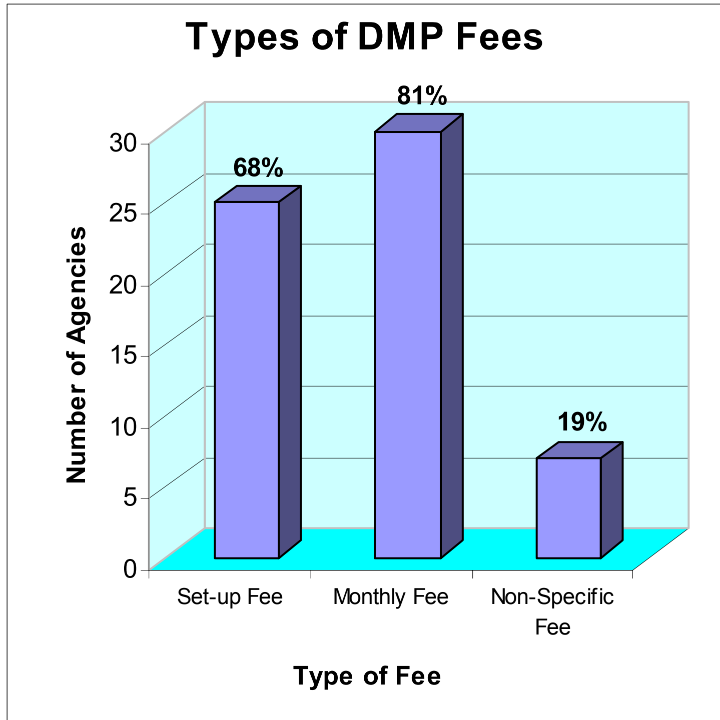
[31] This attitude is exemplified by the comments of Fritz Elmendorf of the Consumer Bankers Association to the *Chicago Tribune*: "There have been cutbacks by some banks, particularly related to general budget tightening, but also because the services were not seen as providing a direct return by lowering credit losses. At the same time there are these payment plan 'mills' coming in with lower fees than the traditional fair-share arrangements. They're trying to gain market share. They help you rehabilitate the customer, and it costs you less." Janet Kidd Stewart, *Debt Management and Counseling Services Are Multiplying as Consumer Loans Mount, But Not All Are Working in the Clients' Best Interest"*, Chicago Tribune, February 23, 2003.

in 2000 to just over half in 2001.[32] These amounts have likely increased since this data was collected in 2001.

Of forty non-NFCC agencies whose fees were examined for this report either by reading through the Internet site or through contact by phone, thirty-seven (92.5%) said they charged some type of fee for their debt management plans.[33] Of the agencies that said they charged fees, thirty (81%) acknowledged charging a monthly fee and twenty-five (68%) charged both a monthly and set-up fee. The others would not specify the types of fees charged.



[32] Statistics provided with permission from the National Foundation for Credit Counseling. Data is derived from the 2001 Member Activity Report, p. 33.
[33] Thirty of the forty non-NFCC agencies in the survey were randomly selected through an Internet search for "credit counseling organizations." The other ten were agencies that had been the topic of media reports or other consumer complaints. We gathered information from the web sites of all forty agencies, following up by phone with about half of them. In the follow-up phone calls, we did not identity ourselves as calling from a national consumer organization. We used our real names, however, and simply asked for information about their services. We asked generally about their services, about costs, and about courses, seminars and basic counseling services. The information was gathered between November 2002 and January 2003.



Graph shows agencies in survey that acknowledged charging certain fees. Many charged both a set-up and monthly fee and are counted in both categories.

The fees vary. NFCC indicates that member organizations, on average in 2001, charged about $14 for budget counseling sessions, $19 to enroll in DMPs and $12 monthly to service the DMP accounts.[34] These monthly and enrollment fees have likely increased since this data was collected in 2001.

A separate March 2003 survey of twenty NFCC affiliates throughout the country found that most agencies charge a range of monthly fees, depending on the consumer's financial situation and number of unsecured creditors. Only two agencies charged no monthly fees at all. However, an additional six of the agencies surveyed charged fees on a sliding scale, with 0 being the lowest amount on the scale. The amount of the monthly fees ranged from 0 to $50. Set-up fees were more uniform, with seventeen of the agencies surveyed charging a fixed fee that averaged $21, and ranged from 0 to $95. None of these agencies charged a full month's payment to set up the account. By comparison, only seven of the

[34] National Foundation for Credit Counseling, "Fact Sheet and Industry Background", available on-line at www.nfcc.org.

twenty agencies charged fees for budget counseling. Among these seven agencies, the average fee for budget counseling was $20.[35]

Our survey of non-NFCC agencies, described above, found a range of fees charged by these agencies.[36] The highest number of agencies (9) charged $50 to set up a plan. The second highest number (5) charged a full months payment. This latter practice has generated confusion and complaints among consumers. Many consumers report that they did not know that their first DMP payment would go to the agency rather than to creditors. Among other problems, these consumers often end up with late fees from creditors who they thought were being paid by the agencies for the first month of the DMP.[37]

Monthly DMP fees charged by the non-NFCC agencies in the study also varied. The most frequent price tag was $6 for each account in the DMP, sometimes with a ceiling of anywhere from $25 to $50/month. Some agencies charged a percentage of the consumer's total monthly DMP payment. The percentages ranged from three to ten. Others charged a set monthly amount, ranging from $10-50.

Charging modest fees is not intrinsically exploitative and may even be necessary for reputable agencies attempting to maintain their services while facing funding cuts. However, these practices raise serious questions with respect to the non-profit status of credit counseling agencies. A number of agencies appear to be charging more than is necessary to cover their expenses and to provide quality services.

[35] Fees were checked on March 25, 2003 by phone and/or Internet. Agencies serving small, medium and large towns or cities were selected within each of five regions of the country.

[36] Thirty of the forty non-NFCC agencies in the survey were randomly selected through an Internet search for "credit counseling organizations." The other ten were agencies that had been the topic of media reports or other consumer complaints. We gathered information from the web sites of all forty agencies, following up by phone with about half of them. In the follow-up phone calls, we did not identity ourselves as calling from a national consumer organization. We used our real names, however, and simply asked for information about their services. We asked generally about their services, about costs, and about courses, seminars and basic counseling services. The information was gathered between November 2002 and January 2003.

[37] As mentioned earlier, this is one of the charges in a February 2002 lawsuit filed by the Illinois Attorney General's office against AmeriDebt. See "The High Cost of Lowering Debt: Madigan Takes on AmeriDebt, Says Company Hides Fees, Fails to Send Consumers' Payments", Press Release, February 5, 2003. For further discussion of this problem, see Massachusetts Senate Committee on Post Audit and Oversight, *Losing Credibility: Troubling Trends in the Consumer Credit Counseling Industry in* Massachusetts, July 2002; Consumer Reports, *Pushed Off the Financial* Cliff, July 2001; Matthew Benjamin, *A Pricey Debt* Lesson, U.S. News & World Report, June 17, 2002; Christine Dugas, *All Debt Counselors Are Not The* Same, U.S.A Today, May 28, 2002.

Our survey of I.R.S. 990 tax reports found numerous instances of agencies reaping what appear to be windfall revenues. For example, Credit Counselors of America, based in Phoenix reported net gains of just over $6 million in their 1999 tax report; Cambridge Credit Counseling reported a net gain of about $7.3 million in a 2000 tax report and Genus Credit Management reported about $5.6 million in its 2000 tax report.[38]

The abuses that are often associated with high fees are also troubling. One serious problem is that the fees are often hidden. For example, nearly 20% of the agencies in our survey reported on their web sites or when initially contacted by phone that their services were free. In fact, all of these agencies charged for their services, only acknowledging the truth after follow-up questioning. Another common problem is that fees are not disclosed to consumers or are obscured in mounds of confusing paperwork. These allegations have arisen particularly with respect to companies that charge a full first month's consolidated payment as an enrollment fee.[39]

A second problem is that many agencies claim that the fees are not required, but are rather voluntary charitable contributions. Forty-six per cent of the agencies in our survey specifically characterized their fees in this way. Abuses associated with this practice are discussed in detail in section 4.5 below.

A third problem is simply the amount of fees. Although charging a nominal fee for a worthwhile service may be acceptable, anything beyond that amount dilutes whatever benefit consumers may be receiving and decreases their chances of successfully completing a DMP.

[38] These were the most recent tax reports for these companies available on www.guidestar.com as of January 2003.
[39] This is one of the allegations in a February 2003 lawsuit against AmeriDebt filed by the Illinois Attorney General's office. See "The High Cost of Lowering Debt: Madigan Takes on AmeriDebt, Says Company Hides Fees, Fails to Send Consumers' Payments" Press Release, February 5, 2003. See also Consumer Reports, *Pushed Off the Financial Cliff*, July 2001.

3.3 Where Have All the Services Gone?

Most of the original NFCC organizations were mutli-service agencies. They set up DMPs for clients, but also provided community seminars, diagnostic services and basic budget counseling to clients for whom a DMP was not appropriate. At least some agencies are trying to retain the non-DMP elements of their businesses. For example, of the one million households counseled by NFCC member agencies in 2001, only about one-third enrolled in DMPs. Another one-third chose to repay debt independently after counseling.[40] According to NFCC, the remaining one-third of their clients are those with more intractable problems such as gambling and other addictions, domestic problems, and mortgage foreclosures. NFCC reports that its members primarily refer these clients to other agencies (such as social service agencies) or to bankruptcy.[41]

In addition, NFCC reports that its agencies gave over 50,000 educational programs in 2001.[42] These educational programs vary in frequency. It is also very likely that they vary in quality. Most NFCC and some other agencies respond to requests for speakers on budgeting and credit use at schools and other forums. Some provide regular educational sessions, usually at their offices.[43]

NFCC in particular has tried to demonstrate the benefits of education and counseling, not only to consumers, but also to creditors. To this end, NFCC commissioned a study on the longer-term benefits of credit counseling on consumer spending and debt habits. [44] The study focuses on the behavior of consumers who are not enrolled in DMPs. According to the report, borrowers who received basic

[40] NFCC, "Fact Sheet", (2002).
[41] NFCC, "Fact Sheet and Industry Background", (2002), available on-line at nfcc.org.
[42] Id.
[43] David Lander, *There Is Another System Out There to Which Many People in Financial Trouble Turn For Relief,* Federal Judicial Center, Program for Bankruptcy Judges, 2003. Unpublished paper on file with author.
[44] See Dr. Michael E. Staten, Dr. Gregory Elliehausen, E. Christopher Lundquist, *The Impact of Credit Counseling on Subsequent Borrower Credit Usage and Payment Behavior*, Georgetown University, March 4, 2002.

counseling reduced their debt loads and improved their credit profile over three subsequent years, compared to similar borrowers who did not receive counseling.[45]

Despite these efforts, multi-service agencies are a dying breed. With respect to education, in-person presentations by NFCC members declined by 16.2% from 2000 to 2001.[46] Total attendance also decreased.[47] The multi-service agencies are also struggling to keep affordable counseling services for those consumers who are not enrolled in DMPs. Those agencies that continue to provide education and non-DMP counseling are increasingly charging for these services. Almost one-quarter of NFCC members, for example, now charge fees for the counseling services offered separately from DMPs.[48]

Although many NFCC agencies are struggling to provide free educational and counseling services, most non-NFCC agencies never offered these services in the first place. Their educational materials, if available, are almost always for sale. Our survey of non-NFCC agencies found that only five of the 40 agencies offered services unrelated to DMPs. Among this minority of agencies, four of five charged for these other services, including books and videos on debt problems.

Nearly all of the counselors at non-NFCC agencies we contacted by phone were surprised by inquires about courses or other consumer education resources. When asked this question, one counselor simply said, “We consolidate credit cards. That’s it.” Another incorrectly said that no agency in the country offers classes. Although not true at the moment, this statement may unfortunately be an accurate prediction of a future where no agency that offers worthwhile education programs can stay in business.

[45] Id.
[46] Statistics provided with permission from the National Foundation for Credit Counseling. Data is derived from the 2001 Member Activity Report. p. 8.
[47] Id.
[48] Id. at p. 33.

3.4 Problems With The "DMP Only" Business Strategy

3.4.1 Agency Reliance on DMP Revenues

The growing gap between multi-service agencies and "DMP mills" is beginning to define the industry. Among other issues, this trend highlights the inherent problem with the industry's reliance on creditor funding. The multi-service agencies are suffering not only because of the cuts in Fair Share, but also because they have been unable to diversify their funding sources. NFCC, for example, encourages its members to seek funding through government and private sector grants and contributions and from non-profit agencies such as the United Way. Despite this advice to its affiliates, in 2001, NFCC reported that about two-thirds of member agency funding in 2001 was from Fair Share payments and almost one-quarter (23.9%) from consumer fees.[49]

Our survey of selected I.R.S. 990 tax reports for both NFCC and non-NFCC credit counseling agencies found near complete reliance on Fair Share contributions and consumer fees for revenues. For example, American Consumer Credit Counseling, a Massachusetts agency, reported Fair Share and client fees in 2000 of almost $3 million. This figure plus interest revenue equaled the agency's entire revenues for that year. Consolidated Credit Corporation, based in Florida, listed about $6.5 million in revenue in 2000 as Fair Share income and about $5.8 million from "membership dues and assessments." In a later section of the tax report, the agency described "member dues" as amounts assessed to each "member" (presumably consumer clients) of the agency to participate in the programs offered.[50] It is unclear in what way clients of the agencies are "members." In any case, interest revenue added to these Fair Share and "member" fees equaled total revenues for the year. This pattern was repeated in almost every I.R.S. 990 form studied.[51]

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[49] Statistics provided with permission from the National Foundation for Credit Counseling. Data is derived from the 2001 Member Activity Report, p . 34.
[50] Credit Counselors of America in Phoenix is another agency that described "member dues" in this way in its 1999 tax report.
[51] One notable exception is that some agencies reported government funding for housing counseling.

One way to stop the trend toward DMP mills is for reputable agencies to secure other funding, such as foundation or government grants. This would allow these agencies to fund non-DMP services without using DMP-related funds. Another possible solution, discussed earlier, is for creditors to create a Fair Share system that rewards agencies that offer "full" services and products beyond DMPs and to cut funding for agencies that don't.[52]

3.4.2 Creditors Control The DMP Business

As with most businesses in a competitive market, credit counselors now compete by trying to distinguish themselves from their competitors. For example, the agencies in our survey that were contacted by phone consistently told us that they were able to get consumers a better deal than their competitors. These claims disguise the fact that the agencies actually have little control over what they can offer to consumers.

Creditors, not agencies, call the shots when it comes to concessions.[53] They rarely reduce the amount of principal that consumers owe them, never as part of a DMP. Agencies really have only three concessions to offer that creditors will allow. First, creditors can "re-age" a credit card account of a consumer who enters a DMP. This has a positive impact on the consumers' credit report, as any notation that an account is delinquent is eliminated. Most creditors will re-age an account once a year or twice in five years, the maximum allowed by federal financial service regulators. American Express, however, refuses to re-age accounts under any circumstances. Another concession that issuers generally grant is to waive or reduce fees, such as fees for late payments or for exceeding the allowable credit limit. The notable exception on this concession is Capital One, which does not waive fees for payments that are past due.[54]

[52] See §3.1.2 of this report.
[53] Information on credit concessions was provided by several credit counseling agencies, and cross-checked.
[54] Capital One does waive the payment of membership fees paid on an annual or monthly basis, as well as fees incurred for exceeding a credit line.

By comparison, creditor policies on reducing interest rates vary tremendously. Some, like Sears, won't lower interest rates at all in credit counseling.[55] Others, like Bank of America, will lower it to 0%. Most major credit card issuers have raised their interest rates in credit counseling or kept them above 9 percent in the last few years, although Chase Manhattan and Providian are notably bucking this trend. As with the Fair Share contribution, some creditors are now offering a range of interest rates to consumers, depending on their financial condition.

Below are the current interest rates for major credit card issuers, as well as the interest rate concessions that were offered in July of 1999:

Creditor	**Current Interest Rate**[56]	**Previous Interest Rate**[57]
Citibank	9.9%	9.9 %
Bank One Corp/First USA	11.0	6.0
MBNA America	15.9[58]	15.9
Discover	17.99[59]	9.9
Chase Manhattan	7.0	6.0
Bank of America	0.0	0.0
Providian Financial Corp	8.0	12.0
Capital One Financial Corp	15.9[60]	19.8
Fleet Boston Financial Corp	9.99	9.5
Household Credit	9.0	9.0
Wells Fargo Bank	14.0	10.0
Sears	No reduction	No reduction
American Express Optima	No reduction [61]	21.7

[55] The only circumstance in which Sears will reduce the interest rate is if the consumer is paying a 24 percent rate and is "at risk." In that case, the rate is lowered to 21%.
[56] As reported by several credit counseling agencies and confirmed by the Consumer Federation of America, February, 2002.
[57] "Large Banks Increase Charges to Americans in Credit Counseling," Consumer Federation of America, July 28, 1999
[58] The rate can be less than 15.9% depending upon examination of the debtors' finances by MBNA.
[59] This is the highest rate that will be assessed. Discover sets different rates for different consumers, but will always set a lower rate than that originally received by the consumer.
[60] If account is opened at a lower rate, that rate is retained.

3.4.3 The "DMP Only" System Hurts Consumers

The main problem with the "DMP only" approach is that it is not the best fit for many consumers. DMPs tend to be most effective for consumers with short-term debt problems. Consumers with poor money management skills may also benefit. However, consumers with long-term financial problems that can be attributed to a range of complex and often intractable causes are less likely to benefit from the limited concessions creditors offer through DMPs.

Despite the critical importance of matching consumers with appropriate debt counseling and budgeting services, statistics showing whether consumers who are ill suited for DMPs stay on the three to five year plans are difficult to find. Most agencies do not release information on their retention rates,[62] although a 1999 NFCC memo cited by Consumer Reports found that just 21% of their clients completed DMPs while about the same percentage left to self-administer debt payments.[63] NFCC now reports completion rates of about 26% with about 20% leaving for self-administration.[64]

CREDIT COUNSELING VS. BANKRUPTCY: UNDERSTANDING THE CHOICES

The choice between a DMP and bankruptcy is rarely simple as illustrated by the examples below developed by David Lander, a bankruptcy attorney in St. Louis.[1]

Consumer 1 *appears to have enough excess revenue to pay her bills, but could use some interest reductions, installment payments and a bit of counseling.*

Strategy: She should consider getting credit counseling advice from a reasonably priced and effective credit counseling agency or from a religious or social service organization. A reputable counseling agency would determine if she can pay her bills herself after a counseling session or whether she should enter a DMP. Depending upon the size of her debts and her income and personal philosophy, she may wish to pursue a bankruptcy. Ideally a bankruptcy lawyer or counselor would evaluate her level of debt, advise her of the debt counseling option and help her make an informed decision.

[1] See David Lander, *Snapshot of an Industry in Turmoil: The Plight of Consumer Debt Counseling*, 54 Consumer Fin. L.Q. Rep. 330 (Fall 2000).

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[61] American Express will not reduce the interest rate while a consumer is in a DMP. However, when a consumer completes paying back the entire amount originally owed to American Express, all interest accumulated after the consumer entered the DMP is refunded.

[62] At least one exception to this trend is Cambridge Credit Counseling, which has publicly released some information regarding DMP retention rates after six months, one year and two years.

[63] Consumer Reports, *Pushed Off the Financial* Cliff, July 2001.

[64] Statistics provided with permission from the National Foundation for Credit Counseling. Data is derived from the 2001 Member Activity Report, p. 25.

The high failure rate in DMPs is undoubtedly influenced by the limited concessions that creditors now offer to consumers who enter credit counseling. If consumers cannot significantly lower the amount that they owe, they are more likely to fail in completing a three to five-year DMP.

A 1999 nationwide survey of credit counseling agencies by Visa found that one-third of those who dropped out of DMPs (34.3 percent) said they would have stayed on if creditors had waived or reduced additional interest or fees. Close to half of the clients who dropped off a DMP (41.8 percent) had either filed or were going to file bankruptcy. Nearly half of these consumers said they would have been able to stay out of court with improvements in the DMP process.[65]

The rush to a DMP often means that consumers rarely receive advice on all available options. Among other problems, many agencies fail to adequately counsel consumers that DMPs include unsecured debt only. In our phone survey, only one counselor affirmatively pointed out that a DMP never includes secured debt. This is a critical issue because consumers with sparse resources should be focusing on paying back secured debt, such as home and car loans rather than unsecured credit card debt.

CREDIT COUNSELING VS. BANKRUPTCY: UNDERSTANDING THE CHOICES

Consumer 2 *appears to have enough revenue to pay his current operating expenses with some left over to take care of past bills. But too many of his creditors are demanding full payment of past due bills and the penalty interest rates are becoming unaffordable. He also needs some budget counseling.*

Strategy: He has several choices. He may consider a Chapter 7 or Chapter 13 bankruptcy, depending on what assets he wishes to protect and what types of debt he needs to discharge. He also might want to consider consulting a reputable credit counseling agency. The credit counseling service may be able to help pressure creditors to reduce the default interest rates and put him on a consolidated payment plan to catch up on all unsecured debt.

Consumers also need to know whether the DMP will include all of their unsecured debt. Many agencies will only include credit accounts for creditors with whom they have arrangements. It is therefore possible that consumers will have to make one payment to a credit counseling agency to pay off most of their unsecured debts while still having to pay other unsecured creditors separately. Most of

[65] *Credit Counseling Debt Management Plan Analysis*, Visa U.S.A. Inc., January 1999. A representative sample of 481 consumers who dropped off a DMP was surveyed.

the convenience associated with a DMP is wiped out if consumers have to contact creditors on their own**.**

The low overall retention rates cited above indicate that a number of consumers who will not benefit from a DMP are nonetheless irresponsibly steered into these plans. In many cases, a consumer's debt burden is too great and her financial resources too limited to support a DMP. Bankruptcy may be the best option for these consumers. Yet, credit counseling agencies are generally loath to discuss bankruptcy with consumers since they do not make any money on these consumers. One agency, for example, claims to give two words of advice about bankruptcy--Don't File!

This characterization of bankruptcy as a "last resort" is oversimplified. While many consumers benefit from avoiding bankruptcy if possible, others in serious financial condition lose important legal rights by delaying a bankruptcy filing. For many consumers, the benefits of bankruptcy outweigh its costs. In fact, a DMP is very similar to a chapter 13 bankruptcy "reorganization", through which a consumer submits a plan to repay creditors over time. The critical difference is that Chapter 13 plans allow consumers with sufficient income to pay back

CREDIT COUNSELING VS. BANKRUPTCY: UNDERSTANDING THE CHOICES

Consumer 3 *lives in an apartment and does not own a car. She has enough money to pay her current living expenses, but not enough to pay old credit card and large hospital bills.*

Strategy: She appears to be a prime candidate for a Chapter 7 bankruptcy. She needs the discharge of unsecured debts that the bankruptcy provides, but does not need the special help that Chapter 13 provides. Unless she has other reasons for filing a Chapter 13, chapter 7 seems the best choice.

Consumer 4 *owns a house and car. He is several months behind on his house payments and car payments and is in danger of losing both. He has enough money to pay the current house and car payment and other current living expenses, and perhaps enough to make up past due house payments, but not much more.*

Strategy: He is a prime candidate for a Chapter 13 bankruptcy. He needs the discharge of debts that only Chapter 13 can provide. He needs to restructure the debt on his car so he has time to catch up on his house payment. Credit counseling or Chapter 7 bankruptcy is not useful for him for a number of reasons. He does not have any unsecured debt that could be paid back at a reduced rate in credit counseling or discharged in Chapter 7 bankruptcy. Chapter 7 will not help restructure the debt on the car and allow him to keep the car and it cannot keep the mortgage lender from foreclosing on his home while he catches up on payments.

Credit counseling will not be useful for consumers 3 and 4 primarily because every dollar spent on paying unsecured debt increases the risk that they will lose secured property, such as their homes or cars.

secured as well as unsecured creditors. For consumers trying to hold on to their homes or cars, this is a critical distinction.

DMP administration is also an area of significant abuse. Agencies have been accused of failing to remit payments on time or in some cases failing to remit the money at all.[66] In some cases, the agencies send in payments on their own schedules rather than the consumer's schedule so that the consumer is hit with a late fee for each account every month. When the consumer goes back to the agency for help, many inform consumers that they need to deal with the customer service departments of each creditor on their own.[67] In other cases, the agency is simply inefficient in sending money to the creditors.[68]

4. Credit Counseling Agencies and Non-Profit Status: Abuses of the System

4.1 The Marketing of Non-Profit Status

One of the inherent contradictions in the credit counseling industry is that the more the agencies engage in competition, the more they behave like for-profit businesses. Yet nearly every agency in the field is a non-profit.[69] This raises fundamental questions about the nature of the industry. The truth is that non-profit status has been abused to such as extent in this industry that it is virtually meaningless.

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[66] This is one of the charges in a February 2002 lawsuit filed by the Illinois Attorney General's office against AmeriDebt. See "The High Cost of Lowering Debt: Madigan Takes on AmeriDebt, Says Company Hides Fees, Fails to Send Consumers' Payments", Press Release, February 5, 2003. For further discussion of this problem, see Massachusetts Senate Committee on Post Audit and Oversight, *Losing Credibility: Troubling Trends in the Consumer Credit Counseling Industry in* Massachusetts, July 2002; Consumer Reports, *Pushed Off the Financial* Cliff, July 2001; Matthew Benjamin, *A Pricey Debt* Lesson, U.S. News & World Report, June 17, 2002; Christine Dugas, *All Debt Counselors Are Not The* Same, U.S.A Today, May 28, 2002.

[67] Consumer Reports, *Pushed Off the Financial* Cliff, July 2001; Christine Dugas, *All Debt Counselors Are Not the* Same, U.S.A. Today, May 28, 2002; Matthew Benjamin, *A Pricey Debt* Lesson, U.S. News & World Report, June 17, 2002.

[68] See Consumer Reports, *Pushed Off the Financial Cliff,* July 2001.

[69] Non-profit status is technically a state law concept, making an organization eligible for certain benefits, such as state sales, property, and income tax exemptions. Although most federal tax-exempt organizations are non-profit, organizing as a non-profit at the state level does not automatically grant the organization exemption from federal income tax. In this section of the report, we focus on how organizations qualify as federal tax-exempt organizations. The terms "tax-exempt" and "non-profit" organizations or corporations are used interchangeably even though there are some differences between them. For

Credit counseling agencies seek (and get) federal 501(c)(3) tax exempt status for a variety of reasons. Tax-exempt 501(c)(3) status makes them eligible for exemptions from federal and state corporate income taxes. Most states automatically allow corporations that qualify for federal tax-exempt status to also qualify for state tax exemptions. This status is required to receive many public and private grants. In addition, individual and corporate donors may receive tax deductions for gifts to tax-exempt nonprofit corporations.[70] Another advantage is that the directors, trustees, officers, and employees of non-profit corporations are shielded from personal liability for corporate debts or liabilities.[71]

Agencies also seek non-profit status to comply with applicable state laws. As discussed below, most state laws that regulate debt management services exempt at least some non-profit organizations.[72] Other states restrict debt management services in the state to non-profits. In addition, creditors have traditionally required non-profit status to initiate Fair Share plans.

Perhaps most important, agencies use non-profit status as a marketing tool. They promote the non-profit label as a mark of respectability, appealing to consumer trust that non-profit organizations are "above-board" and about more than just making money.

It is easy to see why agencies seek tax-exempt status. The real mystery is how they get it. One of the greatest abuses in the industry, discussed in detail below, is that many of the non-profit credit counseling organizations now operating should never have received this certification.

more information, see Internal Revenue Service, "Charities and Non-Profits", and I.R.S. Publication 557, *Tax-Exempt Status for Your Organization*, available at www.irs.gov.

[70] An individual donor may claim a personal federal income tax deduction for contributions made to a 501(c)(3), up to 50% of the donor's adjusted gross income in any year. Corporations may make deductible charitable contributions of up to 10% of their annual taxable income. See Internal Revenue Service, *Charitable Contributions*, Publication 526 (December 2000); Internal Revenue Service, *Corporations*, Publication 542, both available on-line at www.irs.gov.

[71] See generally Internal Revenue Service Publication 557, "IRS Tax-Exempt Status for Your Organization", available at www.irs.gov; Anthony Mancuso, How to Form a Non-Profit Corporation, Nolo (5th ed. 2002).

[72] See §6.2.2 of this report.

4.2 Steps to Non-Profit Status

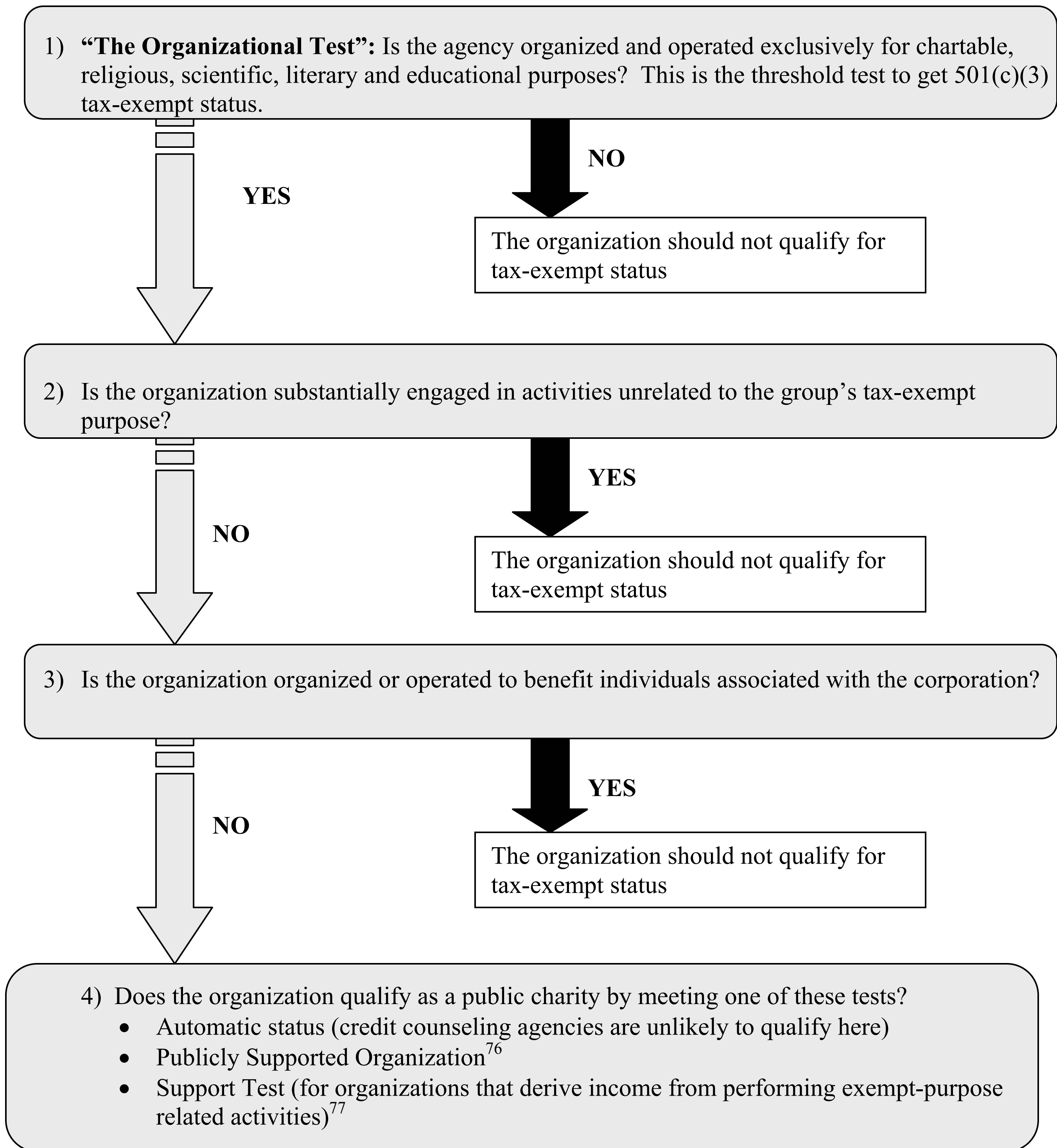
Organizations are required to meet a number of tests in order to qualify for federal tax-exempt status. The Internal Revenue Code section 501(c)(3) exempts from payment of federal taxes groups organized and operated exclusively to accomplish permissible charitable, education, religious, literary or scientific purposes.[73] Organizations must limit their purposes to one or more of these categories and must not engage, other than as an insubstantial part of their activities, in activities that do not further one or more of these purposes.

Agencies that meet the charitable or educational purpose test may still violate IRS regulations if they are organized or operated to benefit individuals associated with the corporation including directors, officers or members.[74] This is also known as the ban on private inurement, discussed in greater detail below.

Agencies that pass the tests discussed above should be eligible for federal 501(c)(3) tax status. But this is not the end of the story. There are two types of 501(c)(3) statuses—public charity and private foundation. Most non-profit credit counseling agencies also seek public charity status because public charities face far fewer I.R.S. restrictions.

There are two main ways to qualify for public charity status.[75] The first requires an organization to prove that a substantial portion of its funding is from public support. Normally, to meet this test, an organization must receive at least one-third of total support from governmental units and/or public contributions. In general, revenues from tax-exempt services are specifically not counted as public support.

[73] 26 U.S.C. 501(c)(3).
[74] 26 U.S.C. 501(c)(3).
[75] There is also an automatic public charity status that applies mainly to churches, schools, hospitals, and public safety organizations and certain government organizations. 26 U.S.C. §509(a)(1). Credit counseling agencies should not be eligible for this automatic status.



4) Does the organization qualify as a public charity by meeting one of these tests?
- Automatic status (credit counseling agencies are unlikely to qualify here)
- Publicly Supported Organization[76]
- Support Test (for organizations that derive income from performing exempt-purpose related activities)[77]

There are a few additional restrictions, not discussed in this chart, primarily related to limits on political activities.

[76] 26 U.S.C. §509(a)(1).
[77] 26 U.S.C. §509(a)(2).

Because credit counseling agencies rely almost exclusively on consumer fees and Fair Share contributions for revenue, they generally should not qualify under this public support test. Most reputable agencies caught in this bind should be able to get public charity status under the second test—the support test. This test applies to organizations that derive income from performing tax-exempt services. If an organization's services are classified as related to tax-exempt purposes, they will likely meet this test. However, it is far from clear, as discussed below, that DMP services should qualify as tax-exempt services, particularly when they are the only (or primary) services offered.

4.3 Do Credit Counseling Agencies Serve Educational or Charitable Purposes?

Organizations are exempt from payment of federal taxes if they are organized and operated exclusively to accomplish charitable, educational, religious, literary or scientific purposes.[78] Due to the broad interpretations of these standards, the I.R.S. and the courts have historically found that credit counseling agencies meet this threshold test. However, the primary decisions on this issue were made in the 1960's and 1970's, long before many industry players became "DMP mills." [79]

Agencies continue to take great pains to characterize themselves as community charities on their I.R.S. 990 forms. Presumably the agencies realize that focusing on educational and counseling services on their tax reports is more appropriate for a non-profit organization than emphasizing DMP sales.

A recent state property exemption case examined some of the reasons why agencies that primarily sell DMPs may not be considered charitable organizations.[80] In deciding that the agency was not entitled to a charitable property tax exemption, the Supreme Judicial Court of Maine found that the NFCC member agency provided benefits to creditors that were not merely incidental to its charitable

[78] 26 U.S.C. §501(c)(3).

[79] For example, in a key 1978 decision, the U.S. Tax Court disagreed with the I.R.S's revocation of tax-exempt status for a credit counseling agency. Consumer Credit Counseling Service of Alabama, Inc. v. U.S., 78-2 U.S.T.C. P 9660, 1978 WL 4548 (D.D.C. 1978). The court was persuaded that the agency's DMP services were merely "adjunct" to its counseling functions. The court also considered the fact that the agency charged only a nominal fee and that the community education and counseling assistance programs were the agency's primary activities.

[80] See Credit Counseling Centers, Inc. v. City of South Portland, 814 A. 2d 458 (Maine 2003) (NFCC affiliated agency was not entitled to state charitable property tax exemption).

purposes. The court noted the magnitude of the amounts collected for creditors and that the creditors returned a percentage to the agency as Fair Share.[81]

Federal and state regulators should also be raising the concerns expressed by the Maine court. The I.R.S.'s historically broad interpretation of "charitable purposes" is outdated. The agency must begin to focus on the reality of the industry, not just on what the agencies report on paper. The I.R.S. should look not only at whether an agency provides a range of services, but whether the principal purpose of the agency is truly to counsel and educate consumers regardless of whether they are enrolled in a DMP. Successfully weeding out disguised for-profits would not eliminate every player in the industry, just those that primarily sell DMP services. An agency that truly offers a range of services benefiting the community and consumers and does not merely sell DMPs, should qualify in most cases.

4.4 Ties to For-Profits and Excess Compensation

Agencies that meet the charitable or educational purpose test may still violate IRS regulations if they are organized or operated to benefit individuals associated with the corporation including directors, officers or members.[82] This is also known as the ban on private inurement.

It appears that the ban on private inurement is violated by some agencies. Numerous media reports during the past few years have documented these abuses, including lavish salaries for agency directors and self-dealing in purchasing real estate and in creating close connections with for-profit businesses such as lenders or payment servicers.[83]

Many agencies do not even try to hide connections to for-profit businesses. One counselor in our survey specifically told us that his agency could help a consumer get a loan and pay off the balance on unsecured debt after only seven months on a DMP. He said that the agency refers consumers to lenders. Other agencies include links to lenders and other businesses on their web sites. It is unclear to

[81] A dissent by Judge Dana argues that any benefit provided to creditors is incidental and that is not clear in any case that creditors receive a benefit since they receive only a portion of the money already owed to them. See Id.
[82] 26 U.S.C. 501(c)(3).
[83] See §2 of this report for more detail on these media reports.

what extent improper affiliations with for-profit businesses permeate the industry. The media has reported what may simply be the tip of the iceberg.

In addition, we found a number of questionable practices related to compensation of company officers and employees. For example, Cambridge Credit Counselors reported in 2000 paying President and Director John Puccio $312,000 plus nearly $80,000 in benefits. Director Richard Puccio received the same compensation. Each also received separate compensation from a related organization, Brighton Credit Corporation, of $156,000, while John Puccio received an additional $26,000 from Debt Relief Clearinghouse, yet another related organization. The company also reported paying its general manager a salary of $394,122 plus benefits and its sales manager just over $150,000 plus benefits. Another Massachusetts-based agency, American Consumer Credit Counseling, reported in 2000 paying its president a salary of $462,350 plus just over $130,000 in benefits. Genus Credit Management, in 2000 reported a lower, but still lavish sum of $246,000 for its Chairman. Phoenix-based Credit Counselors of America reported compensation in 1999 for its President Michael Hall of $371,542 plus benefits while Florida-based Consolidated Credit Counseling reported paying its Director/President in 2000 a salary of $275,000 plus benefits with just over $170,000 in compensation provided to the company vice-president. For comparison purposes, *BusinessWeek* reported in 2001 that the average top salary nationally for comparable non-profits was $134,000.[84]

NFCC agencies were not immune from this overcompensation trend. In its 2001 tax report, the Foundation reported paying its former president and CEO Durant Abernethy $365,695 plus benefits. There was a wide range in salaries paid by NFCC member agencies in our survey, with most salaries at lower levels than those above. There were some exceptions, however, such as Consumer Credit Counseling of Greater Atlanta (with 2001 compensation for its President at $173,600 plus benefits) and

[84] Christopher H. Schmitt with Heather Timmons and John Cady, *A Debt Trap for the* Unwary, Business Week, October 29, 2001.

Consumer Credit Counseling of Massachusetts (with 2001 compensation for the Chief Executive Officer at $198,800 plus benefits and $191,244 plus benefits for the Chief Operating Officer).

Nonprofit organizations that pay compensation that is far higher than that paid by comparable organizations in the same geographical area for directors or others who are performing comparable services may be paying unreasonable or excessive compensation in violation of §4598 of the Internal Revenue Code.[85] Payment of excess compensation is just one kind of excess benefit transaction that may subject an offending organization to sanctions. This is often referred to as the "intermediate sanctions" rule. Before this rule was implemented in the 1990's, the primary way the I.R.S. could penalize an agency for improper payments was to revoke its exemption. The relatively new rule gives the I.R.S. an intermediate option, allowing the agency to impose a tax on "disqualified persons" on the "excess benefit" they have received from an "excess benefit transaction."[86] A tax is also imposed on board members who approved the transaction knowing it was an excess benefit transaction.

It is essential for the I.R.S. to use this intermediate sanction authority in addition to its authority to revoke exemptions in order to restore respectability and legitimacy to the credit counseling industry.

4.5 Characterizing Fees and Contributions as Donations

The agencies aggressively advertise that contributions to them are tax-deductible. In fact, one counselor specifically told us that it's better to do business with a non-profit because of the tax benefits to creditors and consumers. According to this counselor, the tax benefits explain why creditors agree to work with the agencies.

This basic scheme is really a sham. In truth, these consumer fees are generally not voluntary and not donations. A number of counselors in our survey acknowledged that consumers don't have to pay

[85] 26 U.S.C. §4958.
[86] An excess benefit transaction is one in which a disqualified person receives more from a 501(c)(3) nonprofit than she provides to the organization. A "disqualified person" is defined as any person who is in a position to exercise substantial control over the affairs of the organization. In general, reasonable compensation is defined as the value of services that would ordinarily be paid for like services by like enterprises under like circumstances. See 66 Fed. Reg. 2144 (January 10, 2001). See generally, "Expansion on §4958 (The "Intermediate Sanctions" Rule")", available at www. Guidestar.com.

the fees, but told us that most do. "How else can we stay in business?" they asked us repeatedly. Given this pressure, how many consumers will truly resist paying "voluntary fees"?

Even if voluntary, these fees are not properly classified as charitable contributions. The basic tax rules for charitable contributions state that a consumer or corporation can deduct only the amount of a contribution that is more than the value of the benefit received.[87] Creditors and consumers that are paying fair market value for a service from the agency should not be able to classify these as donations even if the agency is in fact a qualified 501(c)(3) organization.

Characterizing creditor contributions as donations may be even more misleading. The reality is that creditors pay a Fair Share to these agencies because the agencies are helping creditors to collect debts. It is also deceptive to characterize Fair Share contributions as voluntary. The industry standard is that agencies propose the DMPs to creditors and creditors pay for them. It is a business arrangement, not a charity.

The industry disputes this interpretation. NFCC, for example, emphasizes that Fair Share is a voluntary contribution by creditors and that no contract exists between the agencies and the creditors. Although this may be technically true, the reality of the industry is that agencies expect payments from creditors for DMPs and creditors expect to pay. This is evident in the I.R.S. 990 reports of many agencies. Credit Counselors of America in its 1999 tax report, for example, describes Fair Share revenue as "…fees charged to banks, credit card companys and other creditors on payments collected from members that are then distributed to the members' creditors." The agency is honestly describing the way these programs generally work---the agencies propose DMPs and both the agencies and creditors expect that the creditors will return a portion of the amounts distributed to the agencies. These are "fees charged" to the creditors, not donations from the creditors.

[87] IRS Publication 526 (12/00), available at www.irs.gov.

5. Implications of Proposed Changes to Bankruptcy Law and State Credit Counseling Mandates on the Credit Counseling Industry

If pending federal bankruptcy legislation is enacted into law—which has nearly happened three times in the last five years—the rising tide of Americans seeking credit counseling will become a flood. The legislation would require debtors to receive a credit counseling "briefing" within six months before filing for personal bankruptcy and to complete a credit counseling instructional course before receiving a discharge.[88] Although some debtors who declare bankruptcy now seek credit counseling first, the legislation is likely to dramatically increase the number of Americans in credit counseling. More than 1.5 million people declared personal bankruptcy in 2002.[89]

The proposed legislation requires bankruptcy trustees and administrators to scrutinize agencies before allowing them to offer credit counseling. Among other things, agencies are required to:

- Maintain nonprofit status;
- Provide "adequate counseling";
- Assist consumers without regard to their ability to pay. If the agency charges a fee, it must be "reasonable";
- Fully inform consumers of their fees, funding sources, counselor qualifications and the possible impact of credit counseling on credit reports. Counselors must be adequately trained and not be paid more for placing consumers in a DMP; and
- Safeguard client funds, through employee bonding and an annual audit.

Unless these requirements are rigorously enforced on a continuous basis, it is quite possible that a new bankruptcy law will only exacerbate the serious problems that currently exist in the credit counseling industry. Although the legislation clearly seeks to ensure some measure of quality with respect to credit counseling agencies by requiring them to be approved by bankruptcy trustees or administrators, it would not authorize funds to investigate these agencies, their fees, practices or success rates. This will make it much harder to prevent shady operators from getting placed on the approved list

[88] Section 106, H.R. 975.
[89] Administrative Office of the U.S. Courts

maintained by the courts and trustees and to ensure ongoing compliance by these agencies. Meanwhile, the hundreds of thousands of new consumers who are required to seek credit counseling could be harmed. If agencies don't comply with these requirements, the bill would give bankruptcy officials very little power to sanction them (only actual consumer damages or court costs could be levied as fines) other than removal of the agencies from the list of approved credit counseling organizations.

States are also increasing traffic at credit counseling agencies by imposing counseling mandates or requiring the disclosure of credit counseling options to consumers. New York state, for example, does not allow lenders to offer high-cost mortgage loans unless they provide a notice urging the potential borrower to consider consulting "a qualified independent credit counselor or other experienced financial advisor" and a list of approved counseling agencies.[90] Florida law allows consumers who cannot repay a payday loan to obtain a 60-day repayment grace period, but only if they successfully complete credit counseling by an approved agency during that period.[91] Illinois regulations require payday lenders to provide information about the availability of credit counseling to consumers who obtain a loan or are in arrears on a loan.[92]

6. WHAT IS BEING DONE TO REGULATE THE INDUSTRY?

6.1 Federal Regulation

6.1.1 Federal Laws

There is no comprehensive federal regulation of the credit counseling industry. The closest federal requirement is the Credit Repair Organizations Act (CROA), Congress' response to abuses in the credit repair industry.[93] Many credit counselors also offer credit repair services as defined in the statute.

[90] Section 6-1(1) of the Banking Law of New York State, which takes effect on April 1, 2003.
[91] Fla. Stat. Ann. §560.401 et. seq.
[92] Regulation 110.350 of the Illinois Department of Financial Institutions.
[93] 15 U.S.C. §1679 et seq.

However, because the CROA specifically does not apply to tax-exempt 501(c)(3) organizations, it is generally inapplicable to the consumer credit counseling industry.

The CROA is relevant as a framework for building similar regulations that apply specifically to credit counseling agencies. As discussed in detail below, the comparable law for credit counselors should differ from the CROA in one critical respect—it should apply universally to both for-profit and non-profit organizations that provide DMP services.

6.1.2 I.R.S. Role

The Internal Revenue Service has the power to revoke 501(c)(3) status from agencies that do not qualify. It also makes the decisions whether to grant the status in the first place and whether to penalize the agencies with intermediate sanctions as discussed above.[94]

The I.R.S. recently issued a report examining abuses in the credit counseling and credit repair industries.[95] However, it is unclear to what extent the agency has followed up on the report by beginning to weed out credit counseling agencies that do not meet 501(c)(3) standards. Nor has the IRS taken action regarding agencies that have allegedly funneled income to affiliates by entering into above-market contracts for various types of services.

6.2 State Regulation

6.2.1 State Regulation of Non-Profits

The states have a number of important roles to play. In addition to the I.R.S., the states are the primary regulators of charitable nonprofit corporations. States vary widely in how they regulate charities. Some have special charity divisions within the offices of the attorneys general. Others have separate state agencies to handle charitable registration and reporting, while enforcement is within the

[94] See §4 of this report.
[95] Debra Cowen and Debra Kawecki, "Credit Counseling Organizations", CPE 2004-1 (January 9, 2003). As of Feburary 2003, available at www.irs.ustreas.gov/pub/irs-tege/eotopica04.pdf.

attorney general office. Most states also have separate reporting requirements for non-profit corporations.

In most states, the Department of Revenue or Banking or similar agency has the power to deny an organization's application for a state sales tax exemption, regardless of whether the agency is exempt from paying federal income taxes. Some of these state agencies have in fact denied the petitions of credit counseling agencies, but most have not.[96] However, the vast majorities of states do little enforcement and routinely approve state exemptions for organizations that have met federal standards. More state oversight in this area is necessary and critical.

6.2.2 Debt Management Laws

Although the majority of states already have laws on the books that regulate credit counseling agencies, few of these laws directly address the abuses cited in this report. Nearly all of the existing laws focus almost exclusively on debt management plan (DMP) practices. This is also referred to as debt or budget adjusting or debt prorating. With notable exceptions, these state laws are generally ineffective and/or under enforced.

Even if properly enforced, many of these laws do not go far enough in regulating agency practices or contain too many loopholes. For example, about half of the states require some type of licensing for agencies providing debt management services. As detailed in the map below, about three-quarters of these states exempt at least some non-profit organizations from the licensing or registration requirements. Most of the state laws include an explicit exemption for non-profits and others such as attorneys and escrow agents. A minority of the states that require licensing implicitly exempt certain non-profits by defining the practice of debt management to include only those organizations that charge fees for services. In these states, the small sector of credit counseling agencies that do not charge fees for DMPs appear to be exempted from licensing and any other regulation. A minority of states restricts

[96] See, e.g., Consumer Credit Counseling Service of the Florida Gulf Coast, Inc. v. State of Florida, Department of Revenue, 742 So. 2d 259 (App. Fl. 1997).

debt management business in the state to non-profits and requires these non-profits to be licensed. The states with dots in the map below include all states that exempt non-profits from licensing requirements, whether explicitly or implicitly.

State Licensing or Registration Requirements

Shaded states are those with licensing or registration requirements. States with stripes have licensing or registration requirements, but exempt some non-profit organizations from these requirements. Unshaded states are those with no licensing or registration requirements.

[1] The law in Louisiana is unclear. Louisiana has two laws governing debt adjusting that contradict each other. One law generally prohibits for-profit debt adjusting, but exempts non-profit organizations. A second law allows financial planning and management services (similar to debt adjusting), but requires the agencies to be licensed. Non-profits engaging in debt management services are exempted from the licensing requirement.

[2] South Carolina limits debt adjusting for a fee to licensed attorneys.

[3] Michigan: Certain organizations receiving compensation from the government or from tax-exempt foundations may apply for an exemption from the licensing requirements upon a showing of safeguards in the handling of debtor's funds.

A key problem with these licensing provisions is that they rely on non-profit status to ensure some level of quality. Allowing non-profits to avoid licensing or other regulation may be effective for reputable agencies. However, for the most part, no distinction is made between reputable multi-service agencies and "DMP only" agencies that slide through the under-enforced I.R.S. and state tax exemption system. A few states, such as Connecticut, do make this distinction, limiting the business of debt management to "bona fide nonprofit organizations."[97] These organizations are defined in the Connecticut law as those in which no one in the organization profits financially other than receiving reasonable salaries if applicable and which provide services at no cost or at a cost not exceeding that required to defray necessary, reasonable and bona fide expenses. Most states do not qualify the term "nonprofit" in this way. Thus, even strong state laws are weakened by assuming that non-profit status helps provide quality control.

The stronger state laws provide regulation beyond licensing and/or registration. The most common substantive regulations include fee limits, requirements that consumers be given written contracts and that agencies maintain consumer payments in separate trust accounts. In addition, most of the states that require licenses also require agencies to post bonds.

With only a few exceptions, most of the states that have licensing requirements also limit the fees that licensed agencies are allowed to charge. Fee limits vary from state to state. Some states set very specific amounts for start-up and monthly fees. Arizona, for example, sets a ceiling of $39 for retainers and a monthly limit of three-quarters of 1% of the consumer's total indebtedness or $50, whichever is less.[98] Certain out of pocket expenses may also be charged with debtor approval.[99] California caps fees for enrollment (a one-time fee) at no more than $50 for education and counseling combined in connection with debt management or debt settlement services and a monthly sum not to

[97] See Ct. Stat. Ann. §36a-655 et seq.
[98] Az. Stat. §6-702 et seq.
[99] Id.

exceed 6.5 percent of the money disbursed each month, or $20, whichever is less.[100] Other states use percentage limits for monthly fees, based on the level of the consumer's indebtedness (compared to income) or of the total amount of the monthly DMP payment. The percentages allowed are as high as 12 or 15 in some states. In other states, a maximum dollar cap is used.[101] At least a few states simply limit fees to bona fide and reasonable costs.[102]

About twenty states take a different, generally less restrictive approach. Most of these states generally prohibit debt adjusting (or consolidation). On the surface, these complete prohibitions on debt management or debt adjusting seem exhaustive. The reality is that every state that bans debt adjusting also provides a long list of exceptions. Most important, nearly all of these states exempt non-profit agencies from the general ban on debt adjusting. Some only exempt non-profits that do not charge for their services or that charge only nominal fees, thus indirectly regulating the fees that even non-profits can charge. A minority of the states that do not require licensing have enacted fee limits or other restrictions on agency behavior.

In addition to the debt management or debt adjusting laws, other state laws such as unfair and deceptive acts and practices (UDAP) and state credit repair laws should also apply to credit counseling agencies. Case law among the states varies with respect to whether UDAP laws cover non-profit organizations, but they should apply in most states.[103] Loan broker laws may apply as well.

State laws that prohibit the unauthorized practice of law may also affect some agencies. Some of these laws may restrict or prohibit non-attorney credit counselors from advising a consumer regarding bankruptcy or even just regarding basic budget concerns. What is authorized in one jurisdiction may be

[100] Cal. Fin. Code §12100 et seq.
[101] For example, New Jersey sets a limit of no more than $15/month and Tennessee no more than $20. N.J. S.A. §2C:21-19 et seq.; Tenn. C.A. §39-14-142 et seq.
[102] See, e.g., Connecticut's law at §36a-655 et seq.
[103] See National Consumer Law Center, Unfair and Deceptive Acts and Practices §2.3.5 (5th ed. 2001 and Supp.). Although there is some question whether the FTC Act applies to non-profits, the agency has been involved at various points in regulating credit counseling agencies and should be encouraged to continue oversight. In particular, non-profit organizations that are really engaged in profit-making enterprises should be covered by the FTC Act. See, e.g., Community Blood Bank, Inc., 405 F.2d 1011 (8th Cir. 1969).

expressly forbidden in another. Despite the variations, a few common themes emerge. For example, most states allow nonattorneys to make legal forms available to consumers and to complete those forms at the direction of the consumer. On the other hand, most states do not permit nonattorneys to give legal advice pertaining to the particular facts of an individual's case.[104]

6.3 Industry and Creditor Self-policing

The two main industry trade associations, NFCC and AICCCA, have both developed best practices standards and accrediting procedures. The Council on Accreditation (COA) is an independent non-profit organization that accredits over 4,000 programs throughout the U.S. and Canada, including nearly 200 credit counseling services, both NFCC and non-NFCC. NFCC certifies that all of its members are accredited by COA.

Minimum requirements for COA accreditation include:

- Members must demonstrate that they provide credit counseling services according to best practices standards.
- Members must hold all applicable licenses required by the state and locality in which they operate.
- Members must have engaged in providing services for at least one year at the time of an initial site visit.[105]

NFCC lists a number of specific best practice standards that are evaluated as part of the accreditation process including:

- annual audits of operating and trust accounts,
- licensing, bonding, and insurance requirements,

[104] These prohibitions apply only to nonattorneys who are not agents of licensed attorneys. See generally Deanne Loonin, Kathleen Michon, and David Kinnecome, *Fraudulent Notarios, Document Preparers, and other Nonattorney Service Providers: Legal Remedies for a Growing Problem*, 31 Clearinghouse Rev. 327 (November/December 1997).
[105] NFCC, "Member Agency Accreditation", (2002).

- support and delivery of a variety of consumer education programs,
- adherence to consumer disclosure requirements as set forth by the FTC, [106]
- providing DMP clients with a detailed review of current and prospective income, as well as present and anticipated financial obligations.[107]

NFCC also says that affiliated agencies must attempt to negotiate concessions for their clients with all unsecured creditors, even those that do not pay the agency a Fair Share contribution.[108] The NFCC does not set a specific ceiling on the amount of fees member agencies may charge but does require that those fees "be kept as low as possible" and that they not be "excessively large or unconscionable."[109]

The AICCCA has also adopted industry standards. Similar to NFCC, AICCCA members must be 501(c)(3) organizations. The AICCCA also requires third party accreditation by COA or according to the standards developed by the International Organizations for Standardization (ISO).[110] They also require that agencies be licensed in any state that has a licensing procedure and in which they conduct business. AICCCA also requires that the agency maintain a satisfactory rating with the Better Business Bureau and provide a community resource for educational materials and information concerning personal finance and debt issues.

AICCCA's Code of Practice includes requirements that counselors receive "proper training", that counselors not receive compensation based on a client's enrollment in a DMP, that services be made available to the public regardless of ability to pay and that fees for DMPs not exceed a maximum set-up

[106] The disclosure informs consumers that most of the agency's funding comes from voluntary contributions from creditors who participate in debt management plans (DMPs). Most of the disclosures state "Since creditors have a financial interest in getting paid, most are willing to make a contribution to help fund our agency. These contributions are usually calculated as a percentage of payments you make through your DMP—up to 15 percent of each payment received. However, your accounts with your creditor will always be credited with one hundred percent of the amount you pay through us and we will work with all of your creditors regardless of whether they contribute to our agency. We also receive grant funds from some governmental agencies and private foundations."
[107] See generally, NFCC, "Fact Sheet" (2002). NFCC standards are also discussed in the I.R.S. report cited above, Debra Cowen and Debra Kowecki, "Credit Counseling Organizations", CPE 2004-1, January 9, 2003.
[108] NFCC Member Handbook.
[109] Id.
[110] The process of accrediting AICCCA members according to ISO standards is conducted by the BSI Group.

fee of $75 and no more than $50/month for maintenance. The AICCCA generally requires that member fees should be "as low as possible" and that payments should be remitted to creditors promptly.[111] AICCCA also states that, "No creditor will be excluded from a DMP unless it is beneficial to the client", which appears to require member agencies to attempt to negotiate concessions with creditors that don't pay a Fair Share contribution.

It is unclear to what extent the trade associations enforce the standards and how rigorous the accreditation and auditing process is. For example, AICCCA's best practices standards state that members must provide community resources for educational materials and shall allocate a reasonable percentage of operating expenses to develop, foster, and provide a variety of community education programs beyond counseling. However, as discussed above, only five of the non-NFCC agencies in our survey offered services other than DMP and DMP-related products. About one-third of the agencies in the survey were AICCCA members. Those that did offer other services generally charged for them.[112] In any case, the standards are voluntary. This type of voluntary self-policing, while positive if it is rigorously applied, is not a substitute for effective federal and state laws.

As mentioned above, creditors are also requiring that agencies meet a variety of accreditation and other standards. These standards vary from creditor to creditor. Some could improve the quality and affordability of credit counseling, such as limits on how much agencies can charge clients, while others appear to be focused only on reducing creditor expenses. Moreover, new creditor requirements do not address one of the most significant problems identified by this report: the decline in authentic credit counseling options for consumers who do not enroll in a DMP. Indeed, as mentioned above, the fact that creditors only compensate agencies for the amount of money recovered in DMPs and that this

[111] The AICCCA Code of Practice is available on-line at www.aiccca.com. The standards are also discussed in the I.R.S. report cited above.
[112] See §3.3 of this report.

funding has been significantly cut has accelerated the decline of these services and helped to foster the development of DMP mills.

7. RECOMMENDATIONS TO IMPROVE CREDIT COUNSELING

There clearly is a need for effective credit counseling, particularly for consumers who can benefit from limited counseling and advice. Consumers receiving limited advice should in many cases be in a better position to deal with debt problems on their own. Consumers who want to pay back as much unsecured debt as possible, but need third party assistance and modest creditor concessions, may also benefit from counseling and/or DMP services. In addition, credit counseling organizations can also provide a community service by offering educational forums and seminars.

Those agencies that exist to meet a range of consumer needs, not just the provision of DMPs, and can offer quality services should qualify as non-profits. But this is not enough. Even these reputable agencies need to be clear on who their primary clients are-consumers or creditors. Only those that primarily serve consumers should receive the benefits of non-profit status.

Below are our recommendations for changes that will help bring about much needed reform in the industry and better protect consumers.

7.1 Federal and State Public Policy

1. **Congress and state legislatures should adopt new laws specifically addressing debt management plan practices and abuses.**

An effective federal law would be useful because it would apply consistent standards across the country to an industry that is quickly becoming national in scope. **It is critical that any federal law that is passed not preempt states from going further.** States should still be allowed to pass more protective consumer regulations if they choose.

In addition, those states with existing debt management laws should strengthen those laws along the lines recommended below and devote sufficient resources for enforcement.

Below is a summary of our recommended law:

Scope:

This law should apply to both for-profit and non-profit agencies that offer DMP services, regardless of whether fees are charged. Only the DMP component of an agency's services would be regulated.[113]

This law would apply only to those who are in the business of providing and/or selling debt management plans. Certain individuals or companies that assist consumers in sending money to creditors outside of DMPs should not be covered. Those excluded would likely include certain attorneys performing their duties as attorneys rather than as DMP providers, certain banks, escrow agents and others.

Summary of Key Recommended Provisions

Advertising:

The law, at a minimum, should:

- Prohibit false advertising.
- Ban the practice of paying referrals to customers who bring in new customers.
- Require that agencies disclose in all advertising, in any initial contacts with consumers and in written contracts the portion of their funding that comes from creditors.[114]
- Require agencies to disclose in all advertising, initial contacts with consumers and in written contracts that DMPs are not suitable for everyone and that consumers can request information about other options, including bankruptcy.
- Prohibit any untrue or misleading representations regarding the services the agency can provide or the fees it charges.

Written Contract:

- Consumers must be given a copy of a written contract for services. If the transaction is conducted by telephone, consumers must receive a contract by mail.

[113] Credit counseling agencies that do not provide DMPs should still be regulated by other applicable state and federal laws as well as state and federal charity (non-profit) regulators.
[114] This could be similar to the disclosure that NFCC agencies currently use.

At a minimum, the written contract should include:

- A full disclosure of all services to be provided, any up-front and ongoing fees to be charged for services (including "contributions"), and a prominent notice that secured debt is not included in the DMP.
- An estimate of the length of time it will take to complete the DMP, the amounts to be sent to each creditor each month, and the types of concessions offered by creditors.
- Existence of a surety bond.
- Agencies should not receive a fee for service until the agency has given notice of the contract to all creditors listed and all creditors listed have approved the plan. Consumers must then be given a final contract specifying the creditors participating in the DMP, a list of all debts included in the DMP, and the concessions creditors have agreed to.
- The final contract must include a cancellation provision giving the consumer three days to cancel without obligation. In addition, either party should be allowed to cancel at any other point with proper notice.

Additional Provisions

- Agencies must promptly remit all consumer payments to creditors.
- Agencies should charge no more than $50 for enrollment (also known as up-front fees). Monthly DMP fees, if any, must be reasonable. In no circumstances should an agency charge a first month's consolidated payment as an enrollment or up-front or monthly fee.
- The DMP must provide only for payments reasonably suitable for the consumer, based on her ability to pay.
- Agencies must hold all funds received from or on behalf of consumers in a separate trust account maintained for the benefit of the agency's clients. Agencies must maintain separate records of account for each consumer.
- Agencies must not commingle trust accounts established for consumers with operating accounts.
- Agencies must have an explicit fiduciary duty to DMP clients.
- All agencies must be bonded in each state where they do business.
- Agencies must not purchase debts from consumers.
- Agencies must not make loans to consumers.
- If the agency has a financial arrangement with any lender or any provider of financial services and the agency receives any type of compensation for referring clients, this arrangement must be prominently disclosed to the consumer. Such disclosure must be in writing.
- All credit counseling agencies should register with the relevant state enforcement agency.
- Consumer waivers of this law would be invalid and any attempt to obtain a waiver will be a violation of the law.

Remedies

- Any contract not in compliance would be void and unenforceable.
- Consumers must have a private right of action to enforce the law.
- State (or federal) enforcement actions with civil penalties would also be provided.
- Private remedies must include actual damages, punitive damages, and attorney's fees.
- Injunctive relief must also be available.

This recommended law has many similarities with a few well-crafted state laws already in place. Many of the provisions are particularly close to the law recently passed in the state of Maine.[115] However, there are a few significant differences between the recommended law and similar state laws, including:

- **Flexible Fee Limit.** The recommended law recognizes that it is often reasonable for agencies to charge fees and that it may be difficult to legislate reasonable limits. However, it does call for limited regulation. First, since most of the abuses related to fees have involved the set-up fee, an up-front fee limit of no more than $50 is recommended. This will easily cover the administrative fees necessary to establish an account. In addition, we call for monthly fees, if any, to be reasonable, without setting a specific limit. The appropriate limit for monthly fees may well vary from state to state.

- **No new licensing requirement.** States that already have licensing requirements should be encouraged to increase enforcement of these laws. However, recognizing the difficulties in enforcing these laws, we do not call for new licensing requirements. Instead, existing state agencies that regulate non-profits should aggressively enforce tax exemption and non-profit corporate status laws and regulations. There should also be a simple and separate registration process that requires credit counseling agencies to register in each state where they do business. This should help enforcement agencies track the credit counseling business in their state. As with other consumer protection laws, strong state Attorney General involvement and enforcement (and other relevant state and federal enforcement agency involvement) is critical to ensure effectiveness of this law.

- **Inclusion of Non-Profit and For-Profit Agencies.** Restrictions on DMP practices are not limited to non-profits primarily because this label has become virtually meaningless. As discussed below, we strongly recommend stepped up enforcement by the I.R.S. and state agencies of nonprofit status.

7. 2 Aggressive Enforcement of I.R.S. Standards by federal and state enforcers

True regulation of the industry will not occur until the I.R.S. and relevant state agencies begin to properly enforce the nonprofit status rules. This cannot be overstated. Abuses of the tax laws must be stopped in order to clean up the industry. Without this critical element, regulation of the industry is

[115] Maine R.S.A. tit. 32 §6172 et seq. Also see M.R.S.A. tit. 17 §§701 and 702.

nearly impossible as for-profit businesses masquerading as non-profits will continue to slide under the regulatory radar.

7.3 Industry Self-Regulation

Credit counseling trade associations should continue their efforts to set best practices standards and to enforce them. It is especially important that industry trade associations specifically mandate that their affiliates offer a range of consumer options, not just DMPs. Moreover, the industry should publicly reveal what sanctions member agencies will face if they do not meet these standards. All agencies should also publicly disclose information about its practices, including:

- Funding sources,
- Numbers of consumers on DMPs and DMP retention rates, and
- All fees for services.

However, we do not believe that policymakers should rely on these model standards for enforcement.

Trade associations and individual agencies should also work to diversify agency funding and decrease agency reliance on creditor funding. This will improve the financial stability of these agencies and decrease the potential conflicts of interest that currently exist.

7.4 Creditor Reform and Self-Regulation

Creditors should immediately take steps to encourage the improvement and expansion of effective credit counseling options for consumers who would not benefit from a DMP. Creditors should increase financial support to credit counseling agencies, especially to improve credit counseling options for consumers who are unlikely to benefit from a DMP. Creditors should also reverse the current trend toward reducing the concessions they offer to consumers who enter a DMP, especially regarding lower interest rates. This will help improve the retention rates in credit counseling and decrease the number of former DMP clients who end up in bankruptcy. Creditors should also work together to develop

consistent administrative and payment requirements, thus reducing agency overhead and ensuring that more funds are used to assist consumers. In addition, creditors should immediately stop providing funding to agencies that charge high fees or are employing deceptive or misleading marketing practices.

Creditors should also require agencies to:

- Prominently disclose to consumers the advantages and disadvantages of DMPs, as well as the retention rates at that agency, what proportion of a consumer's debt load will be affected by a DMP, all fees charged by the agency, the amount of creditor funding that the agency receives for DMP clients, counseling options that agencies offer to consumers, and non-counseling options that are available, including bankruptcy, and

- Continue to take steps to improve the low retention rate in DMPs. This would include more effective evaluation of whether consumers will successfully complete a DMP, and

- Provide thorough training to their counselors and not offer compensation based on DMP enrollment.

ADVICE FOR CONSUMERS WHO ARE CONSIDERING CREDIT COUNSELING

IS CREDIT COUNSELING RIGHT FOR YOU?

1. DECIDE IF YOU NEED HELP

Some warning signs of financial trouble are clearer than others. For example, if you are consistently late in paying bills or are already behind in paying some debts, you probably know that you need help. Other warning signs of financial trouble are not so obvious. If your total debt payments, excluding your mortgage and car, are between one-quarter and one-half of your after-tax income, you could benefit from credit counseling or other forms of financial assistance. You should consider seeking assistance even if you are current on all bills.

2. CONSIDER ALL OF YOUR OPTIONS

Credit counseling isn't for everyone. Make sure you consider other options, including developing a reasonable and affordable household budget and savings plan and negotiating individually with your creditors. Most important, you need to understand what types of debts you have. Are you having trouble with secured debt (such as a home mortgage or car loan) or mainly with your unsecured credit card debts?

Credit counseling won't help lower your secured debts. However, a debt management plan (also called a "debt consolidation plan") might help you lower your unsecured debts, making your home and car payments more affordable. If you are in danger of losing your home or car, bankruptcy may be your best option.

If you have mainly unsecured credit card debt and your monthly bills are completely unaffordable, a debt management plan may not lower your monthly payments enough to allow you to pay all of your other bills, especially if emergencies arise. Chapter 7 bankruptcy may be your only viable option.

Similarly, if your credit card bills are becoming more difficult to pay but are not yet unmanageable, you might be able to improve your situation by taking a budget counseling class and sticking to a tight budget. You might not need to enroll in a debt management plan.

A debt management plan is most likely to help you if you are in trouble with unsecured debt and can make payments on those debts and still afford higher priority debts, such as house payments, rent, and utilities. However, be sure to factor in any fees you will have to pay to the agency itself. You may also benefit from the convenience of sending only one payment to the agency rather than making multiple payments to creditors, particularly if you have many different creditors.

FINDING A GOOD CREDIT COUNSELING AGENCY

1. **Take the time to shop around.** Making the wrong decision could cost you dearly. Talk to two or three agencies before making a final decision. You do not need to provide personal financial information in order to find out the basics about an agency. Ask friends and family for referrals or consult the Yellow Pages. Don't just respond to advertising. Call your local Better Business Bureau and the consumer protection office of your state Attorney General's office and rule out agencies that have been the subject of multiple complaints. **Consider visiting an agency in-person before signing up.** Although it is sometimes embarrassing or inconvenient to talk face-to-face with counselors, it often leads to a more thorough and direct discussion of your finances than is possible by phone or Internet.

2. **Look for a variety of services.** Seek out an agency that will offer you a range of counseling options, not just enrollment in a debt management plan. The more options the agency offers, the more likely they will be able to offer you assistance that will fit your needs. Ask them if they offer budget counseling, savings and debt management classes, or other educational options. Ask them directly if they will tell you if you should consider options other than a debt consolidation plan, such as bankruptcy or managing your own finances.

3. **Check out all costs.** Most agencies offer similar "deals" from creditors to cut your debt, but their fees can vary significantly. Find out what the agency charges to set up your account (get a specific dollar amount) and for a monthly fee. Ask them if any of the fees are voluntary, or if they offer lower fees for customers in serious financial hardship. Get a specific quote in writing.

4. **Non-profit status or an affiliation with a particular trade group does not guarantee quality.** Non-profit status does not guarantee affordable fees. Nearly all credit counseling agencies are non-profit, including those that take advantage of consumers.

5. **Demand good customer service.** The training and skill of agency employees can mean the difference between effective and shoddy credit counseling. It is hard to distinguish between the various employee training and certification programs, so ask a few specific questions. Find out if the employees you are dealing with have taken actual courses in subjects like credit, budgeting and savings, not just a few weeks of training. Make sure the employee spends a good deal of time carefully evaluating all of your debts, not just your credit card bills, and looks at your pay stubs and bills before recommending a counseling plan to you. Find out if the agency provides assistance after you enroll in a debt consolidation plan, such as one-on-one counseling.

6. **Ask about privacy.** Make sure the agency does not sell or distribute any information about your account to others without your permission.

7. **Find out about employee compensation.** Ask employees directly if they are paid more if they sign you up for a debt management plan. Consider going elsewhere if they say yes.

8. **Get the specifics on credit concessions.** Ask the agency if it will deal with all of your unsecured creditors, not just those that pay the agency a fee. Find out exactly how much lower your monthly credit card balance will be and how long it will take to pay off your bills. Creditors sometimes overrule agencies, so don't agree to a debt management plan until the agency has contacted each of your creditors and they have agreed to the plan you were offered.

9. **Keep an eye on the agency after you sign up.** If you sign up for a debt management plan, don't stop paying your bills until the plan has been approved by your creditors. Make sure that the agency's payments schedule allows your debts to be paid before they are due each month. Call each of your creditors the first month to make sure they have been paid on time by the agency.

10. **Ask about how credit counseling will affect your credit report or score.** Although some creditors do disclose to credit reporting agencies whether a customer is participating in a debt management plan, this won't necessarily have a negative effect on your ability to get credit in the future. Fair, Isaac and Company, the developer of credit scoring software used by all major credit reporting agencies, says that it does not negatively score a consumer's participation in a debt consolidation plan. On the other hand, individual creditors that pull your entire credit report may consider your participation as a negative factor if you apply for credit after you enter the plan. Moreover, if you are considering credit counseling because you have already fallen behind in paying your debts, your credit score has likely already been negatively affected. As the situation varies significantly depending on your current credit situation, talk to your credit counseling agency and creditors about what will happen to you if you enter a debt consolidation plan.

RED FLAGS: SEVEN REASONS TO REJECT A CREDIT COUNSELING AGENCY

1. **High Fees.** In general, if the set-up fee for a debt management plan (also known as debt consolidation) is more than $50 and monthly fees are more than $25, look for a better deal. Similarly, if the agency is vague or reluctant to talk about specific fees, go elsewhere.

2. **"Voluntary" Fees that Aren't So Voluntary.** Some agencies publicly claim that their fees are voluntary, but don't pass this information on to consumers. Others will tell you that their fees are voluntary, but will put a lot of pressure on you to pay the full fee, even if you can't afford it. Ask all agencies you contact if their fees are voluntary. If the full fee is too much, do not pay the agency more than you can afford.

3. **The Hard Sell.** If the person at the other end of the line is reading from a script and aggressively pushing debt "savings" or the possibility of a future "consolidation" loan, hang up.

4. **Employees Paid by Commission.** Most credit counseling agencies are non-profit organizations that are supposed to consider your best interests when offering you counseling options. Employees that receive commissions for placing consumers in debt management plans are more likely to be focusing on their own wallets than yours.

5. **They Flunk the "Twenty Minute" Test.** Any agency that offers you a debt management plan in less than twenty minutes hasn't spent enough time looking at your finances. An effective counseling session, whether on the phone or in-person, takes a significant amount of time, generally thirty to ninety minutes.

6. **One Size Fits All.** Some agencies are like a shoe store that sells just one type of shoe. The only choice they will offer you is a debt management plan. The agency should talk to you about whether a debt management plan is appropriate for you rather than assume that it is. If the agency doesn't offer any educational options, such as classes or budget counseling, consider one that does.

7. **Aggressive Ads.** Many agencies that advertise treat consumers fairly. However, some are being investigated or sued for deceptive practices. Many others charge unreasonable fees or offer no real counseling. Don't just respond to television and Internet advertising, or telemarketing calls. Get referrals from friends or family, find out which agencies have been subject to complaints and talk to a number of agencies before making a decision.