Consumer Debt Settlement

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Consumer Debt Settlement Industry
Clear Guidelines Create Legitimate Consumer Service Business

The consumer debt settlement industry has been experiencing a resurgence since the shake-out of 2010 - 2011, and we anticipate continued growth in the sector. This growth, along with the intrinsic returns of debt settlement, will drive investor interest in the space. Successful debt settlement firms are likely to be targeted for acquisition by private equity firms and other investors in the coming years.

The consumer debt settlement industry had a terrible reputation. Debt settlement operators would solicit desperate consumers with promises of debt relief, collect an up-front fee to negotiate discounted payoffs with creditors and, in some cases, do very little in return for the payment. The charlatan factor in the debt settlement business was significant. The landscape changed on October 27, 2010 – the Federal Trade Commission issued the Revised Telemarketing Sales Rule, which prohibited debt settlement companies from charging fees to consumers prior to delivering any services. Along with this prohibition, the FTC established very clear rules of the road for the debt settlement industry. This is an unusual case of regulation rescuing an industry from its worst participants. The charlatans are gone, the legitimate players have adjusted, and the new guidelines actually do protect and benefit consumers while allowing debt settlement firms to generate attractive returns to their equity holders. Most importantly, the debt settlement industry provides consumers with significant debt relief – according to one study, the average settlement of an account enrolled in a debt settlement program was 48% of the balance owed.

Debt settlement has been around as long as there has been debt – creditors typically try to recover whatever they can when a borrower is in distress, and settlements are often negotiated to discharge the debt for far less than the amount owed. Consumer debt settlement is a process performed by a service provider working on behalf of a financially distressed consumer. The service provider negotiates the settlement and discharge of the consumer's unsecured debt. The debt settlement firm acts as an intermediary/expert agent, but does not provide legal or tax advice. Consumer debt settlement took off during the great expansion of consumer credit in the 1990's and the subsequent recession of the early 21st century.

Debt settlement companies also got a lift from the Bankruptcy Abuse Protection and Consumer Protection Act of 2005 ("BAPCPA"). The law makes it more difficult for some consumers to file bankruptcy under Chapter 7, which fully discharges debt. BAPCPA forces these consumers into Chapter 13, which requires a five-year repayment plan for some or all of the consumer's debt. Consumers can find more flexible options with debt settlement firms and avoid the massive credit score damage caused by a bankruptcy filing.

The robust expansion of consumer lending is setting the table for significant growth in the consumer debt settlement industry, and a growing group of legitimate debt settlement players should benefit from this environment.

- **Growing Market for Debt Settlement:** After a major contraction during the financial crisis and recession of 2008 through 2010, credit card debt is expanding at a steady clip. According to the Federal Reserve, total revolving consumer debt outstanding hit $946 billion in August 2016. Industry observers predict that total outstanding credit card debt will exceed the July 2008 peak ($1.02 trillion) before the end of 2016. Personal savings rates increased from 4.4% of household income in July 2008 to 11% in December 2012; the savings rate is back down to around 5%. According to data from Equifax, the credit standards of credit card issuers are eroding: 10.6 million cards were issued to subprime borrowers in 2016, up 25% form 2014 and the highest level since 2007. This expansion of debt, reduction in savings, and increased household leverage will result in more financial stress and an increased pool of potential clients for debt settlement firms.
- **Debt Settlement Companies as Consumer Advocates:** Consumer debt settlement firms act as expert agents for consumers, similar to the roles played by tax preparers or lawyers specializing in residential real estate transactions. Of course, consumers can negotiate directly with creditors to obtain a settlement, thus avoiding the fees charged by debt settlement firms. This requires (i) the confidence and

persistence to engage with consumer lenders, which are often large, bureaucratic, unsympathetic counterparties and (ii) some knowledge of what is normal and customary in a consumer debt settlement; parameters vary by creditor. By using a debt settlement firm with trained, experienced negotiators, the playing field is leveled, and the consumer gains a credible advocate. The 2010 FTC ruling assures that the debt settlement firm is paid only when debts are settled and the consumer has made his/her first payment on that settlement. This ensures that the consumer and the debt settlement company goals are aligned.

- **Debt Settlement as Bankruptcy Alternative:** The consumer debt settlement industry traces its roots to the appearance of credit cards (specifically, Diners Club) in the 1930's. The business first proliferated in 2003. Easy credit followed by a major economic downturn created the conditions for the industry to blossom as a large population of overleveraged consumers struggling with unemployment and other challenges. From a creditor's standpoint, debt settlement was preferable to a Chapter 7 bankruptcy – unsecured creditors receive virtually nothing when a consumer files Chapter 7. Many debt settlement firms popped up in the 2003 – 2010 timeframe to lure the struggling borrowers with promises of debt relief without the stigma and disruption of bankruptcy. The 2005 changes to the bankruptcy law were explicitly designed to make it more difficult for consumers to file Chapter 7 if they have some ability to service their debt. This left the Chapter 13 option as the only available path. Two-thirds of Chapter 13 filers do not make it entirely through their repayment plan and are pushed out of the bankruptcy system without discharging their debt. Consumer debt settlement is more flexible than Chapter 13 – settlement amounts and payment timeframes are negotiated directly with creditors, not imposed by the court. Debt settlement is less negative for credit scores than bankruptcy. When a consumer settles a debt, their credit report is marked as "Settled as Agreed" or "Paid as Agreed" – not as damaging as "Bankrupt". In addition, bankruptcy filings are part of the public record; debt settlements are not.

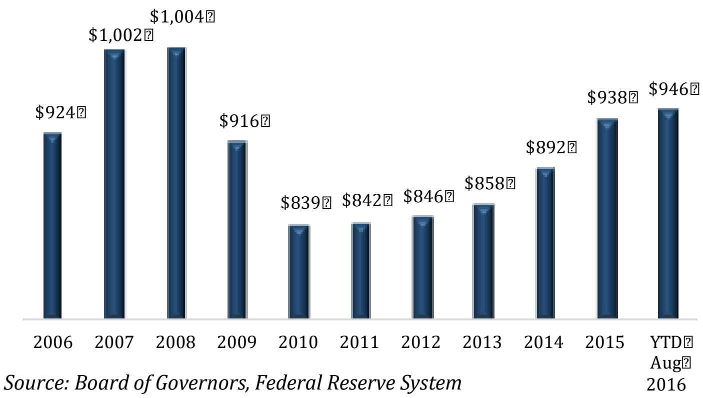
- **Strong Returns Attract Investor Interest:** While the FTC rule changes the operating parameters and timing of cash flows for consumer debt settlement firms, the new model generates excellent returns for investors in well-managed enterprises. Sophisticated investors have taken note – the largest player in the industry, Freedom Financial Network (*aka* Freedom Debt Relief), was purchased by Stone Point Capital, a major private equity firm, in September 2015; Freedom also received a $125 million investment from Vulcan Capital (Paul Allen's primary investment vehicle) in December 2013. Another significant participant, Century Support Services, is controlled by JH Capital Group, an investment firm focused on the financial services sector.

Consumer Debt Settlement Services – the Market

To state the obvious, consumer debt settlement activity is tied to growth in consumer lending. Settlement activity does not appear to be closely tied to the credit cycle, however. When consumer credit is expanding and the general economy is growing, a segment of consumers over-spend and have difficulty repaying the debt they have incurred to fund their consumption. When the economy dips and consumer credit contracts, more consumers are suffering job losses, which disrupts their ability to service debt. Both scenarios create potential clients for debt settlement firms, but prospects for debt settlement firms appear to be brightest when consumer credit is loose.

The recovery in consumer lending since the financial crisis and recession is complete. Outstanding credit card debt is projected to break through the $1 trillion level by year-end when the holiday shopping season is over. The United States last broke the $1 trillion level on credit card debt in 2008 – right as the financial crisis was exploding.

CREDIT CARD DEBT OUTSTANDING *($ in billions)*

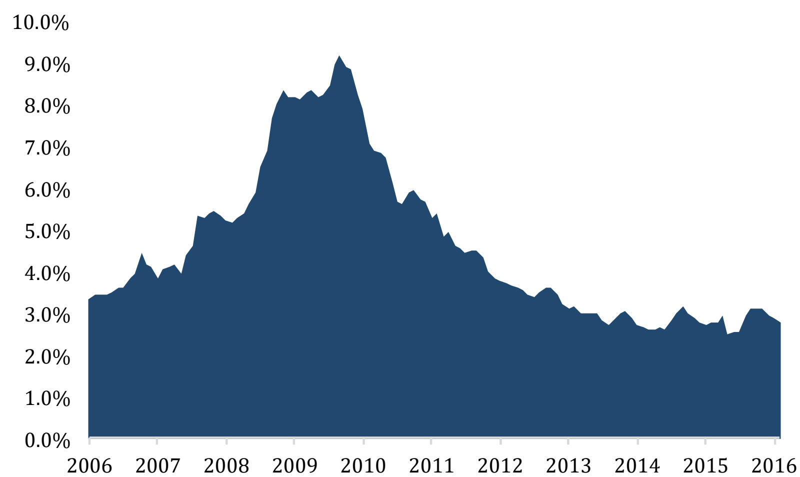


Source: Board of Governors, Federal Reserve System

The consumer credit recovery has increased the credit card debt of the average American family. Average credit card debt per household increased to $7,989 in August 2016, up 7% from July. The peak of $8,299 per household, reached in July 2008, is likely to be eclipsed before the end of 2016.

Credit card default rates spiked during the 2009-2010 recession and have dropped sharply since then. The pre-crisis default rate was 3.34% of outstanding balances in August 2006, leapt to 9.15% in April 2010, and hit 2.76% in September 2016. In our view, this is the calm before the storm.

CREDIT CARD DEBT DEFAULT RATES *(as % of debt outstanding)*



Source: S&P/Experian Bankcard Default Index

In addition to the credit card market, unsecured marketplace lending (Lending Club, Prosper, Avant, et al) generated almost $25 billion of loan volume in 2015, more than double the volume experienced in 2014. These loans are exhibiting elevated default rates in 2016, and debt settlement firms are beginning to see them show up in the consumer's debt mix.

We believe that this major expansion in unsecured consumer debt is creating conditions for significant growth in the consumer debt settlement segment.

Consumer debt settlement is a fragmented sector with firms playing various roles. Some of these firms are highly specialized and some go to market with a more integrated approach.

CONSUMER DEBT SETTLEMENT MARKET SEGMENTS

Front-end settlement firms	• Lead generation and pursuit; data-driven direct-to-consumer operations • Majority of originations are via direct mail; some internet origination and "opt in" telemarketing • Classic sales-driven, commission-oriented, direct-to-consumer operating environment
Back-end settlement firms	• Focused on the multi-step process of settling consumer debts with creditors • Origination relationships with front-end debt settlement firms, some are exclusive arrangement • Customer relationships are longer-term and consultative in nature; back-end settlement firms advocated for the consumer with his/her creditors
Independent trust account managers	• Required under the 2010 rule change – account managers hold consumer funds and act as independent 3rd party payment processors for enrollees in debt settlement plans • Consumer retains complete control over funds; debt settlement firms can't control these accounts
Affiliated consumer lending	• Debt settlement firms can accelerate their revenues if a consumer borrows to fund the settlement amount rather than gradually building a fund held in trust • Some debt settlement firms have consumer lending affiliates

The revenue models of each of these segments are different. Front-end settlement firms receive commissions from their affiliated back-end settlement partners that range from 5 to 6% of the balances owed by the consumers. Back-end settlement firms receive a fee from the consumer borrowers once the debt is settled; those fees can range from 21% to 23% of the face value of the debt settled. Independent trust account managers receive a fixed fee per month per account from the consumers. Those fees generally fall in the range of \$9 – \$12 per month. The affiliated consumer lenders are paid via lending spread and associated late fees and other charges. All segments can generate attractive returns of investor capital.

Change in the Consumer Debt Settlement Business Model

While debt settlement is an old concept, the service did not become widely available to consumers until the early part of the 21st Century. The consumer credit expansion of the 1990's combined with the economic downturn of 2001 led to an increase in consumer financial distress and launched the modern debt settlement business. Prior to 2003 or so, lawyers primarily performed the consumer debt settlement function.

The consumer debt settlement industry has come of age over the past 10-13 years:

HISTORY OF THE CONSUMER DEBT SETTLEMENT MARKET

The debt settlement industry had its first significant expansion in 2005 when the Bankruptcy Abuse Protection and Consumer Protection Act of 2005 (BAPCPA) was passed. BAPCPA made it much more difficult and expensive for consumers to seek discharge of their debts via Chapter 7; indeed, the law instituted a means test that prevented many people with financial problems from accessing Chapter 7. Only Chapter 13, which requires a debt repayment plan, was available to these consumers. This provided a major opening for debt settlement firms.

In the first chapter of the debt settlement industry's development, firms charged fees based on a percentage of the debt that a consumer was seeking to settle. The typical debt settlement firm charged 15% of the debt balance, which was collected up-front in installments over six months. While many debt settlement firms delivered debt reduction amounts substantially higher than the up-front fees charged, there was a significant minority of industry participants that took fees but did not deliver debt reduction. Complaints associated with unscrupulous players led the Federal Trade Commission to open an inquiry into the consumer debt settlement industry in July 2009. This led to the Amended Telemarketing Sales Rules ("FTC Rule") that banned advance fees effective October 27, 2010.

The FTC Rule shifted the risks associated with the debt settlement process from the consumer to the debt settlement firm. This pay for performance model requires that three milestones be achieved before the debt settlement firm is allowed to collect a fee:

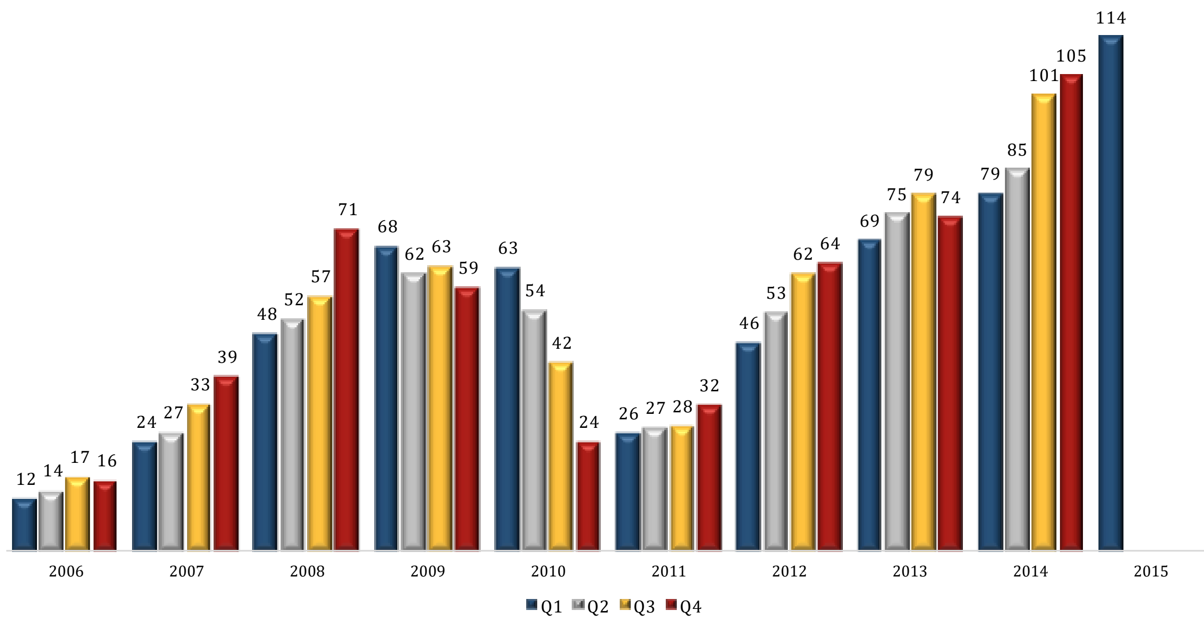
1. The debt settlement firm must negotiate the terms of the settlement with the customer's creditor;
2. The customer must formally agree to the terms of the settlement; and
3. The customer must ratify that acceptance by making at least one payment to the creditor.

This rule created significant carnage in the debt settlement industry. Most debt settlement firms cut back significantly or shut down, unable to cope with the up-front costs of the new debt settlement model. According to a study completed for the industry trade group (American Fair Credit Council), 80% of debt settlement firms exited the industry after the FTC Rule became effective.

After the shake out, the remaining debt settlement firms began to do business using the new business model. The origination of clients and negotiation of settlements required investment prior to receipt of any revenues, but the settled accounts generated significant cash once the consumers started making payments on the settlement agreements. The industry began to turn around, and some of the firms that exited decided to re-enter. New players also emerged after 2010.

The graph below illustrates the shift in the debt settlement business caused by the FTC Rule; this analysis is based on data obtained from the largest debt settlement firms in the country covering 297,000 consumers and 1,964,000 accounts.

ACCOUNT ENROLLMENTS BY QUARTER *(units thousands)*



Source: "Options for Consumers in Crisis: An Updated Economic Analysis of the Debt Settlement Industry," Greg Regan, prepared for the American Fair Credit Council, 8/15/15

The study concluded that the total debt reduction obtained by debt settlement firms for the 1,964,000 accounts included in the database was $2.1 billion on debt with a face value of about $8.9 billion. The debt settlement firms realized fees of $700 million on this pool of accounts. About 433,000 accounts were still in the active phase of settlement, and further debt reduction on those accounts should occur as the debt is settled. Clearly, the industry is delivering value to the consumer borrowers that enroll in debt settlement programs.

The FTC Rule is a rare instance - a regulatory action that significantly improved the landscape of an industry. Prior to the change in 2010, the debt settlement industry generated great dissatisfaction among consumers. This was reflected in the Better Business Bureau ratings of debt settlement firms – many had "F" grades, and no one scored well. In recent years, major players in the debt settlement sector have received "A" ratings from the BBB. The customer experience delivered by the industry has vastly improved, and almost every consumer that enrolls with a debt settlement firm gets some reduction in the balance owed, even if the settlement program is terminated by the consumer prior to completion.

Regulatory Environment for the Consumer Debt Settlement Industry

While the Federal regulatory environment for consumer debt settlement has been stable since October 2010, there have been a few enforcement actions. In addition, most states also regulate the activities of debt settlement firms and a few have created restrictions that make it difficult for debt settlement firms to operate profitably.

The most significant regulatory action that has occurred since October 2010 involved a Consumer Financial Protection Bureau enforcement effort directed at Global Client Solutions, the largest independent trust account manager serving the debt settlement industry. The CFPB initiated this civil action based on allegations that Global Client Solutions was enabling debt settlement firms to collect up-front fees from consumers in violation of the FTC Rule. Global Client Solutions settled the case (without admitting to any of the charges) on August 25, 2014. The settlement required the company to pay $6 million in relief to consumers and a $1 million civil penalty. The CFPB will also monitor the company and subject it to reporting requirements for an unspecified period. The CFPB fined another independent trust account manager, Meracord, about $1.4 million for similar violations in October 2013. There have been a number of CFPB actions against debt settlement companies, all accused of violating the "no upfront fees" provision of the FTC Rule (the CFPB obtained judgements in two of these cases). Companies that have carefully complied with the FTC Rule appear to have had no trouble with the CFPB or any other Federal regulator.

State regulatory authorities are mostly friendly to debt settlement, but there are about 15 states that are not supportive of the industry. The most challenging issue presented by certain states is a hard cap on the fees that debt settlement firms can charge consumers. In Ohio, fees are capped at 8.5% of the debt owed by consumers. In Florida, the cap is 7.5% of the debt balance. These caps prevent debt settlement firms from operating in these states. Most of the restrictions on debt settlement date back to the period prior to the FTC Rule. The industry is actively seeking to change the views of state regulators regarding debt settlement and is using the FTC Rule as a proposed guideline for the states.

Consumer Debt Settlement Industry Participants

The table on the next page lists and describes a few of the significant participants in the consumer debt settlement sector.

Company	Category	Scope	Other Information
Freedom Financial Network	• Integrated credit services firm	• Debt settlement – front and back end, also works with affiliates (Freedom Debt Settlement) • Debt consolidation loans (Bills.com) • Unsecured lending (FreedomPlus) • Largest firm in the industry	• Established in 2002 • Over 1,000 employees • Over $4B of consumer debt settled • Major private equity firm is a shareholder
National Debt Relief	• Debt settlement firm	• Debt settlement – mostly back-end • One of the top five participants in debt settlement	• Established in 2008 • A+ BBB rating • Privately-owned
Century Debt Settlement	• Back-end debt settlement firm	• Back-end debt settlement; originates via affiliates • Growing rapidly in the past few years after taking on new equity partner	• Traces its origins in the debt settlement industry to 1999 • Owned by investment group that is focused on specialty finance
RescueOne Financial	• Front-end debt settlement firm	• In-bound call center, originating via direct mail • 10,000 calls per month • Affiliate of Freedom Debt Settlment	• Also is a licensed lender, originating debt consolidation loans
Global Client Solutions	• Independent trust account management firm	• Largest trust account manager focused on debt settlement • 400,000 accounts under management	• Handles disbursements via ACH, wire transfers, and electronic checks

While comprehensive industry data is not readily available, Colonnade estimates that there are currently at least 50 substantial consumer debt settlement firms. The American Fair Credit Council lists 36 members, and some significant firms do not belong to this trade association. There are also a number of enterprises that sell services to debt settlement firms, ranging from the independent trust account managers to prepaid legal plan providers.

Prior to October 2010, there were over 200 debt settlement firms in the United States. The shake out was massive, but now the number of firms in the industry is climbing again.

Capital Needs and Investment Activity in the Consumer Debt Settlement Sector

The FTC's October 2010 issuance of the Revised Telemarketing Sales Rule radically altered the dynamics of the consumer debt settlement industry. When firms were allowed to charge up-front fees, cash flow preceded operating expenses and capital requirements of debt settlement firms were quite modest. After the prohibition on up-front fees, debt settlement firms took on more risk and needed to fund origination and operating costs prior to realizing any revenues from debt settlement activities. This created a "J-curve" earnings pattern – until a portfolio of clients is assembled, companies experience compressed earnings, or even losses. Once a pool of consumers makes it through settlement and start paying, the debt settlement business can generate strong investment returns and significant cash flow. The debt settlement firms operating in the post October 2010 environment are generally larger, more profitable and more capital intensive than their predecessors.

The consumer debt settlement industry is beginning to attract institutional investors and some lenders. We have identified a handful of transactions in the sector.

Date	Target	Investor	Comments
Oct-16	Century Support Services	Atalaya Capital	Century raised about $50 million of debt to fund expansion of debt settlement activities
Sep-15	Freedom Financial	Stone Point Capital	Stone Point is a major private equity firm focused on financial services only
Dec-13	Freedom Financial	Vulcan Capital	Paul Allen's investment firm; invested $125MM to build Freedom Financial's lending operation
2012	Century Support Services	JH Capital Group	JH Capital is a specialty finance firm focused on distressed consumer borrowers (debt purchasing, "rehab" lending, etc.).

Investment activity will accelerate in the coming 18 to 24 months as the sector expands due to the expected increase in over-leveraged consumers. In addition, the transformation of the debt settlement industry from pariah to consumer advocate reduces the reputation risk previously associated with investment in the sector – more investors and lenders will pursue this sector now that the charlatans are gone.

Conclusion

The consumer debt settlement industry is an emerging niche for investors seeking a new option for investing in the consumer credit sector:

- The industry has been purged of its unsavory elements by the October 2010 amendment of the FTC's Telemarketing Sales Rule, and the customer experience has improved substantially in the past few years.
- Consumer debt settlement firms level the playing field for consumer borrowers seeking to settle debts outside of bankruptcy court.
- Capital requirements of debt settlement firms have increased after the elimination of up-front fees, which creates barriers to entry and provides an opening for professional investors.
- Private owners of consumer debt settlement companies are likely to begin harvesting the value that has been created since the 2010 FTC Telemarketing Sales Rule change.

For more information on the Consumer Debt Settlement Industry, please contact:

Jeff Guylay	Gina Cocking
Managing Director	Managing Director
208.726.0788	312.425.8145
jguylay@coladv.com	gcocking@coladv.com

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