

Dangers Of Debt Settlement

Consumer Alert!

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Credit Counseling

By Edward Tonini, Director of Education.

“Debt settlement is the equivalent of challenging your creditors to a game of chicken – using your credit score as the ante and your finances as the wager!”

Steve Bucci, president of CCCS of Southern New England.
(Source: www.bankrate.com/brm/new/debt/20040507a1.asp)

Which of the following is true?

- the average American household is more than \$18,000 in debt, not counting a mortgage
- 57% of wage-earners with children are living paycheck to paycheck
- outstanding consumer non-mortgage debt in America is now nearly \$2 trillion

The correct answer is all of the above. With the burden of debt so common, many people are looking for relief and some would like to believe there is an easy way out. While there are reasons to consider debt settlement, be cautious of companies making dream-come-true claims and omitting to tell you the harmful effects. Do you remember the ancient wisdom about things that sound too good to be true?


What Is Debt Settlement?

Finding a definition of *debt settlement* or *debt negotiation* is not easy. And that speaks volumes. Basically, debt settlement is one way of resolving a debt. It involves **negotiating with a creditor on the balance in an attempt to get them to take less than what is owed**. You can try to handle the negotiations yourself or you can hire someone else to do the negotiations, such as a debt settlement company.

Now, common sense will tell you that a creditor has no reason to settle unless they have evidence that you have no way of paying the full amount. What would such evidence be? Well, calling a creditor when your accounts are current and telling them that you can't pay the balance will probably not be enough. The account will need to be past due several months and suffer finance charges and late fees before the creditor will believe that you might not be able to pay. Logically then, debt settlement should only be considered for debt that is several months delinquent. However, there are many debt settlement companies that do not operate with common sense. In spite of this, these companies are flourishing due in part to the exaggerated claims they make and the number of uninformed consumers.

Claims versus Reality

Debt settlement companies typically advertise the following kinds of benefits, but reality may be quite another matter.

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- **Cut your debt in half**
 - **Save you from bankruptcy**
 - **Slash your payments**
 - **Stop harassment from creditors**
 - **Wipe out your debt in 12-36 months**
 - **Improve your credit rating**
 - **Even if the creditor settles for half, your total cost will be more due to fees, account charges, and perhaps taxes.**
 - **Bankruptcy is not the only other option, and in some cases it may even be a better choice.**
 - **Those payments do not go directly to your creditors; the money is held in an account until there is enough saved for a lump sum payment.**
 - **If the original creditor is calling you, the law gives them a wide birth in trying to collect what you owe. A debt settlement company cannot stop these calls. Furthermore, a creditor has the right to sue you for the debt. If a third-party collector is calling you, you can stop the calls yourself by sending them a certified letter telling them to stop calling and only contact you by mail.**
 - **The amount of time it takes will depend on how long it takes you to save up the money for the settlement amount and fees for each account.**
 - **Your credit rating will be damaged and accurate history notations remain in your credit file for at least 7 years.**

Tip-offs To Rip-offs

The Federal Trade Commission warns “steer clear of debt negotiation companies that:

- guarantee they can remove your unsecured debt
- promise that unsecured debts can be paid off with pennies on the dollar
- claim that using their system will let you avoid bankruptcy
- require substantial monthly service fees
- demand payment of a percentage of savings
- tell you to stop making payments to or communicating with your creditors
- require you to make monthly payments to them, rather than with your creditor
- claim that creditors never sue consumers for non-payment of unsecured debt
- promise that using their system will have no negative impact on your credit report
- claim that they can remove accurate negative information from your credit report.”

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The Truth Is in The Details

There is a chance your creditor might settle for half of what you owe, but it will cost you a lot more than that.

Consider the following example. Let's say you have four credit cards with a balance of \$2500 each (many debt settlement companies require that you have at least \$10,000 in debt). **The first group of costs that you will incur in a settlement are directly financial.**

- Remember that in order to negotiate on a balance, the account must be delinquent. In fact, the debt settlement company does not begin negotiations until your account is at least 120 days past due. If you were charged a late fee (let's say \$30) and a finance charge (let's say 20%) each month, your balance after four months would be about \$1200 higher. If the debt settlement company was able to settle your account for half, the creditor would require a lump sum of \$5600.
- Now, add the fees the Debt settlement company will charge you - typically about 25% or more of what they "save" you. In our example, a 25% fee would amount to \$1400.
- Also, the government considers the half you didn't pay as taxable income so if you're in a 25% tax bracket that could cost you another \$1400.

Conservatively then, it would cost you \$8400 (\$5600 + \$1400 + \$1400) to settle the debt. **You would pay 84% of what you owed, not 50%.** Actually, the amount you end up paying would probably be much higher because it will probably take you much more than four months to save up the required lump sum payment, your interest rates will probably be higher than 20%, and if you go over your credit limit, there will be additional monthly charges.

Now consider the hidden costs. After four months of non-payment, your credit files show accounts with serious delinquency or charge-off status (written off as bad debt). Accounts that are charged-off are typically sold to collection agencies so now these companies appear on your credit reports showing that you owe them (and in case you hadn't heard, most people find calls from collection agencies unpleasant). If a settlement is later reached, the credit file notations for that account will typically state "settled" or "settled for less." One result of all this history is that anyone looking at your credit file - creditors, lenders, landlords, employers - might

conclude that you can't be trusted to pay your debts. Another result is that your credit score has been damaged. Finally, the delinquency, charge-off and settlement notations will remain on your credit reports for at least 7 years. Accurate information cannot be removed, except through time.

Other Options

Before deciding to attempt a settlement, carefully explore these alternatives:

Statute of Limitations. If the debt is some years old, check the relevant state laws. A statute of limitations doesn't eliminate the debt but if time has run out, you can't be legally forced to pay it. Be aware that the statute of limitations can be revived if you make a partial payment or otherwise acknowledge that you owe the debt.

Budget. Make a new spending plan that will allow you to pay back the debt. Use a budgeting tool (such as the one at www.knowdebt.org/education.php) to review your income and expenses. Look for money you can free up by dropping expenses that are not absolutely necessary.

Direct arrangement with creditor. If the account has not gone to collections, call the customer service or accounts department and ask to speak with a supervisor. Briefly explain your situation and ask for more time to pay your bills. Tell them what you think you can realistically pay each month. If you are already delinquent, ask if they have a hardship program and see if the terms might help you.

Emergency assistance programs. Many local faith-based groups and community organizations will provide emergency assistance directly or through social service programs. For help finding such programs in your area, try calling 311 for government services and 211 for social services.

Payroll advance. Depending on the amount you owe, you might ask your employer for a payroll advance.

Loan. Consider asking family or friends for a small private loan. Look into a small loan from a credit union or a small loan company. In evaluating each loan option, review all the rates and charges to find the lowest total cost. Always have a written contract.

Credit Counseling. There are non-profit organizations in every state that offer credit education and debt management programs. These services are available at little or no cost. For guidance on choosing a credit counselor, see the FTC article listed

in the "To Find Out More" section below. **Bankruptcy.** On the positive side, a bankruptcy can eliminate your legal responsibility for some debts and give you a fresh start. You can then gradually rebuild your credit rating by showing a new pattern of consistent on-time payments over the next two to four years. On the other hand, a bankruptcy will add damage your credit history and stay in your credit files for 7 to 10 years. It will also be on your public record. Changes to the bankruptcy law in 2005 have made it more costly and more complicated. Seek a free consultation with at least two different local bankruptcy attorneys to help you learn what your bankruptcy options are according to your particular state laws.

When A Settlement Might Make Sense

The National Consumer Law Center completed an investigation of debt settlement companies. The center cautioned: **"Debt settlement assistance should be allowed only when consumers have already saved money or otherwise have the money to attempt to settle a debt and are seeking assistance with negotiation."** The center also concluded: debt settlement **"that requires consumers to stop paying creditors, save money in reserve accounts, and pay large fees does not benefit consumers."** (for the full report, see the reference in the "To Find Out more" section below)

There are **additional conditions** that can indicate when a debt settlement might not be a bad decision: if the debts are more than 5 months past due, if the debts are fairly small (<\$1000), if you've carefully examined all the other options (listed previously), if a negative credit rating will not hurt someone in your circumstances, and if the total costs in a settlement will be less than what you owe.

If you try to negotiate a settlement yourself, here are **some tips**: be honest but paint the bleakest picture of your finances; if you're considering bankruptcy, say so but don't incur any more debt; never disclose where you work or bank; before you make any payment or agreement, get the terms in writing; if the creditor agrees to settle for less than you owe, ask them to agree to report the account to the credit bureaus as "satisfied in full;" if you make a payment, use a money order and send it by certified mail. For additional explanation of these tips, consult the book *Money Troubles* by attorney Robin Leonard.

To Find Out More



- Fiscal Fitness: Choosing A Credit Counselor** (FTC) - www.ftc.gov/bcp/online/pubs/credit/fiscal.htm.
- An Investigation Of Debt Settlement Companies: An Unsettling Business For Consumers** (National Consumer Law Center) - www.consumerlaw.org/initiatives/credit_counseling/content/DebtSettleFINALREPORT.pdf.
- Money Troubles** (Robin Leonard) - www.nolo.com.