Debt Settlement and Bankruptcy

A COMPARISON OF CREDIT SCORES

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Frederic Huynh
Vice President of Data Optimization

freedom
DEBT RELIEF

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ABOUT THE AUTHOR

Frederic Huynh is the Vice President of Data Optimization at Freedom Debt Relief, a leading digital personal finance company. Previously, he spent over 18 years at FICO®, where he oversaw the development, maintenance and analytic support for the FICO® Score. He was the technical lead on all product, client support, regulatory and legal issues surrounding the company's flagship product. Freddie has a Bachelor of Arts in mathematics from Claremont McKenna and a Master of Science in operations research from Stanford.

ABOUT FREEDOM DEBT RELIEF

Freedom Debt Relief is one of the largest providers of debt resolution services in the United States. It works on behalf of consumers to negotiate with creditors and reduce the amount of debt they owe. FDR is an accredited debt resolution company based in San Mateo, Calif. and has served more than 800,000 consumers, helping to resolve over $16 billion in debt since 2002.

THE CONTENT OF THIS REPORT IS NOT, NOR IS INTENDED TO BE: (1) LEGAL ADVICE OR GUIDANCE, (2) ADVICE OR GUIDANCE REGARDING BANKRUPTCY, OR (3) ADVICE OR ASSISTANCE REGARDING A CONSUMER'S CREDIT RECORD, CREDIT HISTORY, OR CREDIT RATING.

/ Executive Summary

A LONGITUDINAL STUDY OF CREDIT SCORES reveals that the typical bankruptcy filer and debt settlement client experience a rehabilitation in their credit score in the years after filing and enrollment. Both groups exhibit a distinct trajectory in their FICO® Scores over time, but debt settlement clients generally experience a more complete and more rapid recovery in their credit scores when compared to bankruptcy filers.

Additionally, bankruptcy filers still have credit profiles that correlate with higher bankruptcy risk six years after filing when compared to debt settlement clients. This is particularly relevant because it can be argued that bankruptcy risk is a more direct barometer of credit health for over-indebted consumers. The lower bankruptcy risk six years after enrollment for debt settlement clients provides another piece of evidence that debt settlement is effective in solving consumers' financial stress over the long term.

The fact that the typical debt settlement client performs better on multiple credit metrics many years after enrolling in debt settlement indicates that these consumers will generally have greater access to more affordable credit, and less friction obtaining services that require a valid credit score when compared to bankruptcy filers.

These findings are not intended to crown one debt relief approach as being better than the other. Rather, given the acceptance of bankruptcy as an effective debt relief strategy that provides over-indebted consumers with a second chance at a fresh start, the analysis supports the notion that from a credit score perspective, debt settlement can be a viable debt relief strategy for financially distressed consumers as well. In fact, with a performance-based fee structure aligned with consumer interests, debt settlement can serve as an effective intervention for debt-burdened consumers before bankruptcy is contemplated.

Bankruptcy and Debt Settlement Offer Unique Paths to Debt Relief

AS CREDIT SCORES HAVE BECOME UBIQUITOUS and consumers' awareness of credit scores have increased, a need grows for fact-based education on how various financial products impact credit scores. There have been limited studies examining how credit scores change over time for bankruptcy filers, and even fewer studies that document how credit scores change for debt settlement clients. For financially distressed consumers who are contemplating filing for bankruptcy or enrolling in a debt settlement program, a clearer understanding of the potential credit score dynamics can play a pivotal factor in their decision-making process.

This paper serves to build on two earlier studies. The first study, *A Descriptive Comparison of Chapter 13 Bankruptcy*, offers a comparison of Chapter 13 bankruptcy and debt settlement across the dimensions of financial savings, recidivism, indirect costs and trends over time. Given the importance that consumers place on credit scores, an evaluation of impact to credit scores over time would have been included had panel data for credit scores been available.

The second study, *The Impact of Debt Settlement on Financially Distressed Consumers: A Longitudinal Study of Freedom Debt Relief Clients*, is a first-of-its-kind analysis of FICO® Scores of debt settlement clients. It seeks to build on the initial analysis by lengthening the observation window. Specifically, FICO® Scores are analyzed from two years prior to enrollment through six years after enrollment. Given the approximately four-year median time to complete a debt settlement program, this provides a more comprehensive long-term view on what happens to consumers who elect to enroll in a debt settlement program.

BACKGROUND

Bankruptcy and debt settlement are two debt relief strategies consumers can use to address high levels of debt. Consumers pursuing bankruptcy can elect to file for Chapter 7 bankruptcy or Chapter 13 bankruptcy. Chapter 7 bankruptcy accounts for approximately 64% of bankruptcy filings.[1] Chapter 7 bankruptcy requires that the filer liquidate eligible assets; the proceeds from the liquidation are used to repay creditors. Chapter 13 bankruptcy places the filer in a three-to-five-year payment plan where, typically, a portion of the outstanding debt is repaid and the remaining debt is forgiven at the conclusion of the plan. Chapter 7 bankruptcy is quick and efficient, with a median time to discharge of 3.7 months and a 93% to 95% success rate.[2] Chapter 13 bankruptcy is much longer and less efficient — the median time to discharge is 5.1 years and the success rate is just under 50%.[3]

The amount of debt enrolled is approximately $29,000, typically spread across seven to eight accounts.

In a debt settlement program, a debt settlement company serves as an agent for the consumer, negotiating the less than full repayment on the unsecured debt enrolled in the program. The amount of debt enrolled is approximately $29,000, typically spread across seven to eight accounts. In the program, clients make periodic deposits into a dedicated account held at an FDIC-insured depository that the client controls. Once the dedicated account reaches a critical level, the debt settlement company can negotiate for the partial payment of the outstanding debt using the funds from the dedicated account after the consumer approves the settlement and authorizes the use of the funds for the settlement. The credit history and credit scores for these three groups will be compared to each other, but the comparison between Chapter 13 bankruptcy and debt settlement is most appropriate because of the greater similarity in structure between those two debt relief strategies.

An excerpt from the paper, *A Descriptive Comparison of Chapter 13 Bankruptcy and Debt Settlement*, is provided in the appendix that provides a detailed overview of the bankruptcy and debt settlement processes.

1 Based on bankruptcy data from 2013 to 2019, sourced from the Federal Judiciary Center.

2 *A Descriptive Comparison of Chapter 13 Bankruptcy and Debt Settlement*. September 2021. Will Dobbie and Frederic Huynh.

3 *A Descriptive Comparison of Chapter 13 Bankruptcy and Debt Settlement*. September 2021. Will Dobbie and Frederic Huynh.

METHODOLOGY AND ANALYSIS

The analysis of credit scores over time is based on data primarily sourced from Equifax, one of the three credit reporting agencies in the U.S. The data represents two primary cohorts: bankruptcy filers and debt settlement clients. The data studied primarily focuses on consumer credit attributes that summarize the credit report and the FICO® 9 credit scoring model. All data analyzed was depersonalized and void of any personal identifying information.

The first cohort is a representative sample of consumers who filed for Chapter 13 bankruptcy or Chapter 7 bankruptcy between March 1, 2014, and February 28, 2015. In addition to the filing chapter, the outcome of the bankruptcy filing was also stored. The first cohort consists of 196,000 individuals; 100,000 consumers who filed for Chapter 13 bankruptcy and 96,000 individuals who filed for Chapter 7 bankruptcy. These records were sampled randomly from Equifax.

The second cohort represents all Freedom Debt Relief clients who enrolled between March 1, 2014, and February 28, 2015. This cohort represents 41,806 consumers. In addition to credit bureau data, data from Freedom Debt Relief's proprietary customer relationship management database was included in the analysis. The latter contains customer-level information such as enrollment date, total amount of unsecured debt enrolled in the program, total amount of debt settled, and other outcomes summarizing different aspects of time in the debt settlement program.

The bankruptcy filers and debt settlement clients were observed over an eight-year window. The observation window begins two years prior to bankruptcy filing or debt settlement enrollment and ends six years after the filing or enrollment. With most debt settlement programs lasting approximately four years and most Chapter 13 plans lasting between three and five years, the length of this panel allows us to observe consumers as they work through the entirety of their respective programs. Additionally, being able to observe the two years preceding the action in question enables us to see the consumer's trajectory prior to the intervention.

THE ANALYSIS OF CONSUMER CREDIT PROFILES IS BROKEN INTO FOUR SECTIONS:

The first section analyzes general FICO® Score trends for the three cohorts — Chapter 7 bankruptcy filers, Chapter 13 bankruptcy filers and debt settlement clients. This high-level analysis focuses on the entire cohort, irrespective of outcome. For example, bankruptcy filers and debt settlement clients are observed irrespective of whether their case was discharged or their enrolled debt was settled.

The second section analyzes FICO® Score trends for subpopulations of the cohorts. A focus is on Chapter 13 bankruptcy filers broken out by discharges and dismissals. Likewise, debt settlement clients will be analyzed across the spectrum of settled debt.

The third section examines the invalid FICO® Score rate over time between the debt settlement and bankruptcy groups. While the analysis in the first two sections is based on consumers with valid FICO® Scores, there are substantial differences when quantifying the invalid FICO® Score rate over time between debt settlement and bankruptcy groups that merit separate analysis.

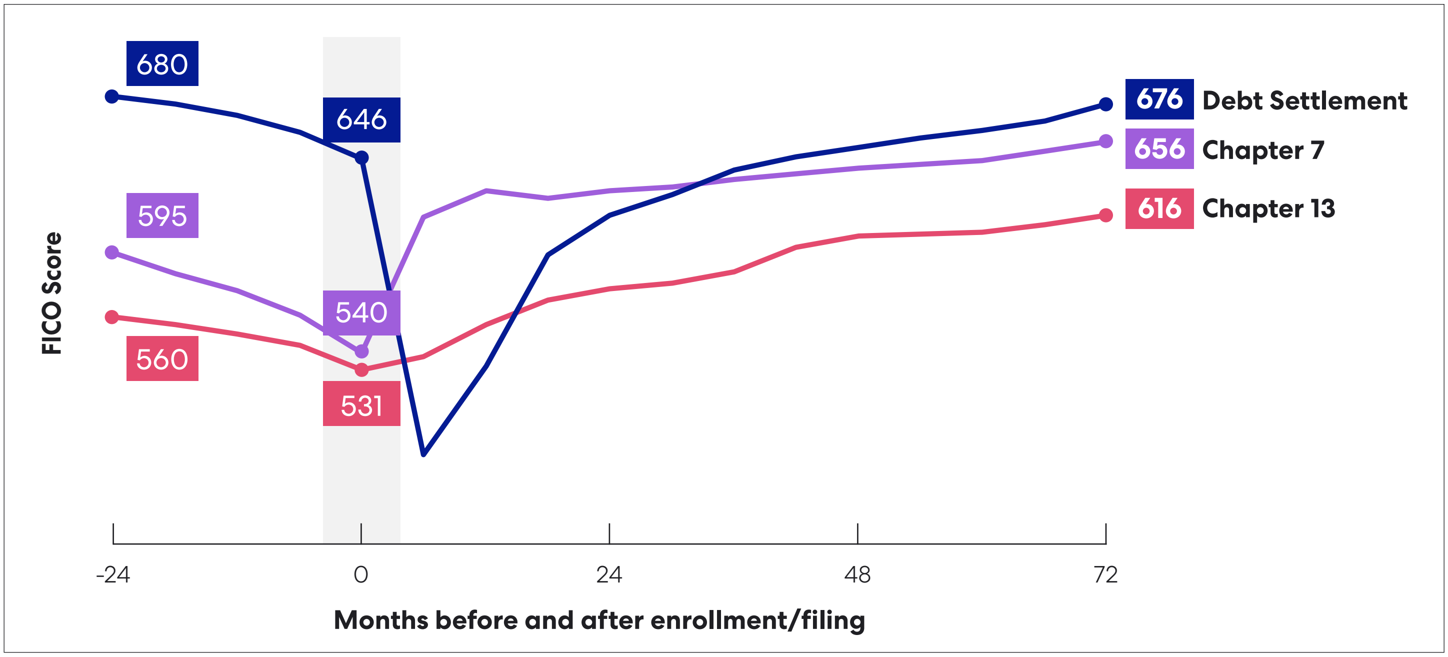
The fourth section analyzes the efficacy of debt relief through the lens of a bankruptcy risk score. This provides an alternative and interesting perspective on the likelihood that a consumer who goes through bankruptcy or debt settlement will require additional financial relief in the future.

How Credit Scores Evolve During the Debt Relief Lifecycle

THE CREDIT PROFILES OF TYPICAL bankruptcy filers and debt settlement clients are quite different in the two years prior to consumers formally taking action to resolve their debt. Among the most notable observations is that Chapter 7 and Chapter 13 filers have lower median FICO® Scores than debt settlement clients during the two-year period before filing bankruptcy or enrolling in a debt relief program. This suggests bankruptcy filers are in a more advanced state of financial stress than debt relief clients before and at the point of initiating their respective debt relief action. At time of filing, the median FICO® Scores for Chapter 7 and Chapter 13 filers are 540 and 531, respectively, considerably lower than the median FICO® Score of 646 observed for debt settlement clients (see Figure 1).

FIGURE 1

FICO Score Over Time: Bankruptcy Filers and Debt Settlement Clients



Another key distinction between these consumer groups is the number of tradelines reported on their credit reports. Typical bankruptcy filers have 16 to 17 tradelines on their credit reports. Of those, only three are open, including one credit card account. Typical debt settlement clients have 27 tradelines on their credit report, of which 12 are open, including nine credit card accounts.

The significantly larger number of tradelines reported for debt settlement clients suggests these consumers at one point had credit profiles that were strong enough to qualify for numerous credit obligations. Often, these "post-prime" consumers accumulate significant amounts of unsecured debt before an unplanned incident such as job loss or reduced income, a medical event or divorce triggered financial stress. Meanwhile, the low number of open tradelines for bankruptcy filers suggests an advanced state of financial stress because when a creditor writes off outstanding debt as a loss, the account is closed. This inference is further reinforced by the accompanying low median FICO® Scores.

For financially distressed consumers, it may be **more prudent to proactively address their burgeoning financial stress** before their credit score declines even further.

Despite the differences in credit profile, all three groups experience a downward trajectory in their median FICO® Scores during the two years prior to initiating a debt relief strategy. As seen in Figure 1, Chapter 7 filers experience the largest decline in FICO® Score, a 55-point drop that brings their median credit score to 540. Chapter 13 filers experience a smaller decline of 29 points, but end up with a lower median FICO® Score of 531. Meanwhile, typical debt settlement clients experience a 34-point drop that brings their median FICO® Score to 646.

For both bankruptcy groups in particular, their downward trajectory combined with their considerably low FICO® Scores suggest an opportunity for intervention before considering bankruptcy after their score bottoms out in the sub-600 range. For financially distressed consumers, it may be more prudent to proactively address their burgeoning financial stress before their credit score declines even further.

The three groups continue to present unique trajectories in their FICO® Score after initiating debt relief. These distinct FICO® Score paths are driven by the structural differences of each debt relief approach and the consumer's current state of financial stress. Bankruptcy filers generally experience an increase in their median FICO® Score immediately after filing. This may seem counterintuitive on the surface, but it can be explained by how the underlying credit report changes after the filing.

The act of declaring bankruptcy impacts a credit report in two main ways. First, tradelines involved in a bankruptcy are marked as such on the consumer's credit report. All other things being equal, if an affected account is already severely delinquent or charged off, there will likely be no additional negative impact to the consumer's credit score. This is because the addition of a bankruptcy filing does not generally indicate significantly new negative information for the purposes of calculating credit scores.

The addition of a **bankruptcy filing does not generally indicate significantly new negative information** for the purposes of calculating credit scores.

Second, the credit report is generally updated to include a public record that further memorializes the bankruptcy filing on the credit report. In a vacuum, a bankruptcy public record is treated as a derogatory marker when calculating FICO® Scores. However, the addition of the derogatory public record is also unlikely to have an additional negative impact on the credit score because bankruptcy filers already have multiple derogatory items on their credit reports impairing their scores.

For example, consumers who file for bankruptcy typically have two unpaid third-party collection agency accounts in their credit reports. These negative items can already have a significant negative effect on consumers' credit scores even before they declare bankruptcy. So long as no additional negative information is added to the credit report, the effect of negative information on credit scores decreases over time, even for consumers who are working through the bankruptcy process.

This is reflected by an increase in the median FICO® Score after filing for both Chapter 7 and Chapter 13 bankruptcies. The median credit score for Chapter 7 filers in particular increases rapidly one year after filing. The median FICO® Score of Chapter 7 filers increases 89 points, to 629, one year after declaring bankruptcy. Meanwhile, the median credit score of Chapter 13 filers increases 25 points, to 556, one year after declaring bankruptcy. In both cases, credit scores continue a modest upward path during the subsequent years.

The disparity in credit score improvement in the first year after filing is the result of significant differences in the duration and success rates of Chapter 7 and Chapter 13 bankruptcies. Chapter 7 bankruptcy cases have a median time to discharge of 3.7 months and a discharge rate between 93% and 95%.[4] This is markedly different from Chapter 13 bankruptcy cases, which take a median time of 5.1 years and have a discharge rate of approximately 50%. The high success rate and quick resolution of unsecured debt in Chapter 7 cases leads to faster changes to consumers' credit reports, which can drive a more pronounced credit score increase. Chapter 13 bankruptcy is a much longer process. While the consumer is in a Chapter 13 bankruptcy payment plan, affected tradelines are still outstanding and the ultimate debt relief being sought has not been fully realized. Even at the end of a successful Chapter 13 case, when remaining debt is discharged, a more pronounced credit score increase is generally not observed because the principal influence for higher scores — aging delinquencies — has already been factored into the score calculation.

After bottoming out at 485, **debt settlement clients experience a sharp recovery in credit score** that eventually transitions into a steady recovery.

The FICO® Score trajectory of debt settlement clients is distinct from bankruptcy filers. The most notable difference is a substantial decrease in the median FICO® Score in the first six months after enrollment. The median FICO® Score of debt settlement clients is 646 at time of enrollment. Six months into the program, the median FICO® Score decreases 161 points, to 485. This is primarily driven by two factors. First, relative to bankruptcy filers, the typical debt settlement client starts at a higher FICO® Score, thus having farther to fall. The second factor driving the decline is the concentration of negative payment history information on the credit report from delinquencies and

4 *A Descriptive Comparison of Chapter 13 Bankruptcy and Debt Settlement*. September 2021. Will Dobbie and Frederic Huynh.

charge-offs of unsecured debt during the initial months of the debt relief program. The precipitous drop in credit score is driven by variables in the FICO® Score calculation measuring the recency, frequency and severity of delinquent accounts.

After bottoming out at 485, typical debt settlement clients experience a sharp recovery in their credit scores that eventually transitions into a steady recovery. The recovery in credit score is primarily driven by the aging of negative credit report information incurred at the beginning of the debt relief program and the successful negotiation of account settlements over time. If reported by the creditor, settled tradelines can be identified by codes on the credit report indicating whether the account was paid in full or for a reduced settlement amount. Though these codes have a negative connotation in credit score calculations, they are unlikely to impact the credit score further because these accounts have already been reported delinquent and charged off. Additionally, credit reporting guidelines indicate that settled accounts should be reported with a balance and amount past due of zero.[5] The zero balances and amounts past due can also have a positive impact to the extent that the FICO® Score assesses balances and past-due amounts on delinquent accounts.

8.2% of debt settlement clients obtained a new mortgage 5-6 years after initiating debt relief, compared to 5.5% of Chapter 7 filers and 3.2% of Chapter 13 filers.

The most important observation in comparing the FICO® Score trajectories of bankruptcy filers and debt settlement clients is that six years after initiating their debt relief process, the median FICO® Score is higher among debt settlement clients than bankruptcy filers. This is remarkable because the lowest median FICO® Score of debt settlement clients is lower and occurs after the lowest median FICO® Score of bankruptcy filers. **This indicates that debt settlement clients in general recover more fully and more rapidly than bankruptcy filers.**

5 *Credit Reporting Resource Guide*. Consumer Data Industry Association.

All groups have higher median FICO® Scores six years after initiating their debt relief action. Chapter 7 filers see their median FICO® Score increase from 540 at time of filing to 656 six years later. Chapter 13 filers see their median FICO® Score increase from 531 at time of filing to 616 six years later. The median credit score for debt settlement clients doesn't reach its trough of 485 until six months after enrolling in a debt relief program. Nevertheless, the median credit score increases to 676 six years after enrollment. These upward shifts are likely a combination of the relative effectiveness of each individual debt relief strategy and the positive influence that aging negative information has on credit scores.

In addition to credit scores, examination of credit reports provides additional insight into the state of these consumers' credit health. Six years after filing for bankruptcy, the typical Chapter 7 filer has four open tradelines, of which two are credit cards, while the typical Chapter 13 filer has two open tradelines, of which one is a credit card. Typical debt settlement clients have six open tradelines, including four credit cards. Additionally, looking at new mortgage tradelines as a signal of meaningful rehabilitation, 8.2% of debt settlement clients obtained a new mortgage five to six years after initiating debt relief, compared to 5.5% of Chapter 7 filers and 3.2% of Chapter 13 filers.

These observations reinforce the stronger credit recovery exhibited by debt settlement clients over bankruptcy filers. Concerns about debt settlement clients having a greater number of open credit cards can be tempered by the fact that the FICO® Score trajectory for this group continues to rise and has not shown evidence of plateauing or decreasing.

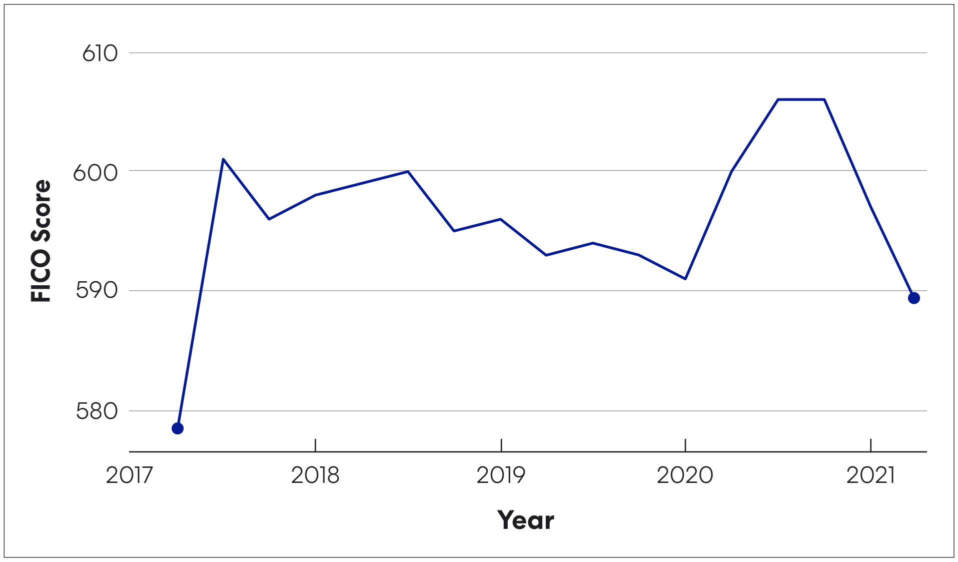
The removal of negative information from the credit report can provide additional insight into the outlook for consumers who have gone through a debt relief process. The Fair Credit Reporting Act stipulates that negative information must be removed from credit reports seven years after it occurred. The only exception to this rule is Chapter 7 bankruptcies, which can stay on credit reports for 10 years. In debt settlement, settled tradelines must be deleted seven years from the date they were first delinquent and never current again.

Looking at new mortgage tradelines as a signal of meaningful rehabilitation, **8.2% of debt settlement clients obtained a new mortgage five to six years after initiating debt relief**, compared to 5.5% of Chapter 7 filers and 3.2% of Chapter 13 filers.

But in debt settlement, it is common for tradelines to not reach this threshold until after a consumer has enrolled in a debt relief program. Given that the nadir of the FICO® Score trajectory for debt settlement clients occurs after that of bankruptcy filers, the differences between these groups would likely be greater further into the future. Had the observation window of this study been longer to capture this event, it is likely that the FICO® Scores of debt settlement clients would be even higher once the settled tradelines are removed from their credit reports.

FIGURE 2

FICO Score Over Time: Recent Debt Settlement Clients



The difference in median FICO® Scores between debt settlement clients and bankruptcy filers is not static. Since the second quarter of 2017, the median FICO® Score of debt settlement clients ranges between 594 and 622 each year (see Figure 2). This is considerably lower than the median FICO® Score of 646 for clients enrolled in the 2014 to 2015 vintage. The lower median FICO® Scores indicate a more financially distressed population. In recent years, a more rigorous assessment of financial hardship has been conducted to ensure that the consumers enrolled are appropriate for debt settlement. This contributes to the lower median FICO® Score at time of enrollment in more recent vintages.

KEY FINDING

Six years after initiating debt relief, consumers who went through debt settlement have higher median FICO® Scores than those who go through bankruptcy.

/ Debt Relief Success Dictates the Path of Credit Score Recovery

NOT ALL CONSUMERS WHO DECLARE BANKRUPTCY OR ENROLL IN DEBT SETTLEMENT are ultimately successful in obtaining the desired debt relief. Chapter 13 filers and debt settlement clients in particular experience varying degrees of success that merit a deeper analysis of their credit profiles and recovery trajectories. As cited previously, 93% to 95% of Chapter 7 cases and nearly 50% of Chapter 13 cases resulted in a successful discharge of debt.

Unlike bankruptcy, the outcomes in debt settlement are not binary. **A debt settlement client may experience a spectrum of success; not all unsecured debt that is enrolled is necessarily settled.** The Telemarketing Sales Rule provides consumers with the option to leave debt settlement programs for any reason and at any time. For example, some consumers may elect to leave the program after securing new employment and are now capable of paying off the remaining amount on their own accord because their source of financial hardship has been addressed.

Chapter 13 is a natural comparison to debt settlement because the two strategies involve a partial repayment of debt over an extended period.

Chapter 13 is a natural comparison to debt settlement because the two strategies involve a partial repayment of debt over an extended period. This analysis will examine the credit profiles of Chapter 13 filers based on whether they received a discharge of their debts or the case was dismissed before the repayment plan was complete. Because of the granular nature of success with debt settlement, this cohort is segmented into groups based on the percentage of enrolled debt that was settled by the program.

Figure 3 shows the median FICO® Score over time for these subpopulations of Chapter 13 filers and debt settlement clients. **The first notable observation is that typical Chapter 13 filers who fail to have their debt discharged continue to have a compromised credit score.** The median FICO® Score for this group is only 579 six years after filing, just below the mark of 580 that

Half of all Chapter 13 filings end up failing.

is generally considered to represent consumers who are high credit risks.[6] This is particularly meaningful because analysis shows that half of Chapter 13 filings end up failing.[7] As a result, those financially distressed consumers bear the additional burden of upfront filing and attorney fees in addition to having a credit profile that prevents them from having access to affordable credit.

The next notable observation is that six years after enrollment, the median FICO® Score for the most successful debt settlement clients is 695. This represents a return to the financial mainstream, as most lenders consider a 700 FICO® Score to be a good score that represents modest risk.[8] For both debt settlement and Chapter 13 bankruptcy, there is a correlation between FICO® Scores and success. The median FICO® Score at time of filing for successful Chapter 13 filers is more than 20 points higher than of those who eventually fail. Likewise, with debt settlement, there is a general rank ordering of median FICO® Scores and the percent of debt settled. The greater the percentage of the enrolled debt that is settled, the higher the median FICO® Score six years after enrolling in debt settlement.

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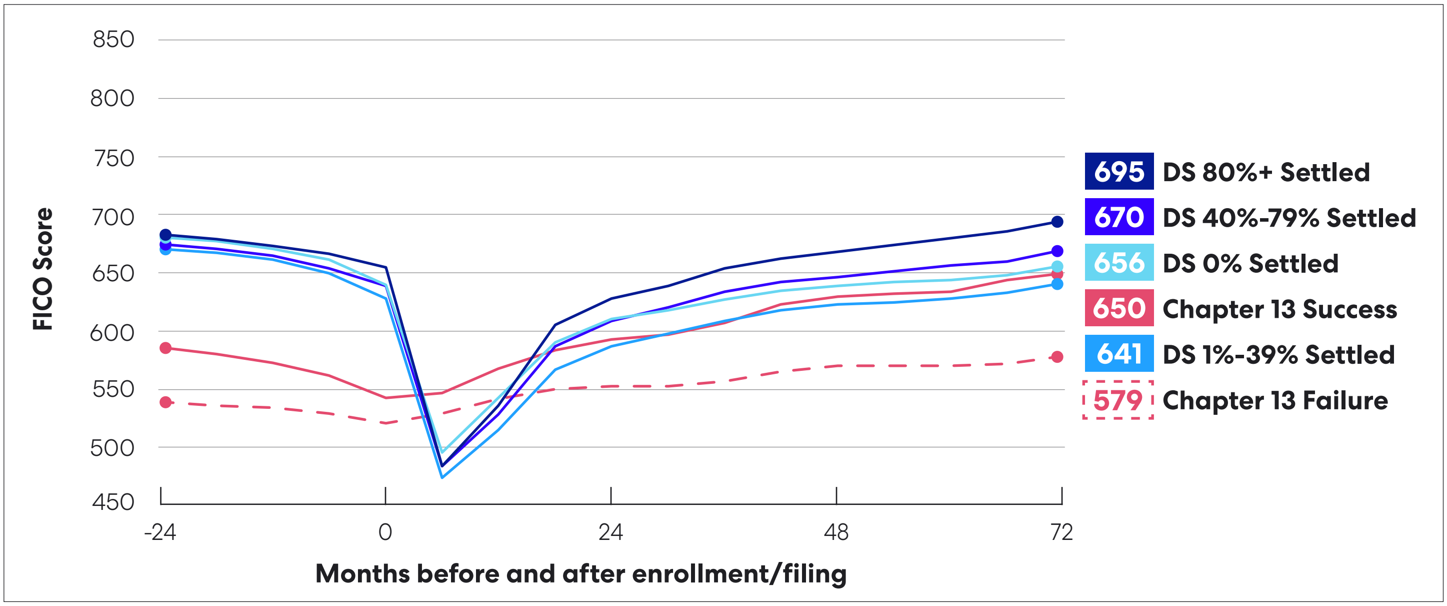
6 https://www.myfico.com/credit-education/what-is-a-fico-score

7 *A Descriptive Comparison of Chapter 13 Bankruptcy and Debt Settlement*. September 2021. Will Dobbie and Frederic Huynh.

8 https://www.myfico.com/credit-education/what-is-a-fico-score

FIGURE 3

FICO Score Over Time: Bankruptcy Filers and Debt Settlement Clients



The only exception to this is the 0% settled group. These debt settlement clients enrolled in the program and made at least one payment into their dedicated settlement account, but voluntarily left the program before receiving one settlement. Six years after enrollment, the median FICO® Score for this group is 656. This is higher than the 641 median FICO® Score for clients with 1% to 39% of their debt settled.

For both debt settlement and Chapter 13 bankruptcy, **there is a correlation between FICO Scores and success.**

This counter-intuitive rank ordering reinforces the earlier point that a lack of settlements is not necessarily associated with a negative outcome. The higher median FICO® Score at time of enrollment for the 0% settled group indicates a certain degree of self-selection. In fact, exit surveys with these clients indicate a degree of proactiveness and self-sufficiency, as nearly half of these clients left the program citing a desire to handle their outstanding debt problems on their own as their reason for leaving the debt settlement program.[9]

Lastly, all subpopulations of the bankruptcy and debt settlement cohorts have higher median FICO® Scores six years after filing or enrollment. This is generally a reflection of the upward pressure that aging delinquencies and aging credit reports can have on a credit score.

KEY FINDING

Debt settlement clients who exit the program before addressing all their debt have higher median FICO® Scores than Chapter 13 filers who fail to have their debt discharged.

9 2020 exit surveys of clients who experienced no settlements revealed that 47% left to directly pay the creditor, 18% had their account closed because of inactivity, 16% left after experiencing additional hardship, 10% left to declare bankruptcy, and 10% left for reasons unrelated to their financial distress.

/ Unscoreable Credit Profiles Hinder Post-Debt Relief Recovery

ADDITIONAL INSIGHT INTO THE FINANCIAL HEALTH of bankruptcy filers and debt settlement clients can be gleaned by examining the population of consumers who don't qualify for a FICO® Score. Analysis of this group reveals compelling evidence that debt settlement is more effective than bankruptcy at addressing consumers' long-term credit needs.

To generate a valid FICO® Score, a consumer must be alive and have a credit report that contains one tradeline that's been open for six months or more and at least one tradeline that's been reported to a credit bureau within the past six months. The tradeline requirements can be satisfied by a single account or multiple accounts.[10] These criteria ensure that sufficient information is present on the credit report to generate a meaningful FICO® Score.

When a FICO® Score can no longer be generated for bankruptcy filers or debt settlement clients, it's typically because their credit reports no longer meet the third criteria for containing recent activity. This is because over time, charged-off and closed accounts stop contributing new information to the credit report. Consumers can also face difficulty accessing credit after their credit scores fall. Likewise, some consumers self-select out of obtaining new credit as part of their ongoing efforts to rehabilitate their personal finances.

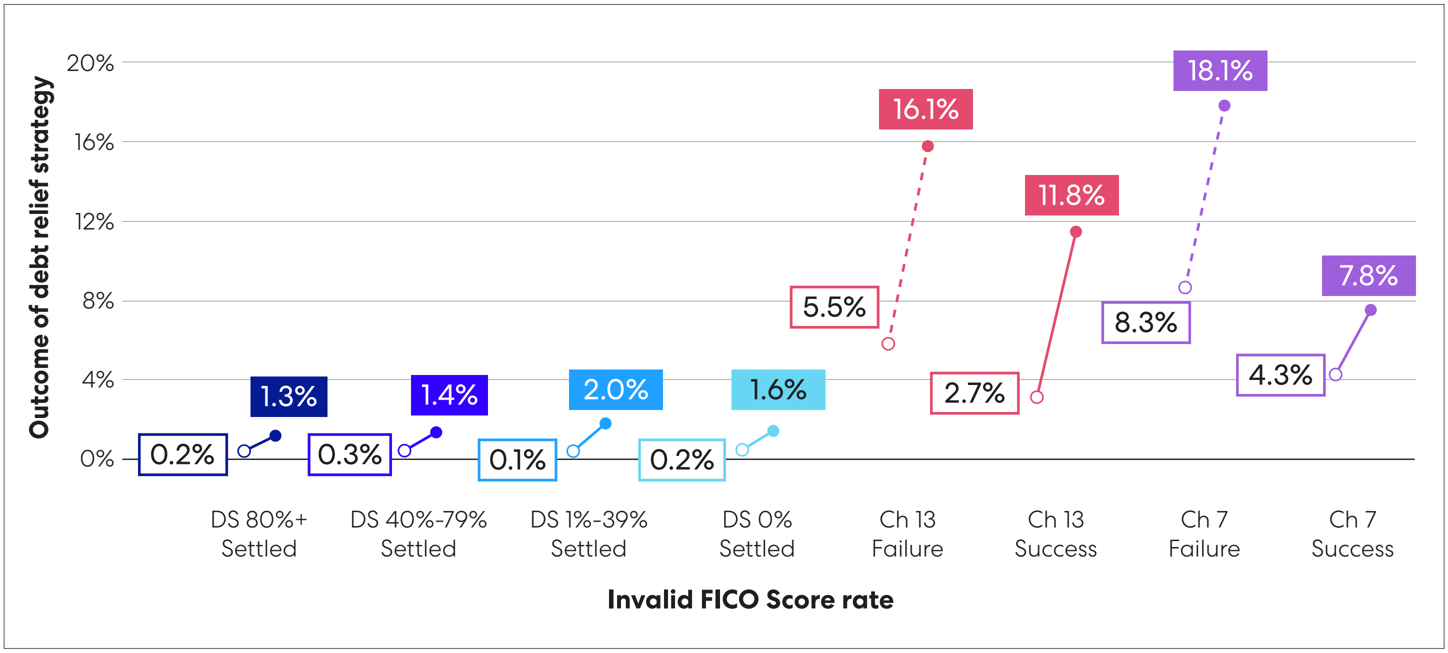
Nearly all debt settlement clients have a valid FICO® Score at time of enrollment, as indicated by this group's having an invalid FICO® Score rate of nearly 0% (see Figure 4). Meanwhile, the invalid FICO® Score rate for bankruptcy filers is comparatively much higher, ranging between 2.7% and 8.3%. There is also a meaningful difference in the invalid FICO® Score rates of bankruptcy filers based on whether they are ultimately successful in having their debt discharged. **These findings support the notion that bankruptcy filers are in a more advanced state of financial distress than debt settlement clients when they initiate debt relief.**

10 https://www.myfico.com/credit-education/faq/scores/fico-score-requirements

FIGURE 4

Invalid FICO Score Rates 6 Years After Initiating Debt Relief

Figure 4 illustrates the change in the invalid FICO® Score rate six years after initiating debt relief. For each cohort, a pair of numbers captures the invalid FICO® Score rate at time of enrollment or filing, and six years later. For example, debt settlement clients who resolved at least 80% of their enrolled debt had an invalid FICO® Score rate of 0.2% at time of enrollment. Six years later, 1.3% of these consumers no longer qualify for FICO® Scores.



Six years after initiating debt relief, the invalid FICO® Score rates among bankruptcy filers are considerably higher than debt settlement clients. For example, unsuccessful Chapter 13 filers have an invalid FICO® Score rate 10 times greater than debt settlement clients who did not obtain any settlements on their debt. Debt settlement clients with the highest rates of resolved debt are the least likely to not have a credit score. Likewise, bankruptcy filers who were successful in discharging their debt were less likely to be without a credit score than those whose bankruptcy cases were dismissed.

The invalid FICO Score rates among bankruptcy filers are **considerably higher than debt settlement clients.**

These are material differences because access to credit, particularly affordable credit, is often predicated on having a valid credit score. While aspirational financial goals of homeownership will be challenging at the best without a valid credit score, more fundamental financial challenges also exist for these consumers. **For example, consumers who don't have valid credit scores can face difficulties securing rental housing. Utility companies may require these consumers to make upfront security deposits as a condition for accessing necessary services.**

FIGURE 5

Voluntary and Involuntary FICO Score Exclusion Rates

POPULATION	INVOLUNTARY	VOLUNTARY
Debt Settlement: 80%+ Settled	80.2%	19.8%
Debt Settlement: 40%-79% Settled	81.2%	18.8%
Debt Settlement: 1%-39% Settled	79.7%	20.3%
Debt Settlement: 0% Settled	79.0%	21.0%
Chapter 13 Failures	80.6%	19.4%
Chapter 13 Successes	81.1%	18.9%
Chapter 7 Failures	78.2%	21.8%
Chapter 7 Successes	77.2%	22.8%

The invalid FICO® Score rates can be further analyzed based on whether consumers are voluntarily or involuntarily avoiding credit (see Figure 5). Consumers who are represented in the voluntary column are deliberately and consciously avoiding new credit. This is defined by the lack of recent consumer-initiated inquiries on their credit report.[11] Likewise, those that fall in the involuntary column have expressed interest in obtaining new credit — demonstrated by the presence of at least one hard inquiry on their credit report in the past 24 months.[12] **Based on these definitions, most consumers who have gone through a debt relief process and do not have a credit score are classified as involuntary FICO® Score exclusions.** This distinction is relevant because involuntary FICO® Score exclusions can signify a consumer whose financial needs are not being met.

Bankruptcy is frequently touted as a way for indebted consumers to get a fresh start on their finances. But the substantially higher invalid FICO® Score rates, combined with the slower recovery in credit scores, demonstrate that debt settlement performs better on these key dimensions than bankruptcy, reinforcing its viability as a debt relief strategy.

KEY FINDING

Many consumers exiting the debt relief process are unable to reestablish credit, creating a hardship that poses significant challenges to their financial rehabilitation.

11 This approximation likely serves more as an upper bound because a consumer who is a voluntary FICO® Score exclusion over an extended period of time can be an involuntary FICO® Score exclusion who has "given up" and has been conditioned that they will never qualify for credit.

12 Similar to the logic in the prior footnote, the involuntary invalid FICO® Score approximation is likely an underestimate, because consumers who have "given up" and have been conditioned that they will never qualify for credit will not be factored into these estimates.

/ Assessing Recidivism Risk

ANOTHER IMPORTANT FACTOR IN ANALYZING THE EFFICACY of debt relief strategies is evaluating the likelihood that a consumer who goes through bankruptcy or debt settlement will require additional financial relief in the future. One way to do this is by examining the continued risk that a prior debt relief seeker will file for bankruptcy.

The analysis in the first three sections of this study is based largely on findings rooted in the FICO® 9 credit score, a general credit risk score designed to predict severe delinquencies of 90 days or more. This section evaluates debt relief recidivism risk using the Equifax Bankruptcy Navigator Index® (BNI), a specialized credit risk model that is designed to assess bankruptcy risk. Specifically, it is optimized to predict the likelihood of a consumer filing for bankruptcy within a 24-month period.

Before analyzing the bankruptcy risk over time, it is important to understand how often a consumer can file for bankruptcy. **To guard against consumers abusing the bankruptcy process, the U.S. Bankruptcy Code defines the minimum length of time that needs to pass before a consumer can refile.** These timelines are determined by the date and outcome of the prior filing, as well as the type of bankruptcy protection sought in both filings.

For cases that result in a successful discharge of debt, consumers must wait between **two and eight years to file for bankruptcy again.**

Bankruptcy filers whose cases were dismissed are generally allowed to re-file immediately, unless the case was dismissed because the filer did not appear for a hearing. In that instance, a filer may have to wait 180 days before refiling. For cases that result in a successful discharge of debt, consumers must wait between two and eight years to file again, depending on the type of bankruptcy protection sought in both the prior and new filing (see Figure 6).

Consumers can receive valid BNI scores irrespective of their eligibility to file bankruptcy.[13] This makes the time between when a consumer is permitted to file for a new bankruptcy relevant for interpreting the bankruptcy risk assessment of consumers who have previously declared bankruptcy. For example, the BNI score improves significantly soon after a consumer files for Chapter 7 bankruptcy. But the score worsens just 12 months after filing (see Figure 7). This is notable, given that successful Chapter 7 filers must wait a minimum of four years before declaring bankruptcy again. Given that bankruptcy risk for successful Chapter 7 filers is likely overstated in the time immediately after the filing, this analysis will focus on bankruptcy risk scores prior to filing, at time of filing and at least four years after filing.

FIGURE 6

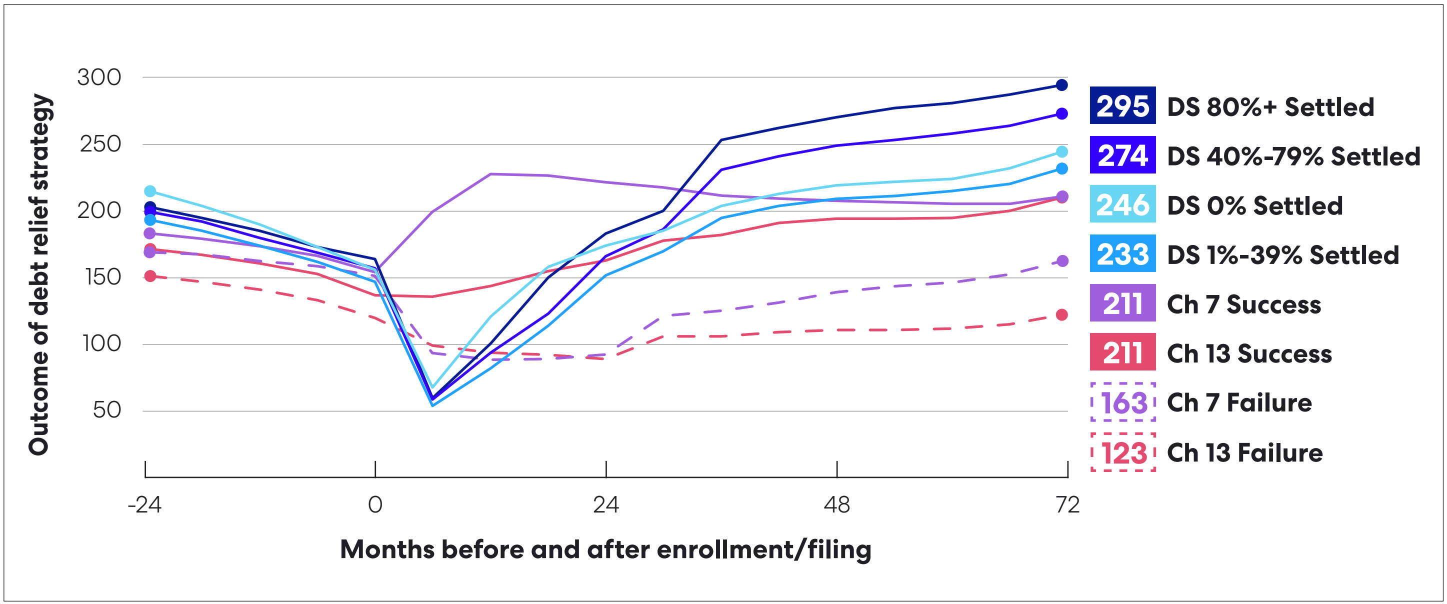
Minimum Length of Time Between Bankruptcy Filings

PRIOR FILING	NEW FILING	MINIMUM TIME ELAPSED
Chapter 7	Chapter 7	8 years
Chapter 7	Chapter 13	4 years
Chapter 13	Chapter 7	6 years
Chapter 13	Chapter 13	2 years

13 Bankruptcy filing eligibility is conditional on numerous factors, some of which may be infeasible to provide during an online credit pull. The inability to factor in more specific eligibility criteria is not a defect, but rather a constraint or practical limitation. For example, a bankcard issuer pulling a BNI score during underwriting will not know if the consumer intends to file a Chapter 7 or Chapter 13 case.

FIGURE 7

Bankruptcy Navigator Index Scores Over Time



The bankruptcy risk score ranges from 1 to 600. Higher scores reflect a lower risk that a consumer will file for bankruptcy in the next 24 months. Conversely, lower scores represent higher risk. These scores have been validated to predict and rank order bankruptcy risk. Two years prior to initiating debt relief, the BNI scores across the cohorts of bankruptcy filers and debt settlement clients all follow the same general downward trajectory. But once the debt relief process is initiated, the BNI scores start to take divergent paths.

Chapter 13 filers who go on to experience a successful discharge realize a steady improvement in bankruptcy risk after filing. On the other hand, Chapter 13 filers whose attempt to discharge debt failed experience an increase in their bankruptcy risk in the first two years after filing, followed by a modest improvement. **The substantially elevated bankruptcy risk that failed Chapter 13 filers exhibit reinforces the notion that these consumers have yet to find a viable solution to address their financial hardship.**

Once the debt relief process is initiated, the BNI scores start to take divergent paths.

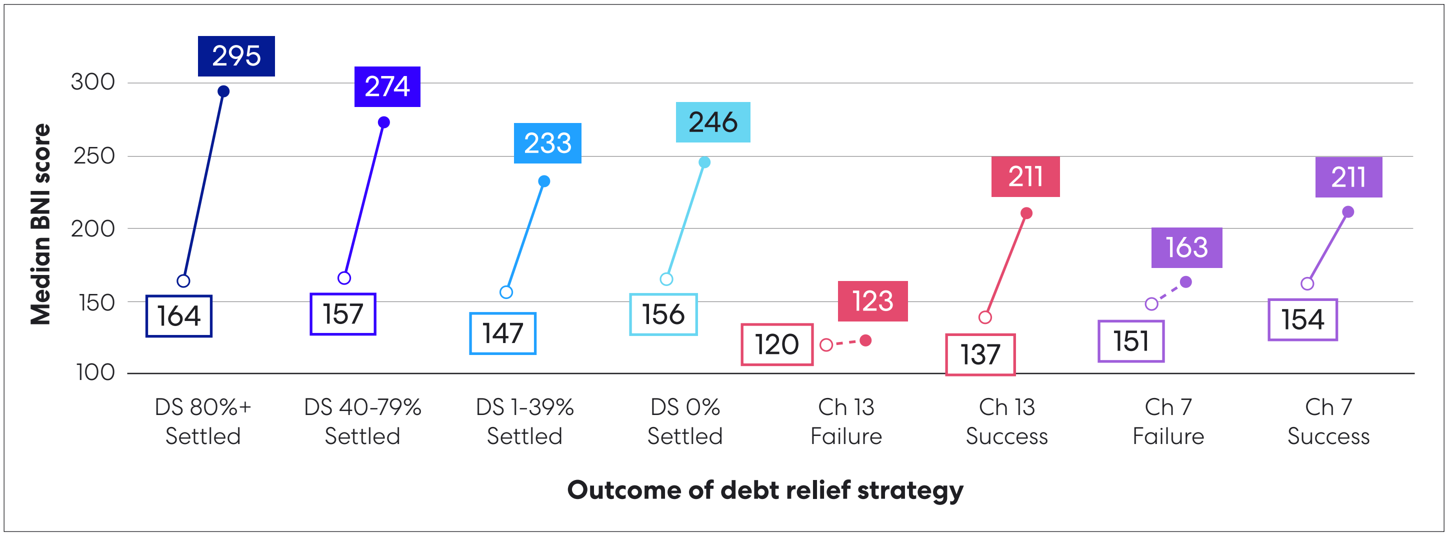
Bankruptcy risk remains high for filers who failed their Chapter 7 or Chapter 13 cases. This is likely an indication that the consumer's financial distress has not been resolved, and that some consumers will refile their bankruptcy cases. The fact that their credit profiles are more correlated to bankruptcy risk six years later reinforces the high refiling rate observed for bankruptcy filers, particularly in Chapter 13 cases.

While the bankruptcy risk of Chapter 7 filers is comparable to debt settlement clients at time of filing or enrollment, it is significantly higher six years later. In fact, even debt settlement clients who experience no settlements have credit profiles that indicate lower bankruptcy risk six years after enrolling than successful bankruptcy filers six years after filing (see Figure 8).

FIGURE 8

BNI Score 6 Years After Initiating Debt Relief

Figure 8 illustrates the change in median BNI score six years after initiating debt relief. For each cohort, a pair of numbers captures the median BNI score at time of enrollment or filing, and six years later. For example, debt settlement clients who resolved at least 80% of their enrolled debt had a median BNI score of 164 at time of enrollment. Six years later, their median BNI score was 295.



These observations are even more notable than the previously discussed FICO® Score analysis because bankruptcy risk scores provide a more direct metric of whether the consumer's indebtedness or financial stress has been addressed. They also highlight the fact that debt settlement clients reduce their financial stress more than bankruptcy filers, as indicated by the larger improvement in BNI score six years after initiating debt relief. The lower bankruptcy risk observed across all subpopulations of debt settlement clients six years after enrollment, combined with the performance-based fee structure of debt settlement, furthers the argument that debt settlement is a viable option for consumers seeking debt relief before having to resort to bankruptcy.

KEY FINDING

Debt settlement clients reduce their financial stress more than bankruptcy filers, as indicated by the larger improvement in BNI score six years after initiating debt relief.

/ Conclusion

CONSUMERS NEED EVIDENCE-BASED ASSESSMENTS of available financial products and services to make informed financial decisions. An examination of credit scores over time shows that debt settlement clients experience a more complete and more rapid recovery in their credit score compared to bankruptcy filers. Debt settlement clients have higher median credit scores six years after initiating debt relief and are more likely to have a valid FICO® Score when compared to bankruptcy filers. This provides debt settlement clients with greater access to affordable credit, and services like rental housing and utilities that require a valid credit score, and enables them to more effectively get a fresh start on their personal finances.

Examination of bankruptcy risk scores reveal that even successful Chapter 7 filers have credit profiles correlated to higher bankruptcy risk than debt settlement clients. Because bankruptcy risk is a more direct metric for financial stress for over-indebted consumers, this result suggests that the typical debt settlement client's experience puts the consumer in a better financial position than that of the typical bankruptcy filer. **Given the broad acceptance of bankruptcy as an effective debt relief strategy, this analysis indicates that from a credit score perspective, debt settlement can serve as an equally effective (and in some cases, more effective) debt relief option.**

APPENDIX

A Detailed Overview of the Bankruptcy and Debt Settlement Processes

The following text is an excerpt from the paper "A Descriptive Comparison of Chapter 13 Bankruptcy and Debt Settlement." It is intended to provide a more detailed overview of bankruptcy and debt settlement and is reprinted with permission from the original authors, Will Dobbie and Frederic Huynh.

BANKRUPTCY

Bankruptcy is the legal process to resolve unpaid debts. In the United States, individuals typically file for bankruptcy protection under either Chapter 7 or Chapter 13. Debt relief from Chapter 7 bankruptcy is achieved through the liquidation of non-exempt assets, while debt relief from Chapter 13 bankruptcy is achieved through the reorganization of debt. While the focus of our report is Chapter 13 and debt settlement, we discuss both bankruptcy options in this section for completeness.

Chapter 7 bankruptcy begins with an individual filing a verified petition with the bankruptcy court. The filing also includes schedules of assets and liabilities, schedules of income and expenditures, schedules of executory contracts and unexpired leases, a statement of financial affairs, and documentation of tax records. A court-appointed bankruptcy trustee is assigned with the primary responsibility of overseeing the liquidation of non-exempt assets to pay creditors. Shortly after filing, the trustee administers a meeting of creditors where the filer is obligated to answer questions regarding the bankruptcy case. A bankruptcy judge then rules on the case and if the case is discharged, the bankruptcy trustee liquidates the filer's non-exempt property and distributes the proceeds to the creditors.

The typical Chapter 7 bankruptcy process is relatively quick, with a median time to discharge of 113 days, or 3.7 months, in the Federal Judicial Center (FJC) data described in more detail below. All unsecured debt is eligible to be discharged through Chapter 7 bankruptcy, except student loans, child support obligations, and debts incurred through fraud. Secured debt such as mortgages and car loans can be discharged if the filer elects to relinquish the property. The direct costs incurred by the filer are filing fees, with a typical amount of $335, and attorney fees, typically ranging between $1,500 and $3,000. Additional expenses would be the surrender of non-exempt property (or its value) to be administered towards the payment to certain creditors. The discharge rate for Chapter 7 is typically very high, ranging between 93% to 95% in the FJC data. Following a discharge, the Chapter 7 filer is free from all eligible debt.

Individuals are assumed eligible for Chapter 7 if their current monthly income is less than or equal to the state median and there are no other disqualifying criteria such as having a bankruptcy filing that was dismissed within the last 180 days because the filer willfully failed to appear before the court or comply with the orders of the court. Individuals with a current monthly income that is greater than the state median must pass a separate "means test" that determines whether their income is low enough to file under Chapter 7, or whether they should file under Chapter 13. Filers are also ineligible to receive another Chapter 7 bankruptcy discharge if they received a discharge of debts in a prior Chapter 7 case in the last eight years or they received a Chapter 13 discharge in the last six years, unless the Chapter 13 discharge was under a confirmed plan that either (1) totaled 100 percent of allowed unsecured claims, or (2) 70 percent of allowed unsecured claims proposed in good faith and was the debtor's best effort, regardless of income. Finally, all Chapter 7 filers are required to receive credit counseling from an approved credit counseling agency within 180 days before filing to remain eligible for Chapter 7.

While Chapter 7 bankruptcy is an important debt relief option for eligible individuals with its high discharge rates and a fast time to discharge, it also makes for a less natural comparison with debt settlement and Chapter 13. Chapter 7 includes stricter income eligibility thresholds and the requirement that individuals liquidate assets not covered by the bankruptcy exemptions recognized by the Bankruptcy Code, differing from both debt settlement and Chapter 13. It is important to keep in mind liquidating non-exempt assets by a Trustee involves additional cost and expenses to the Chapter 7 filer. Additionally, the filer may not be able to voluntarily dismiss a Chapter 7 case once filed. We therefore omit Chapter 7 bankruptcy from our comparison, while again emphasizing that we believe Chapter 7 is an important debt relief option for individuals with lower incomes and fewer assets.

Chapter 13 bankruptcy also begins with the filer filing a petition with the bankruptcy court. Similar to Chapter 7, a Chapter 13 bankruptcy filing includes schedules of assets and liabilities, schedules of income and expenditures, schedules of executory contracts and unexpired leases, a statement of financial affairs, and documentation of tax records. Chapter 13 filers must also propose a three-to-five-year plan to partially repay their unsecured debt using all of their disposable income. A court-appointed bankruptcy trustee is assigned with the primary responsibility of administering the case and collecting monthly payments from the filer and disbursing the payments to the creditors according to the payment plan approved by the court. Shortly after filing, the trustee administers a meeting of creditors where the filer is obligated to answer questions regarding the bankruptcy case. This meeting is also a forum that can be used to resolve issues with the proposed plan. After the meeting of creditors, a confirmation hearing takes place and the bankruptcy judge decides whether the repayment plan is feasible and meets the standards for confirmation established in the Bankruptcy Code. Creditors also have the right to object to confirmation of the plan or contest the valuation of certain assets.

The typical Chapter 13 bankruptcy payment plan takes between three to five years, as mentioned above, with a median time from filing to discharge of 5.1 years in the FJC data. In a Chapter 13 bankruptcy filing, debt is classified as secured, priority unsecured, and non-priority unsecured. In the case of secured debt, filers may elect to keep the collateral if they stay up to date on all current payments and include any arrears in the repayment plan. This provides filers an avenue for keeping select property while still benefiting from the debt relief of a bankruptcy discharge. The filer can also give up the collateral and discharge the remaining debt. Priority unsecured debt includes taxes, child support, alimony, and the cost of the bankruptcy proceeding, and must be paid in full. Unsecured non-priority claims are paid back per the confirmed terms in the payment plan. There are 100% payment plans where the filer is required to pay back 100% of the non-priority unsecured claims, 0% payment plans where the filer is not obligated to pay back any of the non-priority unsecured claims, and a spectrum in between. The smaller the amount paid towards the non-priority unsecured claims, the greater the potential financial savings. Filers on 100% payment plans will not experience any debt forgiveness because they are repaying the full amount back. For simplicity, we will use the terms unsecured debt and non-priority unsecured claims interchangeably when comparing the Chapter 13 bankruptcy to debt settlement.

There are three general outcomes of a Chapter 13 filing. First, debts can be successfully discharged following the completion of the payment plan, with any balance of the non-priority unsecured claims forgiven. Second, cases can be dismissed prior to receiving a discharge for a variety of reasons such as failure to propose a payment plan that complies with the Bankruptcy Code, failure to submit the required documentation to the trustee, or failure to complete the confirmed payment plan. If the case is dismissed for any of these reasons, the filer will not receive the benefit of a discharge and will be obligated to repay the outstanding balance less any payments made while in bankruptcy. Over the course of the three-to-five-year payment plan, the filer's financial situation may change, jeopardizing their ability to adhere to the payment plan. Under this scenario, the filer may request a plan modification and will be subject to another confirmation hearing and possibly additional fees and costs. These modified plans can either lead to a discharge or a dismissal depending on the filer's ability to adhere to the payment plan. Third, a Chapter 13 filing can be converted to Chapter 7, which occurs approximately 9% of the time in our data. Once a Chapter 13 filing is converted to Chapter 7, the case follows the Chapter 7 process outlined above, where non-exempt assets are liquidated in exchange for debt relief.

The direct costs incurred through Chapter 13 bankruptcy are filing fees, which were $281 for most of our analysis period, and attorney fees, which averaged $3,123 in a hand-collected sample of filings from our analysis period. The bankruptcy trustee is paid through the payment plan, with the exact amount varying by case but never exceeding 10% of the plan payments. The discharge rate for Chapter 13 bankruptcy is considerably lower than Chapter 7 bankruptcy at nearly 50% in the FJC data. The key factors determining the financial savings of Chapter 13 bankruptcy are the discharge rate, the percent paid to non-priority unsecured creditors, and the court and attorney fees.

There are several eligibility criteria for Chapter 13 bankruptcy based on the filer's outstanding debt, their disposable income, and the proposed repayment plan. Individuals are only eligible for Chapter 13 if their unsecured debts and secured debts fall within a limit as defined by the Bankruptcy Code. In addition, individuals generally must be employed with sufficient disposable income to cover the monthly payment amount. The proposed repayment plan based on that sufficient disposable income must also meet the "best interest of creditors" test that ensures that creditors receive at least as much as they would have received if the filer's assets were liquidated under Chapter 7 bankruptcy. Similar to Chapter 7 bankruptcy, filers are also ineligible to receive a Chapter 13 discharge if they have received a discharge of debts in a prior Chapter 7 case in the last four years or a Chapter 13 case in the last two years, or if they fail to receive credit counseling from an approved credit counseling agency within 180 days before filing.

Finally, a key aspect of both Chapter 7 bankruptcy and Chapter 13 bankruptcy is the automatic stay. When a filer is under the protection of an automatic stay, creditors cannot initiate or continue lawsuits, wage garnishments, or phone calls to collect outstanding debt without getting court approval.

DEBT SETTLEMENT

Debt settlement is a process that negotiates the less-than-full-balance resolution of eligible unsecured debt. Debt settlement companies work with creditors to negotiate settlements for less than the full amount owed on behalf of the individuals. Settlements are typically completed by a one-time lump-sum payment or a series of smaller payments. Creditors represent settlements as a partial write-off of principal at the time of settlement. We focus on Freedom Debt Relief, the source of our debt settlement data, throughout this section. As the largest debt settlement company in the nation with approximately 30% to 40% market share during the analysis period, Freedom Debt Relief's practices and data provide a reasonable representation of the financial outcomes created by debt settlement. That said, there may be some variability in the practice of debt settlement with other debt settlement companies that are not accounted for here.

Debt settlement typically begins with an in-depth debt consultation that spans several phone calls and consumes an average of 80 to 90 minutes of elapsed time. The consultation, which includes a review of the individual's credit report and an assessment of the individual's income, expenses, and debt obligations, determines the individual's fitness for the program. As part of the debt consultation, interested individuals are sent a request for financial documentation, regulatory disclosures, and a contract that documents the services and fees of the program. Not all debt is allowed to be included in the program as the typical focus is on unsecured debt. Government student loan debt and tax obligations are also excluded from debt settlement programs. The most common types of unsecured debt enrolled in a debt settlement program are credit card debt, department store charge card debt, unsecured personal loan debt, medical debt, and select private student loan debt. The unsecured debt referred to in debt settlement is thus roughly analogous to the non-priority unsecured claims in Chapter 13 bankruptcy. Upon receipt of the requisite documentation, a final determination is made to determine if the individual can be enrolled in a debt settlement program.

Once enrolled, a dedicated account that is owned and controlled by the individual is established to facilitate the debt settlement program. The debt settlement program has the individual making deposits into the dedicated account, typically at a monthly cadence and primarily funded with an automated electronic draft. A debt settlement company can only access the dedicated account with the individual's consent, generally when a settlement has been negotiated and accepted by the individual. Should the individual elect to leave the debt settlement program, the remaining balance in the dedicated account is directed back to the individual.

As sufficient funds accumulate in the dedicated account, settlements can be made. Fees are collected as these settlements are completed. Debt settlement companies must comply with the “Advanced Fee Ban,” a component of the Federal Trade Commission’s Telemarketing Sales Rule that prohibits debt settlement companies from collecting fees for settling a debt until the debt settlement company reaches a settlement of the debt, the individual agrees to the settlement, and the individual has made at least one payment to the creditor. The importance of the Advance Fee Ban is that it is designed to align the financial incentives of debt settlement companies with positive financial outcomes for individuals enrolled in debt settlement programs. Financial savings for debt settlement is driven by the settlements, the deposits into the dedicated account, and the fees collected.

Debt settlement companies are for-profit organizations whose primary revenue stream is the fees that are associated with a successfully settled account. The typical debt settlement participant enrolls between $28,000 and $29,000 of debt, experiences 66% to 72% of their enrolled debt being settled, and incurs between $3,400 and $3,800 in fees. The key factors determining the financial savings of debt settlement are these settlement rates and program fees.

Eligibility in a debt settlement program is established by the individual meeting three main requirements. First, the individual must have suffered financial hardship through, for example, a job loss, reduction in income, a medical event, an unexpected expense, or divorce. Second, the individual must be able to demonstrate the capability of making monthly deposits that are applied to their outstanding debt, typically through a detailed cash flow assessment. Finally, the individual must be able to demonstrate that they understand and believe that debt settlement is their preferred option of debt relief, generally through a detailed conversation with the debt consultant and the execution of a debt resolution agreement which includes extensive disclosures.