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Consumer Debt Management Options[1]

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When a consumer has unwanted debt or high amounts of debt, there are different options that can help eliminate or decrease their debt level. However, it is important to choose the right option. This publication will describe some of the debt-management options that are available to consumers. These include:

- Do-it-Yourself
- Debt-Consolidation Loan
- Credit Counseling
- Debt-Management Plan
- Debt Settlement
- Bankruptcy

Nevertheless, with any of these options, if basic money-management skills are not adopted, or if behaviors remain unchanged, debt may be eliminated or reduced only temporarily. Ultimately, a consumer will not be free of debt unless income exceeds expenses and money is set aside to cover unexpected emergencies and expensive purchases.

Understanding Secured vs. Unsecured Debts

Debts can be secured or unsecured. Secured debts are usually tied to an asset like an automobile or a house. If the borrower does not pay as agreed, the lender can repossess the automobile or foreclose on the house. Unsecured debts

Figure 1. *Facing Foreclosure with a Sea of Mail Credits:* Photo by Casey Serin. CC BY 2.0. http://flic.kr/p/qET5r

are not tied to any asset, and include unsecured credit-card debt, medical bills, and signature loans.

The distinction between secured and unsecured debts is important because it will determine which debt-management options are available. For example, debt-management plans focus on unsecured debts, but not secured debts. Therefore, a debt-management plan could help with credit-card debt but not mortgage debt. If a consumer is facing foreclosure, they may want to seek help from a foreclosure-avoidance counselor whose agency has been approved through the

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U.S. Department of Housing and Urban Development (HUD). Information about foreclosure avoidance can be found at http://www.hud.gov.

Debt-Management Options

Do-It-Yourself (DIY)

The DIY option means developing and following a budget in which necessities are met and paying off debts is a high-priority budget item. An advantage of DIY is that there are no fees to pay. DIY can also be satisfying because a consumer will have taught themselves money-management skills along with changing their financial behaviors, both of which are necessary for achieving and maintaining financial stability.

University of Florida IFAS Extension and the Cooperative Extension System have many resources to help a consumer track expenses and develop a budget. Visit UF/IFAS Extension at http://solutionsforyourlife.ifas.ufl.edu/families_and_consumers/money_matters/ to become a more informed and empowered money manager.

Another resource is the PowerPay debt-analysis program developed by Utah Extension. This free, online program (http://www.powerpay.org) helps consumers develop a debt-management strategy. In order to be successful, a consumer must:

1. Stop adding to their debt load.
2. Make at least the minimum payment required on each debt.
3. When one debt is paid in full, apply the dollar amount of that payment to other debts.

PowerPay debt analysis helps consumers analyze their debt and develop a management strategy. The analysis will provide the following information:

- The month and date each debt will be paid
- The total amount you will pay for each debt
- The effects of extra payments on a debt or a consolidation loan

Credit reports are another tool that can help consumers evaluate their debt. Consumers are entitled to one free credit report per year from each of the three credit-reporting agencies. They are available free of charge through the federally authorized website http://www.annualcreditreport.com, or by calling 1-877-322-8228. A consumer has a choice to order all three credit reports at the same time, or space out the order (order one initially and the others at a later date). If all three are ordered together, the reports can be compared. If you order one from each of the three reporting agencies at a time, then you can order all three throughout the year. Ideally, you could order one of these every four months. This can allow you to look for changes to your report. Beware of imitators! Other companies may offer a free report, but there is likely to be a hidden charge or subscription fee.

Debt-Consolidation Loan

A debt-consolidation loan involves taking out a new loan to pay off debts. Sometimes this is done through a home refinance or home-equity line of credit. The current housing situation may make this option unrealistic for borrowers who are upside down on their home mortgage (owing more on the mortgage than the actual market value of the home). A person who does have equity in their home needs to be cautious and consider all refinance costs. Paying off unsecured debt with a home-equity loan means that the borrower's home now secures the new loan. Failure to follow through on the terms of the loan may lead to foreclosure.

A debt-consolidation loan may be a way to make monthly payments more manageable. However, in the long run a consumer may end up paying more overall because a consolidation loan is likely to have high interest rates. It may also take longer to pay off the debt.

Credit-Counseling Agencies

The two, large trade associations that represent counseling agencies are the National Foundation for Credit Counseling (NFCC), and the Association of Independent Credit Counseling Agencies. There are many credit-counseling agencies that are not members of these associations. Many credit-counseling agencies have non-profit status. As a requirement of this non-profit status, these agencies are required to provide financial education and counseling.

Credit-counseling agencies also provide debt-management services, and some agencies may offer debt-settlement services. Agencies usually charge a fee for these services.

During a credit-counseling session, a counselor reviews the consumer's financial information and offers advice to work out a plan to pay off debts. Counseling sessions may be offered online, by telephone, or in person. Typically there is no charge for these sessions.

The counselor will ask the consumer to provide the following information:

- Recent creditor statements
- Verification of income/last paycheck stub
- Living expenses

The counselor will also review the consumer's credit report. All information will then be analyzed to determine whether a debt-management plan is possible.

Debt-Management Plan (DMP)

A debt-management plan is a payment plan to pay off unsecured debts in a specified amount of time. Unsecured debts are debts backed by an agreement to pay by the consumer, but not by collateral. Unsecured debts include credit-card debt, medical bills, and student loans. The following are some characteristics of a debt-management plan:

- It is not a new loan.
- Set-up is through a credit-counseling agency.
- Goal is to pay off unsecured debts in a fixed amount of time.

Counseling agencies help negotiate:

- Better terms
- Lower interest rates
- Waiving of fees

Consumers enrolled in a debt-management plan through a counseling agency will deposit money each month into an account held by the credit-counseling agency. The agency will use this money to pay the consumer's debts that are part of the plan. A counseling agency may be able to negotiate with creditors on the consumer's behalf in order to lower interest rates or have fees waived. The consumer also pays the counseling service a monthly maintenance fee for administering the plan.

EFFECT ON CREDIT HISTORY

When a consumer enrolls in a debt-management plan, this may appear on the individual's credit report. While in the plan, the consumer may be denied access to loans by lenders and/or have to pay higher interest rates on new loans. Current creditors may close his/her lines of credit. However, a consumer who successfully completes a plan will have significantly reduced their unsecured debts and their credit score is likely to increase.

CHOOSING A CREDIT-COUNSELING AGENCY TO HANDLE YOUR DEBT-MANAGEMENT PLAN

Consumers should shop carefully and ask many questions before choosing a credit-counseling service. Even though a credit-counseling agency administers the debt-management plan, the consumer is still responsible for debt repayment. If either the consumer or the agency makes a late payment, the consumer is likely to face financial consequences.

QUESTIONS TO ASK THE COUNSELING AGENCY—BEFORE AGREEING TO A DMP

1. How often will the consumer receive account statements and will they be sent in the mail, be available online, or both?
2. What fees are charged for enrolling in the DMP?
3. What debts will be included in the plan and what debts will be excluded?
4. Will the consumer work with one counselor or many?
5. What type of training or certification have counselors received?
6. How are counselors compensated? Are they paid a commission?
7. What happens if a consumer misses a payment or finds that they are financially unable to meet the payment amount each month?

Consumers should avoid any company that seems to be "pushing" a DMP. A counselor should thoroughly review a person's situation before recommending any type of plan or debt-management strategy.

Debt Settlement (sometimes called Debt-Negotiation Services)

Debt-settlement plans are not the same as debt-management plans. The goal of debt settlement is very different from that of a debt-management plan. With a debt-management plan, a consumer is seeking to pay their balances in full. A consumer enrolled in a debt-management plan may have interest rates and fees lowered, but the consumer will pay the principal amount. By contrast, the goal with debt settlement is to pay only a partial amount of what is owed. A company that offers debt-settlement services will state that they will negotiate with the consumer's creditors to settle their unsecured debts for an amount less than what is owed. However, there is no guarantee that creditors will accept the offer.

Debt-settlement plans are a risky option and, according to the Federal Trade Commission, they can have a negative impact on an individual's credit history. Debt-settlement fees are significantly higher than the fees charged to enroll in a debt-management plan. Some companies may ask for fees up front, before the services are offered, and, according to FTC, they may fail to follow through on the services they sell. These plans are considered risky because there is no guarantee that a creditor will accept partial payment of a legitimate debt. In addition, companies may advise a consumer to stop making payments on their debts and to avoid contact with their creditors.

If settlement fails, a consumer will find that they face greater debt because of interest, fees, and penalties. Creditors can also take court action to garnish wages.

If settlement succeeds, the amount dissolved is considered income and may be taxed by the IRS as such. However, if a consumer is insolvent, then all or part of the settled debt may not be taxable. For additional information about tax obligations, read the article "The Mortgage Forgiveness Debt Relief Act and Debt Cancellation" on the IRS website http://www.irs.gov.

Bankruptcy

Bankruptcy is a legal proceeding governed by federal law. This proceeding can be used by consumers to seek the discharge of many of their debts. Discharge of a debt means the consumer is no longer liable for the debt. Not all debts are dischargeable. Non-dischargeable debts include court-ordered child support, alimony, court fines and penalties, certain income taxes, and government-backed student loans (only dischargeable in special circumstances).

If a consumer is considering bankruptcy, they must contact a government-approved provider for pre-filing credit-counseling sessions. A list of approved bankruptcy-counseling agencies is available at http://www.justice.gov/ust/eo/bapcpa/ccde/cc_approved.htm. Costs charged for the bankruptcy proceeding include court costs, administrative fees, and trustee fees. In addition, while not required by law, hiring an attorney may be helpful.

There are several different types of bankruptcy.

Chapter 7

Chapter 7 bankruptcy is also called "straight bankruptcy." Chapter 7 provides for the liquidation of assets and is permitted when it is highly unlikely that substantial repayment could ever be made.

A trustee is appointed to take over the debtor's property. Any non-exempt property will be sold or turned into money to pay creditors. State and federal laws will dictate which non-exempt property (personal items and real estate) the debtor will be able to keep.

Chapter 13

Chapter 13 bankruptcy is also called wage-earner's bankruptcy. This type of bankruptcy can give an individual with regular income the opportunity to develop a plan to repay all or part of their debts within a 3–5 year period. The court must approve the debtor's repayment plan and budget. A trustee is appointed and collects payments from the debtor, pays creditors, and makes sure the debtor follows the terms of the repayment plan. By filing under this chapter, an individual can stop foreclosure proceedings. However, once the Chapter 13 plan is put in place, the individual must make their mortgage payments to avoid foreclosure. The lender is not required to modify the loan because of the bankruptcy proceeding.

Chapter 12

Like Chapter 13, but it is only for family farmers and family fishermen.

Chapter 11

This is used mostly by businesses. In Chapter 11, the debtor continues to operate the business, but creditors and the court must approve a plan to repay debts. There is no trustee unless the judge decides that one is necessary; if a trustee is appointed, the trustee takes control of the business and property.

Before Filing for Bankruptcy, Learn More

The United States Bankruptcy Court of the Middle District of Florida provides "Bankruptcy Basics" videos in English, Spanish, and Creole online at http://www.flmb.uscourts.gov/bankruptcybasics/. A downloadable guide is available at http://www.flmb.uscourts.gov/bankruptcybasics/documents/bankruptcybasics.pdf.

Shop Carefully

When considering getting help to stabilize your financial situation, your first step is to complete some research. Find out what services a business provides and the cost. It is important to get everything in writing and read contracts carefully. Beware of scams. Unscrupulous people exploit the fact that consumers are more likely to fall for "too-good-to-be-true" offers when they are in financial trouble.

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