

Testimony before the House Ways and Means Committee Subcommittee on Oversight regarding

## **"Non-Profit Credit Counseling Organizations"**

November 20, 2003

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Mr. Chairman and Members of the Subcommittee, the National Consumer Law Center and the Consumer Federation of America thank you for inviting us to testify today regarding the non-profit credit counseling industry. NCLC offers our testimony here on behalf of our low-income clients and the Consumer Federation of America (CFA). The National Consumer Law Center is a non-profit organization specializing in consumer issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys, as well as community groups and organizations nationwide that represent low-income and elderly individuals on consumer issues. The Consumer Federation of America is a non-profit association of almost 300 pro-consumer groups, which was founded in 1968 to advance the consumer interest through advocacy and education.

### **LEGITIMATE CREDIT COUNSELING AGENCIES PROVIDE MUCH-NEEDED SERVICES FOR CONSUMERS IN FINANCIAL TROUBLE**

Recent abuses by so-called non-profit credit counseling agencies have raised serious questions about the quality and legitimacy of credit counseling services. The National Consumer Law Center (NCLC) and the Consumer Federation of America (CFA) highlighted many of these problems in an April 2003 report, *"Credit Counseling in Crisis: The Impact on Consumers of Funding Cuts, Higher Fees and Aggressive New Market Entrants."*<sup>1</sup>

The credit counseling industry is at a critical crossroads. Consumer debt (all non-mortgage loans) and credit card debt continues to grow, increasing consumer demand for debt relief. As of June of this year, American consumers held about \$700 billion in credit card debt.<sup>2</sup> The effects of the economic recession, especially the loss of jobs and a sharp increase in the number of Americans with inadequate or no health insurance, have combined with the growth in consumer debt to cause a record number of Americans to seek bankruptcy protection.<sup>3</sup>

The need has never been greater to ensure that consumers who seek credit counseling receive quality services. Yet, policymakers are increasingly encouraging or requiring that consumers seek assistance from credit counselors without first taking adequate steps to improve the quality of credit counseling. This type of mandate is included in pending federal bankruptcy reform legislation.<sup>4</sup> States are also increasing traffic at credit counseling agencies by imposing counseling mandates or requiring the disclosure of credit counseling options to consumers.<sup>5</sup>

At the same time that these economic and political pressures have pushed more consumers toward counseling, abuses in the industry have led to serious deterioration in quality and an increase in deceptive and abusive practices.

Aggressive firms masquerading as non-profit organizations have been among the credit counseling agencies that are most likely to deceive or to gouge consumers. Massive cuts in creditor funding for agencies has exacerbated this trend, and leaving many well-intentioned organizations without sufficient funding to provide appropriate services. Most creditors have also reduced the economic concessions that they will offer to Americans who enter credit counseling, making it less likely that consumers will successfully complete credit counseling and more likely that they will have to declare bankruptcy.

Despite these trends, we do not believe that the picture is entirely dark. On the contrary, we believe that multi-service credit counseling agencies can provide valuable services for consumers. We also believe that there is a legitimate and important role for non-profit agencies to provide these services.<sup>6</sup> However, if current abuses are allowed to persist, credit counseling services will all too often seriously harm rather than help consumers, leading them deeper into debt.

## **SUMMARY OF PROBLEMS WITH CREDIT COUNSELING<sup>7</sup>**

It is important to note that 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. At first, most of the agencies were affiliated with the National Foundation for Credit Counseling (NFCC), a national trade organization that prescribes various standards for member organizations.

From the outset, debt management plans (DMPs) were the feature service. Through these plans, a consumer sends the agency a lump sum, which the agency then distributes to credit card companies that the consumer owes money. In return, the consumer is supposed to get a break in the form of creditor agreement to waive fees owed, to eliminate all references to delinquent payments on the consumer's credit reports by "re-aging" the account, and, and in some cases, to 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. Through the "Fair Share" contribution, creditors voluntarily return to the agency a set percentage of the funds that are disbursed to them.

Debt management plans include unsecured debt only. This is a critical issue because consumers with sparse resources should generally prioritize secured debt, such as home and car loans, over unsecured debt.<sup>8</sup> In addition, DMPs may not even include all unsecured debt.

NCLC and CFA have found that 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. This new generation has brought some advances, such as flexible hours, electronic payments and easy access to counselors by phone and the Internet. Unfortunately, however, complaints about deceptive practices, improper advice, excessive fees and abuse of non-profit status have grown significantly as this new generation of credit counseling agencies has gained market share.

Key problems highlighted in the NCLC/CFA report include:

- **Deceptive and Misleading Practices:** Among other problems, we described agencies that do not pay consumers' DMP payments on time, that deceptively claim that fees are voluntary, and that do not adequately disclose fees. In many cases, agencies deceptively exaggerate the types of concessions they can get from creditors to get people out of debt.
- **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, the vast majority of agencies now charge fees for services. At least a few 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.
- **Abuses in Non-Profit Status:** This is the focus of our testimony today. The reality is that non-profit agencies are increasingly performing like profit-making enterprises. Many agencies aggressively advertise and sell debt management plans and a range of related services. The multi-service counseling, education, and debt management plan provider is becoming the exception rather than the norm.
- **Decline in Consumer Education and Counseling Options:** Consumer educational services are rapidly declining. Many agencies that claim to provide education and/or counseling merely sell slickly produced, but unhelpful, CD ROMs, videos or internet information. For example, our survey of agencies not affiliated with the National Foundation for Credit Counseling (NFCC) found that only five of the forty agencies surveyed offered services unrelated to DMPs. Among this minority of agencies, four out of five charged for these other services, including books and videos on debt problems.

Although all of these issues are important and in many ways connected, I will focus mainly on issues related to non-profit status since this is the focus of today's hearing.

## **ABUSES OF NON-PROFIT STATUS**

Non-profit status has become, in practice, a requirement to do business in the credit counseling world. The credit counseling industry is comprised almost exclusively of 501(c)(3) tax-exempt organizations.

Credit counseling agencies seek (and get) tax-exempt status for a variety of reasons. This 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. Non-profit status is also required to get many public and private grants. In addition, creditors have traditionally required non-profit status to initiate Fair Share contributions.

Agencies also seek non-profit status in some cases to comply with applicable state laws, some of which require non-profit status as a condition for doing business in the state. In other cases, non-profit status allows agencies to escape the reach of consumer protection laws. Many of these laws, such as federal and state credit

repair laws and many state credit counseling laws specifically exempt non-profit organizations. This concern was explicitly noted in the October 2003 joint I.R.S. /F.T.C. advisory urging consumers to exercise caution when seeking help from credit counseling organizations. The agencies stated that, "Federal and state regulators are concerned that some credit counseling organizations using questionable practices may seek tax-exempt status in order to circumvent state and federal consumer protection laws."<sup>9</sup>

Perhaps most deceptively, agencies use non-profit status as a marketing tool. They promote the non-profit label as a mark of credibility, appealing to consumer trust that non-profit organizations are "above-board" and about more than just making money. Agencies take great pains to characterize themselves as charitable in 990 tax forms, advertising and promotional materials. For example, many claim to serve the community through education even though, as noted above, they often charge for educational services or simply provide videos and CD ROMs and no individual counseling. More than one agency we contacted as part of our national survey told us that they are a non-profit agency, "just like a church."

Using non-profit status as cover, many agencies characterize any fees charged as "donations." Similarly, agencies often claim that creditors work with them because they too can "write off" contributions to the agencies. All too often, the basic scheme is a charade, disguising what is in reality a business arrangement between creditors and agencies. The truth is that even if they are voluntary, fees paid by consumers for services should not be classified as charitable contributions. Instead, consumers are paying for services. Similarly, the Fair Share arrangements between creditors and agencies are often formal, written agreements that describe how creditors will compensate agencies for helping the creditors collect money owed to them.

Sadly and at great expense to taxpayers and to consumer clients, many credit counseling agencies should never have been able to attain the advantages of tax-exempt/non-profit status. There are two key areas where I.R.S. (and corresponding state laws) are being violated. Each of these is discussed in greater detail below.

## **1. Improper Ties to For-Profit Businesses**

Agencies are not properly "non-profit" if they are organized or operated to benefit individuals associated with the corporation including directors, officers or members.<sup>10</sup> No part of the net earnings of a §501(c)(3) organization may inure to the benefit of any private shareholder or individual. This is often called the ban on private inurement and is a basic tenet of I.R.S. tax-exemption requirements. There is considerable evidence that the ban on private inurement is violated by some credit counseling agencies. Beginning a few years ago, the media began to uncover the extent of this problem, documenting instances of lavish salaries for agency directors and self-dealing in purchasing real estate and in creating close connections with for-profit affiliated businesses such as lenders or payment services.<sup>11</sup>

More recently, these abuses have been the target of public and private lawsuits. For example, both the Missouri and Illinois Attorney General Offices sued AmeriDebt, Debticated and related affiliates and individuals.<sup>12</sup> Among other claims, both suits

allege that AmeriDebt and Debticated falsely represent that they are "not for profit" companies. According to the Missouri complaint, the credit counselors are thought of and even referred to as "salesmen" of DMPs and are judged and evaluated in part upon their current week or month's sales and revenues. The complaint further alleges that AmeriDebt and Debticated transfer virtually all tasks and virtually all consumer fees to the related for-profit company DebtWorks. DebtWorks, according to the Missouri Attorney General, prepares proposals to creditors for consumers, communicates proposals to creditors, obtains consumers' approval for changes, and responds to consumer calls. The suit further alleges that the agencies falsely represent that they provide consumer credit counseling.

Interestingly, AmeriDebt announced in October 2003 that it would lay off most of its workers and stop seeking new customers because of "negative publicity."

A Massachusetts Attorney General action focuses on another way in which "non-profit" agencies have linked up with for-profit businesses to generate profits. In this case against Integrated Credit Solutions and Flagship Capital Services Corporation, the Massachusetts Attorney General alleges that Integrated, a for-profit telemarketer, solicits business for the non-profit Lighthouse Foundation.[13](#) According to the complaint, Integrated induces consumers to pay exorbitant "enrollment" and "education" fees to Integrated, a for-profit telemarketer, in order to receive credit counseling from Lighthouse, which purports to be independent and non-profit.

To the extent the allegations discussed above are true, these agencies should have their non-profit status revoked and/or should be sanctioned appropriately.

Related abuses involve unreasonable compensation and other benefits that are directed by the "non-profit" agencies to directors and officers. In our report, we described "non-profit" agencies that were paying directors salaries and related benefits worth over \$400,000 annually. These troubling practices raise serious warning signs that agencies may be operating more to benefit themselves than the public. In addition, this is an area where I.R.S. has the power to sanction offending agencies.[14](#)

## **2. Many Credit Counseling Agencies Do Not Meet Threshold I.R.S. Tax-Exempt Requirements**

This second set of problems relates to the I.R.S. threshold requirements for tax-exempt status. Section 501(c)(3) exempts from payment of federal taxes groups organized and operated exclusively to accomplish permissible charitable, educational, religious, literary or scientific purposes. 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.

The clearest problems occur among agencies that do not offer a range of services, have inappropriate ties to for-profit businesses as noted above, and aggressively sell DMP products. However, the question is relevant even beyond these most egregious offenders, primarily because of the close ties between credit counseling agencies and creditors. Credit counseling agencies can provide benefits for both

consumers and creditors. However, an agency's primary concern, in all instances, should be providing the most appropriate services for consumers.

It should be clear that an agency that primarily or exclusively sells DMPs is not providing a charitable service or product. This conclusion was affirmed in the October 2003 I.R.S./FTC statement that organizations that offer only DMP services, without significant education and counseling, "...would not qualify for tax-exempt status." [15](#)

A DMP is a structured way to help consumers pay back unsecured debt. DMPs work well for some people, but not for everyone. In today's climate, creditors offer fairly limited concessions for consumers on DMPs. These limited concessions may be sufficient to allow some people to avoid defaulting on debt and to restore good credit. For others, it is just a dead end. It can prolong difficult financial circumstances, ruin a consumer's credit record, create innumerable difficulties and tensions at work and at home, and delay or stop a consumer from taking actions that might be more beneficial, such as negotiating individually with creditors or declaring bankruptcy. The exclusive focus on unsecured debt may also lead consumers to fall farther behind on secured priority debts such as mortgages or car loans. The consequences are severe, including possible foreclosure or car repossession.

The key abuse that can occur when an agency with non-profits status is operating as a for-profit is that it will steer consumers into DMPs regardless of whether this is the best choice for them. The agencies do this because it makes financial sense for them, although not necessarily for consumers. DMPs bring in revenue and the agencies exist to bring in revenue. This may be a legitimate business if done well and honestly, but there is nothing "non-profit" or charitable about it.

Over the years, the close ties between creditors and credit counselors have been questioned in a few court decisions, but for the most part upheld. [16](#) The problem is that these decisions derive from earlier days when the vast majority of credit counselors provided a wide range of services, rarely charged consumers, and were able to receive sufficient funds from creditors to fund other aspects of their services.

A more recent decision addresses the same issues in the context of the current credit counseling environment. In deciding that an NFCC-affiliated agency was not entitled to a charitable tax exemption, the Supreme Judicial Court of Maine found that the agency provided benefits to creditors that were not merely incidental to its charitable purposes. [17](#) The court noted the magnitude of the amounts collected for creditors and that the creditors paid Fair Share. [18](#)

The Maine Court recognized that the traditional model is no longer the norm. For the most part, however, courts and regulatory agencies have yet to catch up. The agencies have continued to get tax-exempt status despite the huge transformation in the industry toward national, aggressive agencies that often function as virtual for-profit business and are in "business" to sell a particular product-a DMP.

Thus, the threshold requirement for tax-exempt status is in serious doubt in many cases. It is not always clear whether an agency is primarily charitable. The picture is clouded even further by unscrupulous agencies' efforts to disguise themselves.

There is a lot of money at stake in the credit counseling industry. Disguised for-profit agencies will go to great lengths to hide the true nature of their businesses. In many cases, the "real picture" can be uncovered simply by calling agencies and asking about their services, particularly about any non-DMP counseling and educational services. We did this as part of our national survey and the results were often astounding. Nearly all of the "counselors" at the 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. It is important to note, in contrast, that most agencies affiliated with the NFCC and some others still strive to provide some type of educational services. However, even among NFCC agencies, in-person presentations by counselors declined by 16.2% from 2000 to 2001.[19](#)

Regulatory agencies should also focus on the content and quality of any education offerings. Does the agency simply sell "cookie-cutter" CD ROMS, videos and other materials? Does the agency have evidence that consumers have used these materials, have learned more about effective debt management, and, most importantly, have changed their behavior? Do they charge for these materials and, if so, how much?

## **WHERE DO WE GO FROM HERE? VISION FOR THE FUTURE**

There have been many developments and responses, just in the past year, that have addressed abuses in the industry. As noted above, the I.R.S., F.T.C. and state regulators issued a joint October 2003 advisory warning consumers about potential problems with credit counselors. The I.R.S. also issued a report earlier this year examining abuses in the credit counseling and credit repair industries.[20](#) Public and private lawsuits, some of which were described above, have targeted key abuses. In addition several states have passed new laws meant to address abuses. However, some of these new laws either exclude "non-profit" agencies from regulation or confine the industry to non-profits without doing additional investigation as to whether the non-profit status of agencies that are operating is legitimate. In addition, to date, most of these laws have been inadequately enforced.

Many sectors of the industry have also responded to the abuses that exist. For example, two of the key trade associations, the National Foundation for Credit Counseling and the Association of Independent Consumer Credit Counseling Agencies (AICCCA) have developed joint best practices standards. These standards are meant to foster self-policing of the industry. Although important, it is unclear to what extent the associations enforce these standards. In any case, the possible penalties include revocation of association membership only, with no effective recourse for consumers. In general, we believe that best practices standards can be positive if rigorously enforced, but are not a substitute for effective federal and state laws.

Creditors have also begun to respond to these problems, but in contradictory ways that have had more of a negative than positive effect so far. For example, 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. In conjunction with lowering Fair Share contributions and making them more conditional, creditors have begun imposing restrictive standards that agencies must meet before they will accept proposed DMPs. Some of these new creditor-imposed conditions and requirements could help limit some of industry abuses. 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. Despite that fact that creditors have abandoned this unilateral approach and say that they are trying to properly fund effective agencies, the overall trend in the Fair Share has been down. This trend hurts the good agencies and the consumers who need access to quality credit counseling.

Moreover, creditor 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. [21](#)

In addition to these existing responses, much more needs to be done. It is particularly critical that the I.R.S. and state charitable regulators follow up on the October 2003 advisory and take disciplinary action against offending agencies, including, if necessary, revoking agencies' non-profit status. Only through proper enforcement can a legitimate non-profit credit counseling sector flourish. We believe that credit counseling can be a viable choice for many consumers. We also believe that scrupulous credit counseling agencies can properly meet non-profit standards. However, these goals will not be reached by federal and state regulatory enforcement alone. Agencies and creditors must also work to preserve the credibility of credit counseling and non-profit credit counseling in particular. Among other changes, non-profit credit counseling agencies must avoid undue reliance on creditor funding. Agencies can and are diversifying funding. Many receive funding from HUD or from foundations to provide housing counseling to first-time homebuyers and homeowners in distress.[22](#) Others receive local funding to help seniors, for example, understand long-term care options and how to budget on a fixed income.

The fact that agencies are funded by creditors is not intrinsically a violation of I.R.S. rules. The key question is whether the agencies are working primarily for the creditors or for the consumers. As one way of addressing this very real conflict in the industry, we recommend that new laws regulating credit counseling place an explicit fiduciary duty on agencies to their consumer clients.

In addition, it is important to emphasize that legitimate non-profit credit counselors can charge fees in some cases. However, these fees must be reasonable and imposed without undermining the charitable purposes of the agency. Whenever possible, agencies should strive to charge fees on sliding scales so that the neediest consumers can still receive assistance.

In order to restore consumer confidence in the industry, it is also critical that the agencies and creditors operate more transparently. Financial arrangements, including Fair Share, must be disclosed. Fee scales should be honestly disclosed and not deceptively described as voluntary or donative. Agencies should also disclose their client "retention rates" annually – the proportion of consumers who do not successfully complete DMPs. And finally, non-profit agencies must counsel clients, provide education, and advise consumers on the full range of options.

The creditor role in bringing about change is just as critical. 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. This step alone will insure that agencies are meeting the educational requirements that non-profit status demands. Creditors should also increase financial support to credit counseling agencies, especially to improve credit counseling options for consumers who are unlikely to benefit from a DMP.

Citigroup took a hopeful step in this regard when it notified agencies on November 4th that it will be replacing its Fair Share donation with lump sum charitable donations, which could be used for counseling and client education.<sup>23</sup> This could have the positive long-term effect of decreasing a major incentive for agencies to inappropriate enroll consumers in DMPs. However, this move could also prove to be hollow and counterproductive if Citigroup doesn't increase the actual amount it provides to effective agencies, allowing these agencies to hire additional staff to assist in providing and increasing counseling efforts. Otherwise, the agencies will be stuck simply trying to process DMPs and maintain the status quo, especially over the short-term.

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.

Finally, to promote these goals, there is a need for greater regulation to ensure that consumer rights are protected and that victims can seek redress in the courts. We are in the process of developing detailed recommendations.

Among other provisions, we call for a limited registration system requiring an agency to register as a debt management or debt settlement provider in each state where it is doing business. Only agencies that are properly registered should be allowed to perform services in that state. At the time of filing for registration, all agencies should be required to furnish a cash or surety bond.

We also recommend that the following written disclosures be given to consumers before initial enrollment for any service with the agency:

- Percentage and amount of funding the agency receives from creditors (as defined).

- Disclosure of any other financial arrangement the agency has with any lender or other provider of financial services.
- Disclosure of the various types of services offered by the agency.
- A statement that debt management and debt settlement plans are not suitable for everyone and that consumers can request information about other options, including bankruptcy. **(This disclosure must appear in all advertisements as well).**
- A statement that debt management and debt settlement plans do not include secured debt, including a brief description of the most common types of secured debt such as mortgages and car loans.
- Existence of the surety bond.
- Statement that the agency cannot require donations. **(This statement must appear in all advertisements as well).**

We recommend that the following disclosures be given to all consumers before initiating debt management or debt settlement services:

- Full disclosure of all services to be provided and any up-front and ongoing fees to be charged for services **(“fees” includes both mandatory and voluntary fees).**
- An estimate of the length of time required to complete services, the types of concessions offered by major creditors, and estimated amounts of concessions throughout the entire period of the plan.

Agencies should be required to give consumers enrolling in debt management plans copies of written contracts that include certain critical information. Among other substantive provisions, we recommend that all contracts contain a right to cancel without obligation within a prescribed period of time after initial enrollment. A separate notice of the right to cancel must be provided at the time the contract is signed. In any case, either party should be allowed to cancel with proper notice. In addition, we believe that all contracts must include a full disclosure of services to be provided and all fees that will be charged.

We believe the law should include strong standards to ensure that only consumers that can benefit from a DMP are enrolled. In order to make this assessment, agencies should be required to evaluate the consumer’s household budget, including types and amounts of debt.

New regulations should also specify minimum requirements for counselor training and reasonable fee limits for services. It is important to require agencies to maintain consumer funds in separate trust accounts and not commingle these accounts with operating accounts.

At a minimum, we recommend prohibition of the following practices:

- False and/or deceptive advertising.

- Agencies should be prohibited from paying referrals to customers who bring in new customers.
- Agencies should be prohibited from purchasing debts from consumers and other third parties.
- Agencies should be prohibited from making loans to consumers and from profiting in any way or receiving any compensation from referring consumers to lenders and other creditors.
- Agencies should be prohibited from compensating employees or contractors based on any formula that provides commissions or incentives tied to the numbers of consumers enrolled in debt settlement or debt management plans.

In order to ensure that these laws are meaningful, we call for strong remedy provisions including the voiding of contracts that are not in compliance and a private right of action for consumers to enforce the law, including provision for actual damages, treble or appropriate statutory damages, attorney's fees, and injunctive relief. Record keeping requirements are also critical to ensure that regulators can track trends in the industry and address abuses.

In a time of economic uncertainty and growing debt, it is increasingly important to preserve credit counseling as an option to help consumers deal with debilitating debt problems. The services are not appropriate for all consumers, but can provide a much-needed safety net for many. This vision of a thriving credit counseling sector is possible only as long as the services provided are quality services, appropriate services, and to the extent offered by non-profit organizations, truly charitable and educational in nature.

Thank you for the opportunity to testify today.

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1 The executive summary is attached at the end of this testimony. The full report is available for downloading from either the NCLC web site or the CFA web site ([www.consumerfed.org](http://www.consumerfed.org)).

2 Revolving debt, most of which is credit card debt, was \$725.6 billion in June 2003, up from \$712 billion at the beginning of the year and \$667.4 billion at the beginning of 2001. Non-revolving debt (primarily auto and household loans) was \$1.04 trillion in June, up from \$1.01 trillion at the beginning of the year. Federal Reserve Bulletin, Table 1.55, October 2003.

3 There were 1,661,996 non-business bankruptcies filed in fiscal year 2003, the highest level ever, and an increase of 7.4 percent from the 1,547,669 filings in fiscal year 2002. American Bankruptcy Institute, November 14, 2003.

4 Section 106, H.R. 975.

5 For example, Georgia and North Carolina do not allow lenders to make high cost mortgage loans unless the borrower has received counseling from an approved agency. Ga. Code Ann. §7-6A-5(7); N.C. Gen. Stat. §24-1.1E(c)(1). New York requires the lender to provide a notice urging the potential borrower to consider consulting a "qualified independent credit counselor or other experienced financial

adviser” and a list of approved counseling agencies. N.Y. Banking Law § 6-1(1). Florida law allows consumers who cannot repay a payday loan to obtain a sixty day repayment grace period, but only if they successfully complete credit counseling by an approved agency during that period. Fla. Stat. Ann. §560.404.

6 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. We are focusing on qualifications for federal tax-exempt status, but use the terms “tax-exempt” and “non-profit” interchangeably.

7 Although not the topic of this testimony, many agencies now offer debt negotiation or settlement services in addition to or instead of debt management plans (DMPs). 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.

8 See generally, National Consumer Law Center, *Surviving Debt: A Guide for Consumers* (2002).

9 See “*IRS, FTC and State Regulators Urge Care When Seeking Help from Credit Counseling Organizations*”, IR-2003-120, October 14, 2003.

10 26 U.S.C. §501(c)(3).

11 See, e.g., Eileen Ambrose, “*Debt Counseling Leads to Deeper Credit Woes*”, Baltimore Sun, November 14, 2003; Jennifer Bayot, “*Not-for-Profit Credit Counselors Are Targets of an I.R.S. Inquiry*”, New York Times, October 14, 2003; Caroline E. Mayer, “*Easing the Credit Crunch?*”, Washington Post, November 4, 2001 at H01. Also see Massachusetts Senate Committee on Post Audit and Oversight, *Losing Credibility: Troubling Trends in the Consumer Credit Counseling Industry in Massachusetts*, July 2002.

12 The Illinois suit was filed in February 2003 and the Missouri suit in September 2003. For a copy of the Missouri complaint, see <http://ago.missouri.gov/lawsuits/2003/091103ameridebt.pdf>. For a detailed discussion of a private lawsuit with similar allegations against Debticated, see Debra E. Blum, “*Checking Upon Credit Charities*”, The Chronicle of Philanthropy, August 21, 2003.

13 This lawsuit was filed in December 2002. See “*AG Reilly Sues Telemarketer Accused of Using Deceptive and Misleading Tactics to Sell Credit Counseling Services to Consumers*”, Press Release, December 19, 2002. Available at: [http://www.ago.state.ma.us/press\\_rel/ics.asp?searchStr=1](http://www.ago.state.ma.us/press_rel/ics.asp?searchStr=1).

14 26 U.S.C. §4958 (I.R.S. “intermediate sanctions” rule).

15 See “*IRS, FTC and State Regulators Urge Care When Seeking Help from Credit Counseling Organizations*”, IR-2003-120, October 14, 2003.

16 For example, in a key 1979 decision, the U.S. Tax Court disagreed with I.R.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.

17 *Credit Counseling Centers, Inc. v. City of South Portland*, 814 A. 2d 458 (Maine 2003).

18 A dissenting judge argued that any benefit provided to creditors is incidental and that it 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.*

19 Statistics provided with permission from the National Foundation for Credit Counseling. Data is derived from the 2001 Member Activity Report.

20 Debra Cowen and Debra Kawecky, "Credit Counseling Organizations", CPE 2004-1 (January 9, 2003). As of November 2003, available at [www.irs.ustreas.gov/pub/irs-tege/eotopica04.pdf](http://www.irs.ustreas.gov/pub/irs-tege/eotopica04.pdf).

21 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 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.

22 Housing counseling funding, in particular, is limited and credit counseling agencies are in competition with non-profit HUD-certified housing counselors. Traditional housing counseling agencies, for the most part, do not receive Fair Share funding and generally do not charge for services.

23 Letter from Citigroup, November 4, 2003. On file with the Consumer Federation of America and the National Consumer Law Center