DISCUSSION PAPER
PAYMENT CARDS CENTER

Consumer Credit Counseling: Credit Card Issuers' Perspectives*

Mark Furletti

September 2003

Summary: *On Friday, May 23, 2003, the Payment Cards Center hosted a workshop led by collections managers from J.P. Morgan Chase and Juniper Bank. The managers provided the credit card issuers' perspective on the consumer credit counseling industry. The day's discussion complemented an earlier workshop at which representatives from local consumer credit counseling services (CCCS) discussed their business model. After describing the ways in which new market entrants have affected the counseling industry, the issuers discussed the challenges associated with administering and appropriately valuing the services of various agencies. This paper provides highlights from the workshop discussions.*

* The views expressed here are not necessarily those of this Reserve Bank or of the Federal Reserve System.

FEDERAL RESERVE BANK OF PHILADELPHIA
Ten Independence Mall, Philadelphia, PA 19106-1574• (215) 574-7220• www.phil.frb.org

Introduction

Almost two years ago, the Payment Cards Center hosted a workshop at which several regional consumer credit counseling services (CCCS) discussed the changes in the credit counseling and debt management industry. [1] Historically, not-for-profit CCCS organizations have taken a holistic approach to helping consumers. They use face-to-face budget counseling and debt management programs (DMPs)[2] to help people regain control of their finances. The budget counseling is typically offered for free, and CCCS's debt management programs require a nominal fee from the consumer and a "fair share" contribution from the consumer's creditors. For decades, the economics of the CCCS business model resulted in the agencies' having very little competition. Since the mid-1990s, however, hundreds of organizations that advertise debt management services have entered the market. According to consumer interest groups, credit card issuers, and various states' attorneys general, some of these newer organizations are more interested in profits than in providing debt-laden consumers with sound advice.[3] The less reputable of these new market entrants, often referred to as "debt mills," charge higher levels of fees, do not offer meaningful budget counseling, have difficult-to-understand fee structures, and are often seen as abusing their non-profit status.

[1] A summary of the July 2001 workshop can be found on the Payment Cards Center's web site at www.phil.frb.org/pcc/workshops/workshop1.pdf

[2] When a consumer enrolls in a debt management program (DMP), the CCCS agency helps the consumer assess his or her financial situation, create a spending plan, and negotiate improved terms with his or her creditors. By negotiating lower interest rates and penalty fee waivers, DMPs can provide consumers with more affordable payments and a shorter payoff period. DMPs usually involve consolidating a consumer's unsecured debt payments into one monthly payment that is then disbursed directly to creditors by the CCCS agency. Given that the most viable alternative to such programs is often bankruptcy, credit card issuers are usually willing to pay the agencies a fee for their services. This fee, which is usually calculated as a percentage of the person's balance with the creditor, is called "fair share." Consumers also typically pay a small monthly fee to the CCCS agency to help defray the costs of administering DMPs.

[3] In April 2003, the National Consumer Law Center and the Consumer Federation of America released a detailed study of the credit counseling industry. Among other things, the report analyzes the rise of profit-motivated debt management agencies, the abuses of the nonprofit status by some agencies, and the impact that proposed changes to the bankruptcy code will have on debt management programs. A copy of this paper, "Credit Counseling in Crisis: The Impact of Funding Cuts, Higher Fees and Aggressive New Market Entrants," can be found on the web at www.consumerfed.org/credit_counseling_report.pdf.

The workshop the Center hosted in 2001 examined these issues from the perspective of CCCS agencies and their national parent organization, the National Foundation for Credit Counseling (NFCC).[4] On Friday, May 23, 2003, the Payment Cards Center hosted another workshop at which representatives from J.P. Morgan Chase and Juniper Bank discussed credit card issuers' perspectives on the consumer credit counseling industry. After describing the ways in which they perceived the industry changing, the issuers discussed the difficulties associated with administering and appropriately valuing the services of various agencies. This paper provides some highlights from the workshop discussions.

Changes in the Industry

Two representatives from Juniper Bank, Kevin Murphy, managing director of the collections department, and Lisa Wilson, director of collections strategy, opened the workshop with a background discussion describing the history and recent development in the consumer credit counseling business. Murphy, who has a long professional history of working with credit counseling firms, indicated that 10 years ago, there were approximately 200 credit counseling organizations in the U.S. Today there are over five times that number. In the early 1990s counseling was almost exclusively provided in person. Now, the majority of debt management service is provided over the Internet, by telephone, and by facsimile. A decade ago, only a negligible portion of any issuer's receivables were involved in DMPs. Today, Murphy estimates that between 2 percent and 4 percent of most large *prime* issuers' assets are involved.[5]

In Murphy's view, the reputation of the debt management industry has significantly eroded and intra-agency competition has led to changes in business practices. Once perceived as quasi-charitable operations with unquestioned motives, a number of providers now find

[4] For more information on the NFCC, please visit the organization's web site at www.nfcc.org.
[5] The top 10 bank credit card issuers in the U.S. had approximately $435 billion in credit card loans outstanding as of the end of 2003, according to the *Nilson Report*. Applying Murphy's estimate to this figure, the top 10 card issuers have anywhere between $8 billion and $17 billion in DMP loans.

themselves the target of investigations by the Federal Trade Commission, various state attorneys general, and consumer action groups. CCCS agencies that have traditionally relied on creditor and consumer referrals now compete with agencies that recruit celebrity spokespersons and aggressively market their services on the radio and television.

Murphy and Wilson noted that card issuers are particularly alarmed by recent trends in agency marketing strategies. In addition to targeting "credit stressed" consumers, some agencies market their services to any consumer who believes he or she is paying too much in finance charges. This makes it difficult for card issuers to know whether consumers who enroll in DMPs are actually trying to avoid bankruptcy or trying to save money in interest and fees

The cost of administering debt management programs, Murphy explained, has also increased. Top issuers receive thousands of DMP proposals from hundreds of different debt management agencies each month. Issuers must evaluate and then accept or reject each proposed plan. This job is complicated by the uneven success of agencies' plans and differences in proposed fair share, payment, and interest amounts.

As the percentage of issuers' assets involved in debt management plans has increased, so has the fair share contribution that issuers must pay. For most collections departments, fair share expense is now second only to the expense of employees' salaries. The significance of this cost, combined with the profit-driven motives of some debt management agencies, has resulted in increased issuer scrutiny of credit counseling and debt management efforts. Instead of passing the benefits of payment and interest rate concessions along to consumers, many issuers fear that some agencies are effectively retaining the value of these concessions to further increase agency profits.

The Agency-Issuer Relationship

Rob Hughes and Chris Kohl, both vice presidents from Chase Cardmember Services' collections loss management department, joined Murphy and Wilson in a discussion of the changing relationships between card issuers and agencies.

Ideally, card issuers would want agencies to provide consumers with the education and tools necessary to help them budget responsibly, regain control of their finances, and remain committed to any necessary debt management program. In return for consumers' good faith effort to repay their debts, card issuers would lower consumers' interest rates and fees and compensate agencies for their assistance. Such a scenario is ultimately in card issuers' best interest. If consumers feel they are trapped and that their card issuers are unwilling to offer them assistance, they will likely seek to discharge all of their credit card debt in bankruptcy. Such an outcome could be detrimental to both the issuer and the debtor.

Hughes and Kohl asserted, however, that the world of credit counseling is moving further away from this ideal. Many of the newer agencies that have entered the market do very little counseling, charge consumers high fees, and recommend DMPs regardless of an individual consumer's situation. The DMPs initiated by these newer agencies are often based on a 15-minute phone conversation and have a significantly reduced chance of success. In response to the decreasing success of DMPs, some issuers are offering lower fair share contributions or fewer concessions. Other issuers, knowing that most consumers will not be able to stay on a plan developed in haste, are offering no contributions or concessions at all.

As the performance of many agencies' DMPs has deteriorated, many large issuers have changed the ways in which they evaluate DMP proposals. Some issuers have adopted a "pay for performance" method of determining their fair share contribution. Under a "pay for performance" plan, issuers use different levels of fair share contribution amounts (usually calculated as a percentage of the consumer's monthly payment) to reward agencies that perform well and penalize those that perform poorly. Some issuers use a minimum standards mechanism, by which proposals are accepted or rejected. A decision is made based on whether the proposal meets a set of predetermined interest rate, payment rate, and fair share rate thresholds.

In an effort to reduce fair share expense, some issuers have partnered with agencies they perceive as being reputable and compatible with their own values. The issuers then periodically audit that agency and refer indebted customers to it for counseling. In return for these referrals, some agency partners are willing to accept lower amounts of fair share from the referring issuer. Given the distrust that some consumers feel toward their card-issuing bank while they are experiencing financial trouble, Hughes thought that the majority of consumers seeking help will often choose an agency other than the one with which the issuer has partnered.

In addition to dealing with lower performing DMPs, issuers have struggled to appropriately assess the value of various agencies' services. As mentioned earlier, the costs of concessions and fair share is quite high for issuers. Consider, for example, a debtor who has $35,000 in revolving debt spread equally over seven credit cards. Assuming that the interest rate on each card is 20 percent and that the cardholder is charged a $29 penalty fee every other month, each of the seven issuers earns approximately $1200 in interest and fees per year. Now, assume that the same debtor enrolls in a debt management program. That person's card issuers agree to stop charging penalty fees, reduce their interest rate by one-half, and pay a fair share contribution to the agency equal to 8 percent of a standard monthly payment (3 percent of the balance). Under these assumptions, each issuer's annual interest and fee revenues net of fair share drop more than 70 percent, to approximately $350. Together, the seven issuers forgo almost $5800 in interest and fee revenues. Given the growing proportion of consumers enrolled in DMPs and the significant revenue sacrifice, issuers want to be sure that DMPs are worth their high costs.

Issuers are not unaware that the likely alternative to receiving $350 in annual revenue could be a loss of the entire consumer's balance at a Chapter 7 bankruptcy proceeding or through contractual chargeoff. Card issuers, however, want to better understand the value of the service that agencies provide. Is that service worth the fair share contribution that issuers are currently providing? Is there a better compensation system that issuers should be considering? How should issuers value the non-DMP services that some credit counseling agencies provide, such as budget counseling and referrals to social service agencies (e.g., for addictions or family instability)?

Should issuers accept proposals from "debt mill" organizations that may not have the consumer's best interest in mind?

Discussion of such price and value questions among the issuers themselves is not really a viable option. Such discussions would be fraught with legal problems. In addition, the issuers themselves do not have all of the data necessary to determine whether consumers who undergo counseling or enroll in a debt management program perform any better (i.e., have lower overall default rates) than consumers who do not. For these reasons, the issuers are seeking help from outside researchers in answering some of these questions.[6]

The issuers also raised concerns about government regulations that restrict their ability to assist consumers who need to be placed on a debt management program. In June 2000, the Federal Financial Institutions Examination Council (FFIEC)[7] released a set of account management guidelines for credit card issuers that affected the ways in which issuers assisted delinquent and credit stressed consumers.[8] The guidelines restricted the number of times an issuer could "re-age" an account — a process by which the issuer forgives past-due payments and brings the account current. Last year, the FFIEC released for comment guidelines regarding accounts involved in workout or debt management programs. The guidelines suggest that the length of such programs should not exceed 48 months. To fulfill this requirement, issuers need to reduce interest rates and fees such that consumers' monthly payments sufficiently reduce their principal balances.[9]

[6] Earlier this year, researchers at the Credit Research Center at Georgetown University released a paper that describes their attempts to quantify the long-term value of credit education. Their paper, entitled "The Impact of Credit Counseling on Subsequent Borrower Credit Usage and Payment Behavior," can be found on the Federal Reserve Board's web site at: www.federalreserve.gov/communityaffairs/national/CA_Conf_SusCommDev/pdf/statenmichael.pdf.

[7] The FFIEC is an interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

[8] A copy of the account management policy revisions can be found on the FFIEC's web site at: www.ffiec.gov/press/pr061200.htm.

[9] A copy of the Account Management and Loss Allowance Guidance can be found on the FFIEC's web site at: www.ffiec.gov/PDF/pr072202_guidance.pdf.

A number of issuers have contended that these guidelines are not sufficiently flexible. The re-age restrictions limit issuers' abilities to assist consumers who fall off agency plans and subsequently try to get themselves back on a regular payment schedule. The 48-month restriction inhibits issuers' abilities to help consumers with heavy debt burdens. Even if an issuer were to waive all the fees and interest on an account, a consumer with a $20,000 balance making monthly payments of $300 would not be able to pay down the balance in fewer than five and a half years. Some issuers argue that longer periods may be necessary to resolve individual situations.

Conclusion

A flood of new entrants into the credit counseling industry has left issuers, consumer advocates, established CCCS agencies, and policymakers puzzled. While increased competition in any given market usually results in better deals for consumers and increased innovation, such factors have not marked the explosion in the number of firms specializing in credit counseling. Issuers and CCCS proponents acknowledge that competition has provided traditional agencies with the impetus necessary to upgrade technologies and automate systems. This has resulted in a more efficient and accurate administration of debt management programs by CCCS agencies. But they also find that the newer agencies are not always operating in consumers' best interests. The worst of these new competitors charge oppressively high monthly program fees and wage expensive and often misleading advertising campaigns on late-night television.

As a result of these changes in the industry, some issuers have simply refused to work with agencies that do not meet certain standards. Others will accept payments from any agency administering a DMP as long as the terms are acceptable. How can these problems be solved? The Consumer Federation of America and the National Law Center advocate the passage of legislation that would improve the disclosure of DMP fees, impose ceilings on start-up costs and monthly fees, and require that agencies tell consumers when a DMP is not the optimal solution for their situation. Issuers suggest that the CCCS parent organization, the National Foundation for Credit Counseling, adopt stricter standards and audit their member organizations' programs. They also recommend that the card industry consider adopting a compensation model for counseling services that encourages agencies to act in consumers' best interests. CCCS agencies and some government organizations, such as the FTC, have worked to educate consumers about the various fees associated with less reputable debt management programs. Broader financial literacy initiatives, such as those sponsored by the Federal Reserve, aspire to change consumers' behavior such that the need for DMPs is eliminated.

While the ultimate solutions to these problems have not yet emerged, the losses being suffered by consumers, issuers, and reputable counseling agencies make for an environment that is ripe for reform. At the same time, the workshop discussions also highlighted the need for additional research to better inform both the industry and public policy debates.